
**September 19th, 2016**

**The case for a hike – then versus now…**
U.S. equity markets traded modestly to the upside last week with the Dow gaining 38 points (0.21%), the S&P 500 adding 11 points (0.53%), and the Nasdaq checking in as the biggest weekly gainer (largely on the back of Apple jumping by more than 10%...) surging 118 points (2.31%). The rather muted weekly tally in the major averages would leave the casual market observer with the impression that the tranquility that belied much of the summer – where the S&P 500 failed to move more than 1% in either direction over the course of 43 straight trading sessions – is still intact. Au contraire, as the S&P 500 has moved more than +/- 1% in 8 of the last 9 trading days and in the process sliced below its 50 day moving average (2,167) while flirting on a couple occasions with its 100dma (2,122). A move below the 200dma at 2,058 would be a normal and healthy occurrence (likely shaking out a lot of weak hands in the process) and set up a showdown at the 2,000 level which coincidently aligns with a 50% Fibonacci retracement.

The S&P 500 closed at 2,139 last week, which is virtually the same level it reached for the first time in May of 2015, so what we're talking about here is an equity market that is little changed over the last sixteen months with the top of the range at 2,190 (+2.4% upside from current levels) and the low end of the range at 1,810 (-15.4% downside). Here we are a full eight years into the third best bull market in U.S. history where the slope of the line has flattened, leaving many investors (be it bulls or bears) searching for a catalyst(s) that causes a break-out in one direction or the other.

One thing is for sure, and that is that the U.S. economy is skating on some pretty thin ice fundamentally. Over 90% of the macroeconomic data prints in the last two weeks have come in below expectations, which is casting a rather dark shadow over the optimistic (hope) narrative that was all the rage as we ended the second quarter. As a result we are seeing downward revisions in both GDP and earnings for Q3 and momentum coming out of the March – June bounce in the data is surely waning. Here is a rundown of the data reported last week:

- August retail sales dropped -0.3% month-over-month versus expectations of a -0.1% decline and this followed an upwardly revised +0.1% print in July. Excluding the volatile auto component, retail sales declined -0.1% following a -0.4% slide in July. The control group which feeds into the consumption segment of GDP (and excludes autos, gasoline, and building materials) was down -0.1% for the second month in a row and missed consensus expectations for a 0.4% gain. The weakness in the report was broad based and is worrisome from the standpoint that the consumer is really the only segment of the economy that could be counted on over the last six quarters – losing them now with most other segments still weak is/would be problematic.

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- We were on the receiving end of two key gauges on the health of the manufacturing economy last week with the New York Fed's Empire State Manufacturing Index coming in a bit below expectations at -1.99 (consensus was -1.0) and the Philly Fed's regional factory Index jumping to +12.8 (from +2.0 the prior month and expectations for a print of +1.0). There was more than meets the eye in the Philly Fed's bounce: sure new orders moving to +1.4 from -7.2 and employment coming in less bad at -5.3 from -20.0 is comforting, but all-in-all seven of the nine components still had a minus sign in front of them. As for the Empire State Index, it was even worse with delivery times, shipments, inventories, employment, and new orders all weakening from the prior month. Both index's on an ISM-adjusted basis show a material slowing in August from July and rival the weakest prints of 2016.

- Confirming the loss of momentum in the manufacturing sector was the -0.4% month-over-month decline in Industrial Production for August (this was below expectations for a more modest -0.2% decline). Like the other manufacturing readings the weakness was broad-based with just 6 of the 20 factory subsectors registering gains in August. On a year-over-year basis Industrial Production has declined for twelve consecutive months which has never in the history of this data series occurred outside of an outright recession (hmmm…).

Therein lies the dilemma and challenge facing all investors: what do you do and how do you square the weakest economic expansion in the post-WWII era juxtaposed against one of the strongest equity bull markets in history?

Confusion is one adjective that comes to mind and an apt descriptor for the outlook of the Fed as it concludes its two day meeting on Wednesday. There has been no shortage of Fed speak coming out of and including the recent Jackson Hole symposium with the likes of Vice Chair Stan Fischer, San Francisco Fed head John Williams, and even Chair Yellen laying the foundation for at least one hike this year. I just find it ironic that once again (like back in December when they last hiked rates) that the economic data ends up not cooperating with their constructive narrative and turns south right about the time they are bracing markets for a hike.

