May 16th, 2016

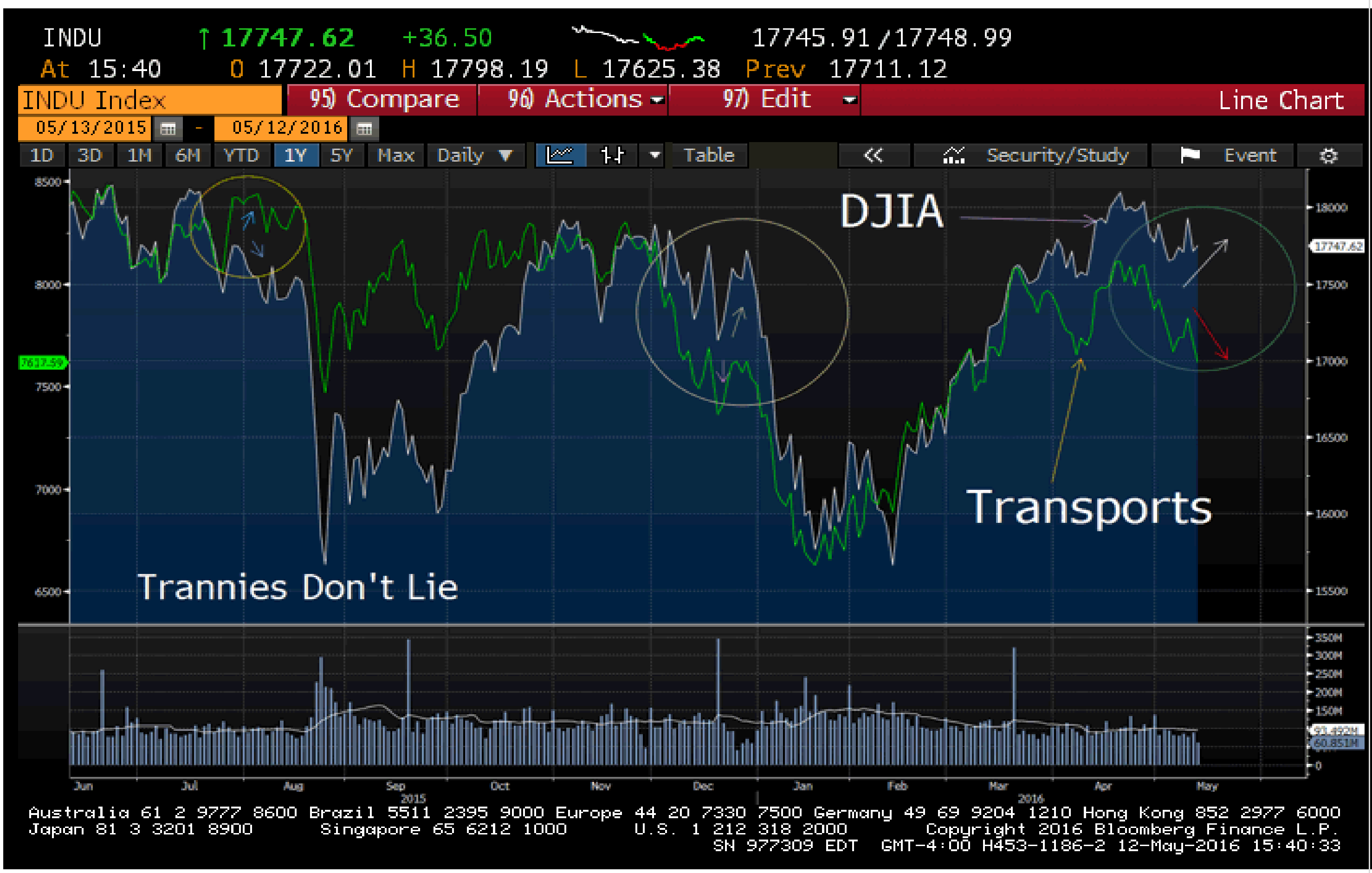
Global debt levels – they aren't a problem until they are…

U.S. equities experienced their third consecutive weekly decline (the S&P 500 has finished in the red in six of the last eight weeks) with both the Dow Jones Industrial Average and Russell 2000 registering losses of a little over -1%, while the S&P 500 and Nasdaq Composite declined -0.51% and -0.39% respectively. Keep in mind that three straight weekly declines and six of the last seven is not as bad as it sounds, with the S&P 500 reaching its year-to-date high on April 20th at 2,111 and its low print since then was

2,039 on May 6th – so a lot of chop at the high end of what has been an 18 month trading range between 1,800 – 2,100. Weakness in the retail space from the likes of Macy's, Kohl's, JC Penny's and Nordstrom (all of which experienced double digit stock price declines last week) set off renewed concerns that one of the last bastions of strength holding the U.S. expansion together (the consumer) is fading.

