October 3rd, 2016

De exitibus…

With a strong Friday rally the U.S. equity market was able to close out the month and the quarter in the plus column with the S&P 500 having logged gains for seven consecutive months and in fourteen of the last fifteen quarters. Impressive streaks for sure and they make for great headlines, but the headlines by themselves are somewhat deceptive and lacking of context. Consider that the seven straight months of gains started on the heels of the worst start to a calendar year in history for U.S. equities (the S&P 500 was down -12.5% in the first six weeks of the year).

Moreover, while the S&P 500 currently trades within 1.5% of its all-time high, it's been treading water since mid-July.

There is no denying the resilience in stocks over the last 18 months, but keep in mind we are talking about an index that first reached 2,100 in February 2015 and was trading at 2,090 in December 2014. So yes, we definitely have a Teflon market on our hands given the many headwinds and challenges it has faced, but also know that current evaluations of the stock market are being made at the high end of a nearly two year trading range – a range that spans 383 points (1,810 – 2,193).

It's not just stocks that are ensnarled in a range, its most asset classes – whether it be interest rates with the 10-year Treasury yield ranging between 1.4 – 1.7% since late June, gold has been in a roughly 100 point range between $1,265 – $1,370 over the last three months, as is the case with oil prices bookended between $40 – $50.

Speaking of oil prices, they spiked nearly +9% last week on the heels of an announcement by OPEC that a stencil of an agreement was in place to limit production to a range of 32.5 – 33.2 million barrels per day. This is first time since 2008 that the cartel has looked to step in and provide some support to back stop the weak oil price environment.

Keep in mind that this agreement has yet to be ratified and will not be until the next OPEC meeting in Vienna on November 30th. Without a doubt this potential agreement (at a minimum) changes the dark cloud of negative sentiment that had pushed WTI down to the low end of its range just prior to the announcement. Another positive development for the sector is the idea that this could close the historically high supply surplus as early as Q1 2017.

The other side of the coin is that the implied production cut (estimates between 200k – 900k b/d) isn't really a cut when you consider that Iran, Nigeria, and Libya appear to have been extended some favorable latitude in terms of the levels to which they can increase production – between the three they can bring on as much as 1.5 – 2.0 million b/d in volume which would more than offset the agreed upon cuts from the rest of OPEC. Not to mention Russia, which is producing at its highest level in years and speculated to have little interest in slowing up.

Moreover, OPEC doesn't have the same clout today as it's had in the past with countries outside of OPEC now accounting for 58% of the world's total output, which in the second quarter ran at 95.9 million b/d and remains above estimated demand of 95.6 million b/d, according to the International Energy Agency. In July, the most recent period for which data is available, stockpiles of crude oil and refined products held by countries in the Organization for Economic Cooperation and Development topped 3.1 billion barrels, up 15% from two years earlier, according to IEA data.

For the here and now this likely puts a floor under the price, and while it's unlikely we see the price runaway to the upside in the near-term, my guess is that sometime next year (assuming this agreement doesn't fall through and the economy hangs in there) prices gravitate to a new higher oil price range between \$50 – \$60. This by no means removes the structural long-term headwinds this industry faces with the advances in production technology and an ongoing secular trend towards a more eco-friendly society, but the short-term fundamental picture got the shot in the arm it needed.

