August 22nd, 2016

What could possibly go wrong?

U.S. equity markets were a big yawn last week with both the Dow Jones Industrial Average and S&P 500 registering miniscule weekly declines of -0.13% and -0.01% respectively. The Nasdaq registered its 8th consecutive week of gains (+0.1%) with the small cap Russell 2000 coming in as last week's big gainer (+0.57%). It was also quiet in fixed income land with the 10yr Treasury yield continuing to be locked in this narrow 1.4% - 1.6% trading range, even despite renewed scuttlebutt from various Federal Reserve officials that the upcoming September

FOMC meeting is a ‘live’ meeting for a possible rate hike.

More on the Fed in a bit, but I remain steadfast of the view that the Fed has painted itself into a very tight corner with an economy that remains stuck in the mud and mounting evidence that monetary policy is an impotent antidote for what has ailed the economy in the aftermath of the ‘08 credit crisis. If the markets were really concerned about the Fed tightening come September they surely aren’t acting like it when you see the dollar index trading down to its lowest level since late June (the first back-to-back weekly decline since April) and Fed Fund Futures only pricing in a 50% chance that the Fed hikes at all this year.

Gold continues to consolidate around the $1,350/oz level and has made very little headway now for the past six weeks. Which brings me to oil (the black gold), where I have to admit my fascination with observing the way in which OPEC has taken the mantle of manipulating investors into moving the oil price with well-timed rumors of a production freeze. The latest instance is the second time this year such rumors have percolated to arrest oil prices from falling below key technical levels – this time it looks as though $40/bbl is the line in the sand. The first occurrence was back in January, and the irony with this latest rumor is that it apparently includes some complicit endorsement from the Saudis and Russians – the irony is that back in January The Kingdom was pumping out 10.2 million barrels per day and expectations today are for them to pump somewhere between 10.7 - 10.9 million bpd in August. So, yes an output freeze on the surface sounds bullish for oil prices, but a freeze from what production levels?

Talk is cheap, so let's just see if any of this comes to fruition. In the meantime the oil spigot remains wide open (price dependent of course), and then there is Iran which has very little incentive to tap the brakes on its production as it pushes forward on its quest to recapture years of lost market share.

Not to mention the latest Baker Hughes rig count data where 10 oil rigs were brought online in the week ending August 19th – this is the eighth consecutive week of gains and 12th in the last 13 weeks where the total rig count has increased from 316 at the May 27th low to 406 as of last week. For sure the current rig count tally of 406 is down -268 rigs from a year ago and still down nearly 75% lower than the peak in the fall of 2014, but as with most things in economics it's the marginal change that matters and it appears as though $50/bbl is a price level at which some producers feel comfortable increasing production.

I want to touch on some of the incoming economic data over the last couple weeks, which has been a bit herky-jerky this year and of late has softened relative to the bounce we got from February through June. It was two Fridays ago when markets were greeted with what was no doubt a super-soft retail sales report with a flat reading for July (handily below consensus expectations of +0.4%). Given what we have been seeing in the BLS employment report, with both job and income growth in June and July (where nearly 550k new jobs were created), one would have expected another strong retail sales print. However, what we got was a big dud.

What is looking more and more evident in this stop-and-start spending pattern for the 70% of the economy that we call the 'U.S. consumer' is that an ever intensifying set of variables is competing for their spending dollars – be it student debt (this now tallies more than $1.3 trillion), rising health care expenses (this category is increasing at more than a 3.5% annualized clip in the latest CPI data), shelter (inflation in this segment is also running north of 3.5%), and a renewed focus (or necessity) on savings.

The savings angle is interesting as it runs counter to what was the theoretical premise for the Fed's zero interest rate policy – a policy that is now approaching its eight year anniversary. The wealth effect theory postulates that if interest rates were flattened like a pancake it would inflate asset prices and incentivize savers/investors to move out on the investment risk spectrum which would increase the access to capital for capital seeking endeavors and in turn unleash a sustainable broad based economic expansion. However in retrospect what these policies have done (in addition to one of their intended effects of raising asset prices) is create an environment where an increased savings rate is a necessity in a world where rates of return are becoming ever more muted.

