There is a big economic calendar competing with mid-term election campaign stories. The increase in hourly wages in the employment report offset some market enthusiasm about continuing job market strength. With inflation concerns on a hair trigger, expect special focus on this week’s PPI and CPI. The Beige Book and JOLTS report will also get pundit scrutiny.

Expect pundit focus to be on Inflation Watch.

Once again, this is the wrong emphasis. More on that below.

Last Week Recap

In my last edition of WTWA I provided a preview of the focus on jobs. This was an accurate (but perhaps obvious) call. I added some value by explaining why a good report might not be celebrated by financial markets.

The Story in One Chart

I always start my personal review of the week by looking at a great chart. I especially like the version updated each week by Jill Mislinski. She includes a lot of valuable information in a single visual. The full post has even more charts and analysis, including commentary on volume. Check it out.
The market lost 1.02% on the week, edging lower each day, and has reached a new all-time high. The weekly trading range was about 1.5%, still very low. I summarize actual and implied volatility each week in our Indicator Snapshot section below. Volatility remains well below the long-term average.

**Noteworthy**

Football season has arrived, commanding the full attention of Mrs. OldProf. You may recall that she grew up in Green Bay and is a very knowledgeable fan. (Can you name the positions of all NFL officials in a game. Do you even know how many there are?) Priceonomics has a chart pack based upon data from Seat Guru. They use this to identify the basic fan base by county. Check out the post for some fun with interactive charts and to check out your favorite team. Here is the basic map. It lacks a green dot in Naperville.

The News

Each week I break down events into good and bad. For our purposes, “good” has two components. The news must be market friendly and better than expectations. I avoid using my personal preferences in evaluating news – and you should, too!

When relevant, I include expectations (E) and the prior reading (P).

The Good

- **ISM Non-Manufacturing increased** to 58.5 E 56.5 P 55.7.
- **ISM Manufacturing spiked** to 61.3 E 57.6 P 58.1.
- **A record-high percentage** of S&P 500 companies beat EPS estimates in Q2. (FactSet).
- **Truck sales beat expectations.** Bespoke focuses on this indicator because of heavy ownership by small businesses and contractors and thus a good read on this sector.
Employment news was solid.
- Non-farm payrolls increased by a net 201K but included revisions of -50 K in the prior two months.
- Unemployment remained at 3.9%. The Atlanta Fed has an interesting online calculator allowing the user to estimate the time needed to reach a particular unemployment rate. The user can adjust the labor force participation rate and some other key variables.
- Initial jobless claims reached the lowest level since 1969, 203K. (Bespoke)

ADP private employment was the “bad” part of the story, showing net gains of only 163K E 186K P 217K. Jill Mislinski’s helpful chart shows both the noisy series and a six-month moving average. The latter, as she notes, is useful in identifying the trend – basically about a monthly gain in net private jobs of 200K for about eight years.
• Average hourly earnings increased 0.4% E 0.2% P 0.3%.

The Bad

• Trade negotiations showed no progress and President Trump threatened to raise the stakes. The Balance of Trade blogger has a nice account including CNBC’
• Factory orders for July registered -0.8% E -0.6% P +0.6%
• Construction spending for July increased only 0.1% E 0.5% P -0.8%, revised from -1.1%, reducing the size of the miss.
• Trade balance worsened to -$50.1 B E -$50.6 B P-$45.7 B. Since the cause was US imports, fueled by economic strength, not everyone sees this as bad news.
• Bullish sentiment remains elevated, reports Bespoke.
The Ugly

Health care administrative costs. This is a key element of consumer inflation. US costs are “uniquely high.” These costs comprise as much as 30% of total costs. Administrative expenses might be justified by preventing fraud and managing care. The tradeoff begs for further analysis. (Joshua D. Gottlieb and Mark Shepard –Econofact).

The Week Ahead

We would all like to know the direction of the market in advance. Good luck with that! Second best is planning what to look for and how to react.

The Calendar

There is a big calendar featuring inflation data. The JOLTS report also provides important inflation information via insight into the labor market structure. Retail sales also has special importance. With mid-term election season in full swing, there will be plenty of political news. Some will even have market relevance.

