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Weak US Employment Data – Europe Data Suggests Continued Expansion

The bad news:

1. May nonfarm payrolls added just 38,000 jobs in May. By contrast, monthly payrolls have averaged around 200,000 new jobs during the last five years.
2. Since the 2008-2009 recession, the monthly payroll number has rarely been below 100,000. Economists were expecting around 160,000 so this is a significant outlier.
3. The last 3 months have seen a pronounced slowdown in hiring, and March and April payroll numbers were revised down by 57,000 jobs.

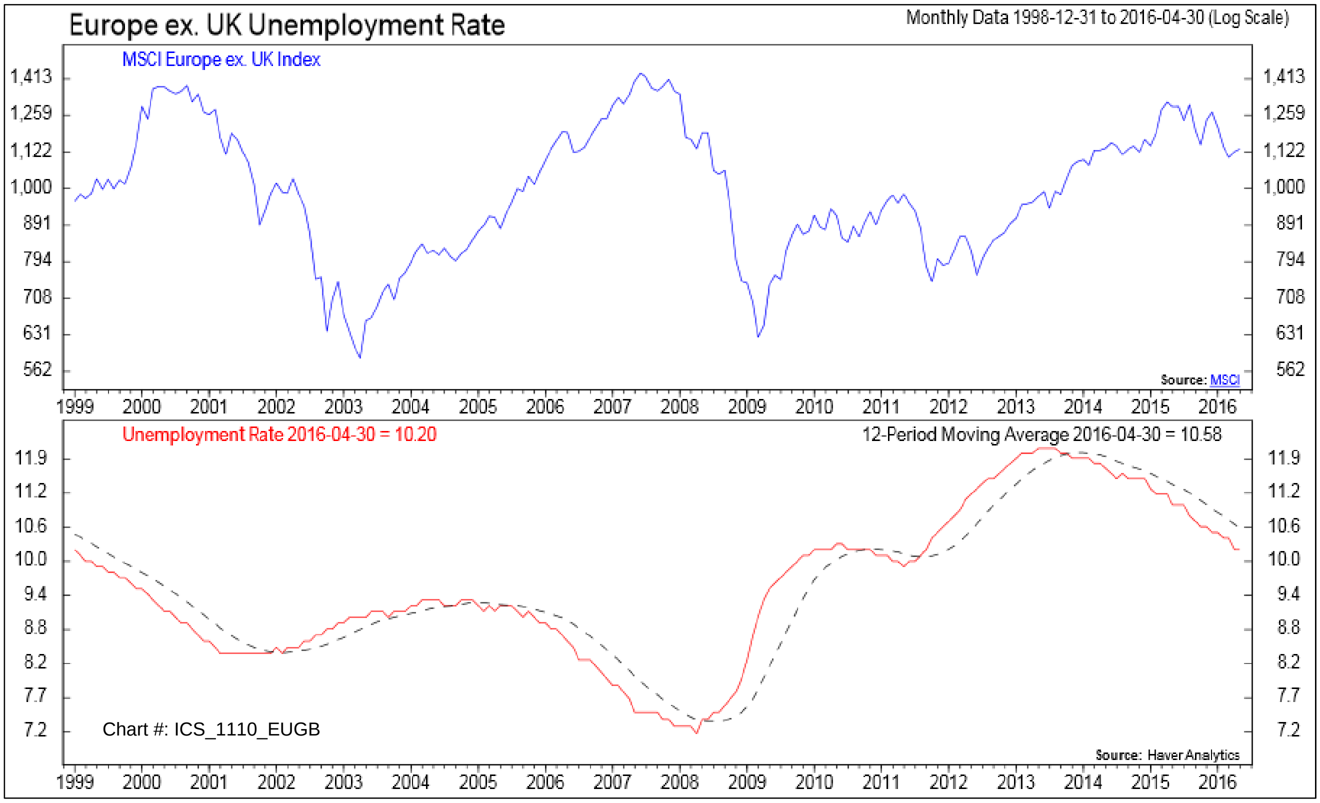
Mitigating factors:

1. ADP, a major payroll company, also publishes monthly payroll data. Their data for May was a solid 173,000, suggesting the weakness in the government data is likely overstated.
2. Seasonal adjustments within the retail and construction industries may have overstated employment in the first quarter and may now be understating it. A mild winter distorted the seasonal adjustments for construction, as did an exceptionally early Easter for retail. Smoothing the data suggests a new normal around 150,000. These seasonal adjustment issues may also have been exacerbated by the Obama administration's new regulations regarding overtime pay for salaried employees, published on May 18th. Employers may have deferred their normal seasonal hiring until the publication of the final rules clarified the potential compensation costs associated with new hires.
3. Purchasing managers in 12 of 14 service sectors reported a shortage of skilled workers in May.
4. Earnings and wages in the US continue to accelerate.

Fed Policy implications: Just last week, we suggested the odds of a rate hike over the summer were greater than 50%. Following Friday's data, it now seems improbable, as the market's odds of a summer rate hike have collapsed. Janet Yellen has been clear that with unemployment levels of 4.7%, monthly employment gains of 100,000 are all that is needed to absorb new entrants to the workforce. If employment is falling towards this pace naturally, then the case for higher rates is greatly reduced. Because the Fed will not be able to assess the "new normal" for payrolls for several more months, we believe they are on hold for now.

Steady data from Europe: While the US employment data stole the headlines, the Purchasing Managers Survey for the Eurozone services sector remains solidly above 50, suggesting that the steady expansion that began in 2014 remains in place. This view is reinforced by our Weekly Chart on page 2, which shows the unemployment rate for Europe ex. UK steadily declining (bottom clip) from the peak in 2013. Unlike the US, the unemployment rate in Europe has a long way to fall before it returns to more normal levels. We believe this will allow policymakers to continue to promote growth. The top clip in the chart shows the MSCI Europe ex UK stock index which, having risen from 2012 to 2015, has since gone sideways with a lot of volatility. As long as economic and earnings growth continues as we expect, we think the stock market will resume its uptrend.

THE WEEKLY CHART: UNEMPLOYMENT IN EUROPE CONTINUES TO FALL



Implications for RiverFront Portfolios:

The equity and high yield markets initially reacted to the weak unemployment number with a sell off across the board. As investors got a chance to digest the data, equity and high yield markets recovered most of their losses, and emerging markets posted gains. Emerging markets are among the biggest beneficiaries of lower US interest rates and a weaker dollar. Fixed income and foreign currency markets soared, maintaining their gains throughout the day, and thus our currency hedges were a drag to our portfolios. We think currency markets will come to realize that weaker US data may prompt more aggressive action on the part of overseas central banks, which would limit dollar weakness. As a result, we have chosen to maintain our current currency hedging posture. As always, we have put in place a risk management plan in the event that things do not play out as we expect.