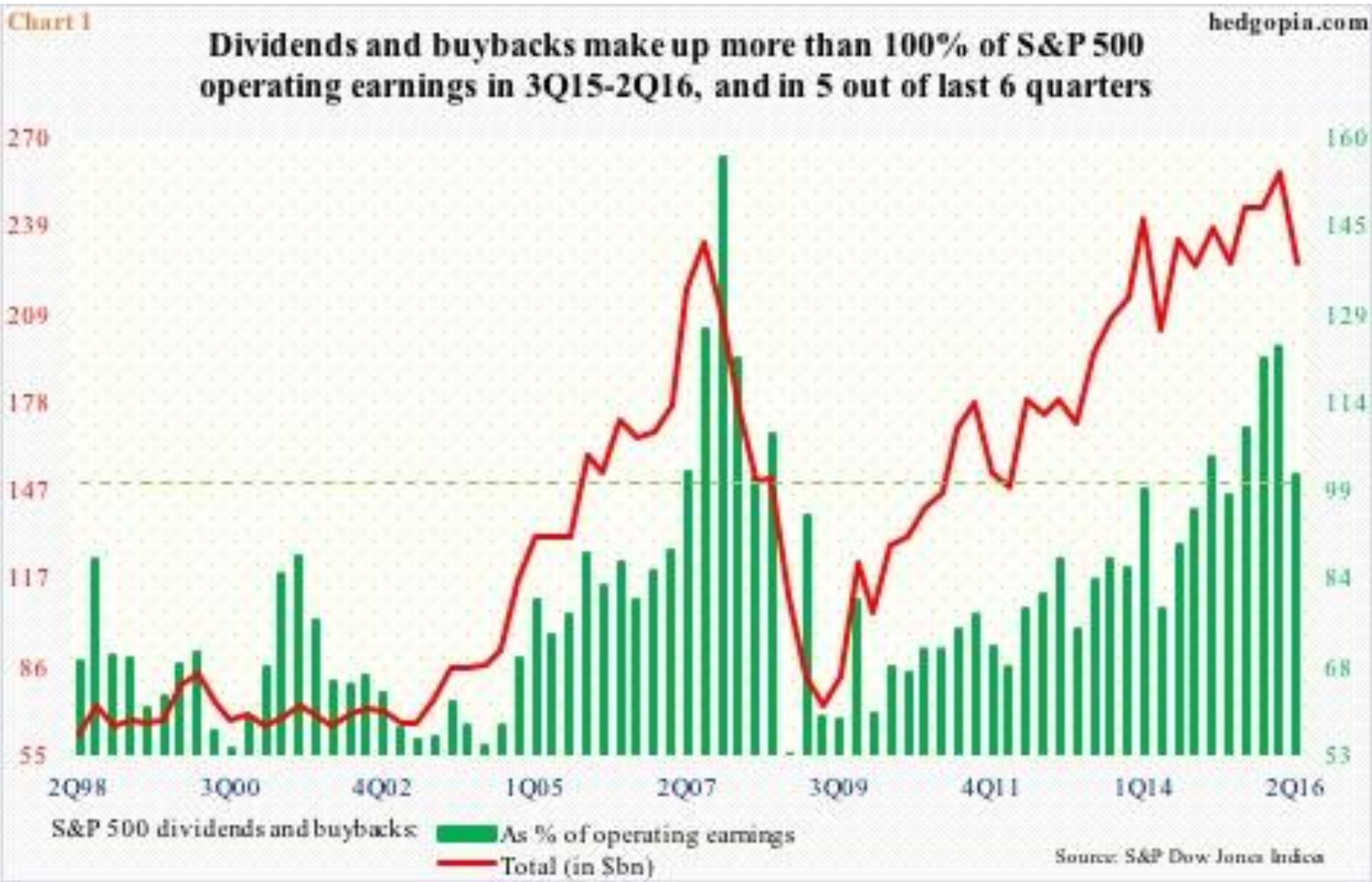
Back to the capital markets and the economy, where the story remains the same as it has for most of the year – a tug of war where the underlying momentum breaks to the upside or the downside. You see, the year began with the fundamental underpinnings for the economy and asset prices deteriorating to a point where material recessionary risks were starting to get priced in, and then in mid-February we had an about face in the market that arrested the downside momentum in the stock market and in turn many of the economic variables.

From late spring through the summer the global economy experienced a broad based bounce in economic momentum. I've heard all kinds of reasons to explain this shift, whether it be government and central bank actions (the historic credit infusion by China into its system, the Fed pivoting back to a dovish posture following its December rate hike, the ECB upping its QE policy to include corporate bonds, or the BoE starting QE following the Brexit vote), or other references which have been made to market price signals (stability in oil prices, lower global interest rates, compression of credit spreads, a trough in the multi-quarter corporate earnings recession, and/or the halt to U.S. dollar bull market).

Whatever narrative an investor chooses to ascribe to when contextualizing the last six months is entirely up to them (do know that many of these variables have an auto-correlated relationship), but what's more important at this time is where we go from here. One thing is for sure and that is that we are in the mature stage of this business cycle with the most important drivers of economic growth (employment, consumption, corporate and consumer credit, industrial production, and housing) having peaked and, while still expanding, they are doing so at a much more subdued pace. This is what we're seeing come through in the GDP numbers with growth taking a leg down this year to a little more than a 1% pace from the 2.5% growth rate in 2015. A similar story is playing out in corporate earnings which have been in decline since the end of 2014.