Briefing.com has a good U.S. economic calendar for the week (and many other good features which I monitor each day). Here are the main U.S. releases.
Next Week’s Theme

There is plenty of economic news, and the focus is on inflation. Much of the trading community embraces a world view that includes the following elements:

- Markets should have and would have declined without extraordinary Fed intervention.
- The Fed merely delayed an inevitable contraction and is now behind the curve on fighting inflation. (Why was 2% inflation a target anyway)?
- Higher rates of inflation will force the Fed to increase rates much faster.
- This will invert the yield curve leading to a recession.
- The increase in hourly wages (finally!) is a signal of incipient inflation.

This meme is repeated so often that it has become the standard framing of the issue.

*Expect the punditry to be on Inflation Watch in the week ahead.*

The entire theme is misguided. Any worries are premature.

- The fixed income market suggests that the inflation rebound has peaked. (James Picerno). This is monitored each week in our indicator snapshot.
- Fed policy supported economic growth. Stock prices are consistent with the gains in expected earnings. The assertion that the Fed “pumped printed money into stocks” is unsupported. The balance sheet expanded, but not in purchasing equities. M2 increased at a normal pace. And
market timing based upon monetary policy does not work. (Flirting with Models).
- The Fed will not react more aggressive to a few reports of higher prices. Every statement indicates a patient approach. Unless observers continue to believe the bogus correlations.

- If inflation expectations increase, yields will move higher on the longer notes and bonds. This actually steepens the curve.
- Economic critics have consistently cited slow real wage growth as a problem. Some of the same voices lead the complaints about signs of improvement. Surely there is a middle ground we can enjoy – at least for a while.

A wiser topic for the week would be the elements of what I called *The Temporary and Delicate Balance* in my July 22 WTWA installment. As I predicted, we have seen a big increase in yield-curve newbies. More important are earnings, about which I wrote:

> In the long term, evidence shows that markets eventually respect earnings. Unless you need to dip into your cash soon, your focus should be earnings growth. And also, the competition from other investments. *If you have a focus on stock values, you need not cheer for an instant rebound. That provides gratification, but not opportunity.*

The other part of the balance is the trade war. Brian Gilmartin describes how the earnings growth from tax cuts has turned into PE contraction. The big reason is the trade war. Free-trade opponents are getting a real-time lesson in the effects. (Barry Ritholtz).
In today’s Final Thought, I’ll provide some suggestions about how investors can deal with these cross-currents.

Quant Corner

We follow some regular featured sources and the best other quant news from the week.

Risk Analysis

I have a rule for my investment clients. **Think first about your risk. Only then should you consider possible rewards.** I monitor many quantitative reports and highlight the best methods in this weekly update.
### The Indicator Snapshot

