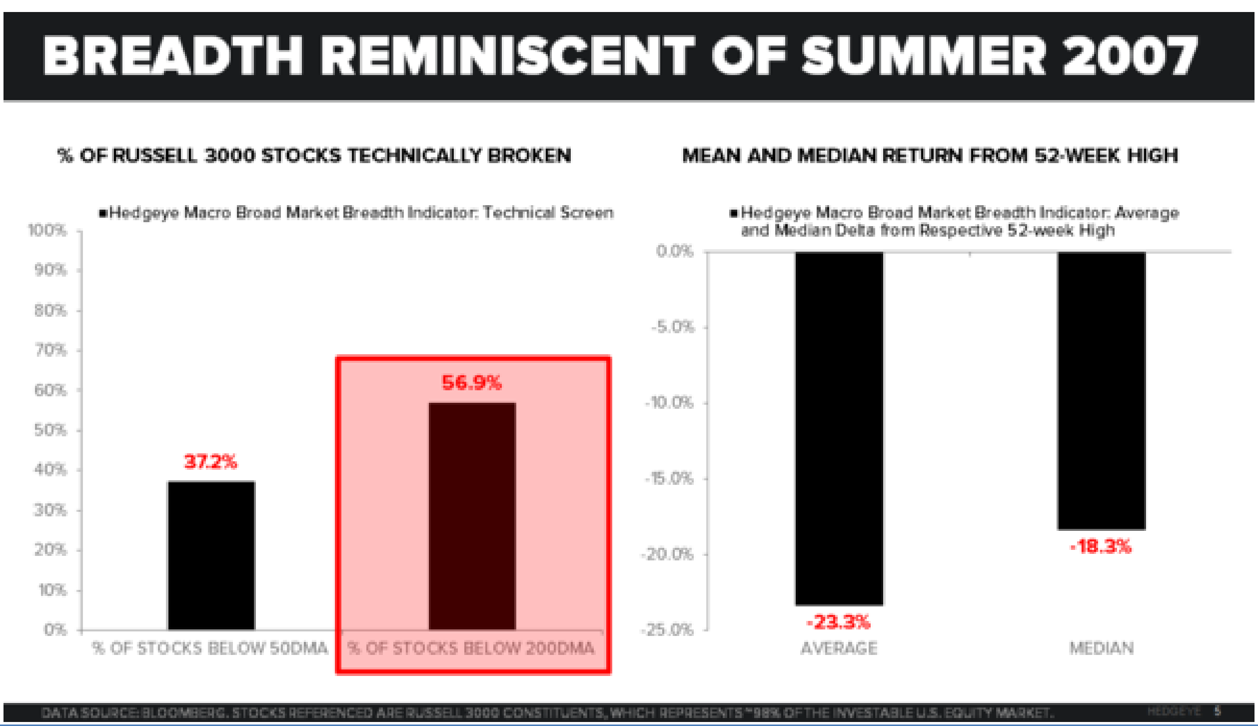

**November 16th, 2015**

**Another indication of being in the late stages of the business cycle…**
Stocks reversed hard last week with the S&P 500 falling 3.63% (the second worst week of the year), which came on the heels of a six week winning streak where the S&P 500 rose 8.7%. Truth be told, the action in stocks over the last couple weeks has been less than stellar with the S&P 500 registering losses (through Friday's action) in 9 of the last 12 trading days and 11 of 15 going back to October 26th. The Dow Jones Industrial Average declined by 665 points on the week with the Energy, Consumer Discretionary, and Technology sectors leading the slide (Utilities were the lone stand out as the only sector in the black on the week).

At Friday's close the S&P 500 has moved back below both its 200-day and 100-day moving averages with technicians keeping an eye on the 50-day moving average (currently at 2006) as the next major level to watch on the downside. The following chart from Hedgeye depicts the lack of participation in the latest stock market rally as they screened the Russell 3000 (encompasses 98% of traded U.S. stocks) and found that even after the face ripping October rally, nearly 60% of stocks still trade below their 200-day moving average – at the market peak earlier this year this figure was almost the polar opposite with 60% of stocks above their 200dma.



