May 9th, 2016

A returnless risk environment…

It was a rather quiet and muted week in the capital markets last week with the price action taking a backseat to a full slate of economic reports (more on these later). The overall tone took on a defensive posture with the Dow Jones Industrial Average (-0.18%) registering the smallest decline of the major indices, the S&P 500 declined 8 points or -0.40%, Nasdaq Composite dropped 39 points or -0.82%, and the small cap Russell 2000 was the week's biggest loser at -1.42%. The bond market was the beneficiary of what was a disappointing slate of economic results as the yield on the 10-year T-note fell 5 basis points to 1.78% (a mere 15 basis points from the low close on the year) and the 10's – 2's Treasury yield spread moderated back to 104 basis points as it nears closer to its tightest level on the year.

What was most interesting to observe last week was the reversal in the dollar as it has now risen for four consecutive days – at its lows last Monday the DXY index traded down to 92.53 (its lowest level in the last 12 months). For sure, the U.S. dollar remains below all of its major trend-lines, but recent talk out of some prominent officials in Japan and Europe highlight their displeasure with the recent strength in the Yen (after falling below ¥106.5, but moved back above ¥108.5 this morning) and the Euro (trading up to as high as €1.15 last week, but since moderating to below €1.14 to the dollar this morning).

Keep in mind that currency values are a relative price to transact commerce across borders where movements in one direction or the other benefit one party to the detriment of the other (this is a zero sum game). In a world of very subdued global growth, it is my opinion that Europe and Japan can only sit idly by for so long as they watch their global competitiveness wither away following the shift in March by the Fed to a more dovish posture. Now, one will never know for sure, but interpreting the market tea leaves it looks pretty clear that one of the Fed's objectives in moving to a more dovish posture was to stop the ascent of the dollar, thereby putting a floor under commodity prices, easing the pressure on the Chinese economy, and placing a tourniquet on a hemorrhaging credit problem in emerging markets.

The only question now is does this force the ECB and BOJ to up the ante and take this global currency war to the next level – awe, you gotta love this job! The dollar is now trading at a critical level with many investors holding the view that the dollar is what has been driving the price action in the main capital market indices. Therefore, if you get the dollar right you can position yourself appropriately to take advantage of what will be the next big global macro move. A break below the 93.0 level likely ignites a renewed 'risk on' mentality and sets up a catalyst for the next leg higher in the equity market rally that started in mid-February. If the dollar has put in a floor and starts to build on the bull market that started in mid-2015 then the 'risk off' trade (with all of its tentacles – commodities, stocks, high yield debt…) will have a major catalyst for a continuation of what things looked like during the first six weeks of the year.

Touching on the oil market before moving onto the economic data, WTI perked above $45/bbl last week but seems to be having a difficult time holding above what is the high end of this $35 - $45/bbl range. The spike above $45/bbl was in part driven by the horrific wildfires in Canada which threatens to disrupt roughly 1 million/bbl per day of supply. Another source of uncertainty stems from news over the weekend that Saudi King Salman issued a whole raft of Royal decrees implementing huge changes in the make-up of the country's most important officials. The most high-profile and newsworthy of the changes was the ousting of Ali al-Naimi, the oil minister who served for 20 years in his position. Al-Naimi was replaced by Khalid al-Fatih, the chairman of the soon to be floated state-owned oil firm Aramco.

It's rumored that he is a much stronger proponent of recapturing market share from the U.S. shale industry than bolstering prices via any output freeze (especially one that doesn't involve Iran). This implies that little is expected to change coming out of the upcoming OPEC meeting in early June.

On the economic data front, the BLS nonfarm payroll report came in light with the U.S. economy adding 160k jobs in April, the weakest gain since September 2015 and well below the 205k consensus expectation. Both March and February's job gains were revised downward, resulting in 19k fewer jobs added than had been previously reported while the diffusion index slipped to 56.3 from 58.6 in March (this number was near 60 at the start of the year) – indicating that not only has the rate of job growth slowed, but so has the breadth of job gains. The unemployment rate held steady at 5%, but the share of Americans participating in the labor force dipped after earlier signs of stabilization over the last six months.

Keep in mind the BLS uses two surveys to report the monthly job data: the Establishment Survey, which provides the monthly job growth tally and is polled from 146,000 business and government agencies representing approximately 623,000 individual worksites, and the Household Survey which is used to provide the monthly level of unemployment as it surveys from a sample of 60,000 eligible households.

On an absolute basis the 160k in new jobs is a decent print considering economists' estimates that only 80k – 100k in monthly job growth is needed to soak up entrants into the labor force, but it is the rate of change (better or worse, not good or bad) that matters most to markets and on this front a discernible decelerating trend is no longer in question. Employment gains have now averaged 192k a month so far this year, down from 2015's monthly average of 229k. The Household survey showed an even more dire picture on the job creation front with a loss of -316k jobs in April (the worst result since October 2013) with 253k of these job losses representing full-time positions. This shouldn't inspire a lot of confidence among the optimists out there as the employment market has been the one part of the economy these individuals have been able to hang their hat on.

The silver lining in the report was the 0.3% advance in average hourly earnings for April which sent the year-over-year change to 2.5% and the average workweek rose by 0.3% to 34.5. If one combines the gain in hours and bodies, the aggregate hours worked index rose 0.4% last month and is running at a 2.0% annual rate for Q2.

