October 30th, 2017

Economic growth? Yes, but…

Investors were on the receiving end of some good news on Friday when we learned that the U.S. economy put up its second consecutive quarter of 3% GDP growth. The 3.0% pick-up in Q3 GDP followed a 3.1% growth rate in Q2 and made for the best back-to-back performance in three years (going back to the 4.6% growth rate in Q2 2014 and 5.2% growth rate in Q3 2014). This report, like much of the economic data over the last two months, had some hurricane related impacts in it, but it looks as though the skew works in both directions (positive boost to foreign trade due to port closures in the Gulf and a negative impact to travel/tourism in Florida).

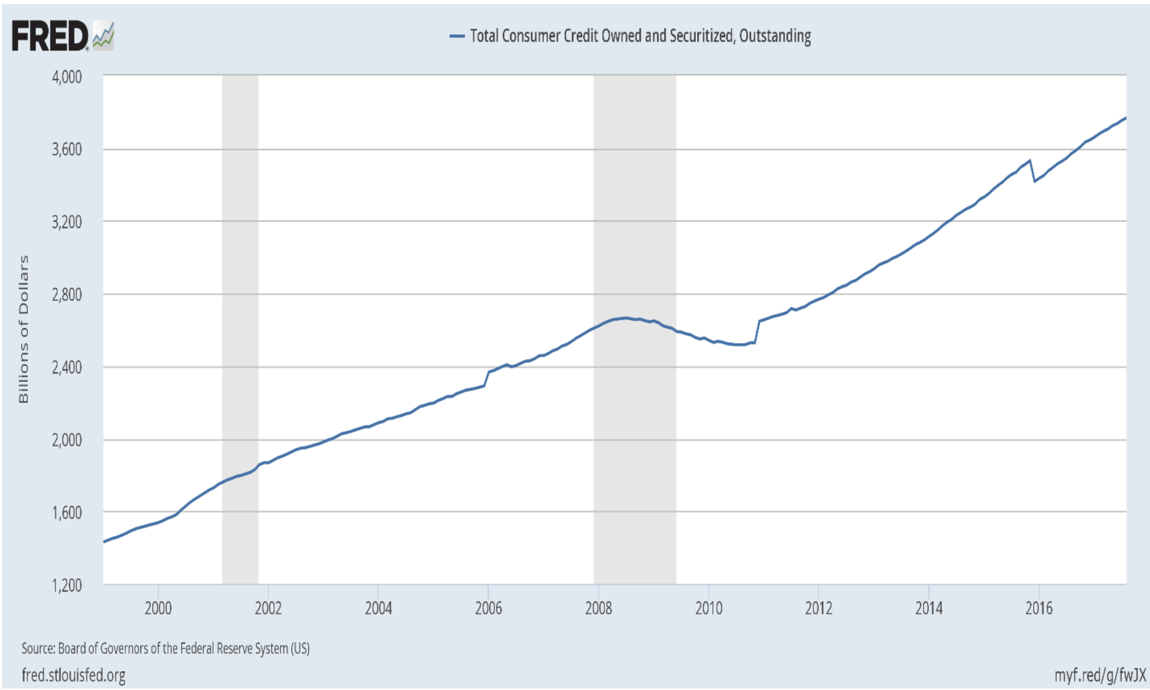
The most meaningful positive standout to me in the report was seeing capex spending on equipment increase by 8.6% which followed an 8.8% gain in the second quarter. Based on these numbers it appears businesses are not just paying lip service to the plethora of business sentiment surveys that have been scaling cycle highs over the last year, but actually putting some money behind this newfound optimism. Time will be the ultimate arbitrator on how lucrative this expansion of capex projects ultimately pays off this deep into this cyclical upturn, but I have to admit it's nice to finally see some capital deepening taking shape in the corporate sector. Another sign of broadening business confidence was evident in the inventory component adding a full 0.7% to the overall GDP print.

However, that was where the good news ended and I must admit that the trends on the consumer side of this report leave a whole lot to be desired. Keep in mind that consumption accounts for 2/3rds of U.S. economic output, so what is taking shape in the consumer segment of the economy is monumentally important for overall economic health. Given that context, if you stripped out the gains in this GDP report from the lumpy inventory run-up and the import-effect on net foreign trade, then real GDP growth (real final sales to domestic purchasers) slowed to an annual rate of 1.8% in Q3 from 2.7% in Q2. The Q3 reading marked the softest print since the opening quarter of 2016 and my guess is this is what the Treasury market was keying in on Friday as it rallied in the face of back to back quarterly prints of 3% GDP growth.

