Weekly Commentary November 27, 2015

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Economy Remains Steady; Friday's Payrolls will Decide Fed

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A huge number of economic reports Wednesday (some advanced from Thursday) came in very near expectations and barely moved the needle of the pulse of the economy. Of course, next week's employment report is the last major report before the December FOMC meeting. Current estimates are for November non-farm payrolls to increase 190k on top of the huge 271k increase reported in October. If the number comes in anywhere near this estimate, an increase in the funds rate is virtually guaranteed. As I stated last week, we would need an extremely weak number and/or a commodity price collapse to delay the increase. Commodity prices in fact firmed last weeks with oil snapping back a few dollars. Jobless claims came in below expectations for the second week in a row, further diminishing the chance of a very weak labor report. Despite last night's 5% slump in Shanghai Composite, the Chinese index is more than 20% above its August intra-day low and other most emerging market equity markets have also stabilized.

Currently the January Fed Funds futures is selling for 30.5 bps, which marks a 72% chance of increase. As I stated before, I think this number is a lower bound and the true probability is more like 90%. The markets have signaled that they are prepared for this increase although there is some anxiety how traders will react when it occurs. To be sure, this is the first Fed funds increase in 9 years, the longest period of time in modern history the Fed has not raised its target Fed Funds rate. Some of us remember September 6 years ago when many claimed that the market was prepared for a Lehman bankruptcy, but clearly was not. However, this time I think the a funds hike will be greeted with a sigh of relief, and when everyone looks around and see that the world is still standing, we might have a very good rally in the last two weeks of the year.

The biggest challenge for equities is not the Fed, it is earnings. The S&P 500 is now selling at 19.5 times estimated 2015 operating earnings of $106.69 at 21.8 times GAAP reported earnings of $95.65, both of which have fallen about 6% from 2014. These multiples can be justified on the basis of low interest rates, but are certainly above their historical average. Clearly the market expects a sharp earnings rebound next year (early estimates of 2016 earnings are way too high at $126), but if a good rebound does not occur, equities will have a tough time next year.
