October 31st, 2016

This is what late cycle looks like…

Weakness across the board aptly characterizes what transpired in the capital markets last week with the S&P 500 declining -0.68% making it the third weekly decline in the last four. While the Dow Jones Industrial Average managed to close ever so slightly in the black (+0.08%), it was an outlier with the Russell 2000 Small Cap Index getting slammed -2.50% to bring its monthly decline to -5.12%, the S&P 400 Mid Cap Index gave back -1.77%, and the Nasdaq broke to the downside through its 50dma as it gave back -1.28% on the week (down -2.30% for October).

In the wake of Friday's mid-day bombshell that the FBI was going to take a second look at Hillary Clinton's never ending email saga the VIX index popped 5% within minutes of the news and rose over 20% on the week. With less than 10 days left until election day this is the last thing the Clinton camp wanted to see, but if the polls are to be believed it seems as though the lead she's been able to build up over the last month remains too steep of a margin for Donald Trump to overcome. What's more is that even with the race tightening up in the latest poll numbers the road to the 270 Electoral College votes needed to win the Presidency is much easier for Clinton.

Look, I tend to shy away from opining on the political front in this weekly missive as it's my view that readers have much better places to go to educate themselves on the issues they view as most important to informing their interests and beliefs when casting their vote. With that being said, this election is important and what the ultimate results are will have both short-term and long-term impacts on the economy and markets.

Putting issues and policies aside, what I will opine on is my interpretation of what the markets expect come next Tuesday. The odds still favor Hillary even as the polls tighten, but I've long believed that the Brexit vote in the UK should serve as a reminder to investors to refrain from underestimating the motivation behind the growing populist movement across the globe. Say what you want and think what you will about Donald Trump the person, but Donald Trump the figure represents an anti-establishment / anti-bureaucratic character that could bring about change to a governmental organization that too many believe is failing them.

Both stock and bond markets are comfortable with the idea of a Clinton presidency on the auspice that she's the more predictable of the two candidates. Markets fear that Trump is more of a wildcard and I can't think of many things markets dislike more than uncertainty. A couple weeks back markets started to get a little jittery over the idea of a clean sweep by the Democrats, but have since mellowed to this outcome with the latest odds indicating a 75% probability that the Republicans will retain the House, and it's roughly 50/50 odds of which party takes the Senate.

So, the big surprises for which markets will be most reactionary to is a Trump victory or a Democratic sweep.

Either way it's looking more and more likely that neither party is going to control all the branches of government – so gridlock for the next four years is likely. Meaning that any material reform in terms of trade, the tax code, or entitlement programs will have to be negotiated across party lines – a tall task for sure, but here's to hoping.

Alright, enough on politics and back to markets, a subject for which I have a much higher affinity to write about. The dollar index was little changed last week as it hovers near nine-month highs in the face of growing expectations that the Fed is determined to get at least one rate hike on the board this calendar year. There is a Fed meeting this week, but expectations are that they will take a pass and craft their statement to further cement a December move.

Oil prices took it on the chin last week with WTI falling more than -4% as the OPEC cut, no wait – freeze, no wait – an agreement to agree to a future production quota deal is unraveling right before our eyes. The question remains who would shoulder the brunt of the production cut with Iraq, Iran, Libya, and Venezuela all seeking exemptions – that's over 1/3rd of total OPEC production right there. This would leave Saudi Arabia with its mounting deficits alone at the alter – a rather interesting twist of irony given it was the Saudis after all that set out on this strategy to ramp up production over the last couple of years in search of taking market share and in the process crush U.S. producers.

This is one issue where the calendar is not on OPEC's side with the next meeting set for November 30th in Vienna where the leaders of this so-called cartel are at risk of losing a lot of respect if nothing materializes after getting the markets to buy into the idea that this was a real possibility. Me thinks anything short of a freeze (I've never bought into the idea of a cut) runs the risk of pushing the price of WTI back down to the lower end of the $40 to $50 per barrel price range and renders the hope of a new range between $50-$60 wishful thinking.

One area of the globe that is garnering increased attention in some circles and not enough attention (in my opinion) in other circles is China. As was the case last year when the Fed was leaning towards hiking rates, Chinese authorities are expecting much of the same which explains in part why they've allowed the Yuan to fall to a six-year low. It's always been a crap shoot on what to make of the reported data out of China – we're talking about the second largest economy in the world printing a 6.7% GDP growth rate (on the nose) for three straight quarters (yeah, right) which is why the market price signals have to be intertwined with the data for a more complete picture.

On this front, the fact that China's yield curve has moved to its flattest level in years – the gap between the 10-year yield of 2.60% and the two year note of 2.30% has collapsed to 30bps – stands in stark contrast to the buoyant GDP prints over the last several quarters. And now Beijing is taking steps to curb its white-hot property market which has become a source of financial instability which portends weaker growth lies ahead for this region of the globe. A region that showed stability over the last six months and as a result ignited a lot of confidence and animal spirits among investors and capital markets. If this region starts to weaken in the months ahead then it's only reasonable for investors to expect some payback in the reflation rally over the last six months (particularly in the commodity complex).

The optimist proclaims that things couldn't possibly get any better, the pessimist fears that this is true, while the realist looks ahead and plots a path forward.

Any and all of these perceptions could be used to describe the Q3 GDP report that was released last Friday. The U.S. economy expanded at an annualized growth rate of 2.9% which beat consensus expectations for a print of 2.6%, was handsomely above the Q2 print of 1.4% and well ahead of the 0.8% growth rate in Q1. In fact this was the strongest growth rate since the 5.0% print in Q3 2014.

