Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

TRENDMACRO LIVE!

On the US Downgrade and July Jobs Report

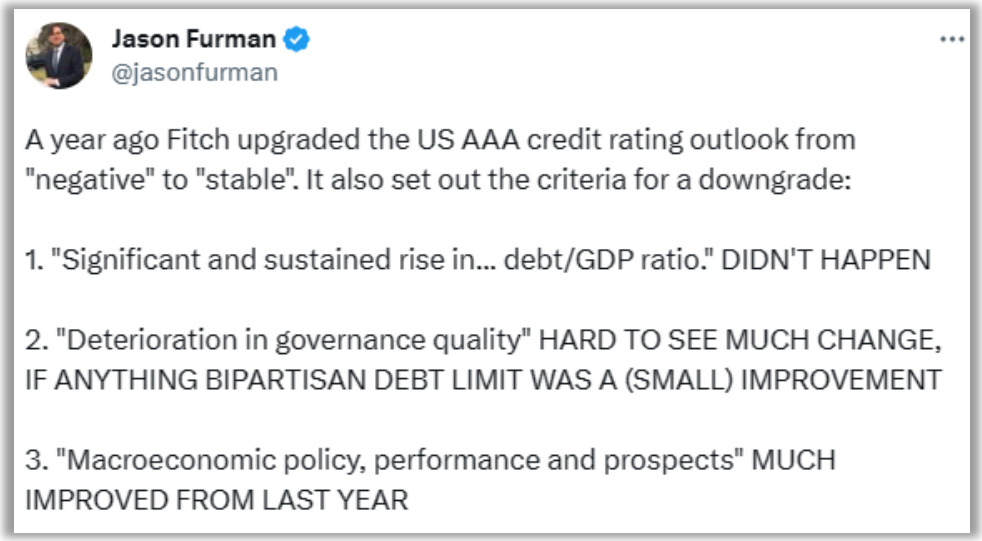
Friday, August 4, 2023

Donald Luskin

The downgrade is just words. But even this slowing jobs report can ruin Jackson Hole.

FIRST, A FEW WORDS ABOUT THE DOWNGRADE *We don't see the Fitch downgrade of US Treasury debt as significant in and of itself*. The actual creditworthiness of US debt is no different after the downgrade than it was before. *No facts on the ground have changed. All that happened is that someone expressed an opinion*. Considering how ratings agencies treated toxic assets in the run-up to the Global Financial Crisis, does anyone really care about their opinions?

- This opinion isn't even new. It's the same one expressed almost exactly 12 years ago by Standard and Poor's. It's not a surprise. Fitch expressed "negative watch" views on US debt in May and July.
- Weirdly, a little more than a year ago Fitch upgraded US debt, moving the outlook from "negative" to "stable." Our friend Jason Furman sums up the weirdness of it very well:



- *We're not saying debt sustainability isn't a problem. We are saying it isn't a new problem. And we are saying that this downgrade isn't a problem*. To be sure long-term Treasury yields have risen since the downgrade. But they've been in a gentle trend since April; they haven't approached the highs of last September; and it feels to us

Update to strategic view

US MACRO, FEDERAL RESERVE, US BONDS, US STOCKS: The Fitch downgrade of US Treasury debt changes no facts on the ground. It was signaled clearly by Fitch earlier in the year, and for that matter just piles on to what Standard & Poor's already did 12 years ago. Perversely Fitch upgraded the US about a year ago, and objective debt conditions now are no worse. Long yields were already rising, the most recent leg up likely associated with the long-expected tentative adjustment to BOJ yield curve control policies. This comports with our secular vision of higher yields associated with lower equity risk premia, as the age of globalization ends and the global economy continues to expand briskly out of the pandemic lows. Payrolls missed a little, and the prior two months were revised lower. But other labor market statistics were all stronger, implying that payrolls are an anomaly. July and June are the smallest payroll gains since the Delta variant-driven contraction of December 2020, they…

[Continued on next page]

like the most recent leg higher has been more in response to the relaxation of the Bank of Japan's long-standing yield-curve control program (long expected – see "Breaking the Bank of Japan?" June 16, 2022).

We continue to see this as part of a new regime of generally higher long-term yields than we've gotten used to since the Global Financial Crisis. We associate that with higher expected global growth coming out of the pandemic crisis, and with the completion of the great globalization revolution begun in the 1990s, which triggered a surge in global demand for savings. This savings demand drove down rates and yields and made central bank inflation targets impossible to attain, even with low policy rates.

