August 29th, 2016

Risk hypnosis…

Last week was yet another quiet week in terms of capital market activity with the only significant headline grabbing event being the gathering of global central bank officials at the annual Jackson Hole symposium. Stock and bond markets traded with little direction and conviction all week in advance of Fed Chair Yellen's speech on Friday where her comments (for the most part) fell in-line with market expectations. Her message was consistent with the view shared by several other Fed officials (Kaplan, Dudley, Mester, Lockhart…) earlier in the week, that incoming

U.S. economic data is such that “the case for an increase in the Fed Funds rate has strengthened in recent months.”

> *"Based on this economic outlook, the FOMC continues to anticipate that gradual increases in the federal funds rate will be appropriate over time to achieve and sustain employment and inflation near our statutory objectives. Indeed, in light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months. Of course, our decisions always depend on the degree to which incoming data continues to confirm the Committee's outlook."*

The market’s initial reaction was rather subdued as assets with a high sensitivity to interest rates declined the most, but what caught my attention was the fact that most assets (stocks, bonds, REIT's, and commodities) eventually sold off later in the day on what was interpreted as a hawkish Fed tilt. The U.S. dollar rallied, but like most other asset classes the DXY index remains ensconced in a range between 93 and 96 and gold (which historically has a negative correlation to the dollar) finished flat on the day. On the margin it looks as though markets continue to retain an elevated level of doubt that the Fed will actually hike at the September meeting with the Fed Funds futures market increasing to 42% post Friday's comments from Fischer and Yellen (was 32% on Thursday) and odds for a December hike moving up to 64% from 57%.

What is clear is that interest rates remain on the 'lower for longer' path irrespective of when/if the next rate hike occurs. This point was made loud and clear by Chair Yellen in her speech where she highlighted the range of possibilities for rates in the years ahead, noting there is a 70% probability rates could be anywhere between 0% and 3.25% at the end of 2017, and between 0% and 4.25% at the end of 2018 – saying that "the reason for the wide range is that the economy is frequently buffeted by shocks and thus rarely evolves as predicted".

Talk about a range you could drive a truck through – to get to the high end of her range of 3.25% by the end of '17 the Fed would have to hike rates by at least 25bps at every remaining meeting this year (three left) and all eight of the meetings next year. This is from a Fed that hiked rates once in the last ten years, so I'll believe it when I see it. What the wide range does tell you is that the 'certain uncertainty' environment that's prevailed over the last several years is here to stay a bit longer. With that being the case, the one thing we do know about the last couple years is that this Fed has little interest in hiking into an 'uncertain' environment and as such will edge on the side of being more accommodative.

Given this setup (that the Fed is leaning in the direction of tightening) and the next FOMC meeting coming up in a little more than three weeks' time (20th -21st of September) it's a reasonable expectation that the upcoming onslaught of economic data to be reported this week will garner a heightened level of scrutiny. Friday's August payroll report will be the main focus for investors with consensus expectations for a print of +180k.

Also on investor's radar screens will be the latest manufacturing and non-manufacturing

ISM reports, especially in light of softening on both fronts in last week's Markit's Flash PMI data. Markit's Flash U.S. manufacturing index registered a modest decline from 52.9 in July to 52.1 in August with total new orders expanding, but at a slower rate than the month prior. There was some bifurcation in the report with subdued domestic demand cited as the reason behind softer growth in overall demand, but this was offset by export sales raising at their fastest pace in 23 months. Employment expanded, but payroll growth was the weakest in four months as stocks of finished goods and purchased items both fell – highlighting the continued cautious inventory policies employed in the manufacturing sector.

Markit's Flash Services PMI declined from 51.4 in July to 50.9 in August – its lowest level since the recessionary scare back in

February. The decline in the August reading was attributed to softer business activity growth as new work expanded at its slowest pace since May and remained much weaker than its post crisis trend. This contributed to a renewed slowdown in job creation during August, with payroll numbers rising at their slowest pace since December 2014. Some firms reported that subdued demand conditions and the need to cut costs had led to more cautious staff hiring plans and the non-replacement of leavers.

Markit's Chief Business Economist, Chris Williamson, had this to say on the report: "The ongoing lackluster economic growth signaled by the flash PMI suggests GDP growth is failing to accelerate in the third quarter from the weak 1.2% pace seen in the second quarter. Historical comparisons indicate that the PMI is signaling an annualized GDP growth rate of just under 1% in the third quarter, based on the data for July and August."