Moreover, without the significant gains in a select few large market-cap companies that are firing on all cylinders (Netflix +120%, Amazon +102%, Starbucks +46%, Google +39%, and Facebook +30%), the S&P 500 would be down in the mid-single digits this year relative to its -1.74% year-to-date decline through Friday.

So what is driving heightened anxiety for Mr. Market?

- Commodity markets continue to lack any semblance of visibility: Gold is hovering at five-year lows, copper recently hit six-year lows, and oil prices are once again flirting with the $40/per barrel level (nearing a 2 ½ month low). This price action in the commodity pits has reignited global growth and deflation concerns. Furthermore the unrelenting supply glut in many of these markets is showing few signs of dissipating in the near term, as per the American Petroleum Institute, U.S. crude stockpiles soared 6.3 million barrels last week (the market was bracing for a 1.1 million build, and keep in mind that this is usually the time of year when drawdowns are experienced). Here we are almost a year and a half into this bear market in oil and the world is still awash with crude. Data cited in the Wall Street Journal indicated that U.S. oil imports from Iraq, Kuwait, the UAE, and Saudi Arabia surged 18% in October – folks that's just in one month. On top of that we have roughly 20 million barrels sitting in ships off the U.S. Gulf coast and Iran has about 40 million barrels of fuels on tankers near the Strait of Hormuz. No wonder why we've seen the rig count in the U.S. cut in half and the latest reports out of North Dakota suggest that more than 1000 drilled wells sit idle waiting for higher prices before they commence fracking.

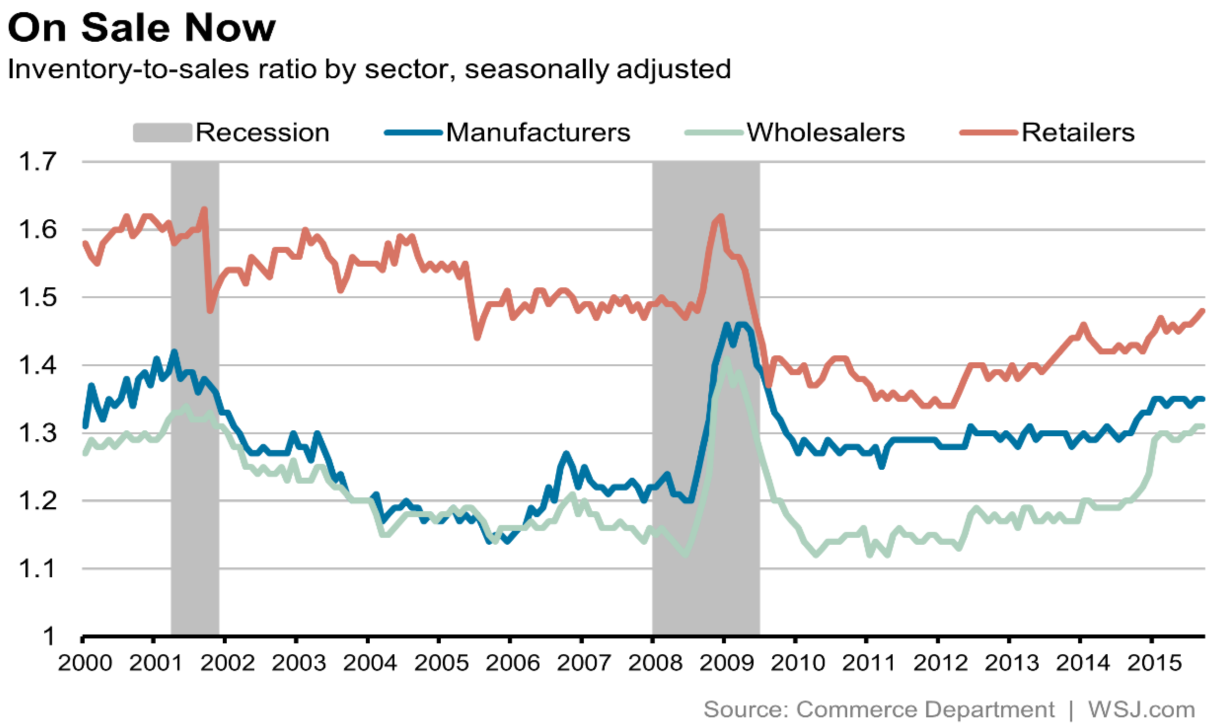
- Fed rate hike anxiety continues to permeate the landscape as a litany of FOMC members have been out and about on the speaking circuit reiterating that December lift-off is a distinct possibility. It seems as though the tug-of-war in the capital markets has evolved from 'can the economy handle a 25 basis point hike or not?' to 'do consumers and investors have enough confidence in the strength of the underlying economy to sustain the modest level of momentum in economic activity that has prevailed over the last several quarters?' For instance, nominal GDP is running at 3.7% year-over-year which is at a level that is historically inconsistent with raising interest rates. Since 1948 the Fed has raised rates 118 times wherein 112 of those times nominal GDP was above 5.5% and only twice was it below 4.5%. In one of the two times when they raised with nominal GDP below 5.5% year-over-year (1982), they had to reverse course almost immediately. Muddying the waters on this rate normalization cycle is the lack of historical precedent given that the global economy has never partaken in this level of monetary policy accommodation in the past. Therefore, unwinding it risks finding out where the unintended consequences of such policy have built up and having the fortitude and ability to contend with the fall out.

