AIRACOBRA
CAPITAL MANAGEMENT

Calling the Ball

2/7/2019

Employment: Not All That Rosy

For the past year or so we have been talking about the amount of issues facing the markets and economy - a traditional relationship destroyed by years of unnatural suppression of interest rates and reporting by the Cheerleaders. Our list of issues: (i) Employment not as rosy as reported; (ii) Market infrastructure; (iii) Inflation; (iv) Lending, or lack of it; (v) Housing; (vi) Pension plans (vii) QE; and (viii) Social and geopolitical strife unseen in at least my life time. After review of prior *Calling the Ball* letters and conversations with industry and non-industry professionals, we realized additional clarifications are typically required not only for each individual issue but how they intertwine to formulate our holistic strategy based on projections of macro-economic shifts from interest rates and other fundamental trends. The objective over the next couple of weeks is to provide additional clarification, perspective, and understanding of our analytical and decision processes.

Macro-economic shift projections are the starting point for our machine. After development of the macro-picture, our analytics flow to the industry level to project which industries may benefit or be hampered given the projected environment. We take the strongest and weakest industries and extend due diligence and analytics to the individual companies and capital structures within said industries. Our process leads to long convictions of individual issuers in healthy industries and improving fundamentals in the strongest part of the capital structure while developing short convictions of individual issuers in lethargic industries with weakening fundamentals in the least protected part of the capital structure. A seemly lost art given the contrived interest rate environment and pontification of passive investing and algo trading.

The list has not changed, nor projected to change, but will continue to worsen since all that currently occurs is further kicking of the proverbial can down the road. We stated even before Trump was elected this was going to occur, only faster if one party got elected over the other. Math, economics, science, and truth always win in the end. We live in a point and click world and tend to forget that things take time to develop; one tends to never know until you are knee deep in it.

Our first discussion begins with why the employment picture is not as rosy as reported or as the Cheerleaders promote even though the latest employment print (2/1/2019) was huge. Based on our analytics, which will be triangulated for you, the real unemployment rate is around 11-14% and will continued to be handicapped by various factors not only from an economical sense but to social and geopolitical ideologies.

First, a quick primer on how unemployment figures are formulated. Please see the following graphic provided by the Bureau of Labor Statistics ("**BLS**"). We know numbers reported by the BLS can be challenged and defended nine ways to Sunday, but we need a baseline to begin projections.

HOUSEHOLD DATA: HISTORICAL [Numbers in thousands
A-1. Employment status of the civilian noninstitutional population 16 years and over, 1984 to January 4, 2019

Year	Civilian non-institutional population	Civilian labor force						Not in labor force
		Number	Percent of population	Employed		Unemployed		
				Number	Percent of population	Number	Percent of labor force	
1984	176,383	113,544	64.4	105,005	59.5	8,539	7.5	62,839
1985	178,206	115,461	64.8	107,150	60.1	8,312	7.2	62,744
1986	180,587	117,834	65.3	109,597	60.7	8,237	7.0	62,752
1987	182,753	119,865	65.6	112,440	61.5	7,425	6.2	62,888
1988	184,613	121,669	65.9	114,968	62.3	6,701	5.5	62,944
1989	186,393	123,869	66.5	117,342	63.0	6,528	5.3	62,523
1990	189,164	125,840	66.5	118,793	62.8	7,047	5.6	63,324
1991	190,925	126,346	66.2	117,718	61.7	8,628	6.8	64,578
1992	192,805	128,105	66.4	118,492	61.5	9,613	7.5	64,700
1993	194,838	129,200	66.3	120,259	61.7	8,940	6.9	65,638
1994	196,814	131,056	66.6	123,060	62.5	7,996	6.1	65,758
1995	198,584	132,304	66.6	124,900	62.9	7,404	5.6	66,280
1996	200,591	133,943	66.8	126,708	63.2	7,236	5.4	66,647
1997	203,133	136,297	67.1	129,558	63.8	6,739	4.9	66,837
1998	205,220	137,673	67.1	131,463	64.1	6,210	4.5	67,547
1999	207,753	139,368	67.1	133,488	64.3	5,880	4.2	68,385
2000	212,577	142,583	67.1	136,891	64.4	5,692	4.0	69,994
2001	215,092	143,734	66.8	136,933	63.7	6,801	4.7	71,359
2002	217,570	144,863	66.6	136,485	62.7	8,378	5.8	72,707
2003	221,168	146,510	66.2	137,736	62.3	8,774	6.0	74,658
2004	223,357	147,401	66.0	139,252	62.3	8,149	5.5	75,956
2005	226,082	149,320	66.0	141,730	62.7	7,591	5.1	76,762
2006	228,815	151,428	66.2	144,427	63.1	7,001	4.6	77,387
2007	231,867	153,124	66.0	146,047	63.0	7,078	4.6	78,743
2008	233,788	154,287	66.0	145,362	62.2	8,924	5.8	79,501
2009	235,801	154,142	65.4	139,877	59.3	14,265	9.3	81,659
2010	237,830	153,889	64.7	139,064	58.5	14,825	9.6	83,941
2011	239,618	153,617	64.1	139,869	58.4	13,747	8.9	86,001
2012	243,284	154,975	63.7	142,469	58.6	12,506	8.1	88,310
2013	245.679	155,389	63.2	143,929	58.6	11,460	7.4	90,290
2014	247,947	155,922	62.9	146,305	59.0	9,617	6.2	92,025
2015	250,801	157,130	62.7	148,834	59.3	8,296	5.3	93,671
2016	253,538	159,187	62.8	151,436	59.7	7,751	4.9	94,351
2017	255,079	160,320	62.9	153,337	60.1	6,982	4.4	94,759
2018	257,791	162,075	62.9	155,761	60.4	6,314	3.9	95,716

