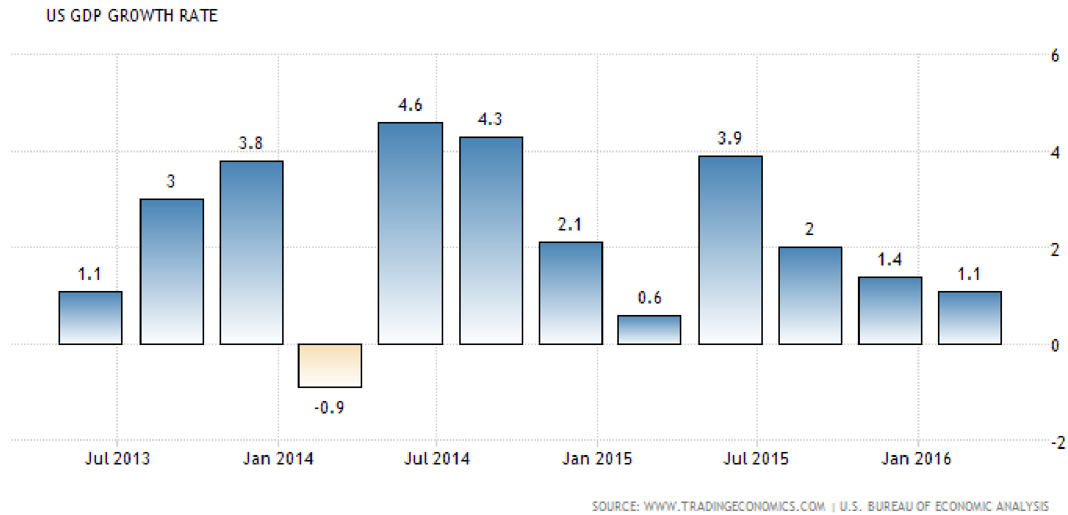
July 18th, 2016

The Bull / Bear Debate…
The global equity market rally continues unabated with the Dow Jones Industrial average setting a new all-time high at the close of each trading day last week (the S&P 500 made it 4 out of 5 with Friday being the sole exception). It's rather remarkable how stocks have shrugged off global events over the last three weeks, whether it be the pro-Brexit vote, continued traumatic terrorist actions around the world, and 'marital law' being declared during an attempted military coup in Turkey. No matter the event, the initial reaction in equity markets was a momentary flinch followed by a spree of investors rushing to buy risk assets on the belief that central banks will be called into action by flooding the system with liquidity and thereby putting a floor under asset prices.

Since the June 27th post-Brexit bottom, the global equity market has tacked on more than $4 trillion in paper wealth – so much for all the calls by prominent officials (Lagarde, Cameron, and Obama to name a few) that the U.K. leaving the EU would be the death knell to a fragile global economy. It's rather entertaining to follow this bouncing ball, with the FT running an article last week titled "U.S. Holds Talks with U.K. on Trade Deal Options After Brexit", my guess is that the powers that be wised up to the fact that 25% of U.S. exports to the EU are accounted for by the U.K., which supersedes Mr. Obama's prior claim that Britain would have "to go to the back of queue" in any trade deal with the U.S. Nevertheless, there still remains a lot of chapters to be written in this book as the newly appointed U.K. Prime Minister Theresa May fills out her cabinet posts, hope is surfacing that a Norwegian style agreement with the EU can be inked (good luck on this front). We are hearing though that Article 50 will not be invoked until early 2017 with estimates that the UK will not exit the EU until 2019.

Back to the capital markets, the strength and breadth of this rally has many investors pondering whether equities (having broken out of what had a been a nearly eighteen month trading range between 1,850 and 2,100) are setting sail on a secular bull run, a la the 80's – 90's, or is this the last euphoric gasp that typifies the archives of previous bull market tops? There is a case to be made for both points of view, and this debate is what makes a market and why investing is far from an easy endeavor. So let's dig into it:

- **The Economy…**
  The bullish view is that the economy is in the initial stage of breaking out to the upside of this sluggish growth quagmire that's befit it over the last six quarters (as this slowdown is clearly discernable in the below table) following what at the current time looks to be a peak in the summer of 2014.



Over the last three months much of the U.S. economic data has surprised to the upside, whether it be the ISM manufacturing and Non-manufacturing indices, retail sales, industrial production, consumer confidence, jobless claims, and inflation. According to the latest Atlanta Fed GDPNow estimate, second quarter GDP is expected to increase to 2.4% from the stagnant 1.1% print in Q1. As a result of this turn in the data over what has been a several month period, economists have been taking up their growth forecasts for the second half of the year, believing not only that this momentum will persist, but the comps in the second half will be much easier given the U.S. dollar has flat-lined and oil prices have stabilized.

