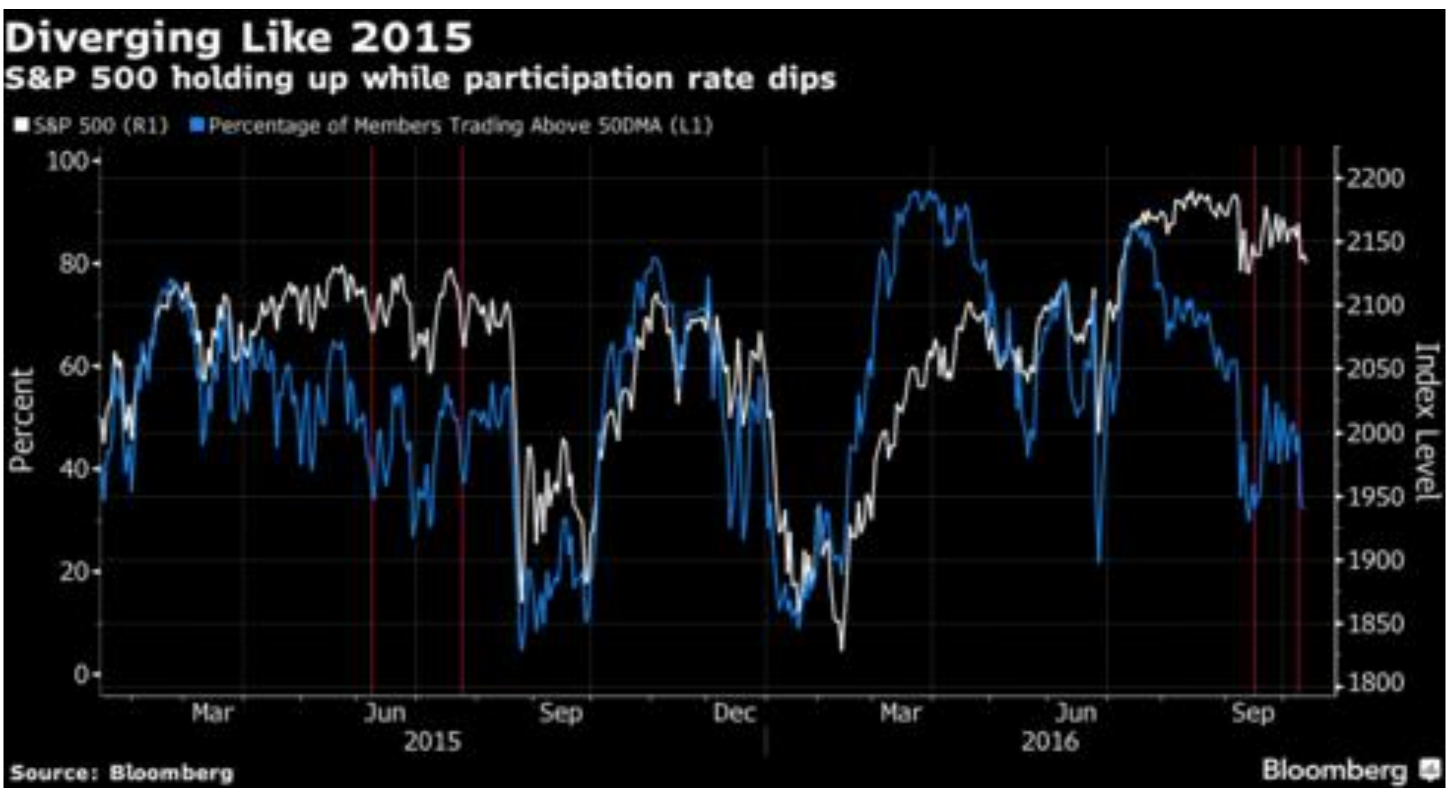
October 24th, 2016

There is no free lunch…

Yet another week and capital markets remain in a hypnotic state awaiting some form of a catalyst whether it be positive or negative to awake them from their slumber. Yes, last week the S&P 500 registered its first weekly gain in the last four, but hold the applause as it was a meager 8 point rise and at Friday's close of 2,141 the major average is at the same level it reached in early July and sits only 10 points above levels it reached in May 2015. And while the major equity averages are holding in near all-time highs there are some cross currents surfacing in the breadth measures that are worthy of monitoring.