You see what perhaps got overlooked in this theory was the demographic profile of the U.S. economy where the most senior of this 'pig in a python' age cohort known as the 'baby boomers' turns 70 in 2016, with nearly 1.5 million boomers reaching this age each year for the next 15 years. These boomers, they're smart cookies and have very little trouble looking at the mortality tables where they can see there is a better than 50/50 chance of living to age 90 which means they have to procure enough capital to subsidize their income needs for another two decades. What do you expect a person to do when they recognize that the asset class they were counting on in retirement to generate a secure 3,4, or 5% rate of return (the bond market) no longer exists?

A. Save more?
B. Spend less?
C. Work Longer?
D. Take more risk?
E. All of the Above?

The answer: E, All of the Above.

Complicating the ‘golden years’ for this demographic is the unfortunate circumstances of living through two bubbles (Tech Bubble in ’00 – ’02 and Housing Bubble in ’08) that has left the median net worth of this age group no higher today than it was 20 years ago and 15% less than at the 2007 peak.

What is key from an investing standpoint is that these boomers are entering the part of the investing life cycle where traditionally their attention turns away from growth and accumulation (stocks) and towards preservation and safe income (clipping coupons from bonds). However this traditional way of thinking and investing is not realistic today when a 10-year Treasury yields 60 basis points *less* than the dividend yield on the S&P 500. It's little wonder why Utilities and Telecom (two sectors recognized for their income characteristics) head up the sector performance scorecard with both generating nearly 20% total returns year-to-date.

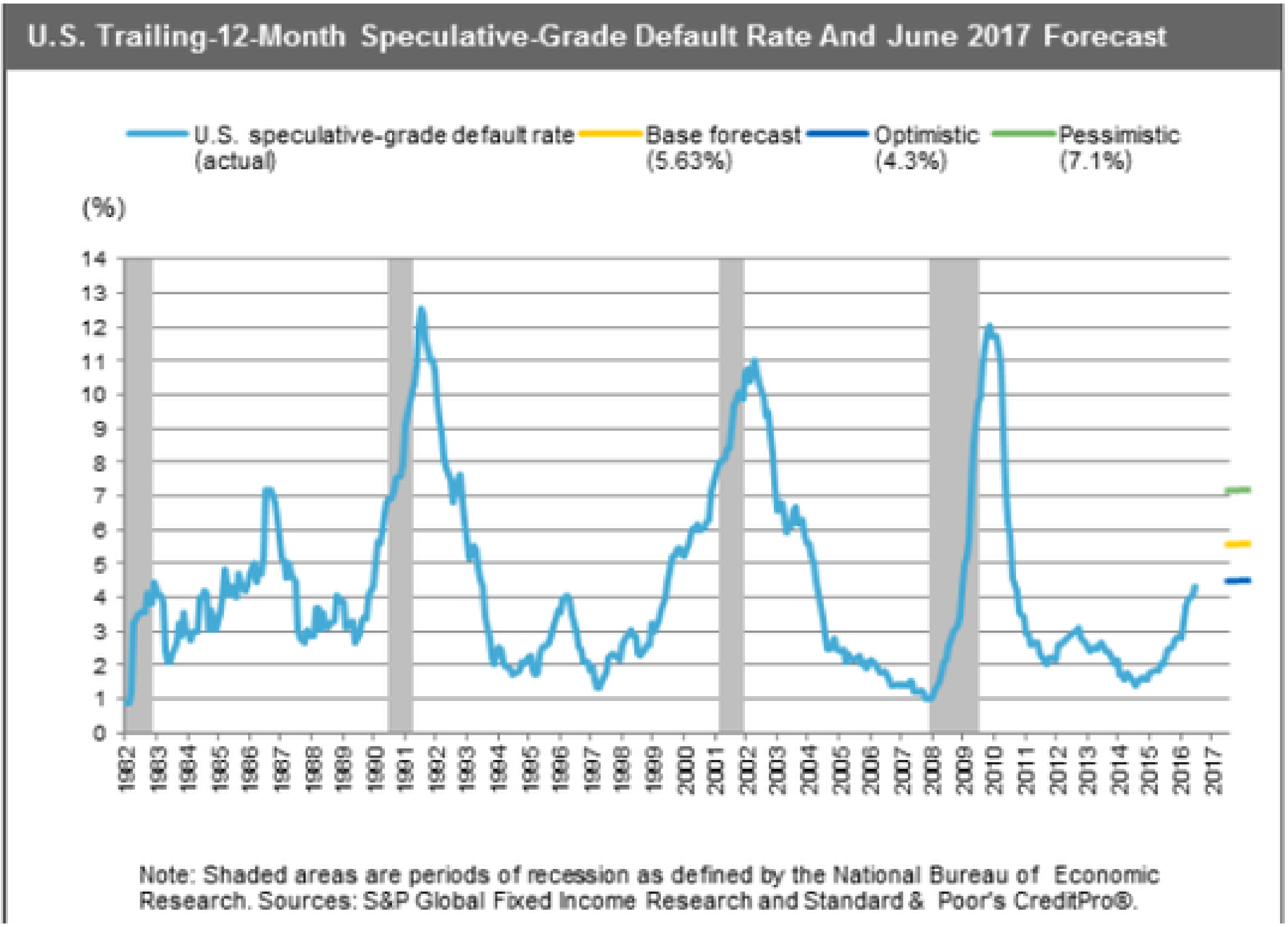
The search for secure income has been an ongoing theme throughout this entire economic cycle, but really took on a whole new meaning with yields across the globe plunging to record lows in 2016. As an investor you can fight it, you can ignore it, and you can doubt it but there is no denying it is a present day reality in this bizarre world that global central banks have created. Who would have ever thought that investors interested in speculative capital gains would be playing in the Treasury bond market and those who want an income stream would be embracing the stock market?