The bear camp sees this recent bounce in the data as just that, a bounce, in what is a decelerating and soon to be contracting U.S. economy. The broad based improvement in the economic data has lifted the Citi Economic Surprise Index to its best level since early 2015, which to a skeptic shows just how bad the economist's community has been at forecasting the data as of late. Furthermore, the last time the Citi Surprise Index was at this level real GDP growth came in at an annual rate of 0.6%, and even if the Atlanta Fed is accurate with Q2 GDP coming in at 2.4%, this implies that first half 2016 growth is tracking at a sub 2.0% annual rate. Hardly a level worthy of uncorking a champagne bottle.

Once again, I go back to that June employment report which the media hailed as a blowout print of 287k jobs and rendered 11k print in May as the black sheep in the data series. I beg to differ as not only has the trend in payroll definitively slowed – the trend in monthly average job growth has gone for 282k in Q4, to 195k in Q1, to 147k in Q2 – but other jobs data has been comporting this slowing trend. The 19-variable holistic Change in Labor Markets Conditions index has been negative now for the last six months running (declining for seven straight months) which is a trend we have not seen since coming out of the depths of the Global Financial Crisis (GFC) in 2009 and before that the 2002 double dip scare.

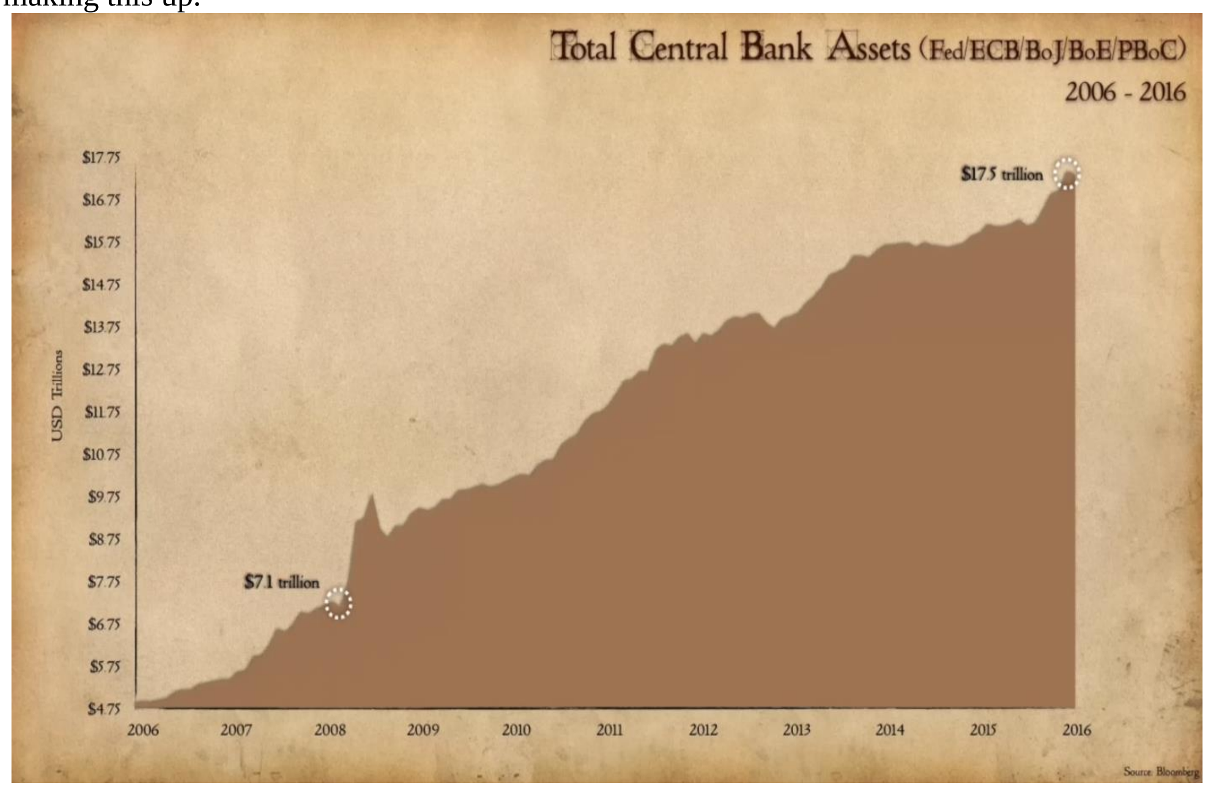
Then there is the Job Openings & Labor Turnover Survey (JOLTS) which was released last week for the month of May and showed that job openings plunged -345k in what is the second steepest decline since September 2008 (history shows that was a pretty challenging month) and the 5.5 million openings are now at their lowest level for the year. In addition to a decline in openings, new hires are rolling over, dropping -49k in May and by -474k over the past three months (the most pronounced plunge since the depths of the GFC in March 2009).

