January 19th, 2016

More wood to chop…

In terms of the economic data reported and the action in capital markets, last week was ugly and continues a trend that began in early November. Following last year's 12% late summer correction the S&P 500 rallied nearly 13%, pushing the index back up to 2,109 (within 1% of its May all-time high), however since that time stocks have acted like a snowball gaining momentum as it rolled downhill, where the S&P 500 has traded lower in 31 of the last 51 trading days. Last week stocks tanked again for the third consecutive week with the Dow dropping 358 points, the

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S&P 500 losing 42 – both falling 2.2% on the week – and the Nasdaq Composite plunging by 3.3%.

Treasuries continued to get a flight to safety bid as yields across the curve continue to fall (the yield on the 10-year T-note fell below 2.0% before closing the week at 2.03%) which pushes up bond prices, making intermediate and long-term Treasuries two of the better places to have capital last week, returning 0.80% and 1.94%, respectively. On the year the S&P 500 is now down 8.0% making it the worst start to a year ever (ever is a long-time) while intermediate and long-term Treasuries – as measured by the IEF (iShares 7-10Year Treasury ETF) and TLT (iShares 20+ Year Treasury Bond) – have generated positive returns of 2.27% and 4.28%, respectively.

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At Friday's lows the S&P 500 traded down to 1,857 (taking out the August 2015 low of 1,867), but staged a late day rally (if you can call it that, on a day where the Dow closed lower by 390 points) to close at 1,880.

On a short-term tactical basis this is a constructive development, but the 'buy the dip' mantra that had been in place throughout the entirety of this bull market (up until the fall of last year) has taken a distinctive turn to a 'sell the rip' mentality. So any bounce over the next couple of weeks is sure to be greeted with sellers looking to unload on any strength – it will likely take some time to work through what appears to be a large amount of supply from these liquidators.

One of the few constructive data points investors can hang their hat on at the current time are indicators suggesting we are in the

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midst of a severally oversold condition and the latest investor sentiment readings are near their most bearish levels of this bull market cycle (a positive signal for those contrarian thinkers out there). The AAII Investor Sentiment Survey results for the week ending January 13th showed the bull camp falling to 17.9% (below the 18.92% bullish reading reached at the S&P 500 low in March 2009) while the bear camp increased to 45.53% (well below the 70.27% reading in March 2009, but its highest reading in almost three years). However, keep in mind that sentiment data, by itself, has a pretty spotty historic track record for making strategic long-term investment decision.

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On Friday we got a trifecta of economic data which continued to confirm a material slowing is underway:

- Retail sales fell 0.1% m/m in December (down from a 0.4% m/m increase in November) while core control retail sales (excludes auto and gasoline sales) disappointed, falling 0.3% m/m in December from +0.5% in November. The trend in this part of the economy that drives 2/3rds of U.S. GDP is troubling as the year-over-year rate of change in the control group is down to a measly +1.5% – not a constructive hand-off as we roll into 2016.

- Industrial production fell 0.4% m/m in December from a downwardly revised 0.9% decline in November – this took the year-over-year decline in IP to -1.8%