- Following a few months of weakness throughout the summer the U.S. dollar has moved back into a discernible uptrend which alone tightens monetary conditions considerably – some economists estimate the appreciation in the trade-weighted dollar so far this year is akin to 100 basis points in Fed rate hikes. Additionally, the strength in the dollar has been – and if the rise persists, will continue to be – a drag on corporate profits as it was a standout scapegoat for corporate executives during Q3 earnings season.

- Global growth remains weak as China continues to slow, Japan recently slid back into recession (the second time in the last three years), and growth in the Eurozone's largest economy, Germany, is stagnant.

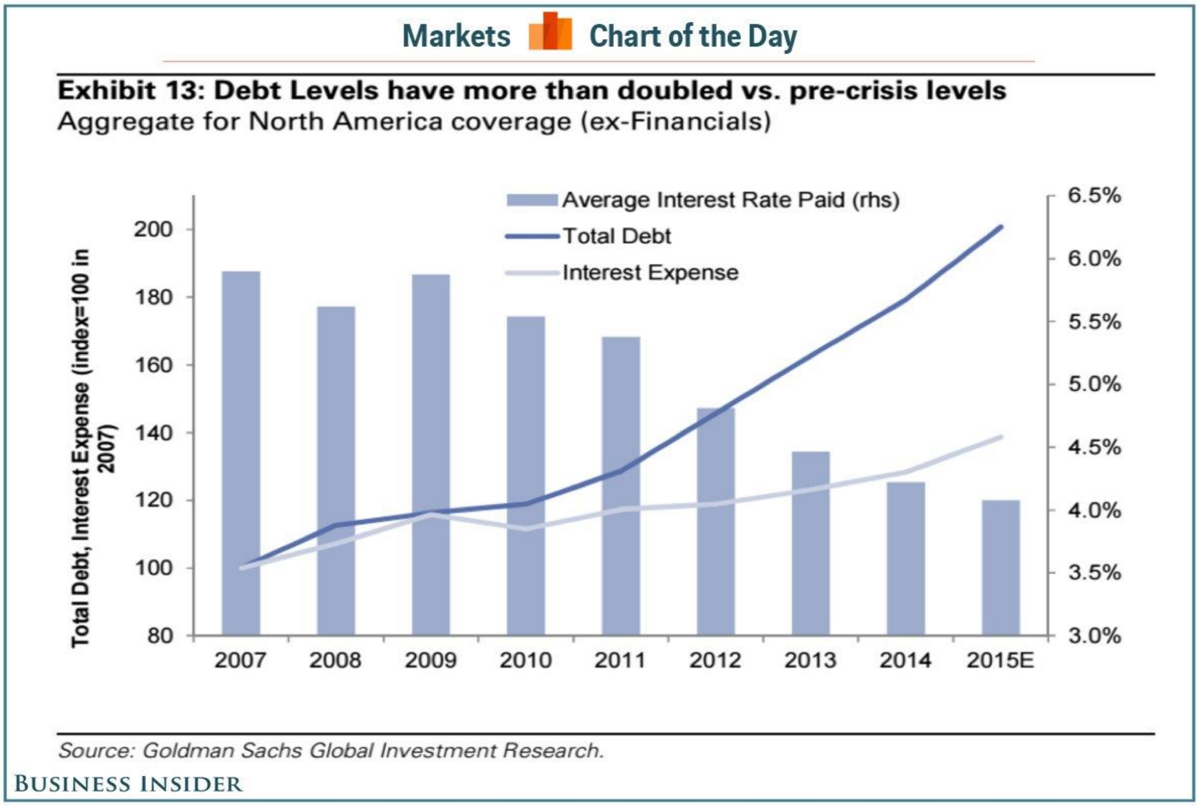
- Fears of a softening consumer spending backdrop are rising as the likes of Macy's, Nordstrom's, and Kohl's all reported weak results last week with their stocks getting hammered (down between 6 -

