February 29th, 2016

Tops are processes, not a single point…

The reflation rally that began off the February 11th lows (when a broad swath of global equity indices reached 52-week lows: the S&P 500, Nasdaq Composite, Russell 2000, German DAX, French CAC, and MSCI All-Cap World Index, to name a few…) continued to push ahead last week, even in the face of some mixed economic data. The Dow Jones Industrial Average, S&P 500, and Nasdaq Composite all gained between 1.5 – 2.0%, lagging higher beta segments of the market, such as the Russell 2000 and S&P 400 Midcap which each surged more than 2.5%. Without question, investors are facing a very turbulent capital market backdrop this year with equity volatility rising to its highest level in several years. So far this year the S&P 500 has experienced daily swings of greater than 1% in 23 trading days (five of these days had moves of at least 2%); at this juncture in 2015 the S&P 500 experienced twelve 1% moves with none being greater than 2%.

As of Friday's close the S&P 500 has gained nearly 140 points (7.7%) from its recent low in eleven trading days and managed to get back near the 1,950 level for the first time since January 6th, but the major average is still down -4.7% on the year with lots of company (Dow -4.5%, Nasdaq -8.3%, Russell 2000 -8.7%, and MSCI World Index -6.0%). At week's end the S&P 500 sits fractionally above its 50-day moving average (1,945.50) which puts it at a critical juncture given this level has been tested twice already in February, failing to sustainably surpass it on both occasions. The 100-day and 200-day moving averages are converging on the 2,000 – 2,025 area with several layers of substantial resistance standing in the way before breaching those levels.

It's worth noting that the leadership in this latest rally is spurious at best with those sectors that have been pulling down the averages the most (in what is now moving on seven months of corrective action) leading the market higher and on lackluster volume to boot. Thursday's rally, which pushed the S&P 500 above its 50-dma, came on the fourth lowest volume day of the year (the bulls would much prefer to see these milestone levels taken out with some conviction behind it). With that in mind, it would be wise for investors to tread cautiously and remain selective when considering whether to deploy fresh new capital at what looks to be the high end of the 1,810 – 2,040 trading range that has been in place for the last twelve months.

Another fly in the ointment of the bullish narrative is this little issue of the financial sector (-10.5%) woefully underperforming the overall market (S&P 500 -4.7%) year-to-date and this continues to remain the case during this bounce back in risk assets. The KBW Nasdaq Bank Index is off some -18% for the year, and some of the large money center banks such as Citigroup and Bank of America are faring much worse (off roughly -25%).

Any rally should be suspect and considered unsustainable without the participation of the Financials, as I can assure you there is no group that better symbolizes the health of the overall economy and capital markets. The

Financial sector is one of many ancillary business segments being impacted by the carnage playing out in the oil markets as evidenced by JP Morgan's move to take a nearly $500 million reserve provision against energy credit losses just a week after it reported its financial results.

Something tells me this phase of the credit bubble, which is in the process of being popped in the over-indebted materials and energy sectors, is still in the early innings. The longer oil prices continue to hover around current levels (let alone move back into the mid-$20's – a very realistic possibility/probability), the more abundant and larger the credit provisioning across the financial sector will be. Also weighing on the financial sector is the whittling away of net interest margins as a result of falling interest rates and the likelihood that the Fed is due to remain on hold throughout all of 2016. The difference between the Fed raising rates just twice in the next two years or staying on the sidelines is equivalent to $2.5 billion of lost interest income for a major bank like JP Morgan.

In my view, the time will soon be at hand where the credit story behind the carnage playing out in the materials and energy sector will be the focus of the market's attention and what the Fed can/will do with monetary policy will have to settle for best supporting actor. At some point in the not too distant future the weak hands in the shale complex will run out of cash flow to service their debt and then they will meet the same fate that all of the over-indebted Dotcom and Telecom companies did back in the Tech Bubble from 2000-2002. This diminishing level of cash flow (as a result of oil prices cratering -70%) pushing up against elevated debt servicing cost as well as a soon approaching aggressive debt maturity schedule will keep the incentives high for companies to continue to spit out as many barrels of oil as possible no matter what price oil is trading at. Since the beginning of 2015 at least 48 North American oil & gas producers have filed for bankruptcy which has affected some $17 billion of debt, with much more to come.

