May 31st, 2016

The faltering Fed's forward guidance cycle…

Global equity markets put in one of their best weeks of the year last week as the Dow Jones Industrial Average, S&P 500, and MSCI All Cap World Index (ex. U.S.) rallied +2.0%, while the higher beta Nasdaq Composite and Russell 2000 each surged by almost +3.5%. Sentiment in Europe was boosted last week when the latest poll results out of the U.K. showed an increasing probability that Britain will remain in the Eurozone following the "Brexit" vote coming up on June 23rd – the German DAX ripped higher by almost +3.75% while France's CAC 40 index ramped by almost +3.7%. However, investors may be well heeled to not bet the farm as it relates to relying on poll results as an accurate predictor of the future, and all one needs to do is look at what the polls were saying about Donald Trump's chances of garnering the Republican nomination throughout the Presidential primaries.

As for the rally in U.S. stocks to close out the month of May, don't overlook the fact that last week's action occurred in front of a holiday weekend and included the 2nd, 3rd, and 4th lowest volume tallies of the year – call it what you will, 'a sellers strike' or portfolio managers 'window dressing' their books into month end, but it's hard to take anything away from last week's upward movement in stocks as it lacked anything resembling investors taking action with conviction. Nevertheless this market has continued to torment the bears and proven itself to be truly resilient as it nudges back up near all-time highs, even if it's been a full year since the S&P 500 has made a new high (this is the longest non-recessionary dry spell since 1985).

Furthermore the market has digested, quite well, the increasing odds that the Federal Reserve hikes the Fed Funds rate at either the June or July meeting. Recall the parade of Fed officials that have hit the speaking circuit over the last couple of weeks (Lockhart, Rosengren, Kaplan, Dudley, Fischer, Bullard, Harker, and Williams) all jawboning markets to not underestimate the Fed's willingness to hike rates if the economic data comes in according to their expectations. I have been of the opinion (and remain of the opinion) that the Fed's forecast represents one of the biggest risks to investors as their track record in forecasting the economy has been nothing short of terrible. It is for this reason (among others) that I believe a rate hike this summer would be reckless and unnecessary as it would sow the seeds to reignite the global systemic risks that arose following the mid-December rate hike.

Yes, a lot of wounds have been treated since then, but very few have healed and I fear that an elevated level of complacency has found its way into capital markets at a very inauspicious time. Nevertheless, on Friday Chair Yellen echoed the message conveyed by her colleagues as she participated in a panel discussion at the Radcliffe Institute for Advanced Study at Harvard University where she responded to a question on the near-term outlook for rate hikes, saying "*It's appropriate…for the Fed to gradually and cautiously increase our overnight interest rate over time, and probably in the coming months such a move would be appropriate,*".

