April 4th, 2016

A coiled spring, but in what direction?

If you happened to be stuck under a rock at the start of the year and just emerged to see the S&P 500 up 1% through the first three months, you are forgiven for thinking that you didn't miss much (very reminiscent of the second half of 2015 which entailed bouts of heightened volatility, intermittent corrections, and swift bear market rallies). Following a nearly -12% decline in the first six weeks of the year it took the S&P 500 posting its best March returns (+6.8%) since 2009 (when the stock market last bottomed) and its fifth best March returns since 1935 to get it back into the black. Continuing to cast some doubt over the sustainability of this recent rally is the fact that leadership is coming at the hands of the smallest, least expensive and lowest quality stocks, although high quality stocks still lead for the year. Energy stocks returned +9% in March, while Utilities (+8%) and Telecom (+6%) continued to benefit from low interest rates. Health Care was the worst-performing sector for the month (+3%) and for the year thus far (-6%).

No matter what, investors doubting the vitality of this rally (myself included) have to at a minimum tip their cap and respect the market's resilience for moving back into the black on the year and within 3% of its May 2015 all-time high. At the same time, the average bond yield in the non-investment grade universe is a rather wide 250 basis points above the lows seen this cycle… one of those things that makes you go 'hmmm'. In hindsight, the whipsawing action in Q1 now looks to be much ado about nothing as the economic and fundamental reality wasn't nearly as bad as investors were pricing in at their February lows, but with most of the major averages moving up to their highs of the year it is my opinion that the overall backdrop is, on the margin, weaker than where we were when the year began.

Furthermore, it has been my view coming into 2016 that the second and third quarter set up to be the most challenging, confusing, and volatile period of the year. Driving this view is the fact that corporate profits, consumer confidence, and the service sector all peaked in Q2 or Q3 of 2015. That means that when investors compare results in Q2 and Q3 2016 on a year-over-year basis it will be the most challenging comp of this entire cycle. Those not anticipating or tracking the business cycle on a rate of change basis might want to dust off their calculus notebook as this second derivative measurement is a meaningful relationship for asset prices. The fact that the VIX index is back below the 14 level is an indication that quite a bit of complacency has crept back into the stock market. Looking back at this bull market cycle, history will show you that buying stocks when the VIX is this low hasn't been a favorable risk/reward proposition.

The fact that the best two performing sectors so far this year are Telecom (+15%) and Utilities (+14%) and among the worst are Financials (-5%) and Consumer Discretionary (+2%) is not a very favorable pro-cyclical mix and attests to a generally defensive tone in an otherwise range-bound market. This is a message that is also being conveyed by the relentless push lower in intermediate and long-term Treasury yields. The yield on the 10-year Treasury began the year at 2.27% and traded down to 1.53% on February 11th when

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investors feared that a global recession was at hand – yet with equity markets hitting their highs for the year, one would not expect the 10-year T-note yield closing last week at 1.77% (a measly 24 bps above the February 11th capitulative low). Surely this is the result of many factors: continued central bank accommodation, sluggish global growth, and low inflation, but the 10's / 2's treasury yield spread having compressed 20 bps this year and hovering near its cycle lows attests to how anchored growth and inflation expectations have become.

Last week we got the latest reading on the labor market which continues to be one of the strongest fundamental aspects of the U.S. economy. Nonfarm payrolls rose 215k in March (the 73rd consecutive month of job growth) pushing the six-month average to a strong 246k and the unemployment rate ticked higher to 5.0% (first increase in nearly a year and the U-6 measure ticked higher to 9.8% from 9.7%), but this was for good reason as the labor force participation rate increased for the sixth consecutive month. The extent to which job growth is touching a wide swath of industries was clearly evident in the report with the private sector diffusion index ticking up to 58.4% from 58.0% (the factory and manufacturing sector continues to face a challenging environment with this diffusion index collapsing to 37.3 from 42.4 in February and 57.6 in December).

Average hourly earnings were also healthy, growing 0.3% month-over-month (2.3% YoY) with perhaps the lone negative coming in the way of average weekly hours coming in unchanged at 34.4 (expectations were for a lift to 34.5). Over the past two years the year-over-year trend in wage growth has been as high as +2.6% and as low as +1.7%, so this report falling near the middle of this range shows nary a sigh that a breakout in wages is underway. This provides further cover for a renewed dovish Fed to remain as such. It's been seven years since we've seen a three handle in the year-over-year trend in average hourly earnings and you'd have to go back to 2007 (the peak of the last business cycle) before you found wage growth above 4%. Suffice it to say what remains constant through this epic run of job creation is the fact that there remains a substantial amount of slack in the labor market.