This isn’t a glowing recommendation for yield hungry investors to run out and buy every and any yield paying instrument available because there looks to be an insatiable appetite and need for securities that offer such characteristics. The demographic element is only one factor of many to consider when assessing the investing landscape today.

Beneath the surface there are some red flags casting a dark cloud over the fundamental backdrop for this chase for yield investment theme. In the stock market it is mainly centered on stretched valuations and the lack of earnings growth. In the bond market the divergences between prices and fundamentals are becoming harder and harder to explain, let alone justify.

In the corporate bond market we have seen spreads compress all the way down to 534 basis points, which is quite an accomplishment when these spreads were at 850 basis points in February. For sure we are in a much a different place today than we were in February as it relates to economic fragility, and yes both the ECB and BoE have joined the BoJ in adding corporate bonds to their QE policies, but it’s difficult to surmise that current spread levels properly reflect escalating default levels.

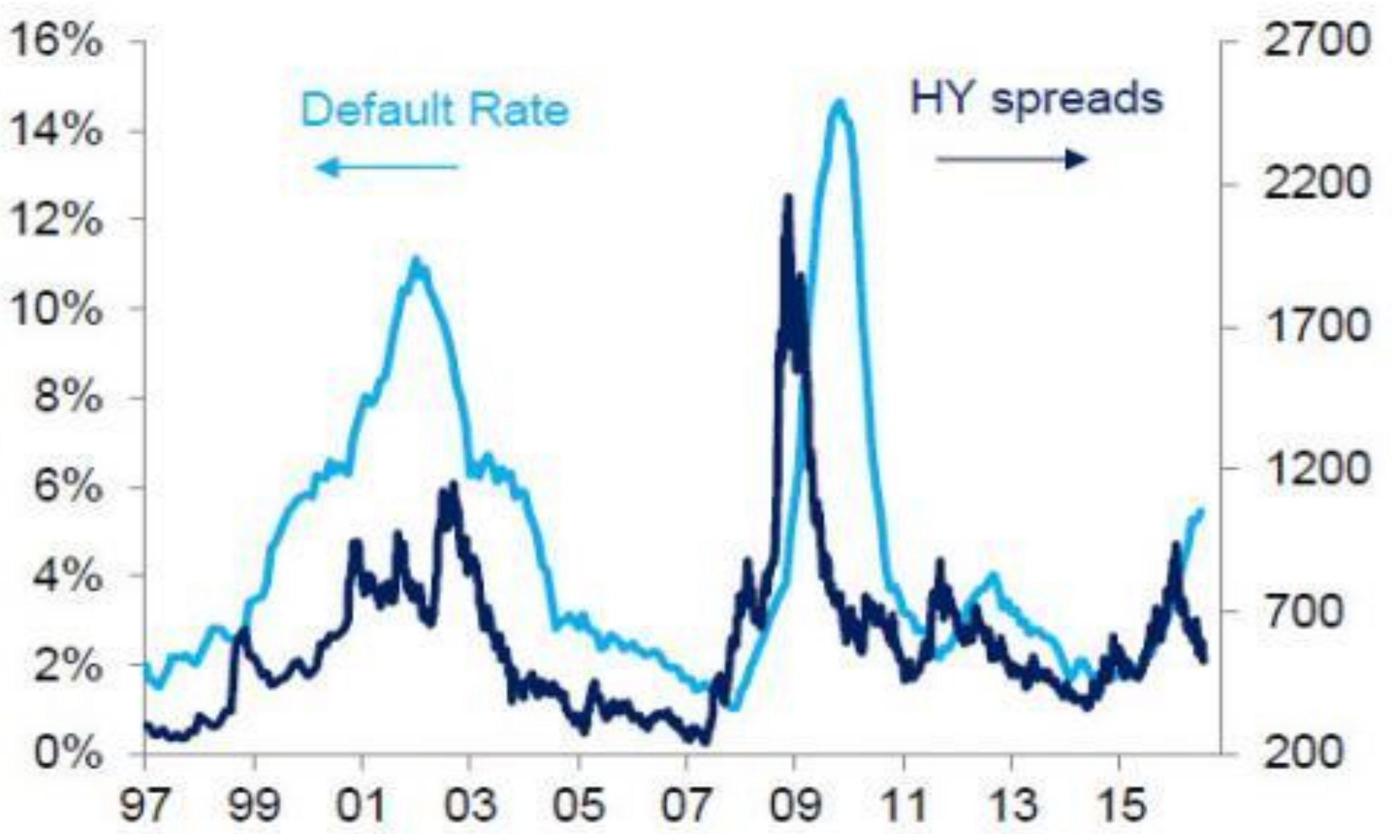
A recent report put out by Standard and Poor's revealed that a total of 113 companies globally have filed for bankruptcy protection so far in 2016 which matches the total for all of 2015 and we are on pace this year to take out the 2009 tally of 208 global bankruptcies (keep in mind back then the U.S. was still mired in recession and the impacts of the Global Financial Crisis). Indeed much of the default pain is a result of the plunge in commodity prices with the natural resource industry having accounted for 57% of the defaults in the last 12 months. S&P estimates that the U.S. corporate default rate will hit 5.6% by June 2017 – up materially from the 4.3% default rate in the 12 months ended June 2016.



As of now markets could care less about the relationship between defaults and the risk premium they demand for taking such risk. Maybe 'this time is different' and investors are right to place such faith in central banks to be able to support all asset classes, but the below chart shows that over the last two

decades when default rates increased, yield spreads followed.

Figure 3. US high yield OAS (bp) vs default rate (%)



Source: Citi Research, Yield Book, Moody's.