To ensure we are on the same page, let's use the 2018 information as the base to discuss the calculation of the unemployment rate:

- **Civilian Noninstitutional Population:** Individuals 16 years of age or older residing in the 50 States and the District of Columbia who are not inmates of institutions (penial, mental facilities, home for the aged) and who are not on active duty in the Armed Forces.
- **Number**: Employed Number + Unemployed Number; 155,761 + 6,314 = 162,075
- **Percentage of Population:** Number/Civilian Noninstitutional Population; 162,075/257,791 = 62.9. This number has been trending down from a high of 67.1 in 2000. Reasons could be several, but more likely from a shrinking population due to lower birthrates and higher mortality rates. We do not project a rebound anytime soon given current social and economic trends.
- **Employed Number:** Number of individuals employed during the period.
- **Employed Percentage of the Population:** Employed Number/Civilian Noninstitutional Population; 155,761/257,791 = 60.4. This number is up slightly for 2018; however, it got hammered during the Obama administration mainly due to the number of individuals Not in the Labor Force and poor "true" economic growth; not market growth.
- **Unemployed Number:** Individuals classified as unemployed and still actively looking for employment.
- **Unemployed Percentage of Labor Force;** Unemployed Number/Number; 6,314/162,075 = 3.9. This number has been trending down due, in part to some recent economic growth, but mainly from a large increase of individuals Not in the Workforce and decreasing individuals comprising the Number figure.
- **Not in Labor Force:** Individuals given up looking for employment. A number that exploded during the Obama Administration and the main reason for a decreasing unemployment rate percentage.

Through our analysis we developed an unemployment figure of around 11-14% via the following adjustments: (i) individuals returning to the workplace, which should have occurred if employment and economic growth was as strong as reported over the past 8 years; (ii) individuals maintaining more than one job; and (iii) illegal aliens/undocumented workers. The baseline for our adjustments is provided directly below:

Year	Civilian non-institutional population	Civilian labor force						Not in labor force
		Number	Percent of population	Employed		Unemployed		
				Number	Percent of population	Number	Percent of labor force	
2018	257,791	162,075	62.9	155,761	60.4	6,314	3.9	95,716

1st Adjustment: Return of individuals not participating in the labor force. The economy, as of our base year, has 37.13% of the Civilian non-institutional population not participating in the economy. The average rate since 1984 is 35.00%. We added the difference between the current amount not participating in the economy and our adjusted amount to reflect the average non-participation rate, 6,684 individuals, to the Unemployed Number and Number buckets. This leads to an unemployment rate of 7.7% (12,988/168,759) as noted directly below.