All in all one would have to look pretty hard to find something to complain about in the March employment report, but the flat workweek at 34.4 (tied for the second lowest reading in over four years) is worth acknowledging. No traction in the workweek, in addition to jobless claims rising for the third consecutive week to an eight week high of 276k (up 11k), are both leading indicators of the labor market and are something to monitor in regards to a potential weakening in what continues to be one of the best stories in the economy.

Another tertiary yet valuable data point to measure the health and forward path of the labor market is the Challenger, Gray & Christmas job cut report which was released last week. Layoff announcements fell to 48,207 in March – declining for the second consecutive month and 21.7% below the 61,599 announced cuts in February. However, while the sequential decline in job cuts is a constructive near-term signal, the trend in job cut announcements is a bit troubling as job cut announcements in March were 31.7% higher than March of last year (36,594), which marked the fourth consecutive year-over-year increase. Also visible in the report is the broadening out of job cuts, whereby a lower proportion of job cuts are coming from the oil and gas industry, prompting the following comment from John Challenger (CEO of Challenger, Gray & Christmas): *"(…) it is not just the energy sector that is seeing heavier job cuts. Layoff announcements have increased significantly in the retail sector and computer sector, as well. While it may be too early to sound the alarm bells, the upward trend outside of the energy sector is somewhat worrisome."*

A couple other noteworthy economic data points released last week were the latest reading on manufacturing activity and auto sales. First on the latter, auto sales were a disappointment falling to an annualized rate of 16.6 million units (consensus was expecting 17.3 million) from 17.5 million in February. Perhaps even more disconcerting than the downturn in the sales trend are the concerns over a default wave in the subprime auto

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loan market. J.D. Power estimates that the delinquency rate will hit 17.5% this year (not far off the 19.6% peak in 2007). The share of car owners who are 'upside down' (in a negative equity situation) is seen rising above 30% which is reminiscent of a time period not too long ago (2006) where easy credit was the culprit for substantial financial pain. The mere fact that lenders are extending loans for as long as seven years just about says it all – 72-month auto loans now represent 34% of sales (you've got to be kidding me given the depreciation embedded in this asset).

Good news came at the hands of the manufacturing sector as the ISM manufacturing survey increased to 51.8 in March from 49.5 (consensus was expecting 51), hitting its best level since July and confirming the pick-up reported by most of the regional Fed surveys reported throughout March. The internals of the report suggest perhaps the worst of the contraction in the beleaguered manufacturing sector is behind us with 12 of the industries reporting growth last month – this indicates a continuation of the trend that started back in November with only five industries reporting growth, six in December, eight in January, and nine in February.

Mind you, the headline ISM reading of 51.8 is still only modestly above the 50 breakeven level and this marks the first time this metric broke the 50 level in the last six months, so let's hold the all clear signal in the on deck circle until we see some follow through over the next couple of months. The pickup in manufacturing wasn't just relegated to the U.S., as the Chinese PMI reading kicked up to 50.2 in March (consensus was at 49.4) which matched the best level since November 2014.

The same can't be said for Japan as this is a region that is spiraling out of control in its attempt to arrest its economy from economic gravity. The Tankan survey disappointed as it declined to a three month low in March of +6 (from +12 in December) with expectations for this metric to fall to +3 by June – this report followed a very downbeat industrial production print (-6.2% YoY) released earlier in the week. Japan may very well be the canary in the coal mine for what the negative effects could be when investors lose faith in the effectiveness of central bank actions. Abenomics, which gave so many investors hopes that it was going to resurrect the faltering Japanese economy, is now being viewed as a failure with the region on the precipice of slipping back into another recession. What more can Japanese officials do: interest rates are negative, they QE out the wazoo, and they're forcing pension funds to buy stocks, yet growth and inflation still can't find a pulse.

All deference aside to the all-important data deluge that comes at the beginning of a new month, but last week was all about Chair Yellen quelling any misconceived notion that the Fed was backing off the dovish tone she laid out following the March FOMC meeting. To summarize, at that meeting the FOMC marked down its rate hike expectations to only two hikes from four (more closely aligning with market expectations for only one hike this year) and in the process set off the latest leg higher in risk assets. Subsequent to that meeting we had several regional Fed Presidents hit the speaking circuit singing a different tune which stirred some indecision among investors as it seemed to conflict with what the Chair was laying out only a few short weeks prior, to wit:

- **March 21: Atlanta Fed head Dennis Lockhart** said U.S. economic growth has "sufficient momentum evidenced by the economic data to justify a further step at one of the coming meetings, possibly as early as the meeting scheduled for end of April."
- **March 21: San Francisco Fed head John Williams** said the U.S. economy is "looking great" and the Fed would raise rates faster were it not for global factors. "All else equal, assuming everything else is basically the same and the data flow continues the way I hope and expect, then April or June would definitely be potential times to have an increase in interest rates."