However, if one wanted to compare the economic landscape today versus where it stood when they hiked in December – it's not crazy to suggest things are that much weaker on the surface:

- Real GDP Growth in Q3 2015 was 2.0% and moderated to 0.9% in Q4 versus 1.1% in Q2 and forecasts for Q3 to come in between 2.0 – 3.0%. So a decelerating trend then versus an accelerating trend today.
- The ISM manufacturing index was 48.4 going into the December meeting versus the most recent print of 49.4 going into this meeting.
- The three month trend in payroll growth was +241k then versus +232k today.
- The unemployment rate was 5.0% then versus 4.9% today.
- Headline inflation was running at 0.5% and core inflation was 2.0% year-over-year back in December versus last week's reading of 1.1% and 2.3%, respectively.
- The four-week moving average in jobless claims was running at 273k in the week leading up to the December Fed meeting versus 260k today.
- The S&P 500 closed at 2,043 on the day prior to December's Fed meeting versus 2,139 on Friday.
- On a trailing P/E basis the S&P 500 was trading at 18.4x versus 21.4x today.

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- High Yield corporate bond spreads over Treasuries were a bit north of 700 basis points then versus a little more than 500bps today, and Investment Grade spreads were just under 300bps then versus 250bps today.
- The VIX index closed at 20.95 on the day prior to December's meeting versus 15.37 at Friday's close.

This is by no means an exhaustive list of metrics that would be considered for comparison and neither is it fair to justify a hike today based on a comparison to last December, but it's not as if you can look at the above referenced metrics and say things are materially better or worse.

However, I think this comparison is a bit misleading – when you retrace the last eleven months it's easy to see the loss of momentum in the U.S. as we entered 2016. Perhaps it was the December rate hike that accelerated what was a growth slowdown or maybe it was just economic gravity from a very mature business cycle. But don't forget that it took an about face by the Fed in March, where they went from forecasting four rate hikes this calendar year to just two and now they are openly wondering whether they will be able to get just one in this year. So, it took a meaningful loosening in not only the Fed's tightening rhetoric, but stepped up monetary accommodation from central banks around the world (ECB, BoJ, and BoE) to elicit this meager bounce in the economic data over the last several months – a bounce that is looking more fragile by the day and on the brink of rolling over in a meaningful way.

This is what the market has sniffed out for some time now and why Fed Fund Futures are back down to pricing in less than 1 in 5 odds that the Fed hikes on Wednesday and a little better than a coin flip odds that they go at all this year.

One thing I continue to see gaining more attention from the Fed is references to financial stability (or lack thereof, depending on your perspective). It's very difficult to undertake an objective analysis of the capital markets today and not conclude that there is some degree of froth (understandably this will vary depending on one's analysis) in all markets as a result of this period of extended experimental monetary accommodation. For example, data from the Bureau of Economic Analysis indicates that corporate profits shrank at a -4.7% annual rate in the second quarter which marked the sixth contraction in the past seven. The four quarter trend in corporate profits is -4.9% year-over-year and the absolute level of earnings as of the end of Q2 is the same as it was in 2013 – in case you don't recall, the S&P 500 was trading at 1,700 back then.

Okay, so maybe in this new era of investing, Fed policy should trump earnings because of the implicit (meaning unspoken – not explicit which connotes an outright endorsement) central bank backstop supporting stocks and lowering the risk premium between stocks and bonds – whereby stocks will be rerated at a higher valuation going forward. After all, money is cheap and companies can shore up their balance sheets by tapping the debt markets with minimal impacts on their cash flow from servicing the debt. What's more is that companies are flush with cash and this too makes them a relatively more attractive and safe investment opportunity.

Yes, I hear this cash narrative frequently and find it quite misleading when you peel back the onion. In this narrative you don't ever hear that the 1% most cash rich of all U.S. companies control over 50% of all U.S. corporate cash. Nor do you hear that the five most cash rich U.S. companies (Apple, Microsoft, Google, Cisco, and Oracle) control 30% of all U.S. corporate cash.