Back to the economic data for a moment, where the good news continues to be that a U.S. recession is not imminent, but the not so good news is that the economy remains soft.

- Last week’s Philly Fed Index came in at a somber +2.0 reading in August which is up slightly from the -2.9 level in July, but the internals of the report were much worse than the headline. The employment index plunged to -20 from -1.6 and this is the lowest reading on this subcomponent since July 2009 (the depths of the GFC). New orders fell to -7.2 from +11.8 and backlogs dropped to -15.0 from +1.9, both hitting their lowest readings for the year. On an ISM adjusted basis the Philly Fed fell to 45.4 (a four month low) from 49.9 and suggest we could be in for a soft ISM print when it is released next week.

- In contrast we also got the New York Empire Index which sagged to -4.21 in August from +0.55 in July. The internals of the report were a bit more constructive than the Philly Fed Index with the biggest standouts being the "six month outlook" index falling to a five month low at +23.74 (down from +29.24 in July and +29.59 in June) and the hiring plan component swinging from a +1.1 in July to a decline of -6.19 in August (a level that hasn't been seen since March 2009).

- The Conference Board's Leading Economic Indicator (LEI) came in a little better than expected with a 0.4% month-over-month increase for July which raised the annual growth rate to a three month high of +1.2%. This indicator – which has a reasonable track record at forecasting economic recessions in advance of their occurrence – is confirming that while the overall economic footprint is rather dismal, a recession remains some ways off. It's not until the year-over-year trend in the

LEI turns negative (currently at +1.2%) and the diffusion index falls below 30% (currently at 80%) that we are within six months of a recession – within three months of a recession these metrics are at -1.0% and 25%, respectively and by the time the recession hits we are at -4.0% YoY and the diffusion index is at 20%.

Which brings me to the Fed, where over the last week many of the FOMC members (Williams, Dudley, Lockhart, Bullard, and Fischer, to name a few) have been voicing their views on current policy in relation to the economy, where a chorus is growing that the Federal Reserve is nearing a point where it might make sense to raise rates again. Consider me one of those holding the view of "I'll believe it when I see it". Investors have been down this path before with the Fed pivoting back and forth between hiking and not hiking several times over last 10 months. Dust off your history books – whenever the Fed has paused for this long in the past after a hike (pushing on nine months come September), the next move was an easing.

This is the same Fed that hiked rates in December and went on to guide the markets to expect four to five hikes in calendar year 2016 – and how many hikes have we had this year? ZERO. I'm not saying they should hike rates – quite frankly I think they'd be crazy to when real GDP growth in 2016 is running close to 1.5%, which is a material slowing from the 2.6% pace in 2015. There are growing signs that we've reached the peak of the automotive cycle, we may be approaching the peak of the housing cycle, productivity has contracted for three straight quarters, corporate profits have declined for five straight quarters (going on six?), and now we’re seeing signs of the consumer slowing down.

Yes, the labor market looks tight with a sub 5.0% unemployment rate, but if you look at the U-6 measure of unemployment at 9.7%, the 8 million citizens seeking employment, or the 94+ million people not in the labor force you could make the argument that the labor market is as weak today as it was during ’08 recession. Furthermore, inflation levels remain subdued with inflation expectations nowhere near a level where economists would be concerned that “Joe the Plumber” was starting to base his consumption patterns off the prospect of things being more expensive in the future.

So no, on the strength of the economic data argument, it does not make sense to hike. I’m of the view that the Federal Reserve is more than mindful of the fragile foundation underpinning U.S. growth and they realize that in the context of even more accommodative monetary policy by other central banks around the world, their standing pat and doing nothing is (for all intents and purposes) tightening on a relative basis. Lastly, we are already seeing tightening across the credit channels as has been on full display in the Senior Loan Officer Opinion Survey (SLOOS) with lending standards tightening for three straight quarters. For context, looking back at past cycles when we see this level of tightening in the SLOOS (C&I loans tightening for four consecutive quarters, CRE tightening across the board, and Auto Finance tightening in Q2 for the first time since 2011) it doesn't reverse course until it runs its full cycle.