24%). These results were reported in tandem with retail sales for October inching higher by 0.1%, but well below 0.3% market expectations. With sales roughly flat we've seen inventory levels building which has pushed the 'inventory-to-sales' ratio to its highest levels since the waning months of the recession in 2009.




Another troubling sign is the latest port activity data which showed that imports into the three busiest U.S. seaports (Los Angeles, Long Beach, and New York harbor) declined in both September and October for the first time in at least a decade. These three ports handle just over half the goods entering the country by sea which fell by just over 10% between August and October. However, imports over the first 10 months of the year at the nation's busiest ports are still up 4% from a year earlier.

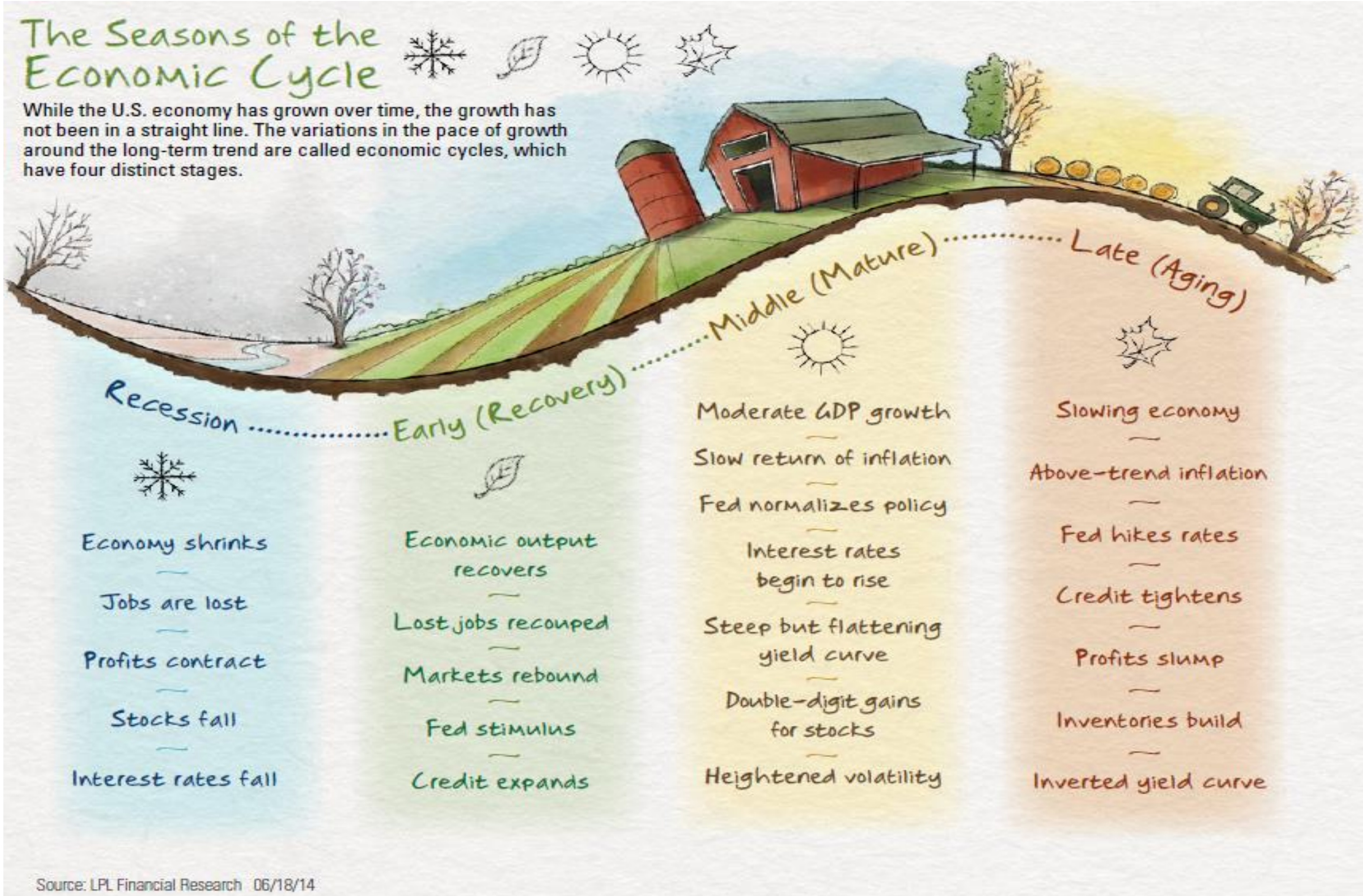
- We are seeing a growing deterioration in the High Yield Corporate bond market with the average yields in the noninvestment grade corporate bond space having gapped up to two year highs in front of a heavy supply calendar and as global default rates rise. The BofA Merrill Lynch US High Yield Index (H0A0) has not followed the S&P 500 rally above the mid-September peak. Technicians view this as a negative divergence for the U.S. equity market since breakdowns in the H0A0 in late July preceded the late August and late September weakness in the S&P 500. More importantly, the H0A0 has a similar set up to the 'U.S. Most Active Advance-Decline line' and should the H0A0 break below the October and December lows, it could confirm an important top for high yield and the S&P 500 could follow. As for the fundamental makeup of corporate balance sheets, Goldman Sachs published some research last week indicating that total debt in corporate America has more than doubled since 2007 (see chart below).