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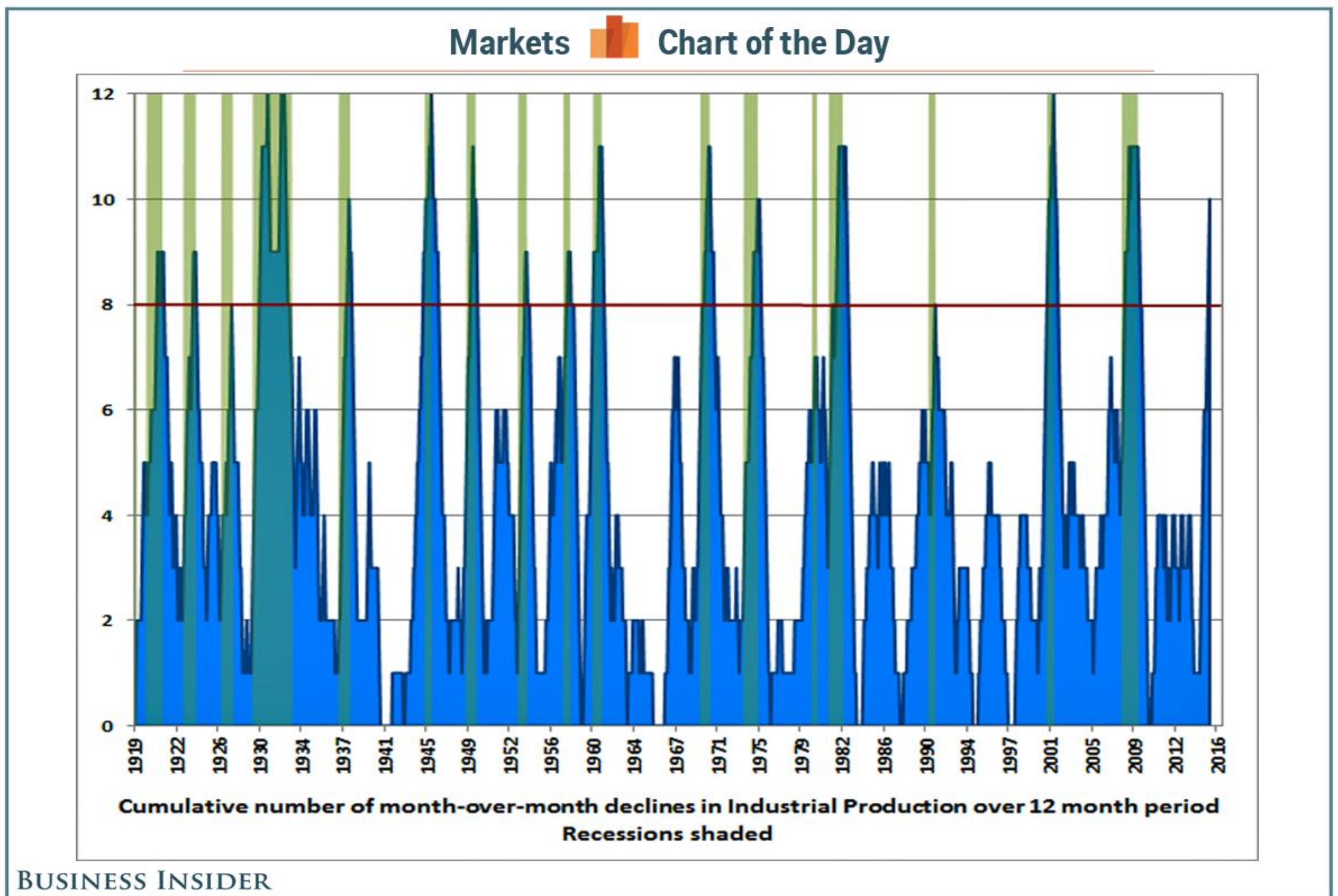
(ugh). Industrial Production has declined on a month-over-month basis in 10 of the last 12 months – this is a level of declines that has never been observed outside of a recession (see accompanying chart).



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- Producer Price Index (PPI) showed deflationary risks remain pervasive as this metric declined 0.2% in December sending the y/y decline to -1.0%.

I hear and read the arguments all the time that while the manufacturing side of the economy (which constitutes less than 15% of GDP) is obviously contracting, the services side of the economy (which accounts for a much larger +60% of the economy) is chugging along just fine. While I don't think this argument lacks factual basis, what I do think it overlooks is the leading characteristics that stem from the more cyclically oriented manufacturing sector. This is best illustrated by the following chart showing the divergence that has occurred over the last year between the ISM services index and the ISM manufacturing index.