The below chart plots the S&P 500 versus the number of its constituents trading above their 50-day moving averages, where a significant divergence between the pair has taken shape since early July.



Last Tuesday was the second time in the past month where the S&P 500 closed within 2.5% of its peak while fewer than 45% of its components traded above their average price over the last 50 days. This occurred in June and July of last year, and low and behold that marked the high for this bull market cycle at the time.

Coincidentally (or not) the other time when two warning signals like this flashed within three months of each other – in December 1999 and February 2000 – equities ended up erasing half their value over the next two years. This is not a forecast, but rather just an observation.

The bond market rallied last week with yields dipping across the curve, but like the equity market the move was of little consequence as the 10-year Treasury yield at 1.74% remains well ensconced in its trading range of 1.50% – 1.80%. The one market that rightly is catching a lot of investors' attention is the U.S. dollar which rose +0.6% last week (its third straight week of gains) and is now up +3.3% on the month, flirting with its highest levels of the year.

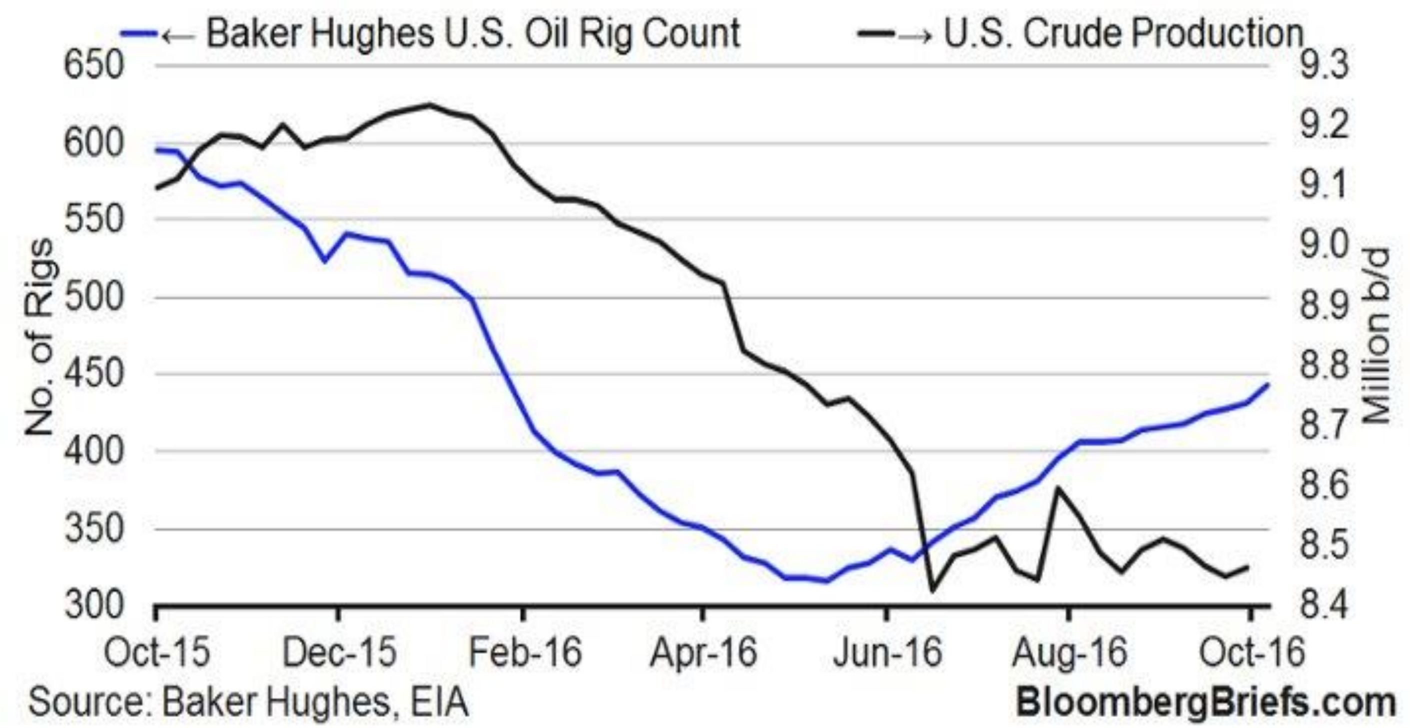
Surely this move higher in the dollar coincides with increasing probabilities that the Fed will hike the Fed Funds rate in December for the second time in this expansion (the Fed Funds futures market is pricing in 68% odds of a hike in December, which is up from 61% a month ago). However, keep in mind that currency prices don't adjust in a vacuum, whereby a stronger dollar is relative to currency weakness elsewhere. The Euro is one of the culprits as it fell back below €1.09 last week (its lowest level since early March, just prior to Mr. Draghi announcing the ECB was going to include corporate bonds in its QE program).