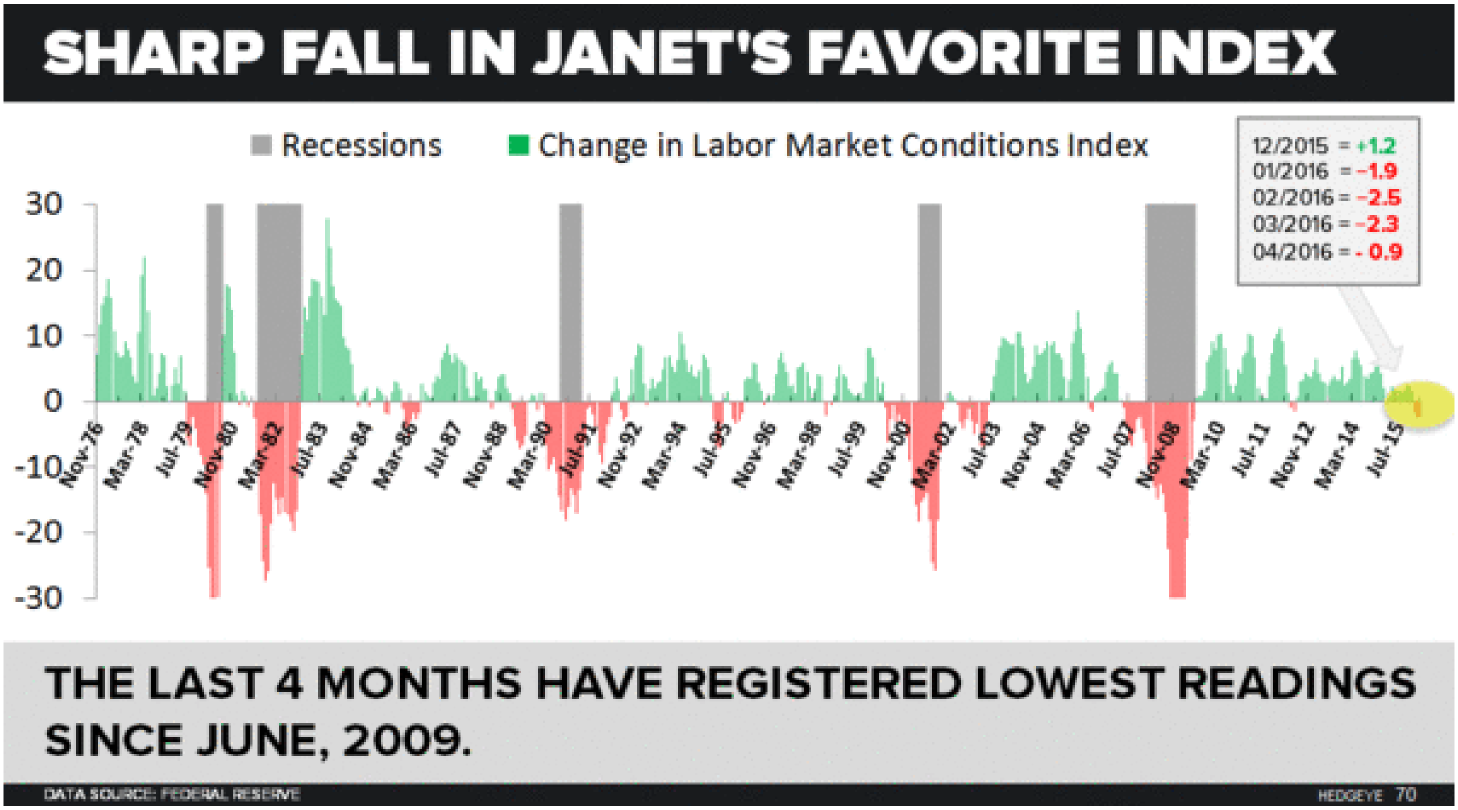
Call me crazy, but I just don't see the strength in the underlying fundamentals that justify the Fed moving forward with its quest to normalize interest rate policy. Don't get me wrong, I think rates have been artificially held down for far too long, but to continue to try and normalize rates into an environment where economic growth is slowing, corporate profits are in recession, and inflationary pressures are muted just doesn't make sense. Moreover it is entirely inconsistent with the trend in the data during prior tightening cycles. While I don't think the U.S. economy is on the brink of collapse, it is difficult to interpret any other way than to say things are unambiguously weakening.

Even if one assumes we get a statistical rebound in GDP growth to 2.5 – 3.0% in the second quarter, underlying growth is still running south of a 1.5% annual rate. The trend in quarterly GDP growth has gone from 3.9% in Q2 2015, to 2.0% in Q3, 1.4% in Q4, and now stumbled to 0.8% in Q1 2016. The output gap is close to 2% which indicates that there remains plenty of slack in the system and validates why capacity utilization rates are well below the 80% level (a level that has historically been emblematic of an economy operating efficiently).

Economists have been tripping over each other as of late in a race to sharpen their pencil so they can raise their Q2 GDP estimate, but the better question is whether there will be any follow through beyond the second quarter as this recovery has been replete with false dawns. And while the economic data that has come in better than expectations over the last month has been grabbing the headlines, more than 50% of the incoming economic reports have disappointed. For example, the latest decline in the Markit's Services PMI to 51.2 in May was the weakest reading in three months and well below the long-run survey average of 55.6. The internals of the report were even worse than the headline with the employment category slowing to its softest level since December 2014, backlogs of work fell at its fastest pace in two years, and incoming new work recorded one of its lowest readings since 2009.