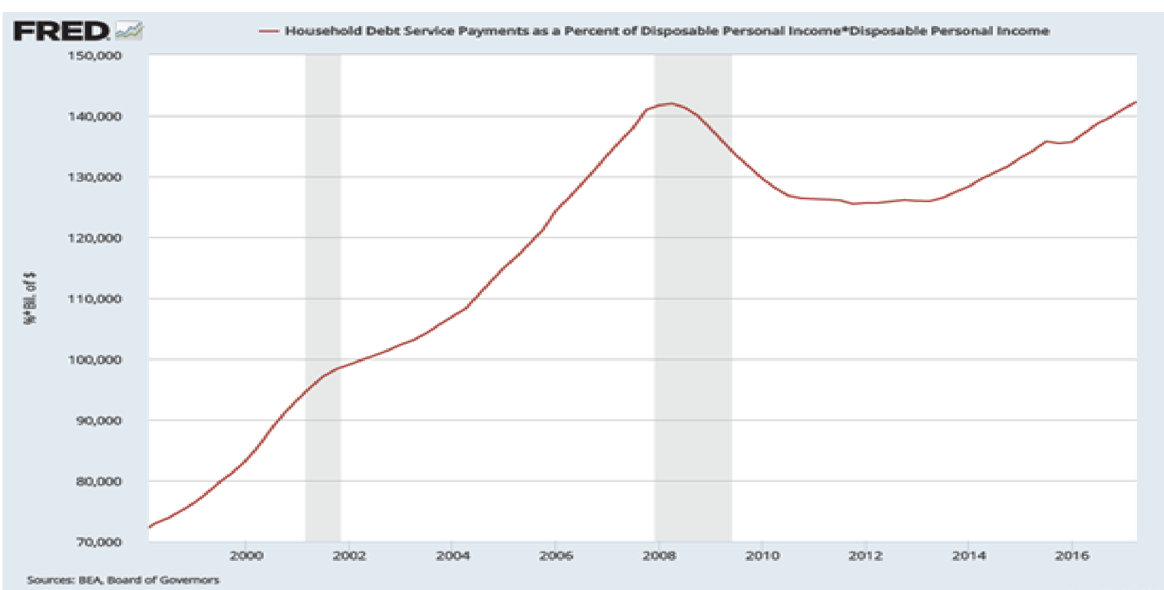
It's not just the sanguine absolute readings on the consumer segment that are concerning, but the make-up of getting to this point is even more alarming. What is becoming clearer with each passing month is the degree to which consumption has become reliant on tapping into savings and ever higher levels of indebtedness. We just learned in this morning's personal income and spending report that the household savings rate has been pared back to 3.1% from 3.8% in the second quarter and now stands at its lowest level since December 2007. Last I checked, the economic archives show that the last recession began that very same month – not a forecast, just an observation.

Look I'm not calling this report a stinker by any means, but I think this report is much less impressive than the headline figures portray. Moreover, the foundation underlying the nearly 70% chunk of the economy we call the consumer is looking more unstable with each passing day. Consider the following charts pulled from the FRED database maintained by the St. Louis Federal Reserve:

Consumer Credit: At the height of the 'Credit Crisis' this measure peaked out at just under $2.7 trillion in July 2008, and after a little more than two years of household deleveraging this metric declined to a little over $2.5 trillion in November 2010 before resuming its growth trend. As of the latest data from August 2017 this metric has risen to almost $3.8 trillion – a nearly 50% increase from the '08 cycle peak.