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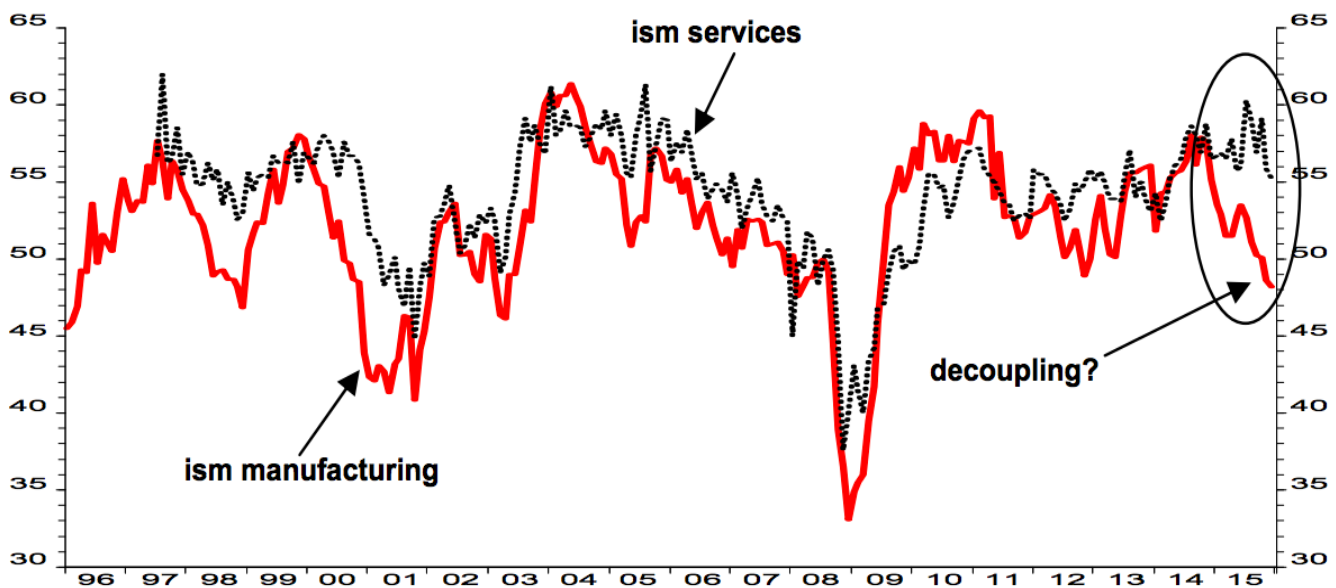

Looking back over the last 20 years the correlation between these sectors is high and unless ‘this time is different’, it is reasonable to expect that the weakness that started occurring in the manufacturing sector during the fall of 2014 will bleed into the services sector (a trend we are starting to see with the ISM non-manufacturing index steadily declining from its recent peak of 62 in July to its lowest level in twenty months at 55.3 in December).

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Outside of the U.S., investors were greeted with the latest read on China's GDP where it expanded at 6.8% (expectations were for 6.9%), retail sales rose 11.1% year-over-year (below consensus estimates of 11.3%), and industrial production advanced 5.9% (expectations were for 6.0%). While these results are enviable for any developed economy, they continue to show a slowing underway in China (not to mention the lack of confidence investors have in the accuracy of this data).

Perhaps more perplexing to investors than the 'hard-landing' concerns in China is the level of debt this region has accumulated over the last eight years where debt to GDP has ballooned to 295% at the end of 2015 from 158% in 2007. The following chart from McKinsey highlights the breakdown of this debt load with the big increases stemming