An article in last Thursday's WSJ estimated that as much as half of all shale producers could go under if the Saudis do not cut output soon. In my opinion, this is precisely why any rumors about production freezes (let alone cuts) are just that, rumors and lip-service. After all, this is the pain the Saudi's have been waiting for and they realize that if they were to pull back the reigns at this point (likely causing oil prices to move higher) it would be akin to pulling out of a marathon less than 100 yards from the finish line.

Therefore, my guess is the Saudis will continue to remain patient no matter how frequent and how forceful the pleas are from Russia, Venezuela, and all the other financially strapped OPEC nations to cut production to support oil prices. By being patient they will allow these producers who are not financially equipped to weather the storm to go belly up, thereby organically cleansing and resetting the oil exploration and production market. Moreover, the IEA has recently come out with estimates suggesting that since oil prices peaked in mid-2014 energy companies have slashed 300k jobs worldwide and nearly $1.5 trillion of planned spending through 2019 has been shelved. It's estimated that this will take an average of 4.1 million barrels per day out of new production over the next five years with the shale industry seeing daily production decline by 800k barrels per day by the end of 2017.

One last thought on this topic: keep in mind that myself and every other informed market follower on the planet is aware and talking about low oil prices. We are now at the point where the pain is transitioning into actual fatalities, so those contrarian thinkers out there may want to start taking notice because it appears that a lot of bad news is already priced in. Yes, hindsight is always 20/20, but as unrealistic as oil prices above $100/barrel seemed only a few years ago, it is perhaps just as unrealistic to think that oil staying below $30/barrel over the intermediate term is plausible given that more than 75% of global production is uneconomic at current price levels. The long-term equilibrium price level for oil is an entirely different analysis given the growing focus on climate change and energy efficient technological advancements, so I'll leave that forecast for experts much more astute on the subject than I.

The economic data flow last week continued to remain mixed, but on the whole it was one of the more constructive weeks so far in 2016. The second revision of Q4 GDP growth was revised higher to 1.0% quarter-over-quarter (consensus was expecting a downshift to 0.4%) from the initial estimate of 0.7%. Unfortunately the internals driving the upward revision were not the kind that support the view that growth is picking up steam, given it was a result of a smaller inventory drawdown and weaker net exports (in large part driven by a bigger decline in imports than exports). Furthermore, personal consumption was revised lower to 2.0% from 2.2% as core PCE inflation moved up to 1.3% from 1.2%.

In addition to the upwardly revised GDP report, existing home sales increased 0.4% in January to 5.47 million units which represents the strongest pace of sales since last July and the second best reading since 2007. The strength in sales is coming against an extreme lack of inventory as the month's supply of homes on the market sits at just 4.0 in January (this is well below the typical six months of supply associated with a balanced market). This dearth of inventory (in tandem with an economic expansion moving into its 81st month) is a significant contributing factor to the S&P/Case-Shiller home national house price index continuing its upward climb as it increased 0.8% month-over-month in December (its fourth straight monthly gain of greater than 0.7%). This pushed the year-over-year acceleration in the national index to 5.4% (a 17 month high) as it now stands at its highest level since August 2008 – up 30% from the January 2012 lows but still 3.7% below the pre-recession peaks.

The all-important consumer side of the economic growth picture got a nice shot in the arm last week with both personal spending and income increasing a strong 0.5% month-over-month in January (consensus was expecting a print of 0.3%). Also in this report, investors got the latest reading on the Fed's preferred measure of inflation, the core PCE deflator, which accelerated to 1.7% from 1.5% (revised up from 1.4%) which marked the highest reading since February 2013.

In my opinion, this pushes the Fed deeper into the box it finds itself in as it closes in on the objectives of its dual mandate: 1.) Full Employment: the unemployment rate is below 5% and at the lower end of its Summary of

Economic Projection estimates, and 2.) Price Stability: inflation is moving up towards (and will likely reach) its 2.0% objective over the next couple months. Recall that these two economic variables lag the business cycle and are reaching the Fed's mandate at a time when many other parts of the economy are turning down. If/how the Fed moves the goalposts once again to skirt raising rates into a slowing U.S. economy will be interesting to see, because I believe they do know that additional hikes from here risk further exasperating the slowdown.