This took the composite PMI down to just 50.8 (down from 52.4 in April) which Markit claims is consistent with less than +1% real GDP growth. So far in the second quarter, the PMI has averaged 51.6 which sits only marginally above the mean of 51.5 recorded in Q1 as the service sector has fallen to its worst level since 2009 – this is coming at a time when the manufacturing side of the economy is already in its steepest downturn since the 'Great Recession'.

As for the labor market (a notoriously late cycle economic indicator), it is starting to give some ground and this is coming at a time when underlying strength is more fragile than it appears on the surface. For instance, an employment to population ratio at 59.7 is consistent with an unemployment rate closer to 7.5% versus the reported 5.0%. Friday's jobs report for May will be closely watched to see if the downshift to a below trend 160k jobs created in April was just a blip or a precursor of a slowing labor market. Wage growth, while showing some signs of improvement, is still running between a half point and one-and-a-half points below the trend that Janet Yellen has said herself is consistent with sustainable 2% inflation. Another cloudy labor market indicator (and one of Chair Yellen's favorites) is the "Change in Labor Markets Conditions Index". This index collective tracks 19 labor market metrics and the trend in this data series is not going in the right direction. It rolled over in January and has been contracting for four straight months to its lowest reading since June 2009.



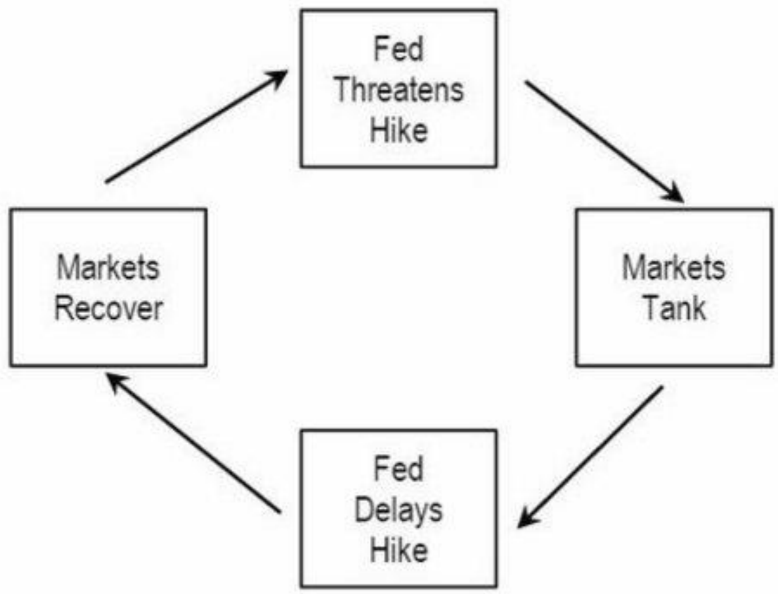
One of the best leading indicators in the employment market is the trend in temporary jobs being created month to month, where an economic downturn historically has followed a peak in temp hiring. The data on this front so far in 2016 has not been good with hiring by staffing agencies having ground to a halt. At the end of 2015 more than 1 in 50 U.S. workers were employed as temps, eclipsing a record set in early 2000. Similar to today, the unemployment rate back then was near its cycle low and payrolls were expanding when temp hiring peaked, but by the spring of 2001 the U.S. economy was in a recession. Since December the temp sector has shed 27.4k jobs, which is a distinct reversal from the preceding five years when the temporary-help category grew five times as fast as overall employment.

These are just some of the many market variables that make up a mosaic that has driven the Treasury yield curve (10's – 2's spread) to its flattest level since just before the last recession in 2007. At a mere 94 basis point spread it would not take much more than three rate hikes from here to flatten the curve (or maybe even invert it depending on what happened at the back end) and recreate the conditions that caused a relapse following the 'Great Depression' back in 1937 / 38.

Beyond the theoretical drivers of long-term interest rates (growth and inflation) what is going on with interest rates in the rest of the world is likely acting as an anchor on long-term Treasury yields. At the 10-year part of the curve in Japan's government bonds, investors are willing to accept a negative yield of -12 basis points (yes, you pay them…) and 10-year German Bunds give investors a grand total of +13 basis points. Only in this reality would 1.84% on a 10-year U.S. Treasury look so juicy.