One observation that I think continues to warrant attention is the decisively defensive shift in leadership among the sector-constituents of the equity market. The S&P 500 and the Dow are back to a snick above the flat line for the year, yet it's the Utilities (+14.12%), Energy (+7.74%), and Consumer Staples (+5.45%) sectors that are heading up the year-to-date performance leaderboard with Healthcare (-4.01%), Financials (-3.99%), and

Technology (-1.45%) falling to the back of the pack. Not exactly the sort of leadership one typically sees in a bull market, and the latest divergence between the Dow Jones Transports Average and the Dow Jones Industrial Average could spell trouble ahead as the Transports have led the market in both directions (up and down) over the last 18 months.



The weakness in U.S. equities looks marginal relative to the pain that is playing out in other parts of the world: China's Shanghai Index is in the midst of its longest negative stretch in two years having declined for four straight weeks (off over -40% from its highs), Emerging Markets lost ground for their fourth consecutive week (a streak not seen since last August when China's devaluation sent shock waves through global markets), the main Italian and Japanese stock indices are down over -25% from their highs last summer, and the MSCI All-World equity index has fallen for three straight weeks (the longest streak since January).

Adding to the cloudy narrative hovering over the 2/3^{rds} of U.S. GDP that we call the consumer was the surge in weekly jobless claims for the second week in a row to 294k (a 15 month high). This marked the third consecutive week of rising claims and after a worse than expected and below trend April payroll print of 160k, many investors are nervously coming to the belief that employment growth may finally be taking a step down to fall in line with the slide in business output that has persisted for over a year now. Over the last two quarters nonfarm business activity has inched ahead at a 1% annual rate while the total hours worked has risen at nearly 2.5% – something clearly has to give? If this dichotomy converges as the data would suggest, it should not take investors by surprise given the global earnings recession remains in full swing: Bloomberg data shows nearly 460 S&P 500 companies have reported Q1 earnings, which are down -8.8% year over year – which are poor for sure, but much better than the -19% decline in Asia or the ugly plunge of -27% in Europe.

Suffice it to say while the global macro and capital market environment has grown more confusing over the last several months one has to respect the resilience and resourcefulness of the S&P 500, which at last week's close still sits just 4% shy of its all-time high. Surely one can question whether a market that hasn't made a new high in almost a year can still be considered a bull market, but it sure as heck can't be called a bear market either – let's call it range bound and directionless for now with a sprinkle of intense buying and selling pressure from time to time.

What's been fascinating about this year is observing (at times) the gradual transition and (at other times) the sudden shift in the optimistic or pessimistic investment narrative. Whether it be the negative impacts of the strong dollar on corporate profits, emerging market debt, commodities and deflation (which was the case coming into the year, causing the worst start to a calendar year for the stock market in history) or the about face of this narrative as the dollar reversed course (declining over -7% at its nearby lows from where it began the year) and all of what ailed the markets was cured. Or the Fed implementing its first rate hike in nine years in December while guiding investor expectations for an additional four hikes to occur in 2016 (a policy which undeniably rattled investors and markets at year end and into this year) to then surprise markets in March by lowering their growth and inflation projections to be more in-line with market expectations and in tandem reducing their forecast for interest rate hikes from four hikes this year to two.

This game of trying to catch the bouncing ball is likely to continue for a little while longer, but many of the major themes that will dictate the next significant and protracted move in the capital markets are still very much in play. The elephant in the room remains the sheer size and amount of outstanding global debt which is acting as an anchor on global growth. Before peeling back this onion it must be stated that the U.S. banking system is in far better shape than was the case seven years ago when the housing market (the bedrock of the household balance sheet and financial system) crumbled and nearly brought the entire global financial system down with it. As government policy is prone to do following a major catastrophe, they've moved too far in the direction of overregulating these financial institutions in an attempt to stave off this calamity from ever happening again. The trouble with this reflexive reaction is that household balance sheets are in their best shape since before the credit crisis and are no longer the problem. The debt problem today resides on the balance sheets of sovereign governments and corporations.

McKinsey published a report in early 2015 where they estimated that global debt has increased by $57 trillion in the seven years ending 2014. The biggest culprits of this debt heap were sovereign issuers, where government debt swelled to $58 trillion from a starting point of $33 trillion (9.3% annual growth rate) while at the same time corporations increased their debt levels by 5.9% per annum from $38 trillion to $56 trillion. As a result global debt to GDP ratios are higher now than they were before the ‘08/‘09 ‘Credit Crisis’, having risen from 213% in 2007 to nearly 235% today. What’s more is that the growth rate of this mounting debt pile is nearly double the rate of global GDP over the last seven years.