While the average interest rate on this debt has declined since 2007 it has not been enough to lower overall interest expense, which becomes even more concerning when put it up against the complete lack of top line growth this year. It's this cacophony of variables that appears to have sterilized the record pace of stock buybacks which have helped manage EPS, but has done little for equity returns.

Also complicating the landscape in the corporate debt markets is this new regulatory environment, which has caused a secular shift in bond market liquidity. As the bond market has grown in size, the piping that facilitates the trading in these markets (the dealers) have been cut in half. With dealers unable to commit the capital they used to, the ability for this market to remain orderly in the face of mass liquidation is a notable risk to overall capital market stability.

Beyond the latest bout of angst troubling investors over the last week, I want to shift the focus of this commentary to another more impactful evolution in a data point that adds to my cautionary view. Throughout time, business cycles have demonstrated a history of following a distinct pattern. Identifying and recognizing the pattern is the scientific part of the analysis, while dating where we are in the business cycle requires both art and science as it is very difficult to precisely pinpoint it with 100% conviction. Nonetheless, it was my view at the turn of the year that we were in the mature stages of this business cycle and as the year has played out, my view has evolved to believe we are in the late stage of this cycle.




This view is formed by many variables, but the one I want to focus on through the duration of this commentary is the synchronization of the credit and profit cycles. At the beginning of the business cycle, as the economy climbs out of recession, economic growth picks up, unemployment troughs, and corporate profits begin to grow. As the economic recovery continues, animal spirits get ignited, momentum builds, realized profits continue to grow, bankers become more willing to lend, and investors become more enthusiastic about investing – a la, optimism rises.

This is a self-reinforcing process as higher stock market values encourage firms to borrow more and bankers to lend more, but this process does not go on forever. Human nature is to extrapolate the present into the future, but this process also does not go on forever. Inevitably some of these optimistic expectations prove to be misguided as sales and earnings begin to disappoint and initially prices begin to decline – just a few at first as the broad market continues to climb, but then this trend broadens out.