While the headline reading provided the optimists with what they wanted to see, the internals of the report left much to be desired – giving the pessimists plenty to sink their teeth into. Consumer spending, which drives almost 70% of GDP, expanded at a 2.1% annual rate in Q3, but this was less than half the 4.3% growth rate in Q2. Business spending remained weak (edging higher by 1.1% after a tepid 1.0% pace in Q2), government spending was virtually flat, and residential construction shrank less in Q3 than in Q2 but still fell by a little more than a -6% annualized rate.

If not for the large boost from a 10% surge in exports (2/3rds of which was driven by an explosion in agriculture via soybeans) and an inventory build (two factors that are unlikely to be sustainable going forward), the headline

GDP print would have been much closer to a 1.5% annual rate.

Look, this is a backwards looking economic statistic which doesn't render it useless, but to spend too much time on this one print would be missing the forest for the trees. This report was nothing more and nothing less than confirmation that U.S. economic growth continues on its decelerating trend with the year-over-year growth rate falling to 1.5% in Q3 with growth set to decelerate even further into Q4.

To give you some perspective, year-over-year GDP growth peaked in the first half of 2015 at 3.3% and has since been more than cut in half. It has been a full eight quarters since real GDP grew by more than 3%, which has never happened before in the context of a non-recessionary economy. The weakness in the industrial side of the economy has been in a recession for more than a year now and if not for the infallible propensity for the U.S. consumer to spend, then the U.S. would already be in recession.

All I'm getting at is that with economic growth slowing to such a low level it makes the downside impacts of an exogenous shock outweigh the upside risk to asset prices even more.

Investors will get a whole slew of economic data this week covering the gambit from construction spending, auto sales, an FOMC meeting, productivity, factory orders, ISM manufacturing and non-manufacturing, to the October employment report on Friday. This will be the latest check-up on the health of the U.S. economy and will undoubtedly set the stage for the next directional move in capital markets.

Looking at the whole of the data coming from either the corporate sector or the economy, it's not a stretch to come to the conclusion that we are in the late stages of this economic cycle and the late innings of this bull market in asset prices. Many market prognosticators point to the fact that the Dow and the S&P 500 still trade within spitting distance (3%) of the all-time highs they reached in August.

But in the overall context of the equity market these benchmarks are somewhat narrow indices and largely dominated by large market cap companies. I'm not suggesting they aren't important or that the strong results out of the likes of a few secular growth stories – Amazon, Facebook, Alphabet (formerly called Google), Apple, and Microsoft – aren't real.

But the Dow is at the same level today that it was in December 2014, while the S&P 500 is a measly 35 points higher than it was in December 2014 – a whole two years of nothing other than the dividend income to show for it.

Moving beyond these two indices that garner all the attention, it's hard to ignore the message from the price action in the NYSE Composite – which includes nearly 3000 companies – and the fact that unlike the Dow and the S&P 500, this index never took out its May 2015 all-time high. Same can be said for the Russell 2000 Index – which includes 2000 companies – where, as of the end of last week is almost -8% below its all-time high reached in June 2015.

Speaking of late cycle, is there any better indicator of late cycle activity than when the executives in the C-suite who are having a hard time finding organic growth just go out and buy it? This is where we are at with no fewer than four billion dollar plus deals announced last week (AT&T buying Time Warner, TD Ameritrade/Scottrade, Rockwell Collins acquiring B/E Aerospace, and Genworth getting purchased by China Oceanside) and to kick off this week we have GE and Baker Hughes merging their oil and gas businesses. This month is set to go down as one of the top five months in history for corporate M&A activity – a list that includes January 2000 (the S&P 500 peaked in March 2000) and May 2007 (the S&P 500 peaked in October 2007).

In addition to the late cycle activity in the corporate sector, where money is cheap and for the time being the credit spigot is wide open, the broad economy is sending similar signals. It's becoming quite clear that auto sales peaked in the second half of last year, housing while stable is past its peak activity for the cycle, and the same goes for consumer confidence. Just have a look at the Conference Board's Leading Economic Indicators which has inched down to stall speed and if not for market priced components like the yield curve and the stock market holding it up (two metrics that have become highly correlated with ultra-accommodative monetary policy), it would be sending a more ominous economic signal.

The activity in the credit market screams late cycle when you see auto loan balances topping $1 trillion for the first time ever while annualized net losses for subprime securitized auto loans rose to almost 9% in August (up from 7% a year ago and almost 6% two years back).

Look at the broad measure of unemployment where the official U3 measure began the year at 5% and is at the exact same level currently. Or the fact that a Janet Yellen favorite, the Labor Market Conditions Index (LMCI), has declined in eight out of nine months in 2016 which is quite the trend when you consider it declined in just three months from 2012 to 2015.

But Corey, third quarter earnings are coming in better than expected and earnings growth is set to turn positive for the first time in five quarters…okay, so Q3 earnings are set to grow about 2% year-over-year which is a far cry from the roughly -7% decline at the trough of the earnings cycle in Q1. It's still just 2% earnings growth for an equity market that is at best trading at fair value relative to historical averages and at worst is the most expensive valuation set-up outside of the 2000 tech bubble. What's more is that economic growth is slowing to its slowest pace of the cycle in the quarters ahead and last I checked corporate profits are quite sensitive to economic growth.

I don't mean to pile on here, and I don't subscribe to either the optimist or pessimist camp. I like to think of myself as a realist and do my best to call it like I see it. This isn't to say that I know when or if this market cracks in a more material way than it has in the last 1 ½ years, where equity investors had to endure two double digit corrections. And, while I readily admit that market timing is a very humbling way to make a living, assessing probabilities and risk/reward trade-offs in the interest of positioning capital to side step potential material adverse downside outcomes is (in my opinion) a worthwhile endeavor. To me, now is one of those times, so a focus on quality within both the equity and credit markets is paramount and having some cash on hand for optionality purposes could prove prescient.

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