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- **March 22: Philadelphia Fed head Patrick Harker** said "I think we need to get on with... This economy is really quite resilient to a lot of the headwinds (including the strong dollar).... I am not a two (rate) rise person... I'd rather see [more hikes this year]."
- **March 22: Chicago Fed head Charles Evans** said U.S. economic fundamentals are "really quite good," citing improving manufacturing activity.
- **March 23: St. Louis Fed head James Bullard** said a case could be made for a rate hike in April, sounding a hawkish tone. "The odds that we will fall somewhat behind the curve have increased modestly... We are going to get some [inflation] overshooting here in the relatively near term that might cause the committee to have to raise rates more rapidly later on."

Well, last week Chair Yellen made it clear to everyone who the boss is and who investors should be listening to when it comes to handicapping future Fed actions. At the New York Economic Club Dr. Yellen decisively convened the message that she sees more downside than upside risk to growth and inflation, feels the fed funds rate target is where it should be given prevailing economic conditions, that the future path of rates is much lower than perceived only a few months ago, and even acknowledged the possibility that the next move could be an ease if necessary.

> *"Looking forward however, we have to take into account the potential fallout from recent global economic and financial developments, which have been marked by bouts of turbulence since the turn of the year. For a time, equity prices were down sharply, oil traded at less than $30 per barrel, and many currencies were depreciating against the dollar. Although prices in these markets have since largely returned to where they stood at the start of the year, in other respects economic and financial conditions remain less favorable than they did back at the time of the December FOMC meeting. In particular, foreign economic growth now seems likely to be weaker this year than previously expected, and earnings expectations have declined.*
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> *By themselves, these developments would tend to restrain U.S. economic activity. But those effects have been at least partially offset by downward revisions to market expectations for the federal funds rate that in turn have put downward pressure on longer-term interest rates, including mortgage rates, thereby helping to support spending. For these reasons, I anticipate that the overall fallout for the U.S. economy from global market developments since the start of the year will most likely be limited, although this assessment is subject to considerable uncertainty."*

I must admit that my unease for the Fed merely reiterating its intention to keep the punch bowl spiked and asset prices reflexively racing higher is growing by the day (talk about a Pavlovian response with little to no diminishing marginal return – at this point anyway). Especially when I see headlines like "Yellen Rides to the Rescue of Markets" on the front page of the USA Today the day after her speech. Seriously, we are a full seven years into this economic expansion, the stock market has tripled, and more than 14.4 million jobs have been created since the credit crisis – yet we still need Chair Yellen to leave the training wheels on the bicycle? Nevertheless, that is a philosophical debate for another time and another place, as an investor you have to invest in the market that's before you, not the market you want.

With that in mind, the Fed funds futures market is basically pricing out any residual probability of a rate hike at the April meeting (down from 10%), a 26% probability of a hike at the June meeting (46% before Yellen's speech), and a 63% chance that we get only one rate hike this year. This is music to the ears of fixed income investors who now need only worry about assessing credit risk in their bond portfolios as interest rate risk (a.k.a. rising interest rates) has been pushed out indefinitely.

We've been a happy investor in long-term Treasuries coming into this year and withstanding some moderate bouts of volatility, I continue to have a lot of conviction in the favorable risk-adjusted return this investment

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offers. In addition to tame inflation expectations and the Fed moving to a holding pattern, when you look around the world for assets that would compete with U.S. Treasuries you can't help but lick your chops at what Uncle Sam has to offer. The yield on 10-year Japanese Government Bonds is -0.1%, German Bunds are 0.14%, 10-year French OATs yield 0.48%, and U.K. Gilts are a hefty (by comparison) 1.39%, but all of these pale in comparison to the juicy 1.77% yield on the 10-year T-note. Keep in mind this is a bit tongue in cheek as we're talking about a relative evaluation between the whole lot, but in the land of the blind the one-eyed man is king and this is the theme in a lower-for-longer interest rate world.