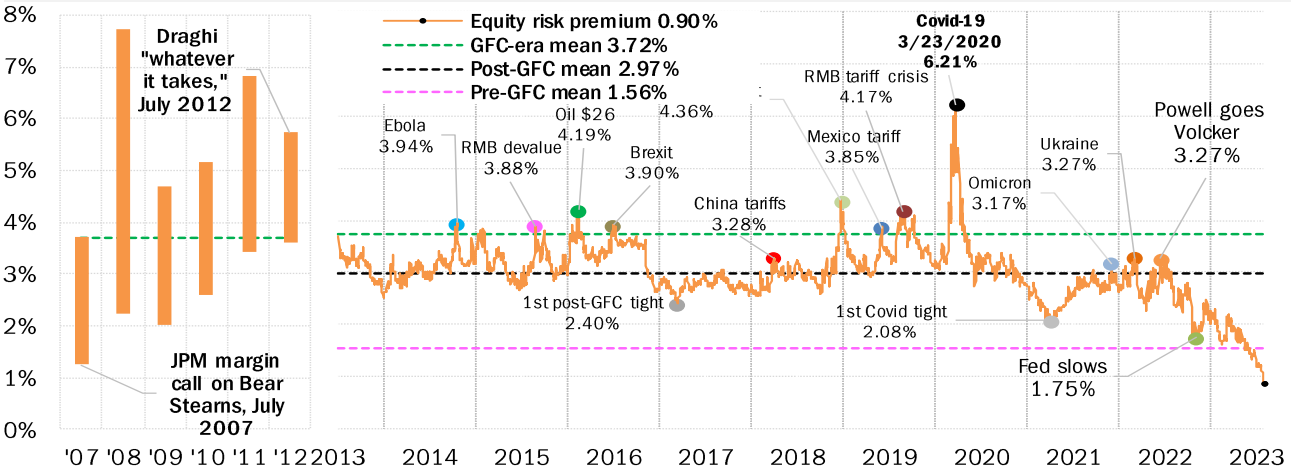
- This, in turn, is associated with an S&P 500 equity risk premium that, as of this writing, has fallen to narrow levels not seen since 2004 (please see the chart below, and "Data Insights: Global Equity Risk Premia" June 19, 2023). We're not ready to pull the trigger yet, but this sets relative valuations up for a severe equity correction and steepening of the Treasury curve, which we believe will arrive when the consensus starts to shift away from inflation fears to deflation fears (see, most recently, "Video: What you're not hearing about the coming deflation" June 23, 2023).

[Continued from first page]

… are still evidence of job market strength, with twice as many new jobs as the number of organic new workers. Strong wage gains will spook the Fed, and July inflation will report relatively poorly. The best we can hope for Powell at Jackson Hole is a signal of no hike in September. We will have to wait for that FOMC for the all-clear signal that this hiking cycle ended in July.

[Strategy Dashboard home]

Equity risk premium: forward earnings-yield minus 30-yr Treasury (2007-2013 July-June, June 2013 onward daily)



Source: Bloomberg, TrendMacro calculations

NOW THIS MORNING'S JOBS REPORT Today's Employment Situation Report with 187,000 net new payrolls was a double miss. It fell short of consensus expectations for 200,000 and the prior two months were revised lower by 24,000 and 25,000 respectively (please see "Data Insights: Jobs" August 4, 2023).

- It also missed the 249,000 expected by our model based on a broad range of other contemporaneous labor market statistics.

Generative AI token: "Another big month for payrolls following a downgrade of US Treasury debt; comic book style"

Source: PlaygroundAI running Stable Diffusion 1.5

- The Current Population Survey – the "household survey", showed 268,000 new jobs, in line with our model. Adjusted to a "payroll basis," the gain was 566,000 jobs.
- *So we conclude that the light payroll number should be seen as the anomaly* – the jobs market in July was stronger than payrolls suggested.
- *But there's nothing weak about 187,000 net new payrolls*. That's more than twice the number of persons aging into the adult labor force (adjusted by the participation rate).
- But a strong labor market isn't a "tight" labor market. When the weakest number of the month is twice as many new jobs as there are new people, the jobs market is both very strong and very loose. That means there are still lots of people on the sidelines, either unemployed or out of the labor force altogether. Indeed, in July 152,000 persons entered the labor force.
- *The problem is that the Fed confuses a strong labor market for a tight labor market.* But with 187,000 payrolls – while objectively strong – is nevertheless weak-looking in the context of the last several years. With today's downward revision, June was actually ever-so-slightly weaker at 185,000 net payrolls. But July and June are the smallest growth numbers since the anomalous one-off contraction of 268,000 in December 2020 at the peak of the Covid wave associated with the Delta variant. So the Fed can take some comfort from something like "slowing momentum" in jobs.
- *But the Fed's confirmation bias about the tightness of the labor market will surely make them obsess about July's 0.42% increase in average hourly earnings, on top of an 0.18% upward revision to June's – insisting as they do, wrongly, that wage growth causes inflation* (it doesn't – among many, please see "Video: What you're not hearing about services inflation and the 'over-tight' labor market" August 16, 2022).

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Dallas TX
214 550 2020
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

- This is the last jobs report before Jackson Hole. And there will be one more CPI report – which will have difficulty comparing well to the anomalous year-ago July zero number, driving year-on-year inflation up slightly even in the context of disinflation (indeed, disinflation morphing into deflation).
- *Unfortunately, while it would be nice to hope – and correct policy, to boot – that Powell's Jackson Hole speech will represent a substantive victory dance on inflation and an opportunity to signal that the July rate hike was the last, that feels at the moment like a bridge too far. The signal will likely be sufficient to confirm the market's expectation that there will be no hike in September. But we won't get the all-clear that hikes are done until then.*

Bottom line

The Fitch downgrade of US Treasury debt changes no facts on the ground. It was signaled clearly by Fitch earlier in the year, and for that matter just piles on to what Standard & Poor's already did 12 years ago. Perversely Fitch upgraded the US about a year ago, and objective debt conditions now are no worse. Long yields were already rising, the most recent leg up likely associated with the long-expected tentative adjustment to BOJ yield curve control policies. This comports with our secular vision of higher yields associated with lower equity risk premia, as the age of globalization ends and the global economy continues to expand briskly out of the pandemic lows. Payrolls missed a little, and the prior two months were revised lower. But other labor market statistics were all stronger, implying that payrolls are an anomaly. July and June are the smallest payroll gains since the Delta variant-driven contraction of December 2020, they are still evidence of job market strength, with twice as many new jobs as the number of organic new workers. Strong wage gains will spook the Fed, and July inflation will report relatively poorly. The best we can hope for Powell at Jackson Hole is a signal of no hike in September. We will have to wait for that FOMC for the all-clear signal that this hiking cycle ended in July.