It's interesting to review the chronology of the Fed's forward guidance over the last nine months as it appears the table is set once again for another hike. It was only last summer when they first began prepping markets to expect a rate hike in September, to then have to pull back that expectation as the S&P 500 corrected more than -12% into late August – citing global economic uncertainty as the scapegoat for not hiking. Equity markets calmed down and subsequently rallied over 10% into early November. Then the Fed, once again, hit the speaking circuit to prep markets for a hike in December. This time the Fed went ahead with a rate hike (the first one in nine years) while communicating to markets that they should expect four additional hikes in 2016. This set off the worst start to a year in history for U.S. equities as the S&P 500 dropped over -11%. Then in March, with global equity markets still unsettled, the Fed backed off its rhetoric and lowered its rate hike expectations from four to two. As was the case in the fall of 2015, equity markets stabilized and went on to stage a significant rally which helped prop up asset prices around the world.

Rinse, wash, repeat.

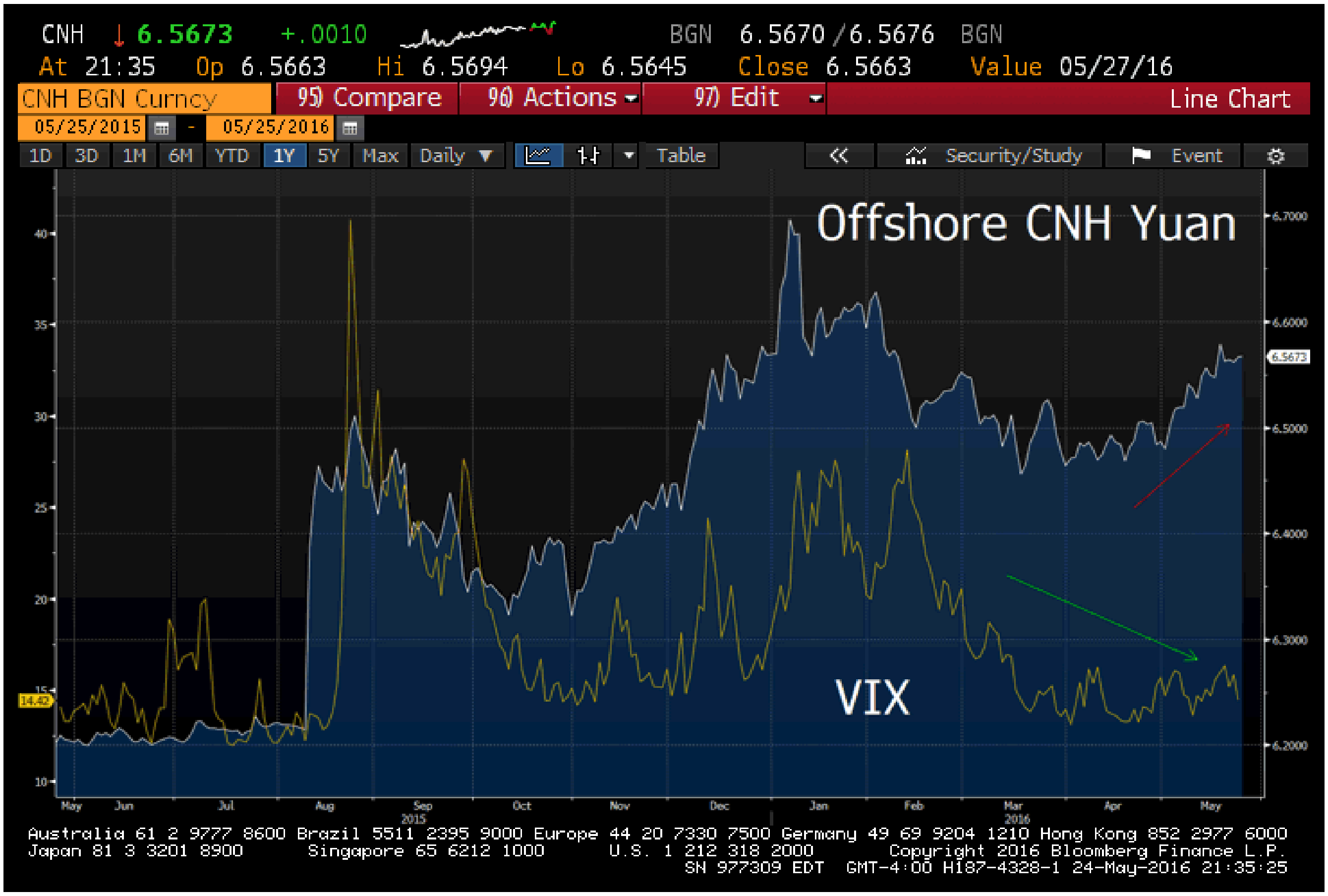


Source: BofA Merrill Lynch Global Research

So here we are once again with a Fed that appears to have an itchy trigger finger while the rest of the world is easing policy. The expectation of an interest rate hike has caused a subtle repricing in the currency markets with the U.S. dollar rising in four of the last five weeks – a condition that has become problematic for China and Emerging Markets and risks setting off the turbulence that rocked global capital markets on two separate occasions over the last year.

Recent action by the People's Bank of China indicates that they are not willing to sit idly by in anticipation of another up leg in the U.S. dollar as they have been taking preemptive steps over the last several weeks by weakening the yuan to its lowest level since February 2011. The onshore yuan has weakened -6% against the dollar since August, when a shift to a market-determined exchange rate and a devaluation prompted months of volatility in the yuan and worries of capital flight from mainland China.

The Wall Street Journal has reported that since January the PBOC has quietly retreated from the more market-orientated exchange rate and resumed adjusting the yuan's daily value higher or lower based on whatever suits Beijing best. Investors should take note of what happened to volatility since August of last year (recall it was in August when China implemented a 3.5% devaluation overnight) when the Chinese embarked on a course to devalue their currency – hint: these periods of rising VIX have not been kind to stocks.