On the negative side of the economic data ledger last week was the Conference Board's measure of consumer confidence slumping to a seven month low of 92.2 in February from 97.8 in January. The deterioration in sentiment was broad based with assessments for both the current situation (three month low of 112.1 from 116.6 in January) and expectations for the next six months (lowest level in a year at 78.9 versus 85.3 to start the year) slumping. This is a trend worth following in the months ahead as it is one of the ten components in the leading economic indicators series and has a reasonable track record at forecasting the future direction of the economic cycle.

The other worrying data point reported last week was the Markit Flash Services PMI report for February, which sank to 49.8 from 53.2 in January. This was the weakest print in 28 months and first time this metric moved into contractionary territory since the government temporarily shut-down in October 2013.

Markit's Chief Economist, Chris Williamson made the following comments on the report:

> *"The PMI survey data show a significant risk of the US economy falling into contraction in the first quarter. The flash PMI for February shows business activity stagnating as growth slowed for a third successive month. Slumping business confidence and an increased downturn in order book backlogs suggest there's worse to come."*

> *"With the exception of the government shutdown of October 2013, February has been the worst month for business since the recession. Business activity in services fell for the first time since the shutdown, accompanying a marked slowdown to near-stagnation in manufacturing."*

"It's worth remembering that the month saw adverse weather affecting many parts of the country, so some bounce-back may be seen in March. But the weather can only explain part of the slowdown. It's clear that business confidence has faltered significantly, reaching the lowest since August 2010 in the service sector in February."

"Optimism about the outlook has been on a downward trend over the past two years, with worries about the global economic outlook, financial market volatility, the presidential election and interest rate policy all taking a further toll on business morale in February."

"Prices are falling again as companies compete to win market share; a boon for

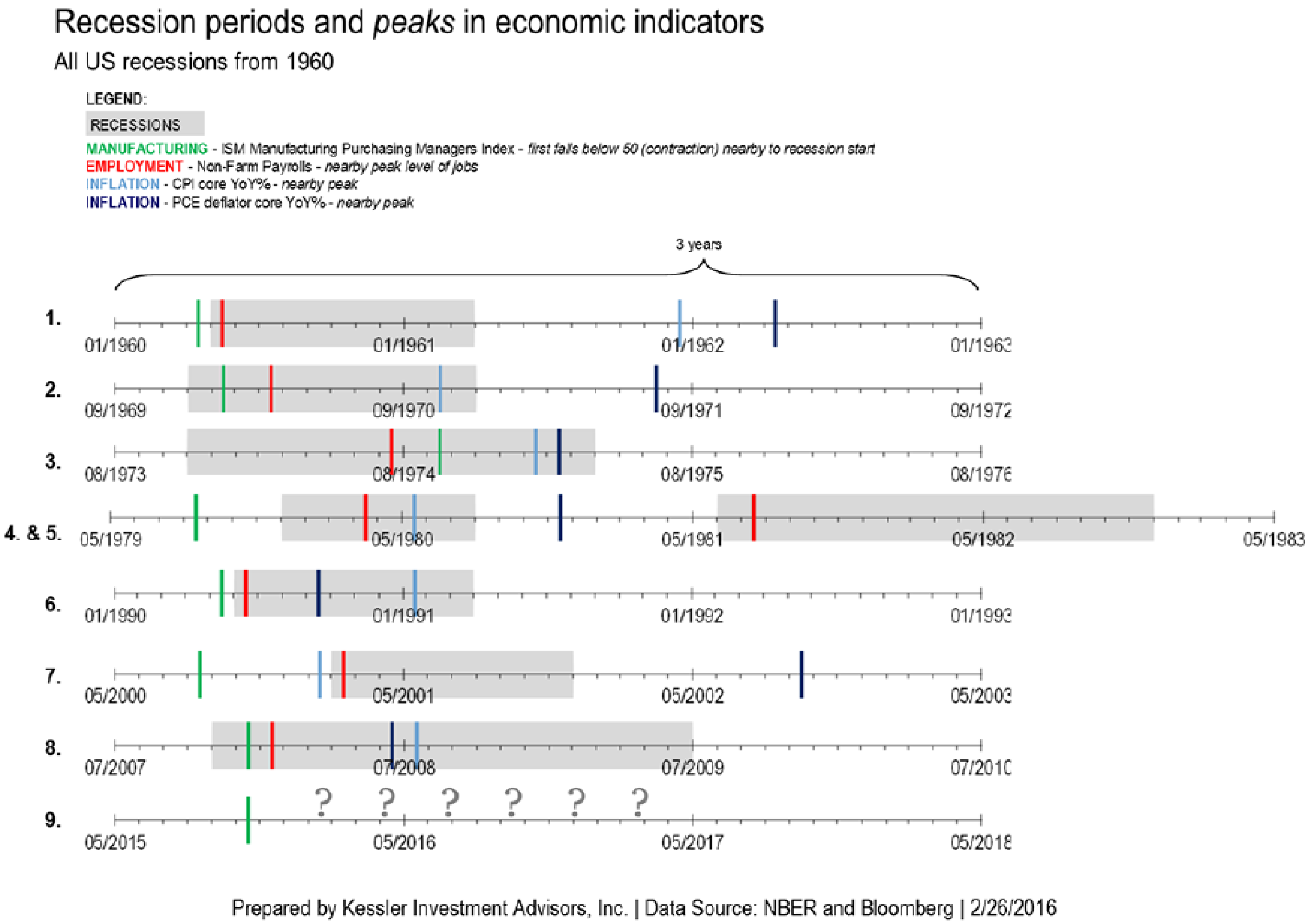
consumers but adding to the deflationary picture."