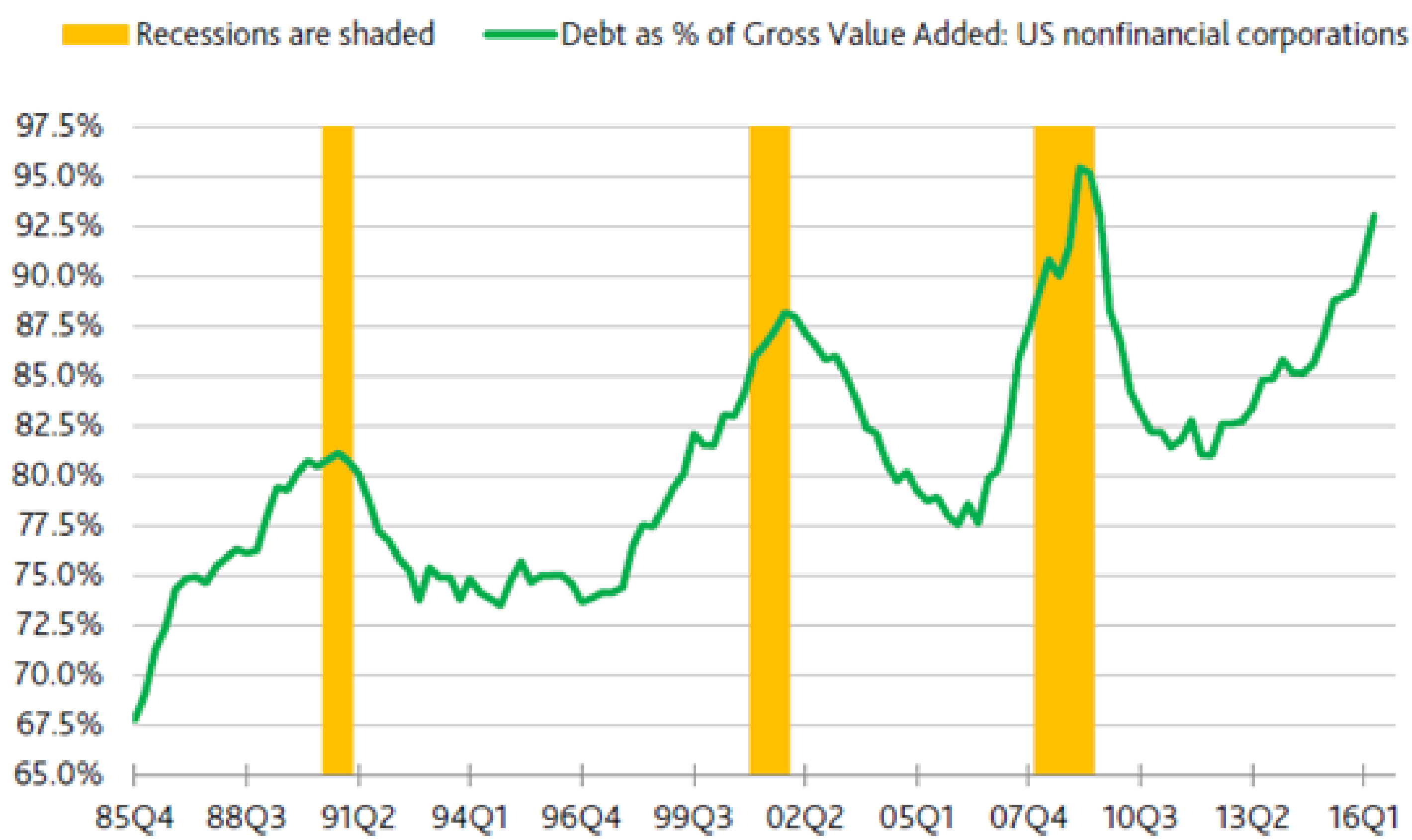
The comment on "subdued demand conditions and the need to cut costs" is something to watch as corporations have been extremely resourceful throughout this cycle at plowing ahead and managing through short term demand deficiencies with the expectation that a pickup is somewhere around the corner. However, with GDP growth hovering around 1% for three consecutive quarters, productivity in outright decline in each of the last three quarters, and a five quarter earnings recession estimated to extend into a sixth consecutive quarter, it begs the question of how much longer companies will be willing (able) to maintain headcounts (let alone add to them) in anticipation of a pickup in demand that continues to be pushed out into the future.

Food for thought: corporate profit margins peaked in Q4 2014 at 12.5% and have declined to 10.6% as of the end of Q1 2016. If these margin pressures don't begin to subside in a more material way in Q3 it's likely that labor costs will fall squarely in the cross-hairs as the low hanging fruit to reduce overhead and expenses. Moreover, as we move through Q3 corporations are starting to work on their 2017 budgets and business plans which, in a world where growth is anemic, an elevated focus will be placed on the overall corporate expense structure.