Another victim is the Chinese Yuan which has fallen relative to the dollar to its weakest level since 2010, back when China was injecting any form of stimulus it could into its economy to offset the fallout from the credit crisis reaching its borders. Recall it was only a little over a year ago (August 8th – 12th) when China implemented a surprise -3.5% devaluation that set off a -11% decline in the S&P 500 over a two week stretch. Back then the USD/CNY going from 6.20 to 6.40 set off a panic, yet with the Yuan falling to multi-year lows of 6.78 last week, markets seem to be digesting this move with much more acceptance.

As for the commodity markets, gold continues to hold above its 200dma closing last week at $1,267, where in my view it remains a good portfolio diversifier against a Fed policy misstep, heightened geopolitical uncertainty, and an escalation in the global currency war. Oil prices pushed back up near their highest levels in a year last week as WTI flirted with $52/bbl, but already it seems as though the bloom is coming off the rose for the stencil of a deal (nothing agreed upon) to freeze OPEC production at 32.5 – 33.2mn bbl/day. Iraq has come out recently indicating they have little interest in freezing production and recent discussions with non-OPEC producers to freeze (namely Russia) seem to be nothing more than lip service, with Russia indicating that a freeze would be great, but "you go first".

On top of that you have U.S. production that slowly but surely is coming back on line with the Baker Hughes rig count data showing oil rigs rose for an eighth consecutive week with 11 new rigs added last week. While oil rigs are still down -25.4% from a year ago and well off the all-time high of 1,609 reached in October 2014, the 443 producing oil rigs in last week's report are up handsomely from the May 27th low of 316 (it's the marginal change and directional change that matters).

What's also likely to be a headwind keeping oil prices from ripping higher is the ability of bankrupt oil companies to continue producing as they work themselves through chapter 11 restructuring – see the article published in the WSJ "Bankruptcy Bust: How Zombie Companies Are Killing the Oil Rally".



Third quarter earnings season is in full swing with 114 companies representing 35% of the S&P 500 having already reported. So far so good with earnings coming in +7% better than beaten down expectations, but the top line (sales) beat is much more moderate at +0.9%. The strong bottom-line results have been led by companies in the Tech and Financial sector with weakness coming from companies in the Industrial and Consumer Discretionary sectors. This week will be the busiest of the entire Q3 reporting season with 36% of the S&P 500 constituents reporting – it's fair to say that after this week we'll have a pretty good indication whether or not the five quarter (dating back to Q2 2015) earnings recession is finally over.

What will be key to watch is further improvement on the guidance front, where so far the three-month guidance ratio has been tracking above average, but this is occurring with the number of companies issuing guidance at its lowest level since 2000. Assuming Q3 and Q4 earnings meet analyst expectations, then full year 2016 EPS for the S&P will come in around $117.50 which would be roughly unchanged from 2015's results of $117.46 and put the S&P 500 P/E multiple at 18.3 – roughly 15% above its historical average P/E of 16x.

Stepping back from the minutia of quarterly earnings accounting I find myself increasingly skeptical that analyst earnings estimates in the future can be achieved, and as a result returns in the U.S. equity market will continue to be muted as has been the case since the end of 2014. You see, over the past several years there have been two primary fundamental sources of support for the stock market (excluding the Fed): stock buybacks and dividend payments. However, it appears as though the fundamental underpinnings that perpetuated the record corporate payouts from these sources are nearing an end.

According to data pulled together from the research team at Barclays, these sources have collectively accounted for an unprecedented amount of payouts to shareholders, where dividends have increased by more than 100% since 2009 (reaching $98 billion in the most recent quarter), while gross buybacks have tripled and are on pace to reach $600 billion in 2016. This sets up 2016 to be the first time ever that stock buybacks plus dividends could eclipse $1 trillion.