"Any bounce-back from the weather may therefore prove to be only a temporary improvement in a steady downward trend of business conditions."

This deterioration in the service side of economy should start to garner more attention as this segment of the economy – which dominates the manufacturing side in terms of output by a factor of 5:1 – had been holding up well until October of last year when it really started to break down. If this trend persists, it's going to throw a real wrench into the current narrative that the U.S. economy is on the cusp of a material reacceleration following the growth scare in the first couple weeks of the year.

Stepping back from the micro and looking at things from a bigger picture perspective, I think it is important for investors to understand how the sequence of dominos fall at the peak of an economic cycle. Keep in mind that tops in markets and business cycles are a process and while each data point will have a precise peak point, they are not all going to line up in unison – so waiting for or trying to time a precise peak is more an exercise in futility and luck than it is skill. Over the weekend I came across the below graphic from Kessler Investment Advisors which I believe provides a simplistic yet instructive summarization of the sequence in which the economic data dominos fall before, during, and after the business cycle peaks.

In the eight economic recessions since 1960 and isolating only three material economic indicators (manufacturing, employment, and inflation), you can clearly delineate a consistent sequential pattern. The following pattern played out in all but one of these recessions: manufacturing is the first major economic variable to peak (usually prior to the recession starting), followed by employment (usually peaks at the onset or early in the recessionary phase), and then inflation (typically peaks in the later stages of the recession and in some cases after the recession is over). The only period where this sequence did not occur was the recession from Nov. ‘73 – Mar. ’75, where employment peaked first and was soon followed by manufacturing turning down.



Those of you keeping a scorecard on these metrics will know that manufacturing as measured by the ISM manufacturing survey peaked in Q3 of 2014, employment on an

absolute basis continues to grow (but on a year-over-year rate of growth basis it peaked in Q1 2015), and inflation is in the process of making its late cycle ramp higher as the plunge in the price of oil and surge in the dollar have stalled.

I'll be the first one to admit that virtually every data point can be evaluated through the prism of one's own perspective – which I attempt to objectively share with readers when I pen these commentaries. That is what makes our industry so fascinating, frustrating, and humbling at times: in very few professions can a terrible result cause a rewarding outcome all because it wasn't as terrible as expected (go figure). Whether one wants to take the opposing side of what I perceive to be an obvious deceleration in economic growth is their prerogative, but they can't insist that this weakness is not being confirmed by the results coming out of corporate America. I'm sorry, you can have your own opinion, but you can't have your own facts.