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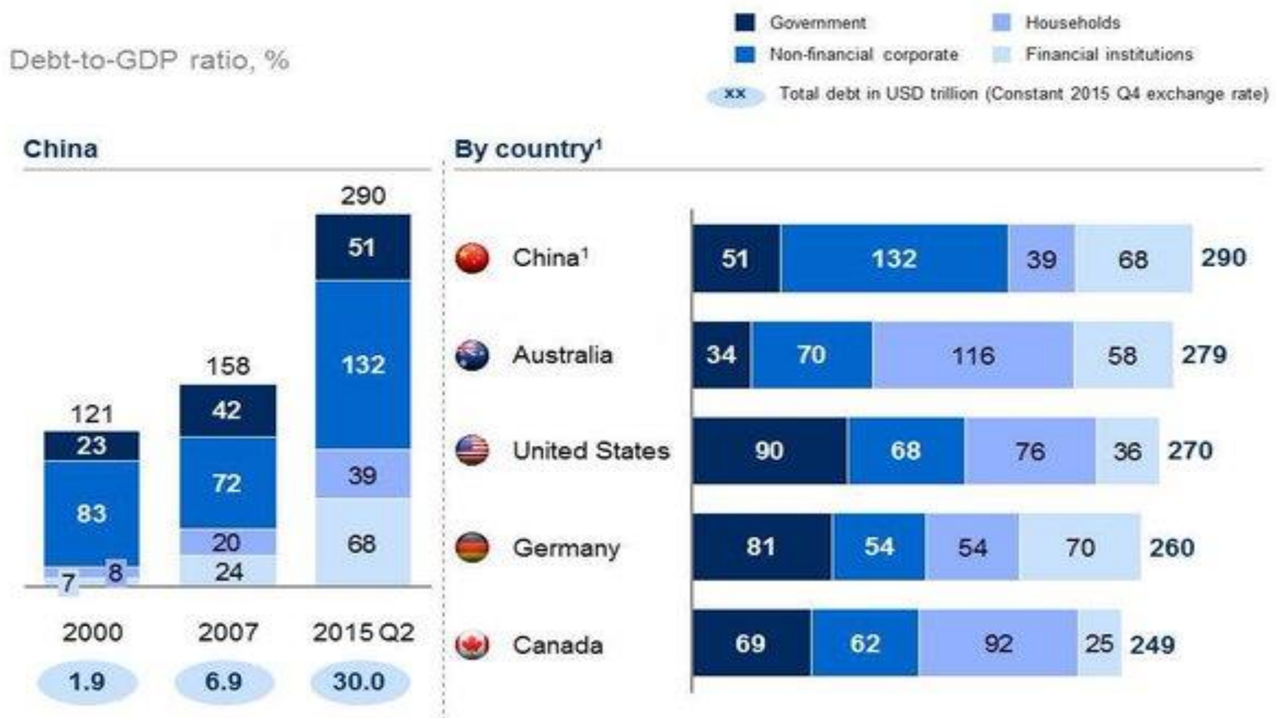
from the private sector (non-financial corporate and financial institutions). This is causing some investors to pull out the '08 U.S. credit crisis handbook and overlay it on the Chinese economy. What is most striking (worrisome) about this data is the $30 trillion of Chinese debt denominated in U.S. dollars where debtors get hurt not only by contracting revenues (as economic growth decelerates), but also by a depreciating yuan relative to the dollar.



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The aggregation of total global debt added since the ‘08 credit crisis – aided and abetted by global central banks cutting rates to foster economic growth – will surely be the epicenter of trouble if a global recession were to materialize.

The war being waged in the capital markets during the first two weeks of this year isn’t about subduing exuberance and/or euphoric investor activity. No, it’s the initial stage of markets acknowledging and pricing in heightened probabilities of a recession. Just because it’s starting to get priced in doesn’t mean that it’s a definite, let alone imminent (although I believe it’s likely in 2H16 or 1H17), but as an investor you have to respect the signals from the market.