Beyond the employment footprint, but very tightly linked is the -11.3% year-over-year decline in personal income taxes. This is not just a one-off as gross domestic income is up just a smidge over 3.0% YoY which is a level that in the past coincided with recessions. What about corporate taxes? Well they're only down -16% from year ago levels and have declined for the last six months.

If all is well and good in the economy it begs the question of why UBS is pegging the odds of a U.S. recession over the next 12 months at 34%, JP Morgan is at 37%, and Morgan Stanley just increased its odds to 40% – these all represent the highest readings since the current expansion began. While none of these are base case scenarios, they are elevated readings and one must consider what these research teams are seeing to assign such an elevated probability?

As you can imagine, this debate on how one chooses to perceive the economic data over the last six months and what it is portraying about the future can go on and on. Without question there is plenty of ammunition for both sides to hang their hats on and make their case. Moreover, I can both appreciate and understand the temptation to accept the bullish and constructive economic outlook – a case that is much easier to believe and buy into with a stock market at all-time highs – but this outlook carries with it a whole lot of downside growth risk and at the same time complacency that nothing can or will go wrong.

- **Central Banks…**
  No discussion about capital markets can be had today without including the extent to which global central banks have reached to keep this cycle plowing ahead. Investors who have embraced this reality and bought into the notion that the central banks will stop at nothing to keep the wealth effect intact have been clear winners. The below chart puts into context just how much capital global central banks have been willing to put up to keep this game going – this chart entails the balance sheets of the Fed, ECB, BoJ, BoE, and PBoC. In addition to the balance sheets of the five most prominent central banks expanding by almost 2 ½ fold we have seen over 650 interest rate cuts since September 2008 (that is equivalent to one interest rate cut almost every three trading days). No, I am not making this up.



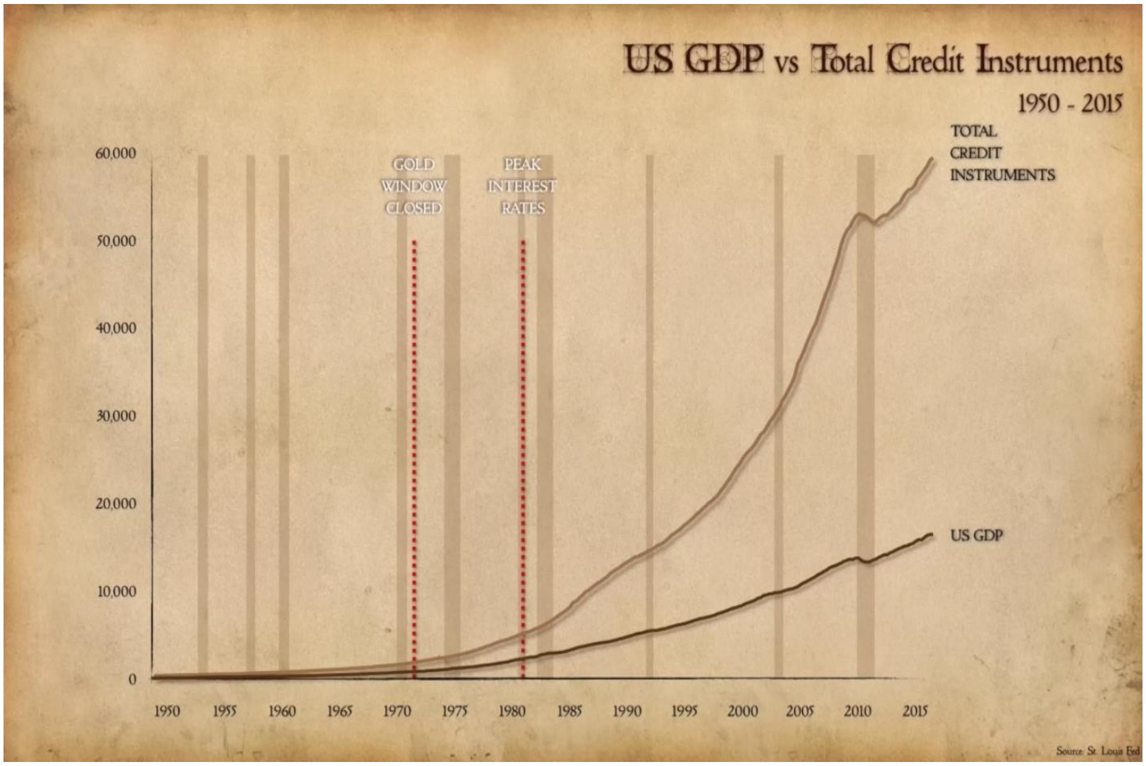
The bull case is that this game can continue on until global growth rates reach a level that are believed to be sustainable without the assistance of a high level of liquidity and ultra-low interest rates.