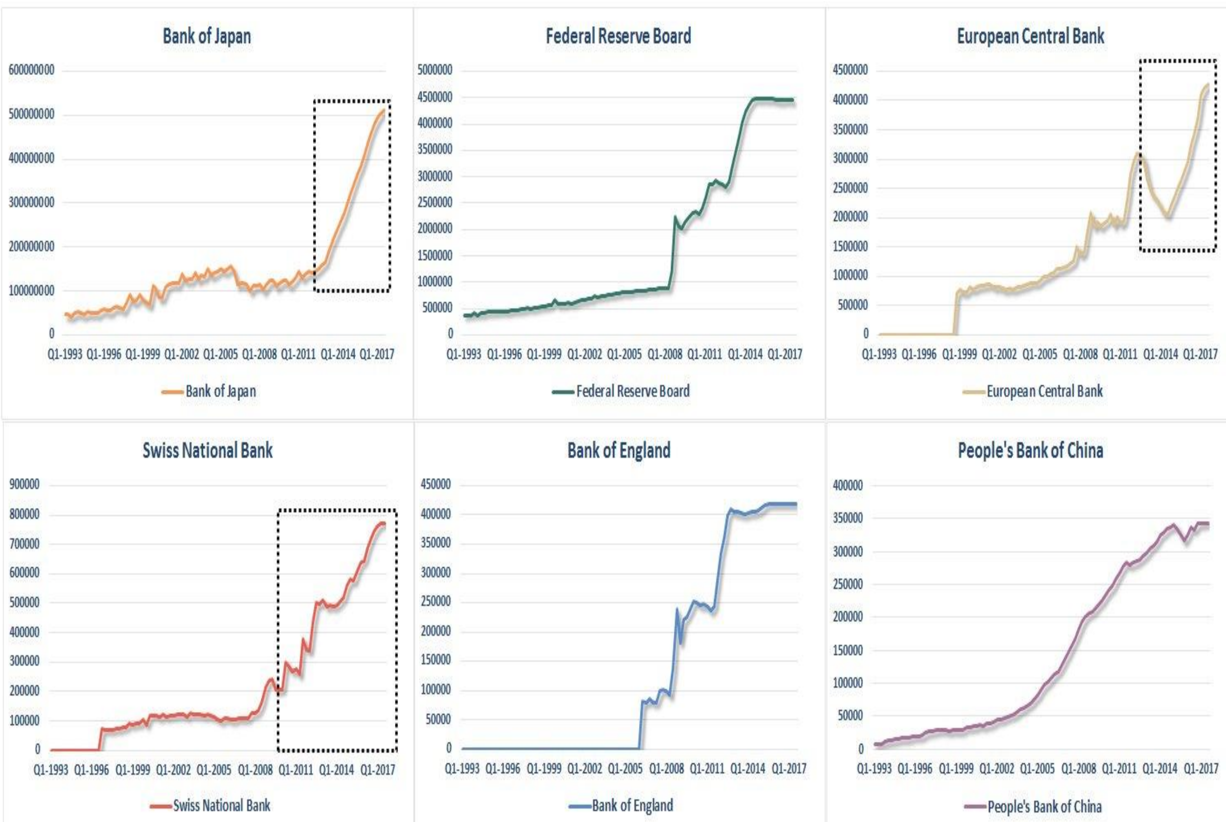


This higher level of debt outstanding has been manageable thus far in this cycle with the assistance of the Federal Reserve slashing interest rates to all-time lows and keeping them there for an extended period of time. However, with the Fed seeming to be more motivated to increase interest rates, the payments required to service this higher level of outstanding debt are now back to their previous peak.



Therein lies the dilemma, challenging the edifice of extrapolating a sustainable economic recovery while assuming all other things remain constant. You can't model an acceleration in economic growth from where we are today and assume that neither inflation and/or higher interest rates won't become a countervailing offset. It's looking more likely that we are at the tipping point where this 'Goldilocks' backdrop of high liquidity, growing indebtedness, low and stable growth with muted inflation pressures and low interest rates cannot be maintained any longer.

Central Bank Balance Sheets: You want to know what it took to create synchronized global growth for the first time in this post-GFC recovery? A U.S. consumer profile that has pulled out all the stops to maintain their standard of living (savings rate drawn down to decade lows with debt balances at all-time highs) coupled with global central banks increasing the collective size of their balance sheets at the most aggressive pace in history over the last 18 months. The following chart from Lance Roberts of Real Investment Advice neatly consolidates into the following chart the respective rise in central bank balance sheets over the last two decades which puts into context how much they've increased in this post-GFC era as well as the recent parabolic rise in the balance sheets of the BoJ, ECB, and SNB.