One recognizable way to track the progression through this process is by comparing the growth rate of corporate profits with that of corporate borrowing. Profit growth in excess of borrowing growth is a highly constructive indication of a strong economy, as at this stage ‘return on capital’ is surpassing the ‘cost of capital’. Conversely, when these growth patterns trade places as the pace of borrowing accelerates beyond the growth rate of profits, it tends to be a signal that tougher times lie ahead. This marks the later stages of the cycle as manager optimism and investment in riskier, lower return on investment projects are funded and an increasing number of borrowers lack the capacity to meet their debt obligations.

This later stage of the cycle takes time to play out (years not months), but an end is inevitable. We are now at the stage in the current credit and profit cycle where credit growth has exceeded profit growth, which began in 2013. The chart below from Tom Cliggott (former U.S. Equity Strategist at Credit Suisse and Chief Investment Strategist at J.P. Morgan) depicts the historical tracking of this relationship going back to 1950.

| Table 1 | Profit growth > debt growth | Debt growth > profit growth | Recession | S&P 500 price decline |
|---|---|---|---|---|
| | | 2013, 2014 | | |
| | 2010 thru 2012 | | | |
| | | 2007 thru 2009 | Q4.07 thru Q2.09 | *2008 (-38%)* |
| | 2002 thru 2006 | | | *2002 (-23%)* |
| | | 1998 thru 2001 | Q1.01 thru Q4.01 | *2000 & 2001 (-22%)* |
| | 1991 thru 1997 | | | *1994 (-2%)* |
| | | 1989, 1990 | Q3.90 thru Q1.91 | *1990 (-7%)* |
| | 1987, 1988 | | | |
| | | 1985, 1986 | | |
| | 1983, 1984 | | | |
| | | 1982 | Q3.81 thru Q4.82 | |
| | 1981 | | | *1981 (-10%)* |
| | | 1979, 1980 | Q1.80 thru Q3.80 | |
| | 1975 thru 1978 | | | *1977 (-12%)* |
| | | 1973, 1974 | Q4.73 thru Q1.75 | *1973 & 1974 (-42%)* |
| | 1971, 1972 | | | |
| | | 1966 thru 1970 | Q4.69 thru Q4.70 | *1966 (-13%), 1969 (-11%)* |
| | 1962 thru 1965 | | | *1962 (-12%)* |
| | | 1960, 1961 | Q2.60 thru Q1.61 | *1960 (-3%)* |
| | 1959 | | | |
| | | 1956 thru 1958 | Q3.57 thru Q2.58 | *1957 (-14%)* |
| | 1955 | | | |
| | | 1952 thru 1954 | Q2.53 thru Q2.54 | *1953 (-7%)* |

*Sources: Cliggott September 2015, Federal Reserve Board, National Bureau of Economic Research, Yahoo Finance.*

In the six decades that this data covers there were 31 years where profits grew faster than liabilities and 31 years when the opposite was the case – a nice symmetrical relationship, right? Yes, but the performance of equities during these periods is anything but: stocks declined in just 16 of these 62 years, or roughly 25% of the time. However, eleven of the sixteen negative years (almost 70%) occurred during periods when credit growth exceeded profit growth.

In the expansion that ended in 2007, profit growth exceeded credit growth from 2002 to 2006 and it wasn't until 2007 that credit growth started to exceed profit growth – the economy entered recession in Q4 of that year. Prior to that, profit growth expanded at a faster pace than credit growth from 1991 – 1997, with that trend reversing in 1998, but a recession did not take hold until Q1 of 2001.

So you see, the lag varies, but going back through the entirety of this data, the one constant is that when this trend reverses it has historically marked an inflection point in the cycle. For the last two years, credit growth has exceeded profit growth, which is an indication that a more cautious investment profile is warranted for investors.

Listen, I realize that these musings over the last several months haven't been all that rosy and trust me I am far from a perma-bear, but I do try and provide readers with an objective view from my perch. With that said, at this time I am much more concerned about the risks on the horizon than I am with potential return opportunities. This doesn't mean that we've abandoned prudence, discipline and process within our investment portfolios, as we continue to maintain a level of balance in our allocation, but the overall risk exposure has been lowered.

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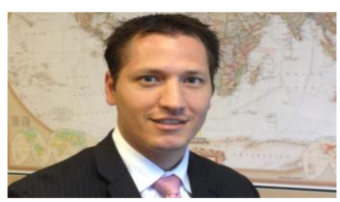

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