It’s interesting to ponder the philosophical dynamics through a game theory ‘prisoner’s dilemma’ paradigm of the position central banks find themselves in. When the markets weaken you hear one of two narratives being construed (the bear and bull argument): 1.) central banks are out of ammunition and there is nothing they can do, or 2.) central banks stand ready to step in and provide more stimulus to support markets and the economy. The most recent example of these antics came last as rumors swirled that the Bank of Japan is gearing up to unleash “Helicopter Money” following a visit by former Fed Chair Ben Bernanke to consult with them on how to arrest the Japanese economy from persistent deflationary forces.

A quick sidebar on Japan – what can be expected of fiscal stimulus for an economy that already carries a government debt to GDP ratio of 240%, an economy where the central bank already owns more than 30% of the country’s entire government bond market and is a top 10 shareholder in more than 90% of the companies in the country’s main equity index – I’m not sure, but perhaps soon we’ll find out.

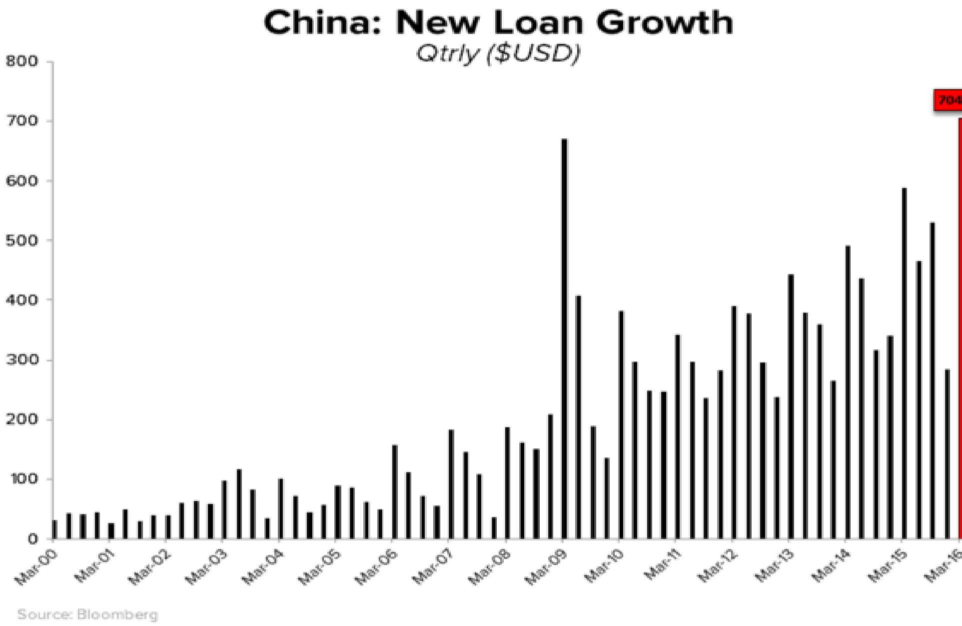
The bear side of this debate is that the belief system in central bankers being able to bend and smooth economic gravity starts to break down. Many believe (including myself) that this process is currently underway. One example of this is when the head of the Bank of Japan (Haruhiko Kuroda) came out in mid-January claiming he would not implement negative interest rates because he believed they did not work. Within ten days of this proclamation Kuroda shocked the markets when he adopted negative interest rates on January 29th.

Another problematic consequence of ultra-accommodative monetary policy is the degree to which debt of all kinds has been added on to the economy. The following chart depicts the level of total credit instruments outstanding relative to U.S. GDP – the little blip you see in the 2008 recession was the GFC, which looks like a mere speedbump on a road to unfathomable debt levels.