Year	Civilian non-institutional population	Civilian labor force						Not in labor force
		Number	Percent of population	Employed		Unemployed		
				Number	Percent of population	Number	Percent of labor force	
2018	257,791	168,759	65.46	155,761	60.4	12,998	7.7	89,032

2nd Adjustment: Individuals with more than one job. It is reported that anywhere between 4-8% of the workforce has two jobs; a data point not included in the figure. To reflect this discrepancy, we deducted 4% (6,230 individuals) from the Employed Number due to one person being counted at least twice and added 2,185 individuals (35% of 6,230) to the Not in Labor Force bucket and the balance, 4,045 individuals, to the Unemployed bucket reflecting the ratio developed in Adjustment 1. This moves the unemployment number to 10.1% (17,043/168,255).

Year	Civilian non-institutional population	Civilian labor force						Not in labor force
		Number	Percent of population	Employed		Unemployed		
				Number	Percent of population	Number	Percent of labor force	
2018	257,791	168,255	65.30	149,531	58.00	17,043	10.1	91,217

3rd Adjustment: Illegal immigrants or undocumented workers, however you want to slice it; are here. Since they are here, we included them in our calculation. Depending on which report you hear or read, their numbers are anywhere between 10 to 30 million; for purposes of conservatism and since they are not all of working age, we used a number of 7 million individuals which we added to the Civilian Noninstitutional Population. Based on the ratio from Adjustment 1, we added 2,450 individuals to the Not in Labor Force bucket and the balance, 4,550 individuals, to the Unemployed Number bucket moving the unemployment rate to 12.4% (21,593/173,574).

Year	Civilian non-institutional population	Civilian labor force						Not in labor force
		Number	Percent of population	Employed		Unemployed		
				Number	Percent of population	Number	Percent of labor force	
2018	264,791	173,574	65.6	151,981	57.40	21,593	12.4	93,667

Now that we developed a better understanding of what our projected "true" unemployment rate looks like, let's focus on other factors restraining the employment environment.

The U.S. manufacturing base has been gutted. One just needs to look at whatever items in your house to notice hardly anything is made in the USA. This process has occurred slowly over time and reflective in historic employment numbers. Even if the trend was to begin reversing today it will take several years and a ton of investment to retool production lines, train individuals, and change the mind set of the employment base before long-term, let alone short-term, effects are felt. By the way, these types of jobs are the backbone of our country, they build actual things and use actual things to build their actual things, not coding to mine data to figure out what to sell you - which does not build anything of use except to market stuff produced overseas.

The U.S. manufacturing and retail base is becoming increasingly more automated. We witnessed this occurring to major manufacturing lines for years and now beginning to experience this change in the retail, restaurant, and even in the investment management spaces. Is it possible to reverse this trend? Yes, but it requires consumers wanting a change in executing transactions via human interaction and requires employers to offer solid products combined with employees providing good customer service having a pride in their work. We are not so sure society wants to change this current trend; without reversal future job/career growth will be all but non-existent.

Failing Educational System. Our children no longer learn skills of any type through all levels of the educational system. High schools use to include life skills such as critical thinking as well as other important and needed skill sets via shop classes. Society has, and continues, failing future generations by allowing the lowering of standards and teaching to tests instead of actually teaching. This leaves a workforce with a decreasing skill set and decreasing ability and want to learn and develop needed skills to advance their abilities.

Bureaucracy, Government, and Unions. All start with the best of intentions however they lead to inefficiencies and a waste of resources. I come from a union family and firmly believe in their original purpose; however, I have seen firsthand how all three eat the host they supposedly are there to defend. These entities continue to grow and demand more, quickening the pace of killing the host while providing limited returns to employees, employers, and the community.

Increases in Wages, Benefits, and Regulation: Societies' perceptions have changed, any type of job must now pay a "living wage", whatever that is, which has led to an increase in employment costs from a wage and benefit perspective, mostly due to regulation. We all want individuals to improve their lot in life, however minimum wage jobs where not developed to be careers but a stepping stone providing opportunity and skill development to offer the prospect for a better job leading to a career and wealth creation – the true purpose of capitalism. Regulation, having grown dramatically over the past 20 years and which at this point in our economic framework only adds to costs and further bureaucracy, has decreased job creation, business development, and competitiveness on all fronts. We firmly believe in having some rules in place; however, competition should determine winners and losers, not outside forces via regulation rigging the game. We believe the government, through direct and indirect means, controls roughly at least 50% of the economy already, which is not capitalism, it is socialism/communism. A topic to be discussed in future issues since these increases have affected our competitive advantages which led to a decreasing employment environment.