FIGURE 1

Payouts (dividends plus buybacks) are poised to top $1 trillion for the first time in history in 2016

Source: S&P, Haver, Barclays Research

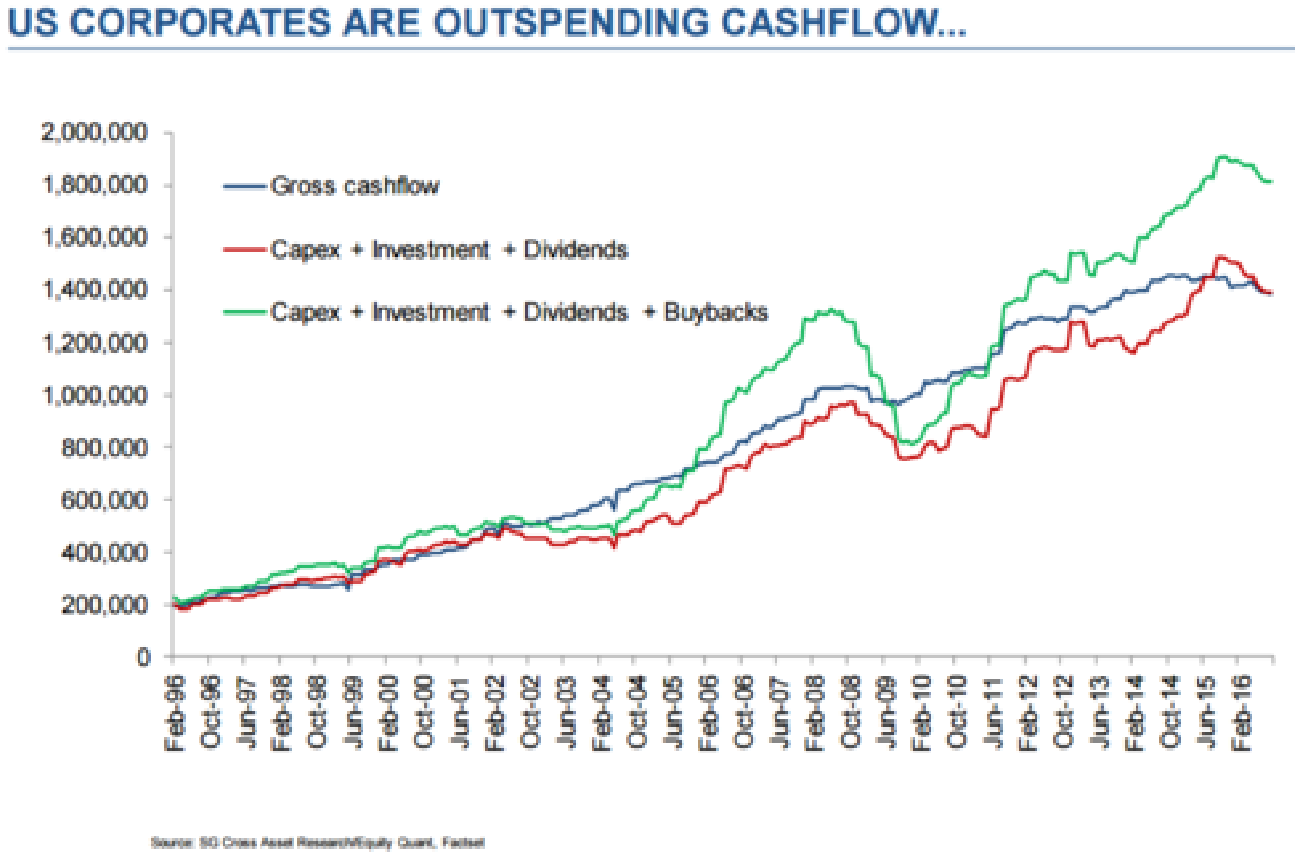
However, this is a case where investors should heed “Herbert Stein’s Law” which states “if something cannot go on forever, it will stop.” In 2014 companies paid out 99% of earnings, more than 100% in 2015, and with the pace of payouts approaching $1 trillion in 2016 it will more than surpass the estimated $900 billion in net income. Prior to 2015, companies in the S&P 500, in aggregate, had paid out more than they earned only six other times during the last 50 years and it has never happened more than two years in a row.