Corporate debt is one of the levers corporations have pulled on to manage themselves through what is now the fourth longest expansion in U.S. history (also the most pedestrian in regards to overall economic growth), but there are broadening indications that this financial engineering crutch is wobbling.

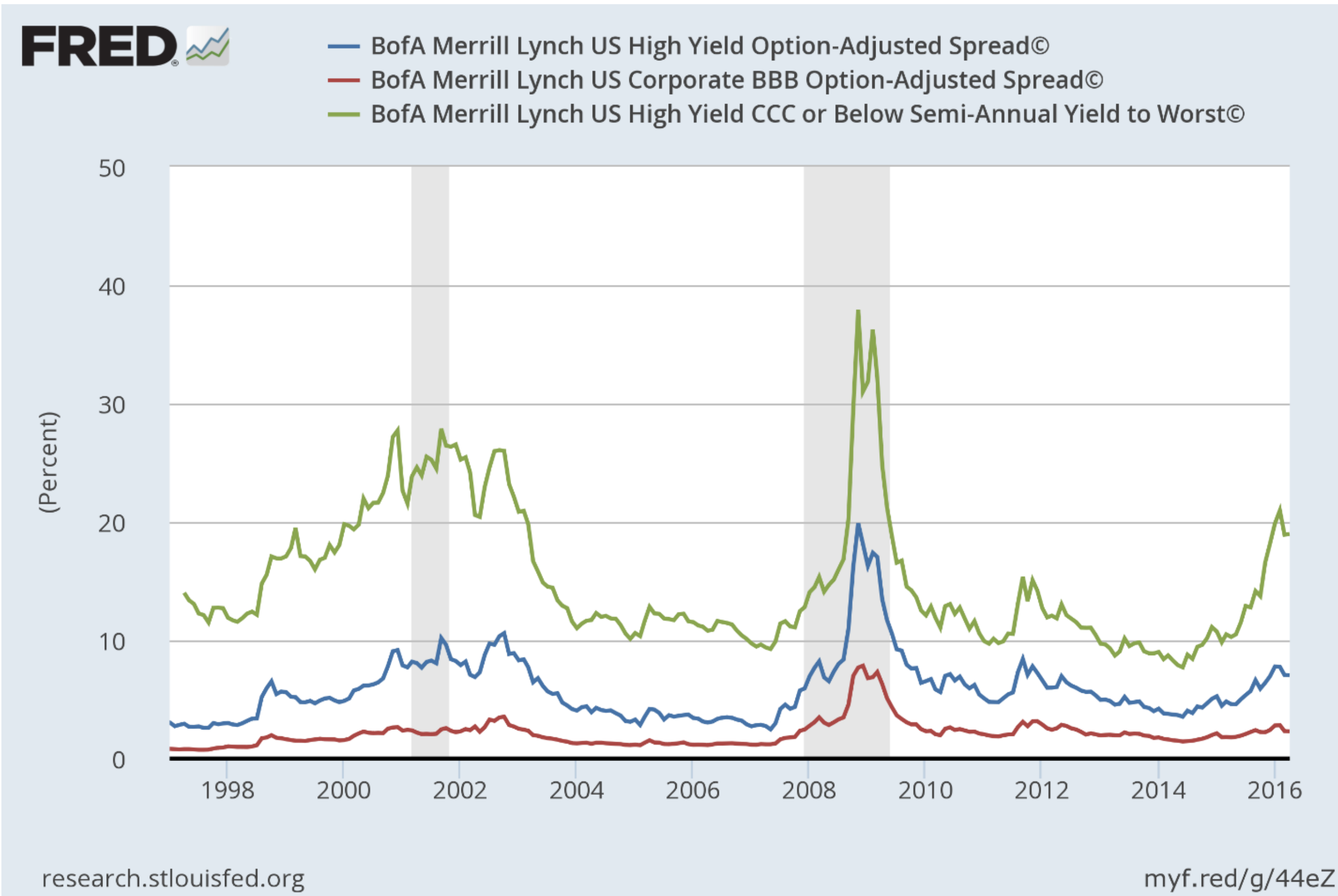
With nearly eight years of ZIRP (zero interest rate policy) corporate executives have not been bashful about tapping this cheap capital source which, according to a recent report out of Moody's, corporate debt levels are reaching levels that should warrant some caution on the part of investors. The report highlights that corporate debt relative to net revenues for nonfinancial corporations troughed in Q2 2012 at 81% and as of Q2 2016 has risen to a cycle high of 93%. This current level of debt to net revenues far exceeds the levels reached immediately prior to the start of the last three recessions: 87.4% in Q4 2007, 84.1% in Q4 2000, and 80.5% in Q2 1990.