However, this falloff in corporate profits has not stopped companies from buying back their stock or paying out dividends. For four consecutive quarters S&P 500 companies have spent more in dividends and buybacks than they generated in operating profits. Operating profits for the S&P 500 in Q2 2016 totaled $222.8 billion which was lower than the combined total of $225.8 billion used to pay dividends ($98.3 billion) and buybacks ($127.5 billion). The level to which buybacks and dividends outpaced operating earnings improved from Q1 2016, and for good reasons as earnings increased and total dividends and buybacks fell, but this still marked the fifth quarter out of the last six that this shortfall occurred.

The last time we saw a trend like this was in 2007/2008 when it went on for six consecutive quarters before the music stopped.



It goes without saying that this is a trend that can't go on forever, and that doesn't mean that the only resolution is a bear market and/or recession (both of which occurred in 2008), but we could also see companies adapt by reducing one or both. This is what occurred on the buyback side in Q2 relative to Q1 where total share buybacks declined -21% while dividends were slightly higher.

Another solution would be a resumption of earnings growth which according to analyst's estimates could come as early as Q4 with earnings growth forecasted to increase 6% year-over-year. It was expected that Q3 would mark the inflection point for positive earnings, but those hopes have been dashed as we get ready for earnings season to kick off in earnest in a couple weeks with the latest Q3 estimates expecting a decline of roughly -2%.

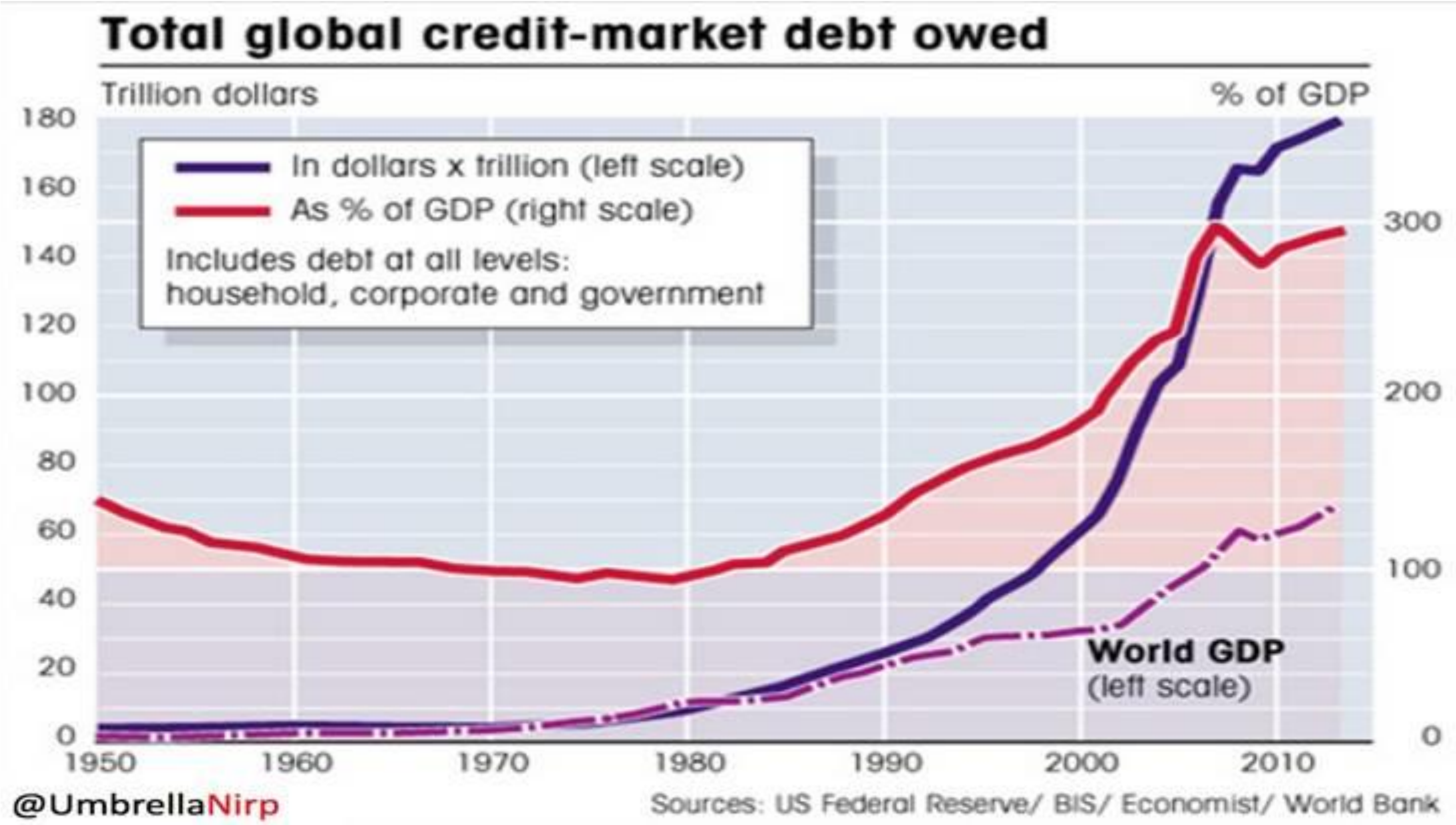
What will be key for earnings season is guidance coming from management on what they are seeing with their companies and the year ahead. In particular will be the outlook beyond the near-term uncertainty posed by the election and whether they are seeing a pickup in economic momentum that makes the lofty double digit earnings growth forecasts for

