October 19th, 2015

Moving forward, but with caution…

Last week was a solid week for investors as both fixed income and equity markets notched moderate gains – the Dow Jones Industrial Average and S&P 500 each gained almost 1.0%, Treasury bonds rallied across the curve with long-term T-bonds advancing more than 1.0%, while international equities appreciated by about 0.5%. Gold continues to shine as it rose 1.5% on the week and is up 5.2% this month following the Fed's non-hike in September and diminishing expectations that they will hike at all this year (fed fund futures are down to 30% odds for a rate hike before year end and only 50% odds that they will hike by the end of March 2016).

All of the major U.S. averages (Dow, S&P 500, Nasdaq, and Russell 2000) have recaptured their 50-day moving average which is a constructive short-term signal – market breadth looks much firmer as well. Focusing on the S&P 500, it will be important for it to continue to make-up ground and push above what remains a declining 100-day moving average (2041) and 200-day moving average (2060). These levels represent significant resistance and will likely require investors with real conviction to step in to push above these levels.

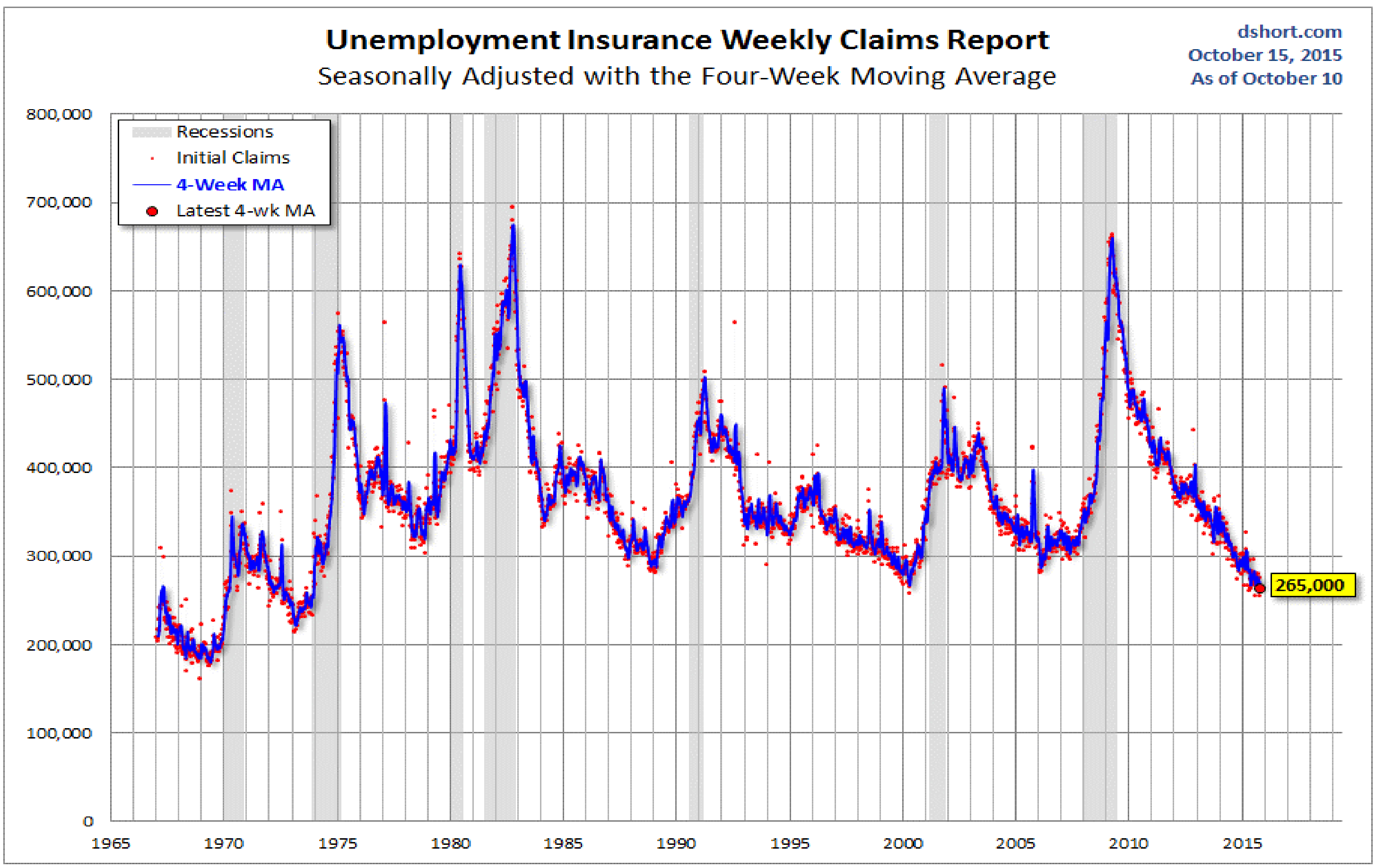
On the economic data front it continues to be a mixed picture – a theme that has been relatively consistent through the balance of this year – hence why the major equity averages find themselves close to where they began the year with the S&P 500 lower by 1.35% and the Dow off a little more at 3.5%. This isn't to suggest the ride has been a smooth one as stocks experienced their first 10% decline in almost four years, and as of Friday's close the Dow is 1,135 points (-6.2%) below its all-time high with the S&P 500 off by 101 points (-4.75%). The same story can be narrated for the bond market as the yield on the 10-year Treasury bond closed Friday at 2.04%, just 13 basis points below where it started the year (2.17%). Like stocks, the path to this point has not been as smooth as it looks with the 10-year yield dipping to as low as 1.65% in late January and hitting 2.49% in early June.