All of this puts a lot of attention on what Janet Yellen has to say when she delivers her speech from Jackson Hole on Friday. For anyone who hasn't caught on yet this is her Fed, it's her voice that matters most, and she is the one that will go down in the history books when they are written about this era. Yes, she inherited this hand from her predecessor (Bernanke) and as a result their legacies will be forever tied, but there remains many chapters yet to be written.

As for the stock market, what can I say – it's been a fascinating year where equities to this point have had no problem climbing what seems like an ever growing wall of worry:

- The S&P 500 has risen almost 10% in the midst of a five quarter earnings recession that saw corporate profits fall 20% – no match for the central bank put.

- Interest rates globally falling to all-time lows – no problem when the benefits of a lower discount rate to support present value models outweigh any indications that low rates might foretell slowing global growth and persistent excess capacity (both of which hinder top line sales growth and profit margins). There were (are) also concerns that liquidity in the bond market is so low that the bond market vigilantes could at any moment create a stampede out of fixed income markets and freeze the entire system (just because it hasn't happened doesn't mean it can't, but this issue is pretty widely known at this time).

- The Chinese economy finally experiences the hard landing that so many investors have been calling for and the 3.5% one-time Yuan devaluation scare last August turns out to be just an appetizer for a much steeper 15-20% devaluation. Nope, didn’t happen and the global currency war that was supposed to ensue as a result – well that looks to be happening but in a very controlled manner.

- A U.S. recession – nope those odds have receded, but haven’t been vanquished.

- The Brexit vote, which was supposed to unleash an economic tsunami that tipped the Euro Area into recession. We got the Brexit, but the fear mongering rhetoric of potential economic havoc turned out to be much worse than the actual bite. Also, nothing really happens on this file until Article 50 is invoked with starts the two year negotiating clock for an outright EU exit. Oh, and BoE head Mark Carney unleashed his monetary policy bazooka just to make sure and flood the U.K. system with enough money to prevent any near-term chance of the U.K. economy drowning.

- Then there is the U.S. election – much of the angst in the primaries centered on the possibility of a Donald Trump presidency. While the polls could change or (as was the case with the Brexit vote) they could be wrong, but most polls show Hillary with a commanding lead and likely to become the next U.S. President. There is no question that both candidates carry their share of baggage, but Hillary represents to the markets a known commodity and a continuation of the Obama agenda – under any circumstances markets will always prefer certainty over uncertainty.

So, nothing to this point has been able to knock stocks off their lofty perch, but the current set up sure looks like a treacherous one to me. You have a VIX index trading with an 11 handle, sentiment indicators across the board reaching year-to-date highs in terms of bullishness, the latest positioning reports from the CFTC and Prime Brokers suggest bullish market positioning is at its most extreme in the last twelve months, and valuations are at the richest levels of the cycle.

The below chart eloquently captures the picture of what it looks like when greed overtakes fear in the stock market. Since the end of the third quarter in 2014 the S&P 500 has appreciated by 10% while earnings for the S&P 500 have declined by almost 20%. The following graph depicts what this divergence looks like when investors are willing to pay 30% more today for a dollars' worth of earnings than they were willing to back in 2014.

Keep in mind that back in 2014 the U.S. economy printed a GDP growth rate of 4% in Q2, 5% in Q3, and S&P 500 earnings growth was hovering around 12% year-over-year. No one knew at that time that Q3 2014 (at this point) would mark the peak growth quarter for U.S. GDP or that Q3 2014 would mark the peak in corporate profits for the next two years. What could possibly go wrong?

No, back then the hope and expectations placed on investing in stocks made a lot of sense based on the fundamental backdrop, where we were in the business cycle, and fair valuation levels. This stands in stark contrast to the current set up where the hope remains well bid, but the constructive fundamental underpinnings are materially lacking.

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