FIGURE 2

The total payout ratio has never exceeded 100% more than two years in a row

Source: S&P, Haver, Barclays Research

The numbers look even worse when looked at on a cashflow basis.



How is this possible? And, can it continue?

Companies have been able to spend more than they generated in cash flow because leverage measures were low coming out of the financial crisis and the Federal Reserve nailed interest rates to the floor for the last eight years. While corporations maintained a disciplined approach towards credit and leverage in the years following the credit crisis (learning a valuable lesson that too much of anything is sure to carry side-effects), this discipline eventually gave way as companies began tapping the credit spigots in earnest in mid-2014. While corporate profits remain below their 2014 peak, corporate indebtedness as measured by debt/EBITDA has continued to rise. Coming out of the credit crisis debt/EBITDA (excluding financials) was just 1.53x in 2010, and as of the end of the second quarter 2016 stood at 2.33x (the highest level in the past 20 years). And the increase has not just been caused by the Energy sector. If Energy is excluded in addition to Financials, the total debt-to-EBITDA ratio is 2.50x and it too has been rising rapidly.

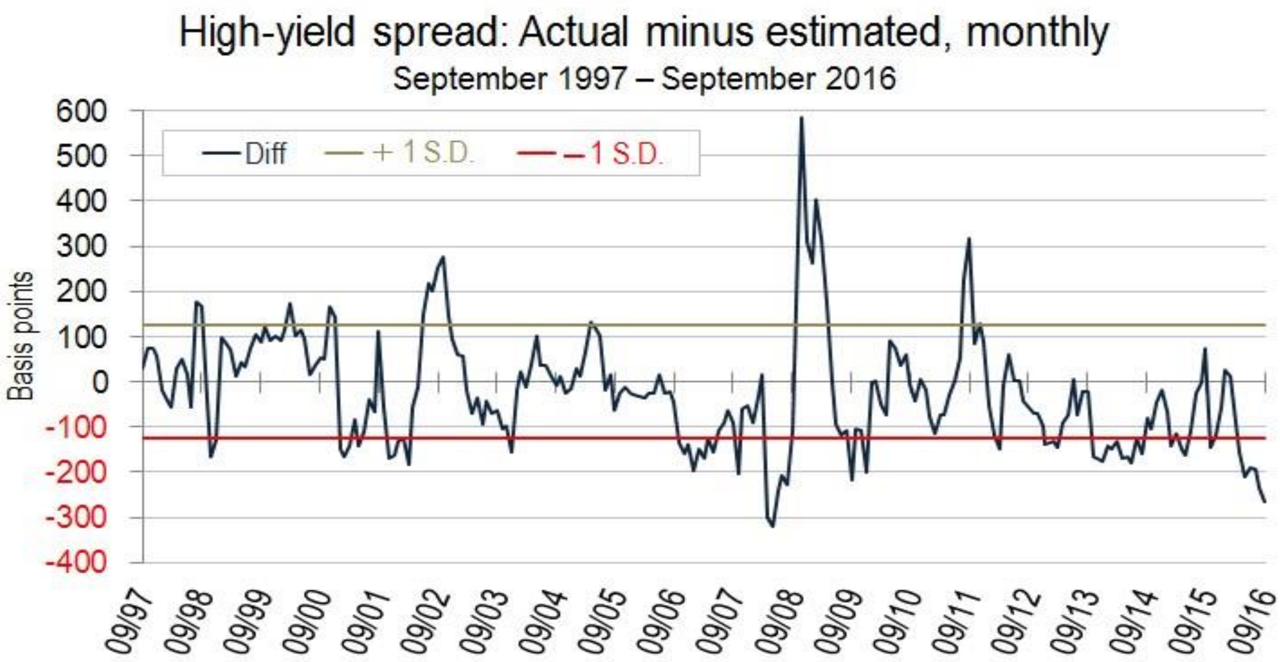
This is leading to lower coverage ratios which in turn will inevitably lead to an increased risk of credit rating downgrades, which no investment grade rated company wants as it would meaningfully increase their cost of capital. What the above analysis means, stated simply, is that even assuming no material increase in rates, companies will have no choice but to moderate their aggressive payout practices – the same practices that were instrumental in supporting the S&P as it's hovered near all-time highs for the last eighteen months.