The culprit for this volatile (yet flat) range-bound market is in large part the result of conflicting economic data. On the one hand you have a strong housing market with starts and sales at or close to cycle highs, auto sales at cycle highs, consumer balance sheets and income statements that are in the best shape they've been in since before the credit crisis – which underpins the 70% of the economy that is driven by the consumer, and a labor market that continues to expand.

On the other hand we have persistently sluggish inflation data (last week's September CPI data showed headline inflation is flat year-over-year – disappointing Social Security recipients as they will get no bump in benefits for the year ahead – Core CPI inched up to 1.9%), a weakening manufacturing sector (both the Empire Manufacturing and Philly Fed declined last week with the former registering a double digit decline for the third straight month while the latter witnessed a 20-point drop in both Shipments and New Orders), sputtering Industrial Production as September's decline represented the eighth monthly decline in nine months this year, and floundering GDP growth with the Atlanta Fed's GDPNow forecast for Q3 recently sagging below 1.0%.

What is bothersome to me is that many of the economic data points that are indicative of a strong economy are lagging indicators – meaning they tend to look best shortly after the economic cycle has already peaked and begun to rollover. Take employment for example: last week we got initial jobless claims which are viewed as a leading indicator and included in the Conference Board's LEI index that declined to 255k – pushing the smoothed four-week moving average to 265k and its lowest level since 1973. For perspective, the last time jobless claims were at this level, the labor force was 90 million people compared to the 157 million people in the workforce today.

Take a look at the following chart from Doug Short and you can see how far claims have declined since the credit crisis and how we are now moving below levels experienced during prior economic expansions:



For sure, an investor could look at this chart and clamor that the employment backdrop could hardly be better. Undoubtedly this trend could continue as companies continue to retain workers at an almost unprecedented rate (there were just 1.9 claim filings last week per 1000 employees covered under the state unemployment insurance programs which was the lowest on record). However, a contrarian investor could look at this chart and take notice of where the level of jobless claims were going into the last seven recessions. The grey bars in the chart above denote economic recessions and clearly demonstrate that jobless claims typically trough (are at their best levels of the cycle) in advance of economic contraction. This lead time varies between when jobless claims trough and when a recession ensues, but what is consistent is that once they trough the clock starts ticking. Investors need not worry about the timer on the hour-glass running out on this indicator yet as it continues to move lower.

The monthly employment data is consistent with what the jobless claims data is saying: job growth continues to expand as can be seen in the below table from the Bureau of Labor Statistics database showing monthly job creation (in thousands) over the last 10 years. So far this year through September the economy has produced almost 1.8 million jobs and monthly job creation is averaging just shy of 200k. Both very solid figures, but both on pace to come in lower than 2014.