Look, April marked the 74th straight month of uninterrupted job growth (tallying more than 14.5 million new jobs) which on the surface is impressive and should be applauded, but as an investor the deeper implications of what the trend in employment and wages will have on corporate profits and the stock market are concerning. Last week we learned that productivity is running at a sub 1% rate over the last four quarters (this is anemic when compared to a 1.9% run rate over the last 35 years or the 2.1% trend rate up until the start of the '08 credit crisis) and estimates for Q2 real GDP growth are tracking close to 1% (this follows growth of 1.4% in Q4 and 0.5% in Q1).

So with growth slowing, wages moderately increasing, and productivity (a gauge of the amount of labor it takes to produce a widget) on track to decline for its third consecutive quarter, corporate America is hiring more workers? To do what – sit in an office and twiddle their thumbs? This just doesn't make sense at a time when earnings for S&P 500 companies have declined for three consecutive quarters. Keep in mind that the compensation of the managers running these organizations is highly dependent on both earnings and the performance of their stock. Neither of these measurement gauges are improved with declining top and bottom line growth and an increasing cost structure (can you say 'margin compression'?) – trends I am confident corporate managers are more than acutely aware of and hastily in the process of remedying – as former Fed official Herb Stein said, "If something cannot go on forever, it will stop".

As much as I would like to refrain from sounding like a broken record (because as loyal readers of this commentary know I have been less than constructive on the equity market for more than a year now), but the fundamental underpinnings of both the economy and equity market continue to deteriorate at the margin. With equity markets at about the same level they were a year ago, I can't say that this has been the right position to take, nor could I say that it's been wrong. Nevertheless, I do remain firmly of the view that caution and defensive positioning is the prudent approach at the current time as the balance of risk continues to elevate with weakening fundamentals.

The economic data both in the U.S. and across the globe hasn't fallen off a cliff (with the exception of Brazil and some other commodity dependent nations), but it continues to be a clearly discernable decelerating trend: China data bounced at the end of Q1 but it is looking more and more like this was the result of officials pouring one trillion in debt funded stimulus into the system, Japan has rolled over in a material way, Europe continues to muddle along with fits and starts, same goes for the U.S. with both regions respectively dangerously close to stagnant growth rates. These are the four biggest economies in the world that are all decelerating at the same time, and emerging markets do not have the gumption that they've had in the past to offset this weakness given that many of these economies are plagued by their own structural and cyclical dynamics. This deceleration in global growth is getting to the point where an investor has to take note and acknowledge the potential risk they are bearing when deploying capital today.

Equity valuations remain a significant constraint to further market upside with the S&P 500 trading at a P/E multiple of almost 18x this year's expected earnings, and this is almost three points above the historical average. I pulled the following table from a piece put out by Stephen Blumenthal at CMG Capital Management Group where it delineates how stocks performed over the next decade from various starting P/E levels. In this analysis they use the median P/E for the broad equity market, where you can see that in the past when stocks were at similar valuation levels as they are today, forward 10 year annualized returns have been muted.

Chart 4 shows a selection of periods.

Starting Median P/E Ratio & 10-Year Returns

Starting Date	Starting Median P/E	10 Yr Annualized Return
12/31/1989	13.9	15.28%
12/31/2000	20.6	-0.48%
12/31/2001	23.5	0.92%
12/31/2002	18.8	4.94%
02/28/2003	16.9	6.06%
12/31/2003	21.2	2.17%
12/31/2004	20.3	5.54%
12/31/2005	19.0	5.24%
12/31/2008	12.5	13.21%*
02/28/2009	11.0	16.69%*
12/31/2015	22.0	???

* Less than 10 years (through December 2015)
Source: CMG Investment Research, Ned Davis Research, Worldscope

As of the end of April the median P/E on the equity market stood at 22.7 which is the highest level (outside of the exuberant Tech Bubble mania period) since 1964.

Beyond the suspect fundamental underpinnings and expensive valuation levels, we have an upcoming election where the two presumptive nominees (Clinton and Trump) have some of the highest unfavorable ratings in the history of a Presidential election. The national polls show Clinton with a decisive edge in beating out Trump in the general election (mind you, these are the same polls that indicated Trump had no shot of getting to this point), but more often than not I hear it's "the devil you know, rather than the devil you don't" as the main argument in support of Clinton prevailing over Trump. Not exactly the ringing endorsement that you want for the leader of the largest and most powerful economy in the world.

Irrespective of what side of the ledger an investor's politics falls, the point I'm trying to make is that the political backdrop isn't exactly one that augurs for sustained above average valuation levels in the stock market.

None of what I penned above suggests that the global economy is about to crater, nor do I believe it is set to take off. My view is that the balance of risk is to the downside, whereby investors should modify their mindset away from expectations for a return of rapid growth rates and understand that the economy is set to grow very slowly for many years. Furthermore, the investment backdrop will be akin to walking on a tight rope where concerns about a recession and deflation will be juxtaposed against an embedded optimism that the forward outlook will always be better than the present and the belief that central bankers still have the ability to stabilize any hiccup along the way. To me all this points to a rather toxic cocktail that renders the current investment environment as one of "returnless risk" which is quite the oxymoron for a system that is predicated on rewarding risk taking. More than ever, investing will need to focus on risk management, as the potential downside would be much more painful than the upside reward from where we are today.

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