<table>
<thead>
<tr>
<th>Risk Indicator</th>
<th>Current</th>
<th>Last Week</th>
<th>Last Month</th>
<th>Last Quarter</th>
<th>Interpretation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Valuation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ten-year note yield</td>
<td>2.94%</td>
<td>2.86%</td>
<td>2.88%</td>
<td>2.95%</td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>2872</td>
<td>2902</td>
<td>2833</td>
<td>2779</td>
<td></td>
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<tr>
<td>S&amp;P Forward Earnings</td>
<td>169</td>
<td>169</td>
<td>169</td>
<td>164</td>
<td></td>
</tr>
<tr>
<td>S&amp;P Earnings yield</td>
<td>5.89%</td>
<td>5.83%</td>
<td>5.97%</td>
<td>5.90%</td>
<td></td>
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<tr>
<td>Equity Risk Premium</td>
<td>2.95%</td>
<td>2.97%</td>
<td>3.10%</td>
<td>2.95%</td>
<td>Very High</td>
</tr>
<tr>
<td><strong>Economy</strong></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>C-Score</td>
<td>367</td>
<td>307</td>
<td>313</td>
<td>311</td>
<td>9 Mo Recession Prob about 24%</td>
</tr>
<tr>
<td>Leading Superindex*</td>
<td>3.32%</td>
<td>3.07%</td>
<td>1.24%</td>
<td>1.04%</td>
<td>3-4 Mo Recession Prob</td>
</tr>
<tr>
<td>BCip</td>
<td>100.0</td>
<td>100.0</td>
<td>99.5</td>
<td>100.0</td>
<td>No recession indicated</td>
</tr>
<tr>
<td>SLFSI</td>
<td>-1.308</td>
<td>-1.302</td>
<td>-1.214</td>
<td>-1.085</td>
<td>Very Low Risk</td>
</tr>
<tr>
<td><strong>Anticipated Inflation</strong></td>
<td>2.10%</td>
<td>2.10%</td>
<td>2.11%</td>
<td>2.13%</td>
<td></td>
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<tr>
<td><strong>VIX</strong></td>
<td>14.88%</td>
<td>13.53%</td>
<td>11.27%</td>
<td>12.13%</td>
<td></td>
</tr>
<tr>
<td><strong>Historical S&amp;P Volatility</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Last Five Days</td>
<td>9.14%</td>
<td>7.66%</td>
<td>6.75%</td>
<td>5.70%</td>
<td></td>
</tr>
<tr>
<td>Last Twenty Days</td>
<td>8.33%</td>
<td>7.29%</td>
<td>7.00%</td>
<td>9.64%</td>
<td></td>
</tr>
<tr>
<td><strong>Technical Health</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>Strongly Bullish</td>
</tr>
<tr>
<td>Long-term</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>Strongly Bullish</td>
</tr>
</tbody>
</table>

Short-term trading conditions continue at highly favorable levels. Actual volatility remains very low. While many point to the low historical level of the VIX, it remains higher than realized volatility.

Some readers have requested a retrospective indicator snapshot from 2008. Others have suggested a standalone article as well. I will provide 2008, but this project is a bit bigger than I thought. Some of the key warnings came in 2007. My plan is a separate article with a couple of past time frames and then a regular link from WTWA.

**The Featured Sources:**

- **Bob Dieli**: Business cycle analysis via the “C Score.

- **Brian Gilmartin**: All things earnings, for the overall market as well as many individual companies.
RecessionAlert: Strong quantitative indicators for both economic and market analysis.

Georg Vrba: Business cycle indicator and market timing tools. None of Georg’s indicators signal recession. Here is the latest chart on the Business Cycle Index.

Doug Short and Jill Mislinski: Regular updating of an array of indicators. Great charts and analysis. With the important recent reports, it is time for an update of their excellent Big Four chart.

There is a lot of green in the last six months.

Guest Commentary

I monitor and report quant themes from a variety of sources. LPL has an update of their Recession Dashboard (HT Fear and Greed Trader). It is quite interesting, and the conclusion is sound. My reservation is the number of variables. At least it is not like the 100+ elements used by the ECRI. Intuitively, it seems like more variables would always be good. Experienced researchers know that you get deceptive results and overfitting when independent variables are highly correlated. The illustration below is only a portion of their complete analysis.
David Rice looks at both the baseline and rate of change for key economic variables, comparing the results with past recessions. His comment on the current yield curve: “…when the yield curve spread is near 0.8, it could mean a recession is a year or two away, or it could mean it isn’t.”
Insight for Traders

Check out our weekly Stock Exchange post. We combine links to important posts about trading, themes of current interest, and ideas from our trading models. This week we discussed whether traders should buy at or near all-time highs. As always, we combined advice by top trading experts with our own conclusions. And finally, we shared some recent picks from our trading models. Our ringleader and editor, Blue Harbinger, provided fundamental counterpoint for the models, who are all of the technical persuasion.

The topic for the traders is also a good one for investors. In a sense, it is a good complement for today’s post.

Insight for Investors

Investors should have a long-term horizon. They can often exploit trading volatility.