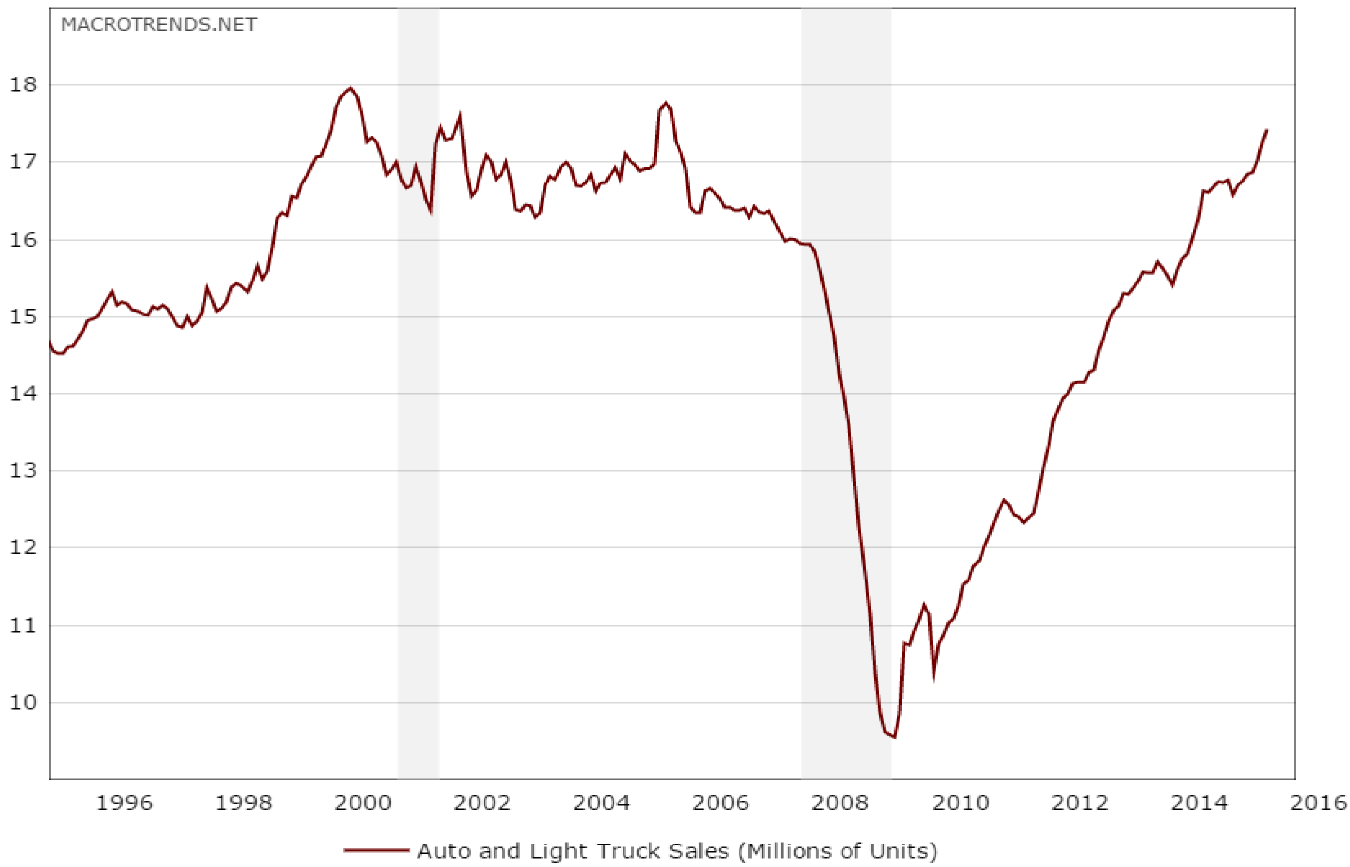
Moreover, what really stands-out and is worthy of monitoring going forward is that the rate of change in the data looks to have taken a leg down (most obvious in the preliminary results for August and September) from the Fall of last year where November's 423k print may represent the monthly peak for the cycle.

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yearly Total	Monthly Average
2005	134	239	135	363	176	243	375	196	66	84	337	158	2,506	209
2006	277	315	281	182	24	77	206	185	156	3	209	172	2,087	174
2007	237	88	188	78	145	71	-34	-17	86	83	117	97	1,139	95
2008	15	-87	-79	-213	-183	-172	-210	-259	-452	-476	-765	-696	(3,577)	(298)
2009	-796	-703	-824	-684	-355	-467	-325	-217	-227	-201	-6	-283	(5,088)	(424)
2010	32	-68	161	247	518	-130	-64	-39	-49	248	121	89	1,066	89
2011	75	167	206	321	103	185	117	128	223	183	146	226	2,080	173
2012	380	247	216	87	113	35	177	188	144	213	164	293	2,257	188
2013	205	314	115	187	219	127	164	256	150	225	317	109	2,388	199
2014	166	188	225	330	236	286	249	213	250	221	423	329	3,116	260
2015	201	266	119	187	260	245	223	136	142				1,779	198