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- Transport Index peaked with the manufacturing sector in late 2014
- Russell 2000 Index (small cap stocks) peaked in June of 2015 and is now down more than 20% from its peak
- More than 90% of Russell 3000 stocks (roughly 98% of U.S. traded stocks) are trading below their 50day moving average and more than 80% are trading below their 200dma. Additionally, the average decline for a stock in the Russell 3000 from its 52-week high is -34%
- Sector leadership within the S&P 500 is decisively tilting in a defensive posture with Utilities as the only sector in the green so far in 2016
- Oil is down more than 70% from June of 2014 – undoubtedly this has more to do with supply imbalances than demand destruction, but it is having large ripple effects across the globe

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- CRB Commodity Index is down almost 60% from its June 2014 high
- So far in 2016, 26 stocks are down more than 20% year-to-date, while just 20 stocks are up more than 1%
- Global stocks have lost more than $3 trillion in value so far in 2016, the biggest decline for global stocks since October 2008's decline of $5.7 trillion
- China's Shanghai Composite has crashed more than 40% since June
- The 10-year Treasury bond yield has declined from 2.28% on December 16th (when the Fed decided to hike the fed funds rate for the first time in almost 10 years) to 2.03% at the end of last week. Furthermore the 10s/2s Treasury yield spread has compressed to its tightest level in this cyclical expansion

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Worthy of more than just a bullet point in the above list is the deterioration in the junk bond market where yield spreads are breaking out to multi-year highs. As the below chart shows, the spread between junk bonds and similar maturity Treasury bonds has increased to 7.39% – which according to Martin Fridson (considered to be one of the brightest junk bond analysts) is roughly at the mid-point of the 5.2% average for expansionary months and 10.2% for recessionary months. Said another way, the high yield bond market is signaling a roughly 44% probability of a recession.

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I could spend countless pages breaking down the divide between the bull and bear case for investors on the economy and the stock market at this time. Depending on how one chooses to view and interpret those arguments will lead you to how you want to position your capital for the road ahead. I've been of the opinion for almost a year now that the risk/reward pendulum in the equity market was becoming unbalanced to the risk side (see

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February 2015 commentary: “More often than not, the hardest thing to do is the right thing to do…”) and investors should be taking measures to insulate their portfolios (see April 2015 commentary: “When did Noah build the ark…” also see November 2015 commentary “Second level thinking...”).

I understand full well that the law of averages are on the side of optimism and bullish positioning – the mere fact that through thick and thin stocks on average compound at a 10% annual rate and on average stocks go up 2/3rds of the time. However, keep in mind that there have only been three occurrences where the S&P 500 fell 20% (we’re not there yet) and the economy wasn’t in a recession – Black Monday crash of 1987 (S&P 500 fell 33%), Russian ruble crisis in the autumn of 1998 that brought down Long-Term Capital Management (S&P 500 fell 22.5%), and the

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fall of 2011 when U.S. sovereign debt was downgraded and the Eurozone crisis was brewing (S&P 500 fell 21.6%).

One of the biggest differences about the fundamental backdrop during these periods and now is the Fed. At each of these prior occurrences the Fed stepped in by cutting interest rates (in the case of '87 and '98) or instituted additional QE policies (Operation Twist in 2011). The Fed lacks this ability today, let alone the reality that the global economy is already suffering from monetary policy exhaustion.

The point I'm attempting to make is that a vast array of the data that would fundamentally support asset prices and perpetuate the bull market cycle that began in 2009 has already or is in the process of breaking down. This is today's reality, where over the last year the

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extended valuation in stocks never corrected (meaning earnings never caught up to where prices were trading), market breadth never regained momentum, economic growth has continued to slow, and Fed policy has shifted from a tailwind to a headwind.

In a nutshell, nothing over the last twelve months (or two months for that matter) has transpired to alter the evolution of the view I've been penning over this time. Moreover, throughout that time I have become more cautious and concerned (as it relates to how we analyze, evaluate, and interpret the tea leaves) about the forward looking investment outlook.

Now I don't know what the future holds (nor does anyone else), but I interpret the current fundamental backdrop as extremely fragile. As such I believe investors, even though we

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are already in the throes of a 10% correction, should employ prudence, caution, and discipline. A lot of wood has already been chopped to bring asset prices back into line with reality, but we're not there yet (in my opinion) and things can potentially get much worse before the contraction phase of this business cycle ends.

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