As with everything, how one chooses to slice and dice this information is entirely their prerogative as households and financial institutions (European banks perhaps being a slight exception) are no longer the problem children of this debt family. Yes, overall debt levels in these categories have increased since the '08 credit crisis, but at a much more subdued pace than the 5.9% CAGR for non-financial corporations globally and 9.3% CAGR for governments around the world.

While Japan is the poster child for how debt can overwhelm economic growth on a long-term basis (look at its economic track record since its peak in the late 80's), China is showcasing how on a short-term basis debt can be used as a tool to prop up growth. China's second quarter GDP report was released last week and showed its economy expanded by 6.7% (a slight beat to consensus estimates of 6.6%) and on the whole the report was decent – their service sector continues to expand and fixed asset investment continues to slow (this is the objective). However, this expansion is being driven by a massive amount of government led credit growth, to the tune of nearly $1 trillion dollars over a 4 week period in February and March (folks this is close to 10% of total Chinese GDP unleashed in a four week window – WOW!). The below chart gives you a graphical depiction and shows that the monthly tally for March is on par with what was unleashed to ignite the Chinese economy coming out of the GFC in early 2009.



You see, the problem the global economy is starting to push up against is the fact that the world is swimming in entirely too much debt which is one of the unintended consequences of artificially holding the price of money (interest rates) at too low of a level to compensate for an acceptable level of risk. This has sent investors on a constant search for yield when the asset class that historically has provided these characteristics for investors (government bonds) is befit by nearly 80% of outstanding issues carrying a microscopic yield of 1% or less.

- **Asset prices and fundamentals…**
  On this topic I'm going to tackle the bull / bear debate in tandem as I ramble along. The media and bulls are all over the fact that the Dow Jones Industrial Average and S&P 500 are making new all-time highs by the day. The flip side of this coin is that these major averages have barely risen now for the past 14 months and the current highs are not being confirmed by other markets as the Dow Jones Transportation Average remains -13.1% below its high, the Russell 2000 is -7.1% below its high, and the Nasdaq is -3.4% below its all-time high.

  What is also a bit confusing is the dichotomy between bond yields and stock valuations. Two weeks ago U.S. Treasury yields on the intermediate and long-end of the curve were hitting all-time lows with the yield curve (10s – 2s) collapsing to a cycle low of 75 bps. This would have been a risk-off price signal in prior economic expansions, but in a world with negative interest rates in Europe and Japan, the forecasting crystal ball that once was the bond market is more than a bit cloudy.

  Valuations in the equity market are pushing up against extreme levels with the S&P 500 trading at a 21 P/E on trailing earnings, 18.5x expected forward twelve month earnings, and on a broader look at the equity market it is now trading at its most expensive median P/E level in history. The bullish cohort chasing stock prices higher at these levels see nothing but clear skies ahead with the expectation that EPS growth troughed in Q1 2016 and Q2 will be down but a sequential increase relative to the first quarter. Then once we get to Q3 and Q4, positive EPS growth will commence on the back of a resurgent economic growth environment, favorable year over year comps to a strong U.S. dollar and low oil prices, and companies will reclaim all-time high profit margins.

> One major fly in the ointment for the bullish narrative that the future looks so much brighter than the five consecutive quarters of year over year earnings declines – where operating EPS has declined -20% from the peak in the second half of 2014 – is the fact that the S&P 500 has rallied nearly 10% over this interval. What's more, is that GAAP earnings (Generally Accepted Accounting Principles) are back to where they were in 2012 when the S&P 500 was trading at 1,400.
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> All deference aside, but it's very challenging to paint the current corporate earnings reality with an overly constructive brush with the per share earnings data being heavily skewed by rampant corporate stock buybacks, as the first quarter attests, being the second largest quarter of buybacks ever! This has taken the total outstanding share count for the S&P 500 down over the past year.

This debate is far from resolved and is sure to rage on over the second half of the year where one of these positions will have a strong hold on claiming victory in this war. At the moment the bulls hold the upper hand helped in large part by a stock market that has rallied 8% in just the past 10 trading days (+19% from the 2016 lows).

Those getting giddy at current levels and rushing in to chase these new all-time highs may want to execute a little restraint and discipline, at least in the short term, and allow this market to digest and settle. Whether it will is up for debate, but since the dust settled on the Brexit file we've gone from fear/panic to greed/complacency in a rather quick fashion. For context the S&P 500 has traded two standard deviations above its 50-day moving average for six straight days (this has only occurred four times since 2000 – just to point out how rare of an event this is) which has driven more than 80% of its constituents into overbought territory.

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