Fourth quarter earnings are coming to a close with earnings set to decline -3.5% and mark the third consecutive quarter of negative year-over-year growth. This puts the S&P 500 trading at a P/E multiple of 15.7 on forward 12-month EPS estimates of $124/share. However, as investors very well know both the "P" and the "E" are subject to change, with the estimates for the "E" already in the midst of coming under the cleaver for Q1 and Q2 of 2016 (both quarters showing negative growth which would run this streak of earnings declines to five if the estimates hold up).

What's more, in an article I came across in the WSJ last Thursday they made the point that earnings fundamentals may actually be worse than they appear on the surface. While noting that operating earnings for all of 2015 are down only -0.4%, when the 'bad stuff' (below the line items that many companies like to categorize as 'non-recurring business activities') is included, reported earnings per share actually retreated -25% for all of last year. The disparity between these two reporting methods has been widening for years (both methods have their logic with the truth usually lying somewhere in between). If one were to believe that the 'as reported' numbers were the better reflection of underlying fundamentals, well then this market is a whole lot more expansive than it seems, trading at a P/E of 21 on reported numbers versus 17x trailing 12-month EPS.

Not until these trends in weakening corporate profits, a fraying credit cycle, and decelerating economic growth abate do I think we have a backdrop that is constructive for stocks. This could mean that stocks continue to lumber along in this broadening sideways trading range, just oscillating from one end to the other, checking time and allowing the fundamentals to heal enough to create a solid base for the next leg higher. Or, perhaps the dam breaks and we enter into recession which creates a widespread cleansing of the weak hands and speculative excesses.

Time will tell how all this plays out in the equity markets, but the action in the bond market is confirming the fragility in both the economy and stock market. Last week with stocks rallying nearly 2%, the yield on the 10-year T-Note fell all of 2bps to 1.74% and the 10s/2s spread compressed to a new cycle low of 96bps. Trust me folks, this compression is not an indication of growth picking up – this spread steepens as growth accelerates and compresses when growth is slowing. I suggest anyone who thinks the U.S. 10-year Treasury yield can't go lower, take a look around the world as 10-year JGB's fell to -6bps last week, the German Bund 10-year yield traded below 15bps (its 5th lowest close in history), the Swiss 10-year bond yield is down to a negative -0.45%, and more than $7 trillion of global sovereign debt now trades with a negative interest rate (all this makes Treasuries look like a bargain).

Falling interest rates, faltering central bank credibility, the growing risk of a global currency war, and escalating political backlash (the threat of Great Britain exiting the Eurozone and a U.S. Presidential election where outsider candidates such as Trump and Sanders are no longer punchlines to a joke but real threats to get the nomination from their respective parties) has created a perfect storm for gold. The yellow metal has regained its allure as a store of value in troubled times as it is one of the best performing assets year-to-date, up almost 16%.

The upcoming week is once again the first week of a new month which brings with it the latest reading on some key economic data, namely: construction spending, vehicle sales, manufacturing and non-manufacturing activity, Fed's Beige Book, and employment. On top of that we will gain some color on the candidates best positioned to take over the executive wing of the White House with a total of 12 states up for grabs on Super Tuesday. Many of these states are in the south and will be critical for Ted Cruz to stay in the race. Marco Rubio has emerged as the most credible force from the establishment to take on Trump, but recent polls show him lagging Trump in his own state of Florida and if he were to lose on his own turf it would serve as a significant blow to both his candidacy and the GOP establishment.

It's a fair guess that between March 1st and March 12th we will have a pretty good idea of who will be the GOP nominee, given 989 delegates are up for grabs with a total of 1,237 needed to secure the nomination. Then once the calendar turns to March 15th the real fun begins with the winner take all states going to the polls. On the Democratic side, Bernie Sanders has put up much more of a fight than the Clinton campaign expected, and his momentum could well continue, but most polls continue to show that this is Hilary's nomination to lose. Whichever way the results come out over the next couple weeks, the market will start focusing more on the policies and potential capital market implications as the front-runners separate themselves from the rest of the pack.

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