Employment is the main driver of economic growth and wealth creation. A strong employment environment raises all and a weak employment environment eventually destroys all. If the picture was as rosy, would there be protests/riots in the streets, an increasing rise in socialism and other isms, and all forms of debt at nose bleed levels? No, individuals would be too busy with work, capitalism would not be threatened, and consumers would not be maxing out credit lines to finance day-to-day living. Employment directly interacts and touches with our entire list of issues except Market Structure. If just part of our projected list transpires, change to the Market Structure will emerge and not to the benefit of a capitalist society.

Pension funds will continue to deteriorate as lack of employment growth reduces cash flows coming in the form of contributions combined with early retirements, mainly due to a lack of faith the pension fund will be solvent when the traditional time to retire comes around, draining pension fund assets will result in exuberating their liquidity needs. Additionally, as unions continue to push for wage increases, corporations will be forced to reduce workforces in order to just maintain margins let alone growth. Pensions need additional employment growth in order to pay prior employees for their services, kind of like a legalized ponzi scheme. The current employment environment combined with mismanagement of fund assets and management caving into unions does not bode well for the future. The big and scary question is what happens when they do implode? In our analysis, one of two things occur: (i) let them fail and participants are own their own – we deem this highly unlikely; and (ii) governmental intervention via a bailout, since it is mostly state and local public plans in trouble. Additional regulatory action could follow leading to accompanying changes in market structure. This issue will increase social strife as the fight for and against bailouts add to the governmental circus and individuals that counted on plan assets for their retirement are no longer available at previously thought of amounts.

Housing and Lending. The housing market is bifurcated and beginning to faulter. Individuals, whether unemployed or underemployed due to slow employment growth, are no longer able to continue using leverage as interest rates increase. We have had ten plus years of low interest rates which allowed the credit spicket to be turned on full power. Underperforming employment growth combined with rising interest rates will negatively affect the housing and lending markets. Auto dealers are beginning to carry more inventory not due to demand but due to lack of sales. The auto sector and other companies will have, and some already are, lending down the credit scale just to maintain growth and will be "aided" by credit reporting agencies that no longer report on tax payments/liens on said consumers. Social strife will increase as the "soak the rich" screams from the socialist in our government - case in point, -the new head of the Banking Committee, Maxine Waters wanting to put on the banks on trial regarding lending practices while others 'social warriors" publicly berates businesses. Memories of 2003-08 with Barney Frank and the other social figureheads crying the same argument that led up to the 2007-08 crisis. This will also change the structure of the markets either through banks and lenders being required to carry highly leveraged loans on their balance sheet with borrowers having zero skin in the game or allowing some new form of CDO/ABS paper to be created and sold to the investing public.

Inflation leading to stagflation. Inflation is out of the bottle, it is just not being reported. Go grocery shopping and notice increasing prices or the cute little trick of smaller packaging even though the price remains the same. Increasing inflation with lack of substantial job growth will lead to stagflation, ala late 1970's style. A look at historic macro-trends provides an insight into current times – Prices increasing, poor economic growth, and a yield curve reflective of that period doesn't revive our belief in rainbows and unicorns. How did the U.S. reverse this? Reagan raised rates by a then ungodly amount which hurt the economy in the short-term but led to one of the greatest economic growth periods in our history. Comparing this to our current times, the U.S. had a manufacturing base that is no longer in place to generate growth, consumers/businesses debt has increased dramatically in every measurement, a Fed out of ammo to combat slow growth, and leadership at all levels (except a few) with the balls to execute policy in the short-term that will have a negative effect now with a greater payoff later providing a solid base to build future sequential growth.

Q/E. One could argue, and we agree with the argument, that Q/E has continued even though all you hear is about the deleveraging the government balance sheet. The basis for this agreement is the current and increasing level of "Other" category that are buying U.S. debt; a nice generic and wide bucket to hide additional purchasing of Treasuries via Fed rat holes. As employment growth continues to underperform combined with a potential pension plan bailout, student loan forgiveness, and some level of housing guarantee will generate some new bastardized form of Q/E, which we will guarantee will not be named anything close to quantitative easing in name. but will look and feel a lot like it.