And while the U.S. is considered to be the sturdiest and best house on the block, it does stir a bit of anxiety seeing GDP growth decelerate to stall speed over the last two quarters (GDP growth of 1.4% in Q4 and 0.5% in the first quarter of this year) as this is an indication of lower nominal income/profit growth to service such a massive debt pile. The global corporate default tally has climbed to 62 issuers for 2016, which is the highest level at this time in the year since 2009, according to data from Standard & Poor's. At the same time, speculative-grade downgrades have been running at 55/month year-to-date, far higher than the 29/month rate over the same period in 2015 and the corporate default rate in the U.S. just hit a six month high of 3.9% in April (still low by historical standards), but S&P is predicting this will rise to 5.3% a year from now and a peak of near 7%. What's more is that companies and economies are at the point where the servicing capacity of this over indebtedness is choking off their ability to invest, expand, and grow.

Take China for example, as I firmly believe a couple decades down the road they will represent a great case study for historians to look back and analyze how they handled this situation in real-time. Over the last five years China's debt/GDP ratio has ballooned from 150% to 250% and currently stands at a higher level than the U.S. at 248%. A recent article from the Economist, 'The Coming Debt Bust', stated that problem loans in China have already doubled in the past two years and currently represent 5.5% of outstanding bank loans. The problem is boiling over into the corporate space as well with 22 corporate bond defaults announced already in the first four months of the year and this matches the total from all of 2015. A full 72 Chinese corporate bond issues have been pulled this year and another 16 new offerings have been postponed.

Clearly recent market activity suggests that this issue is getting worse, not better. However, dealing with this debt burden is a double-edged sword: choosing to look the other way or offset short-term weakness with stepped up stimulus (as was the case in Q1) runs the risk of bringing down the entire global financial system if/when the bubble ultimately bursts. On the other hand, by dealing with it they would be forced to constrict credit creation which will assuredly cut into growth prospects for not only the Chinese economy but the entire world, and likely renew a bear market in the still healing commodity markets.

Sadly, seven years after the credit crisis and unprecedented monetary stimulus and this is the setup investors have on their hands heading into another potential downturn. In my opinion, central banks have painted themselves squarely into a corner – the BoJ and ECB are already running negative interest rate policies and the Fed Funds rate in the U.S. stands at a miniscule 0.375%. There is nearly $7 trillion of government bonds globally that yield less than zero and $9 trillion carries a yield of less than 1%. What possible stimulus could they provide, other than more of the same in the event of an economic recession occurring?

Perhaps as important as pondering what tools the Fed has left at their disposal is assessing whether markets and investors find any additional stimulative actions as credible. Recent statements by Fed officials (Rosengren and George) and Chair Yellen herself continue to suggest they expect two rate hikes this year, yet the futures market does not have a full Fed rate hike priced in until November of 2017. Is this not an indication that the belief system in central bank's ability to bend or curve economic gravity is starting to (at a minimum) fray? Furthermore, policies that were once viewed as a possible panacea (because they were new) to bridge the gap until the economy could stand on its own two feet are now scrutinized under the laws of diminishing returns.

Even though the U.S. stock market continues to hang in there near its all-time highs, the fundamental underpinnings that would validate it not only holding these levels, but breaking out of the upper end of its trading range continue to deteriorate. This is the message I think the bond market is coming around to with the 10’s minus 2’s yield spread compressing to its year-to-date lows last week. This indicator garners a lot of respect from market aficionados given its reliability at forecasting the economy and business cycle. When the economy is healthy – creating sustainable wage pressure and growing above potential – the 10’s - 2’s spread will widen as investors demand a higher yield on long-term bonds as compensation. When the economy isn’t healthy and growth is decelerating, as is the case today, this spread will compress and last week it declined to a fresh 8-year low.

The take away from all of this is for investors to continue to execute vigilance and prudence with where and how they allocate capital today. Security selection and risk management carry more importance today than normal and that's not to say there are not opportunities to take advantage of, it's just that they are fewer and farther between than say three years ago. Investors are looking at a stock market that, for all intents and purposes, is no higher today than it was 18 months ago as valuations push to cycle highs, year-over-year earnings growth has declined for three consecutive quarters, profit margins are contracting and global interest rates are challenging all-time low levels. This in and of itself should tell you something.

It's always tough to forecast a crisis or a recession and it's never an enviable task because those of us that have been through a couple know the implications. They are not fun and sadly people get hurt, and it is for that reason I believe the current environment demands respect from any investor who has capital at risk. Investors should not underestimate the level of potential risk that exists today, as an appropriate measure of skepticism will likely serve them well in successfully navigating through what is a challenging capital market minefield. Patience is a virtue that teases us in all walks of life, including investing, as is detailed in the archives of history: a crisis always takes longer to arrive than you think, and then once it occurs it unravels much more quickly than you thought.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215