Best of the Week

If I had to pick a single most important source for investors to read this week it
would be this insight from “Davidson” (via Todd Sullivan). First, concerning inflation:

Some worry about inflation and believe portfolios should be shifted accordingly towards commodities. The facts behind inflation reveal it to be tied to periods of excessive Government Expenditure & Investment. We have just exited an 8yr period of a reduction in government spending and flat inflation. The 12mo Trimmed Mean PCE, produced by the Dallas Fed, of 1.94% sits only a little above the 1.7% avg since 2009. Yes, government spending under the current administration has risen a little, but it is not clear that this is inflationary. Real government spending as a percentage of US Real GDP is the lowest at 17.2% it has been since 1947. Whatever the government does today will have far less impact than any previous period. Even if this spending has some inflationary impact not only is it likely to be muted but commodities are not the preferred counter balance. The best investments to counter inflation have always been well run companies which pass inflationary price shifts to customers for whom their wares are the most competitively priced.

And on the threat posed by too many people crowding into modern theories:

Just as human society has continuously advanced and never repeated the past, investment markets do not repeat the past. The situation today in relying on MPT to invest for the future has permeated all corners of investment activity. This is a formula for a significant market correction during the next economic correction. All will have been bullish at just the wrong time due to MPT. The better approach, in my opinion, is to identify those indicators which reflect investment behavior and cycles and use one’s experience and judgement counter to consensus opinion. Market prices are set by consensus opinion. The better investments are identified using a combination of economic and corporate financial trends and contrary to market psychology. In other words, buy high quality management teams when other investors are pessimistic and prices are low.

Please see the post for full analysis and some helpful charts.

Stock Ideas

Excited about the Internet of Things? You should be! Shareholders Unite analyzes Adesto Technologies (IOTS), including financials, products, acquisitions, and management plans. Conclusion: A good story, but more evidence is needed.

Peak of cycle for semiconductors? Stone Fox Capital says that Applied Materials (AMAT) has more balance and better yields.
Morningstar updates the choices of the “ultimate stock pickers.” Here are the top ten conviction buys.

<table>
<thead>
<tr>
<th>Ultimate Stock-Pickers’ Top 10 Stock Purchases (by Investment Conviction)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company / Ticker</td>
</tr>
<tr>
<td>Facebook A FB</td>
</tr>
<tr>
<td>Charter Communications A CHTR</td>
</tr>
<tr>
<td>3M MMM</td>
</tr>
<tr>
<td>Pfizer PFE</td>
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<tr>
<td>Bristol-Myers Squibb BMY</td>
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<tr>
<td>Wells Fargo WFC</td>
</tr>
<tr>
<td>PepsiCo PEP</td>
</tr>
<tr>
<td>Gilead Sciences GILD</td>
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<tr>
<td>EQT EQT</td>
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<tr>
<td>Citigroup C</td>
</tr>
</tbody>
</table>

Data as of market close on 8/31/18. Fund ownership data as of funds’ most recent filings.

Colorado Wealth Management highlights W.P. Carey, Inc. (WPC) is a company that has left the business of managing non-traded REITs, becoming a much more attractive investment. It also adds to diversity by generating 30% of its revenue in Europe.

Time for an update of the 94 members of the Rose Portfolio (RoseNose) classified by new sector definitions.

The Stanford Chemist notes the recent decline in equity closed end funds and provides some interesting ideas.

Outlook

Urban Carmel’s September Macro update, with plenty of charts and explanations:

Summary: The macro data from the past month continues to mostly point to positive growth. On balance, the evidence suggests the imminent onset of a recession is unlikely. The largest risk to the economy is the escalation in trade war rhetoric.

The bond market agrees with the macro data. The yield curve has ‘inverted’ (10 year yields less
than 2-year yields) ahead of every recession in the past 40 years (arrows). The lag between
inversion and the start of the next recession has been long: at least 10 months and in several
instances as long as 2-3 years. On this basis, the current expansion will likely last into mid-2019
at a minimum.

Eddy Elfenbein looks at economic indicators and valuation, focusing on the 10-year TIPS, the inflation
protected bond. He sees a yield of 2.43% as worth watching. He also notes the GDP nowcasts and
updates news on his widely-followed portfolio.