To be fair, servicing this record high debt load isn't as onerous because of the historically low level of interest rates. And despite the recent steepening of the corporate yield curve, companies have continued to extend duration, which offers them more certainty about what their interest payments will be over the long term. But over the long haul, the performance of stock markets will be primarily driven by earnings increases—and the level of corporate indebtedness implies that any latitude to boost earnings per share by shrinking the outstanding share level (the denominator) is limited.

One area of the credit markets where this tonic mix of easy lending standards, excessive debt loads, and investor chase for yield is on full display is the high-yield market. Martin Fridson, who is highly regarded in the space and considered a legend in the junk bond market, penned a missive last week sighting that the only time he's ever seen the high-yield market more overvalued than it is today was during the days leading up to the 'Global Financial Crisis' in 2008.

According to his work as of Sept. 30, the option-adjusted spread (OAS) on the BofA Merrill Lynch US High Yield Index was 497 bps. That amounted to a gap of -265 bps versus his fair value estimate of 762 bps, a difference of -2.1 standard deviations, where one standard deviation equals 126.3 bps (Grantham, Mayo, Van Otterloo has proposed a general definition of a bubble in financial markets as a divergence of -2 standard deviations from intrinsic value).

By Oct. 14, the OAS on the BAML High Yield Index was down to 472 bps, a gap of -290 bps or -2.3 standard deviations.



Sources: BofA Merrill Lynch Global Research, used with permission; Federal Reserve Board; LCD, an offering of S&P Global Market Intelligence.

As detailed above, the present shortfall from fair value was greater only in April 2008 (-300 bps or -2.4 standard deviations) and May 2008 (-321 bps or -2.5 standard deviations). Following the record overvaluation of the spring of 2008, the high-yield market did not return to fair value until October 2008, when the BAML High Yield Index's OAS widened by an astounding 521 bps in a single month. Unfortunately for investors who were blinded by the high income irrespective of the prevailing risk, from April 30 to Oct. 31, 2008 the BAML High Yield Index returned -25.94% while the BofA Merrill Lynch US Treasury Index returned +1.79%.

What I'm getting at is that there is 'no free lunch' when it comes to investing. We are approaching the eight year anniversary of when the Fed first dropped interest rates to zero back in 2008. Over this period holders of financial assets have been handsomely rewarded with asset prices in stocks, bonds, and real estate moving back up to or near all-time highs. However, investors now find themselves in a precarious position of continuing to rely on their faith in the Fed, which has served them so well over the last seven years, or the deteriorating economic fundamentals. Granted, this faith has been tested at times in the equity market with a nearly -20% pull-back in 2011, close to a -10% correction in 2013 and two -10% drawn-downs in the last fourteen months. Fixed income investors experienced a similar journey with the ups and downs not as pronounced, but for a lower volatility asset the ride entailed its series of bumps along the way. But at each prior occurrence of economic or capital market weakness, the Fed stepped up to the plate with either another QE program or reassurance that they would not hike rates.

That Pavlovian conditional response buoyed the second best performing bull market in U.S. stock market history and perhaps the end of what has been a 35 year bond-bull market that started back in the early 1980's. Now here we are with the preponderance of economic data suggesting we are definitely in the late stages of this cyclical expansion, equity market valuations above historical averages, corporate credit spreads nearing cycle lows (and corporate bond market prices nearing cycle highs), and debt levels across the board at or near all-time highs (corporate debt, consumer debt, and government debt) – all on the back of eight years of zero interest rate policy and unprecedented monetary policy experimentation.

Yet, there remains this unfettered belief that the Federal Reserve will be able to thread this needle of unwinding this policy largesse without any economic consequences and no downside impact on asset prices. I guess it's possible, however history would suggest it's improbable as I can dig through the historical archives – whether it be just the post WWII era of the last seventy years or go as far back as the post Great Depression period of the last eighty-five years – and I cannot find any occasion where the forces of economic gravity have been upended by central bank policy.

You see, I have yet to find a bull market in any asset that has never experienced at least a cyclical interruption, and while all cycles are different in character, duration, and market forces they all have a similar rhythm. This time is not different – just like the decrees that "tech stocks could never decline" in 2000 or the proclamations in 2007 that "house prices always appreciated in value" were not different. The Federal Reserve and experimental policies from central banks from around the world have not created a new investing environment where risk is obsolete and reward is all that remains.

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