These interactions may seem drastic and far-fetched, however each day they seem to reveal themselves a little more if you only believe what your eyes and gut tell you, not what the Cheerleaders say you should think. Economic cycles and corrections take time and this one, which could have been repaired in 2008 but was delayed via governmental intervention, has been brewing for nearly 20 years.

Do we want this to happen? No, but markets move in cycles and we are overdue given the combined effects of reckless spending, government interventions, and unrealistic demands on all fronts of society.

You may wonder how we even invest with an outlook such as this. We are credit guys that go long and short based on fundamentals and conservative valuations which tends to provide a solid hedge over the long term, not the next reporting period.

Calling the Ball: Markets

Airacobra projects the following: *Please note these projections are general in nature and should not be deemed investment advice nor an offer to buy or sell, just how we view the world.*

- **Macro:** Economic Projections:

  (i) employment and other economic indicators continue slight short-term headline improvement; gains tempered by increases in interest rates, minimum wage (required by some states), and inflation; (ii) continued domestic/international social and geopolitical unrest; (iii) increasing interest rates and costs past throughs leading to: (a) increases in delinquencies and bankruptcies; (b) continued bifurcated/decreasing environment in home ownership; (c) continued lending down the credit rating spectrum to maintain growth, (d) decreased discretionary income, (e) repricing risk premiums across all asset classes, and (f) increased cost to finance current and rolling amounts of private/public debt.

- **US Sovereign Debt**: ***No Change***

  We are still projecting an outright inversion of the U.S. yield curve. Rates increasing across the curve leading to: (i) a decrease in price of already issued debt; (ii) increased governmental costs; and (iii) risk premium repricing across all asset classes. Strongest possible chance of stagflation since the late 1970s which Reagan reversed with a large jump in interest rates and decreasing income tax rates. These actions took several quarters to take effect; U.S. could be in the same type of cycle but has the added weight and negative effects of QE, government debt/spending, with increasing rates/inflation. Redevelopment of the Fed Fund "hinge" to reprice markets.

  - Comfortable being net short US Treasuries – specifically the short-end where we project a continued and substantial repricing with follow thru to the long-end of the yield curve.

- **Investment Grade Debt**: ***No Change***

  Credit spreads continue to widen to U.S. Treasuries from a basis point standpoint due to increasing interest rates and repricing of risk premiums. Issuers, in general were able to strengthen balance sheets given the long, low interest rate environment over the past 10 years assisted in stemming the tide of decreasing consumer spending; however, the overall corporate credit market has become rife with covenant light paper with some issuers, just like consumers, becoming overextended. Continued downgrade of credit ratings.

  - Comfortable being neutral to selective from a long/short perspective.

- **High-Yield Debt**: ***No Change***

  Credit spreads continue to widen to US Treasuries from a basis point standpoint with a distinct gap wider than investment grade debt. A sector historically reserved for issuers having high potential with higher risks will face a major repricing of risk leading to increasing pressure on market prices. Continued downgrade of credit ratings with reduction of new issues/funding.

- Comfortable being net short but believe there are some solid companies from a long perspective.

- **Equities**: ***No Change***

  Repricing of risk premium, effects of increasing interest rates on consumer debt/discretionary income, and increasing cost pass-throughs will cause equities, in general, to experience decreasing prices. Hard to fight the tape, passive investors, and Algos but comfortable being net short; believe there are some solid companies from a long perspective.

- **Municipals:** ***No Change***

  Not an investable asset class for Airacobra. However, the effect of higher rates, overextended state/city pension funds and the possibility of some states/cities seeing a reduction in "revenues" will have a general negative effect on credit, U.S. markets, and the U.S. economy. We project munis to be the canary in the coal mine regarding regulation and governmental activity/intervention.

- **Currencies/Commodities**: ***No Change***

  Not an investable asset class for Airacobra. However, project flat to increasing U.S. dollar strength given an increasing interest rate environment and growth potential of the United States compared to the rest of the global economy. U.S. dollar is the "Best of the Worst." If Trade War(s) saber rattling continues, said wars become "hot" (not only in the sense of economics), or the dollar loses its dominance as the global currency than all bets are off and expect things to get unpleasant across all asset classes.

Thanks for reading and as fellow Pittsburgher Dennis Miller use to say, "But of course that's just my opinion, I could be wrong." Look forward to your comments and never hesitate to contact us.

Be good

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