It's no secret that China has been struggling with its attempt to walk a fine line between rebalancing its economy to a more service and consumption based foundation while at the same time managing the downside impacts to economic growth. That being said, they still remain highly reliant on exports to keep growth propped up during this transition. This is why a strong U.S. dollar is severely detrimental to the Chinese, whose currency is pegged to the dollar. It took nearly $1 trillion in stimulus (debt) from Chinese officials in the first quarter of this year to prop up the accelerating weakness that was gripping their economy.

Debt remains the one tool the Chinese continue to reach for in their tool box which has quadrupled since 2007 (from $7 trillion to $28 trillion by mid-2014 data according to McKinsey). This has been the most explosive creation of new debt over such a condensed time period that the world has ever seen, and while manageable at 282% of GDP it is larger than that of the U.S. or Germany. It poses a sizable systemic risk to global financial markets if it were to unravel in an uncontained fashion. For now this debt binge appears to be contained, but most of the respected analysts I follow who cover the region estimate that defaults and the rise in non-performing loans (NPL's) are much larger than the Chinese publish. This is an issue that investors should continue to monitor when shaping their view of the global economy.

This being the first week of a new month will bring with it a litany of economic data, providing investors with the latest check-up on the health of the U.S. economy. With that, equity markets have been bid back up to near all-time highs, the latest investor sentiment readings aren't overly bullish nor are they bearish, and valuation continues to track on the rich side of fair value near cycle highs. One data point that most glaringly stands out at the current time as a negative contrarian signal is the latest investor positioning readings from the 'Commitment of Traders' report, showing bets on the S&P 500 have reached their most bullish level since the market peak a year ago.

This bullish positioning is coming after a 16% surge in the S&P 500 from its February 11th lows (at the lows net speculative short positions on the S&P 500 eclipsed 200k contracts, compared to long exposure of 95k contracts currently) and after an earnings season that saw corporate profits decline for their third consecutive quarter. The earnings outlook doesn't look all that rosy either with analysts' forecasting earnings will decline -3.5% in Q2, grow +2.6% in Q3, and increase a pretty optimistic +9.8% in Q4. Perhaps these analysts have a direct line of communication with Santa because I have a hard time squaring how earnings can grow nearly 10% in Q4 when sales are projected to grow by roughly 4.5%, corporate profits are almost a full point above their cycle peak, and the business cycle is decelerating.

To me the set-up facing investors today remains challenging and especially up here back near all-time highs where it is becoming evident that some serious resistance is setting in – tread cautiously.

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