2017 in the realm of reality or merely a pipe dream.

Speaking of the election, and outside of the growing disdain and mudslinging that both camps seem to have in common when it comes their respective campaigns – there is one other common twine that is material for markets and the economy, and that is fiscal policy. Both Hilary and Trump's policies include fiscal policy as a tool to reignite a stubbornly sluggish economy – of course the details of the plans are very different in terms of size and its impact on the deficit, but it is something I've been focusing some attention on.

After all, many of the heads of global central banks have made it a point over the last several months to stress the importance of combining fiscal policy with the already ultraaccommodative monetary policy. Maybe because many of them see the writing on the wall and this is their way of acknowledging that monetary policy has reached its limits. Nevertheless you have to respect the views of the likes of Christine Lagarde and Larry Summers (among others) as you'd be hard pressed to find sharper minds in the economic community.

However, what these great minds can't answer (nor can I or anyone else for that matter) is whether or not the multiplier effect of fiscal stimulus will pack the same punch as it has in the past with global debt at much higher levels than in the past.



I don't care how you peel back this onion, but debt levels across the board have never been higher. Debt-to-GDP ratios in the G7 were just shy of 25% back in the early 1970's versus a record high just shy of 90% today. It's looking more and more obvious with the lack of verve in the global economic recovery post the '08 credit crisis that the mountain of debt piled onto the system has to be considered high up on the list of variables constraining growth.

Overlay the debt saturated U.S. economy with an unfavorable demographic profile, where nearly 1/3rd of the population today is under 25 years old compared to a little more than 45% of the population back in the 1970's. You would imagine that any fiscal stimulus plan outside of creating jobs is going to target in some way funneling money to those with a propensity to spend it and not use it to pay down debt. That was one of the main objectives for the Fed's wealth effect monetary policy strategy which targeted raising asset prices to repair consumers balance sheets and therefore drive a pick-up in the 70% of the economy we call the consumer. The miscalculation in that theory is the fact that almost 85% of financial assets are owned by the top 10% of wealthy individuals in the U.S.

Pulling this all together – fiscal policy, debt, and the consumer – the household debt service ratio, while much improved from the highs leading up to the Global Financial Crisis in ’08, has not been able to move south of 10% for the last five years. Keep in mind that this lack of improvement coincides with interest rates moving down and hovering near all-time lows. This 10% household debt service ratio is the same level we had in 1993 when the 10-year Treasury yielded 6% and is little changed from early 1983 when the 10-year yielded almost 12%.

So, I don’t know if fiscal policy will be the panacea for an economy that is stuck in neutral. Take the Federal Reserve for example: former Fed Chair Ben Bernanke and the rest of his constituents in the heat of the ’08 credit crisis thought the recipe to resuscitate the economy from the GFC was extraordinary monetary policy. And in hindsight it was the right prescription for its initial intent, but the Fed hasn't been able to remove the morphine drip since it was prescribed.

Do you think that government officials with term elections as frequent as two-years and constantly on the campaign trail for re-election will exhibit more restraint and discipline with fiscal stimulus than an unelected central banker with much longer terms? For the good of the long-term future of the country you'd like to think so, but history suggests otherwise.

Look, we're at an interesting crossroads where the shorter-term business cycle is vulnerable, and this is colliding with a period with some very large and impactful secular societal forces (the world is old and growing older, the world is over indebted, and the world is too unequal). Fortunately or unfortunately these forces need to be navigated and the path(s) that are chosen will have a material impact on capital markets. With asset prices across the board (stocks, bonds, and real estate) near all-time highs and valuations at a premium to historical averages, this exitibus is being treated with a lot of complacency – that, in my opinion, is where the biggest risk lies.

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