**Personal Finance**

Seeking Alpha Senior Editor Gil Weinreich’s Asset Allocation Daily is consistently both interesting and
informative. This week I especially appreciated his comments on the FIRE (financial independence
retire early) movement. He cites a post by Cullen Roche, creating a nice virtual dialog. Both offer
excellent ideas on money, happiness, and financial security.

Abnormal Returns is an important daily source for all of us following investment news. His Wednesday
Personal Finance Post is especially helpful for individual investors. This week’s typical selection of
great articles includes two important retirement tips.

1. You might well spend more than you think. Forget that 70% rule. Watch out for brokers or
   advisors with questionable beliefs and dubious pasts. ([*WSJ*](https://www.wsj.com))

**Watch out for...**

REITs lacking updated estimates of NAV. Colorado Wealth Management looks at losses in Front Yard
Residential (RESI) and predicts that “the pain will continue.”

Stocks whose attractiveness rests on takeover speculation. D.M. Martins Research offers the example
of GameStop (GME).

Snap (SNAP) is on the way to a $5 target opines Stone Fox Capital.

Amazon (AMZN). Rob Marstrand writes:

> Investors will need some seriously heroic growth, over multiple decades, for that to make sense. Since
> overpaying for such ebullient growth prospects is a classic way to lose money, disappointment is highly likely… eventually.

Just like much of the cardboard packaging used by the companies when it makes deliveries,
investors will eventually realise that Amazon stock is a mostly empty box. Buyer beware.

Final Thought

The Fear and Greed Trader provides a helpful perspective.

Distractions continue to hound investors. The markets have a way of making investors fearful whether stocks are up, “they can’t rise any further, can they?” or down, “surely the worst is yet to come, right?” It’s always something, which is what makes the markets both fascinating and frustrating.

What really matters are corporate earnings. On that score, the situation looks encouraging as we look out to the end of this year.

So far so good. But then:

The stock market is a leading economic indicator and will tell us in advance what’s in store for the economy going forward.

It should be quite obvious by now that the market determines what is important and what is not. It will do so more accurately than pundits, analysts, and the army of investors who believe they can outwit the market.

And also:

Listen to the market, and listen closely. Successful investors are in sync with what the market is telling them. It’s simple, if a market participant is not listening to the message, they are going to suffer constant under performance.

Brett Steenbarger makes a similar point.

An analogy I’ve used in my books is the good dancer on a dance floor. The good dancer doesn’t
just dance his or her style regardless of the music playing. The good dancer does not start
dancing ahead of the music, anticipating the next tune. The good dancer waits for the music to
start, catches the beat and tone, and dances accordingly.

Getting the beat is good advice for traders, but it does not work for investors. Investors with patience
can find opportunity when it comes, waiting for Mr. Market to make an attractive offer.

Current trading starts with a news reaction by high-speed trading algorithms. This week it was the
Trump mention of a new round of tariffs. The Halftime Report gang immediately started discussing
what had caused a ninety-point drop in the DJIA. This is a meaningless move in a rather poor index.
The need to “explain” each blip adds credibility to the noise. Then the news shows pounce on the same
explanations. The wall of worry grows taller.

**But nothing has changed! Investors can try to find the beat and tone, but they will be
dancing to the wrong score.**

For more, see my *Trading, Fast and Slow*
and Dr. Brett’s video on why this differs for traders and investors.

Investors who sit back waiting for a change in the tone should be prepared for a fast upward spike if
there is any kind of definitive trade news. I would not be surprised to see an immediate 4% with
another 4% to follow. This week I heard an estimate of 10%. There is plenty of negativity on this issue.

**The result is a market that may well be the opposite of the traditional up the escalator and
down the elevator.**

[Are you invested in some safe but stodgy stocks – so called value traps? We generate extra
yield from such positions by selling near-term calls. If you need more income, you might want
to get our free description of this method. For this or a free portfolio analysis just email main
at newarc dot com].

**I’m more worried about:**

- Brexit. The lack of progress portends a hit for the European economy.

**I’m less worried about:**

- Trade effects. Dr. Ed Yardeni argues that the eventual result may be less protectionism and an
  unleashing of the “animal spirits of business.” Some of this seems implausible, but thinking about
  contrarian scenarios is a useful exercise.

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