As for the equity market, I think it would be imprudent for investors to overlook the possibility (probability) that the Fed will not be as significant of a crutch for stocks going forward at current valuation levels. For all intents and purposes what the Fed did with its forward guidance over the last couple week was cut rates by moving from a tightening bias to taking two rate hikes off the table for the remainder of the year. In so doing they acknowledge that economic growth continues to remain constrained as has been ratified by the Atlanta Feds' GDPNow model forecasting GDP growth slowing to 0.7% in Q1 (estimates were as high as 2.7% at the start of the year).

In a nutshell, I believe stocks have rallied too far too fast off the February lows and I don't expect this Fed induced rally to have a lot of legs left. Since the conclusion of the FOMC meeting on March 17th the S&P 500 has risen from 2,020 to 2,070 which I believe will prove to have a short shelf life if we don't see a reacceleration in global growth in both the economy and corporate profits.

Already we are seeing divergent price action in market internals with the dollar weakening significantly (-1.8% last week and -4.1% year-to-date), yet oil prices cratered by almost -7% (WTI back below $37/bbl) last week which you wouldn't expect in a weak dollar environment. The Dow Transportation Index has started to rollover and this was one of the first indices to turn and lead the rally in stocks off the February lows. A couple other flies in the ointment is the lack of participation in other significant global equity markets:

- Japan's Nikkei is down -15% on the year and -25% off its July highs
- German DAX is down -9% on the year and more than -20% off its July highs
- Major European Bank stocks have moved back down near their year-to-date lows – Deutsche Bank trading back below $17/share (-27% ytd) and Credit Suisse is back near $14/share (-35% ytd)
- Oil price weakness is back on the front burner with the 'wishful thinking' production freeze all but dead – production data released last week showed Iran output at its highest level since sanctions were lifted, Russian oil production increased to 10.9 million bbl/day, and Saudi production is near all-time highs. This, all at a time when U.S. production has yet to fall below 9 million bbl/day, inventory levels hover near all-time highs, and the oil rig count still in decline.
- Renewed weakness in the oil market has halted further spread compression in the credit markets with credit spreads widening for two consecutive weeks and making higher lows in the process.

The bull case for stocks at this juncture rests on the auspice that the dollar bull market has been broken which arrests a major headwind on lackluster corporate earnings, global growth troughs in Q2, the commodity bear market that started in 2011 is over, and the momentum in wage growth leads to an uptick in consumption. Market bulls see this as a potential coiled spring that could ignite demand and filter through the entire globe.

The most significant variable supporting the bear case has to be lofty valuations – the broadest measure of corporate profits gleaned from the Q4 GDP report ($1.89 trillion) is actually lower today than it was in Q4 of 2011 when the S&P 500 was trading around 1,300. Back then investors were paying a 13x multiple on that

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earnings stream – mind you with the tailwind of an economic expansion that was only in the middle innings as opposed to an expansion that currently stands almost two years longer than the historical average – so in retrospect the upside back then looks crystal clear. Compare that setup to the current one and the potential upside is much cloudier.

On today's lower earnings base investors are paying up for stocks to the tune of an above average 19x multiple – one doesn't need an advanced degree in mathematics to derive that the upside in stocks from here is seriously capped, even despite Chair Yellen's deliberate attempts to obfuscate and smooth economic gravity (otherwise known as the business cycle). Ultimately, what we pay for as equity investors is profits, and while the overall economy is not in a recession, corporate profits are. Once again, looking at one of the broadest measurements for corporate profits from the national accounts data from the Bureau of Economic Analysis Q4 GDP report showed pre-tax earnings dropping at a -7.8% annual rate (the biggest decline since the first quarter of 2011). This followed a -1.6% decline in Q3 (down in five of the past six quarters) which dragged the annual trend down to -11.5% YoY – the lowest since the 'Great Recession'.

The NIPA profits data has been confirmed by what we've been seeing during earnings season the last two quarters and unfortunately this trend is not set to get any better with analyst's estimating that Q1 earnings will decline -9.0%. If one wanted to get deep into the weeds and assess valuation levels for the S&P 500 on a reported (GAAP accounting) earnings basis, investors are paying a lofty 23.5x multiple, a high for the cycle. The range in this valuation estimate has been as low as 13x in Q3 of 2011 (when it was time to buy) to as high as 21.7x in Q2 2015 (when it was time to sell). I'll let you decide what the latest 23.5x reading means to you.

Like the bull argument, market bears see this unfavorable fundamental backdrop as a coiled spring in the other direction where market prices have far outpaced underlying fundamentals and the reversion to the mean will come from prices falling to meet fundamentals rather than fundamentals improving to catch up to price levels.

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