* Aug. & Sept. are preliminary data

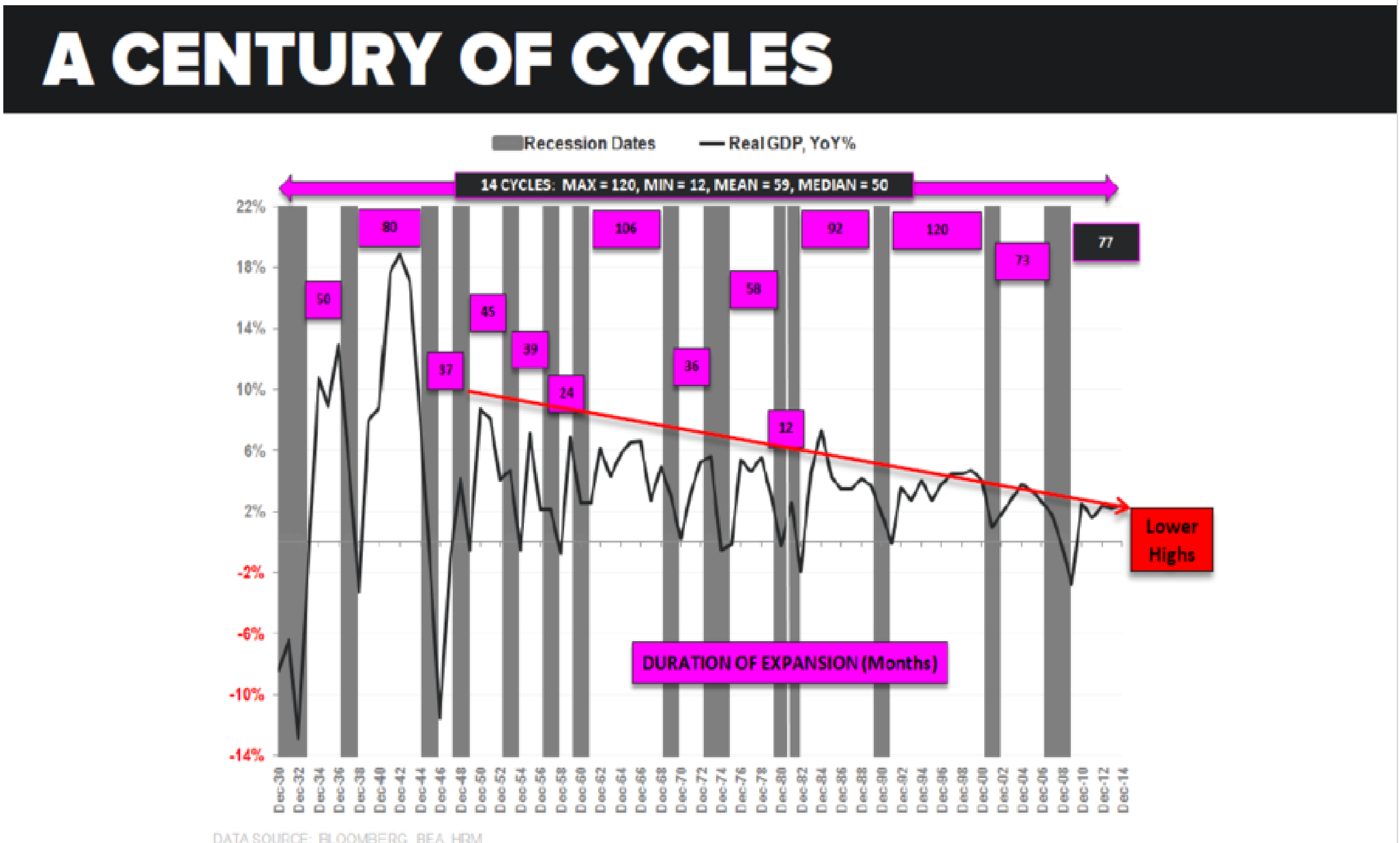
Keep in mind, if last Fall does represent the peak in employment growth (in rate of change terms) this does not mean the expansion ends tomorrow. Far from it, as you can see from the last cycle where the peak in monthly job growth occurred in July 2005 – almost two years before the economy took a material turn for the worst. However, it should cause yellow caution lights to begin flashing in forward looking investors' minds, as it is my opinion that it does portend that we are in the midst of a turning point in the economic data.

The story is similar for auto sales with September's 17.43 SAAR coming in just slightly below the peak level in August 2005 of 17.66 SAAR, and the May 2000 peak of 17.96 SAAR (see chart below from Macrotrends). Just like the employment data this economic data point is a lagging indicator and peaks well in advance of an outright contraction in the economy.



This theme also holds true for the ISM manufacturing data, ISM non-manufacturing data (although this metric has held up much better and only recently began to turndown), consumer sentiment, and corporate profits – all of which at some point in the last twelve months have peaked and rolled over. Once again, this is more an indication of a turning-point in what remains an economic expansion, so implementing the ‘canned goods and ammo', gold, and T-bonds portfolio in anticipation of a recession being just around the corner is a sure fire way to leave profits on the table.