Which brings me to the other side of the balance sheet that includes all the corporate debt that U.S. companies have been so willing to tap in order to shore up the short-fall from falling corporate profits. As of the end of last year total U.S. corporate debt totaled $5.03 trillion (up almost 100% from the $2.62 trillion

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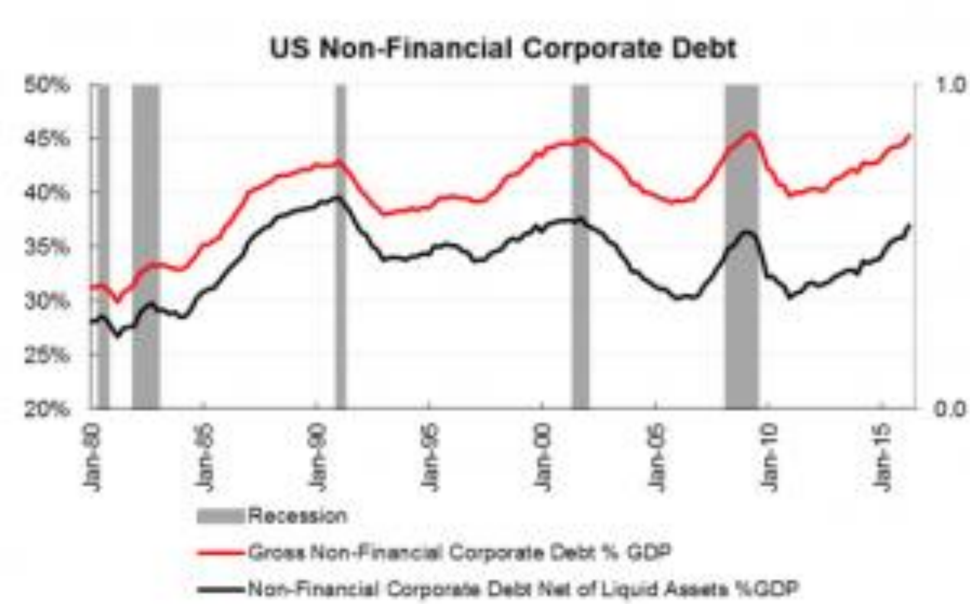
outstanding just prior to the Global Financial Crisis at the end of 2007). Over the past five years U.S. corporate debt has risen by $2.8 trillion while corporate cash has only increased by $600 billion which has pushed net debt levels (debt excluding cash) to almost double ($3.4 trillion) where they stood at the end of 2007.

As a result corporate debt to GDP in the U.S. has reached a new all-time high (north of 45%) where in the last three business cycles whenever corporate debt to GDP got to between 42-45% the U.S. economy was approaching a recession. Yes, interest rates are lower today, but keep in mind that corporate America is not the U.S. treasury and they must pay a premium (spread) to what Uncle Sam can borrow at and this spread gets wider during recessions). Moreover, corporate debt to GDP is already at the high end of this 42-45% range and if you look at the below chart, debt typically expands during recessions – leaving one to wonder just how much room debt can expand if a contraction were to occur.




It's no wonder why I see a growing chorus of people suggesting that monetary policy has reached its limits, and this is a conclusion that I think the Fed is reluctantly coming to as well. As a result you're hearing more about the baton being passed on to fiscal policy as the match that will spark a pickup in global growth from its subdued level. The question is – will it work?

It's hard to tell if the fiscal multipliers will have a similar impact to initiatives implemented in the past given the much higher government debt burdens and contingent unfunded liabilities. Both Hillary and Trump have large fiscal packages built into their policies, but it's difficult to discern how consumers will react to any form of tax cuts – will they be spent, or will they be saved? Don't overlook the demographic profile of the U.S. where a large cohort of the population is staring down retirement and doing so at a time with so few investment options that offer them a secure income in a world of low interest rates.

As the saying goes, "the more things change, the more they stay the same". That continues to be an accurate depiction of the economy and the capital markets. The fundamental data continues to tease investors with brief spurts of acceleration to only lose steam a few months later. As a result fundamentals remain weak but have yet to break to a point where recessionary risks would become a more pressing concern. This keeps central banks at the ready to step in at each sign of weakness and prop up asset prices. It's my contention that without all the central bank intervention, equity values would be much lower than they are based on the underlying fundamentals.

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But the fundamentals haven't deterred households from flocking to the stock market as we learned from the Fed's Flow of Funds data released last week for Q2. The share of household assets in equities moved back above 23% last quarter to stand a full 7% above its long-term average. This metric is now north of where it was at the 2007 peak and topped only by the Tech Bubble back in 2000. So much for the argument that this is the "most hated bull market of all time" – hard to make that claim with stock ownership at its second highest level in history. Sorry, you can have your own opinion, but you can't have your own facts.

It's a rather lite week on the data front, but let's face it – the event investors have been focused on all month is what announcements come out of the Fed and Bank of Japan (both concluding two day meetings on Wednesday). There is less uncertainty with the former than there is the latter as the BoJ has been floating trial balloons for the last three weeks to gauge how markets may react to certain announcements. In both cases it's a read and react type of event rather than one to attempt to proactively front-run.

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