Figure 1: Highest Ratio of Corporate Debt to Net Revenues since Great Recession



By itself there is nothing alarming about this absolute level as the cost of this financing is cheap, but embedded in that rationale is the assumption that this cheap financing environment will persist for the foreseeable future. Yes, it's commonplace to maintain the view that accommodative monetary policy on the part of the Fed will keep us in a 'lower for longer' interest rate environment, but this assumes that risk premiums (credit spreads) on corporate bonds will also remain historically tight – that my friends is an unrealistic expectation.

You see locking in low rates today is akin to maxing out a credit card on the premise that after the promotional period you will roll the outstanding balance onto another credit card with a 0% promotional rate. This game of musical chairs can be played for a little while, but eventually the music stops (economic recession) and when it does the cost of capital for corporations spikes. I know, we live in world today where central banks will never allow another recession to occur, but humor me for a moment – after all, since WWII there have been 10 recessions in the U.S. and three in the last twenty five years. In other words – it’s possible! The below chart covers the last two economic recessions and illustrates just how costly it can be for high yield and lower tier investment grade borrowers that have to rollover debt maturities during a period of economic stress.



The reason this is top of mind for me is because of the eerie feel of market complacency that has overtaken investors at the moment. We have a U.S. economy that appears to be well entrenched in this bounce in the economic data since March, but this bounce looks to be losing some steam from what are some rather pedestrian growth levels. The Citigroup economic surprise index has been trending down since the end of July and second half growth expectations are eclipsing some fairly heady levels – Atlanta Fed's GDPNow is forecasting 3.5% GDP growth in Q3.

As for the stock market, it's barely moved over the last month with the S&P 500 closing on Friday at 2,169 (started August at 2,170) and bullish positioning is at its highest point in more than a year. Estimates for Q3 earnings have recently tipped into negative territory, one-month and three-month analyst earnings estimate revisions have rolled over, and valuations remain not only at cycle highs but also near historic highs on most metrics.

I have to say it is a bit befuddling to see a stock market at all-time highs when Bloomberg publishes an article stating that purchases by officers and directors (insiders) of their own stock were down 44% year-over-year in July to its lowest monthly total ever (according to the data they cited from The Washington Service which goes back to 1988). Moreover, with 1,399 executives unloading stock, sellers outnumbered buyers at a rate that was exceeded only two other times – the 0.23 buy/sell ratio is less than a third of the 0.69 average over the last three decades. These are the people that know the most about what is going on in their business – for them to be selling the way they are, it makes you wonder if others should be following suit?

Nevertheless, at the moment the economy and capital markets are lacking of any meaningful catalyst to dictate much of a change from the status quo – the economy is not great but it's not falling off a cliff (although last week a report from JP Morgan's research team upped its odds of a recession occurring in the next twelve months to 37% - its highest probability estimate during this cycle), corporate profits and revenues are soft but interest rates are low, and central banks around the world continue to step in and provide support at any sign of weakness (i.e. the BoE's reaction to the Brexit vote).

However, starting here in September the calendar throughout the balance of the year is sure to carry with it some market moving events: central bank meetings for the Fed, ECB, and BOJ, Italian referendum vote in October, and the U.S. Presidential election in

November are some of the biggies with a litany of data in between. It’s reasonable to expect a more volatile backdrop awaits and the gap between fundamentals and asset prices to compress – time will tell whether that means asset prices fall to a level more in-line with where fundamentals are or fundamentals improve to a point that justifies current prices.

It’s a humbling endeavor, forecasting and handicapping the future, in an era without precedent on many fronts. Anticipating how all of it will impact asset prices is even more challenging, but I remain steadfast in the view that investors today need be aware that the potential return is low for the prevailing level of risk one must take to achieve it. Given the one way direction in asset prices over the last six months and the even longer seven-plus year bull market we’ve seen since the March 2009 lows – it’s very easy to forget that investing involves risk and the asset prices can and do go down in value. With most asset prices in the U.S. (stocks, bonds, and real estate) at or near all-time highs, now is not the time to get hypnotized into a view that risk has become extinct – it sometimes goes on a sabbatical, but it always returns. Anyone in need of a reminder can look at the following markets that are still down double digits from their 52-week highs (keep in mind this is after a monster summer rally in all markets): Japan’s TOPIX -18.4%, Italy’s FTSE MIB Index -27.35%, Euro Stoxx 50 -15.15%, and China’s Shanghai Index -16.67%.

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