In addition to the slowing rate of change in the economic data I think investors have to pay some respect to what history has shown. The following chart from Hedgeye details the length of the expansionary stage of each economic cycle dating back to 1930. In these 14 cycles, the longest expansion occurred during the '90's and lasted 120 months before succumbing to the popping of the tech bubble. The shortest expansion occurred between the double dip recessions of 1980-81 and lasted 12 months. Over these 14 cycles the average length of the expansion was 59 months with the median being 50 months, which suggests that the current expansion at 77 months is in its mature stages. The idea that we are in the later stages of this expansion is, in my opinion, being confirmed by what we have been seeing in the economic data over the course of the first three quarters of this year.



Beyond the economic data, the corporate earnings picture is whistling a similar tune. While we are still early in the Q3 earning season, consensus expectations are for earnings to decline for the second straight quarter (-4.5% year-over-year). So far only about 20% of the S&P 500 has reported with last week's reports dominated by mixed results from the Banks with weakness in trading revenues and net interest margin pressure being the common themes (some banks were helped by lower legal costs and expense management). A handful of Industrials also reported with big-cap Industrial-Conglomerates seeing the largest beats (General Electric and Honeywell being two of the better reports). It's likely best for investors to reserve judgment on the whole of corporate earnings until we get through the next two weeks which will represent the busiest weeks for earnings season.

How the earnings picture unfolds over the next several quarters will be the tell for investors. Without earnings growth I just don’t see what could be the catalyst to reignite the equity bull market. Yes, we got a risk-on rally in equities following the September FOMC meeting where the Fed decided to punt on lifting rates, but that was on concerns from overseas weakness and potential spill-over effects on the U.S. Given the weakness in the economic data since that meeting, the Fed’s decision has been vindicated. Which begs the question: Is the short-term benefit to this Pavlovian conditioning, where stocks rally on weak data, starting to outweigh any long-term benefits? Me thinks yes.

While it’s been profitable for investors to adhere to the ‘don’t fight the Fed’ investment philosophy over the last six years, the law of diminishing marginal returns does ring true. Investors need to consider what the range of price levels are for stocks in different scenarios. Today's backdrop incorporates an accommodative Fed, low interest rates, an economy that is in a mid-cycle slowdown, and earnings growth reaccelerating to high double digits / low single digits in 2016. That's my view of the base case of consensus group think out there, in which the S&P 500 at Friday's close of 2033 trades at a P/E of 18.3x trailing twelve months earnings ($111/share), and a P/E of 15.9x on consensus estimates for $128 EPS for the S&P 500 in 2016.

In an optimistic world, the best case scenario is the economic growth in the U.S. and overseas reaccelerates, the Fed and other central banks are able to thread the needle and methodically remove monetary policy accommodation, inflation remains tame, and the aggressive corporate profits estimates come to fruition. In a more certain higher growth world it is realistic to expect that investors would be willing to pay a peak multiple of 18x earnings which would put the S&P 500 at 2304. This represents almost 270 points or 13% upside from today's level on the S&P 500.

In a world where things take a turn for the worse, global growth weakens further, the U.S. economy contracts, investors lose confidence in the Fed and their lack of options to counteract a down-turn, job losses mount, fiscal policy remains handcuffed by political dysfunction, and corporate earnings decline. In a recessionary scenario (which is what this would be) the multiple investors would be willing to pay on a less certain and declining EPS would likely be in a range of 12-14x earnings. If we assumed a recessionary average 20% haircut to earnings, using the 2015 EPS estimate of $111, that would take earnings down to $89/share. At a P/E multiple in the range of 12-14x the S&P 500 would trade down to 1070-1246.

What makes investing so hard is that there is no telling which, if any, of these scenarios will come to fruition. Trust me, it's a difficult and humbling task to attempt to predict the future, and extremely difficult to, at times, have a lot of conviction behind your views. Today is one of those times where conviction is lacking, the outlook is cloudy, and unfortunately the probabilities of a bad outcome for investors are elevated.

With that being said, it doesn't mean that investors should abandon a prudent long-term investment strategy. A prudent strategy should be fluid, adaptable, and allow flexibility where you can take steps to stay the course, but adjust the overall risk profile of your portfolio. This will allow you to 'move forward, but with caution'.

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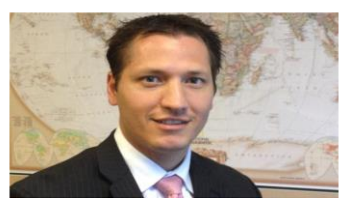

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