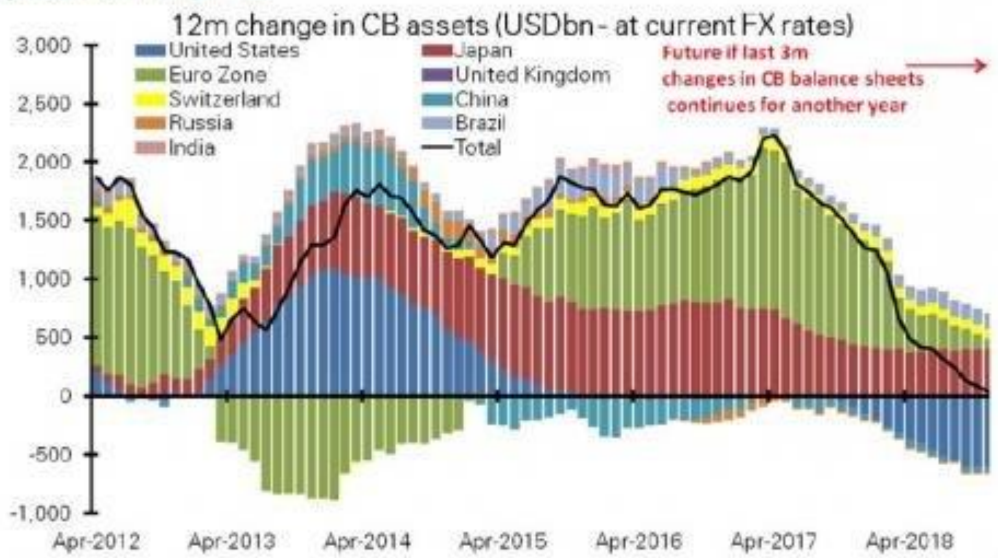


Ladies and gentlemen, this is what it took to create the best synchronized global growth environment in decades, which leads to what I think is the most important question for investors going forward: What do you do for an encore? The U.S. consumer is tapped out and global central bank asset purchases are set to go in reverse in a meaningful way when the calendar turns to 2018.

When you consider each of these components on their own and then aggregate them together, it's hard to come to any other conclusion than something has to give.

- High liquidity transitioning to lower liquidity – we now know that for the first time since 2008 the Federal Reserve is starting to reduce the size of its balance sheet and the ECB announced last week that they will be cutting their asset purchase program from €60 billion per month to €30 billion per month starting in January. The BoJ hasn't made any concrete announcements on their QE program, but the data illustrates that they have moderated their asset purchases of late. Deutsche Bank estimates that central bank balance sheet expansion will go from a current pace of $2 trillion per year to zero by the end of next year.

Figure 1: 12m change in Central Bank assets.
Looking forward CB balance sheets are assumed to follow last 3m changes, expect Fed where balance sheet conforms to recent cap announcements, and ECB tapers by EUR 30bn for Q1-Q3 2018, and then ends balance sheet expansion in Q4 '18.



Source: Deutsche Bank, Datastream

If you were to assume that central banks carry out these intentions then an investor has to consider the possible detrimental impact this will have on asset prices, given this policy was put in place to *raise* asset prices.

- Growing Indebtedness – debt levels across the spectrum are at all-time highs (Federal, Household, and Corporate) and this doesn't mean that they can't go even higher, but even at current low interest rate levels the cash flow necessary to service this outstanding debt burden is starting to crimp the ability to undertake other more productive uses. This is going to be the biggest obstacle for this administration to overcome as they are set to release the much-anticipated tax reform plan this week. Gone are the days where a poorly crafted policy that promises revenue offsets that don't end up coming to fruition can be made up in the future. The future is now and the window for can kicking has passed its expiration date, where the U.S. has plenty of debt to show for previous administrations' miscalculations.

- Economic growth, inflation, and interest rates – all of these variables are sensitive to each other to some degree and as a result they can go either way at this juncture depending on how things play out. This is what makes this current environment extremely challenging for investors as we could very well get a pick-up in economic growth on the back of a stimulative fiscal policy. But this could cause both inflation and interest rates to rise which history shows that the Federal Reserve won't stand idly by and observe. No, this could force the Fed's hand to tighten quicker than they have already guided markets to expect and could set the stage for an interest rate shock to the system. Conversely, a poorly crafted fiscal policy could end up being more bark than bite where we get a meaningful increase in Federal debt without the positive impacts of increased growth which then ends up leading to a debt trap that exacerbates the deflationary forces already built up in the system.

It's very possible that both fiscal and monetary policy can be married in a way that they are able to thread this ever-shrinking eye of the needle, but investors need also consider how this impacts asset prices. As they say, "beauty is in the eye of the beholder" which to me is apropos to describe all asset classes today. Frankly, I find it growingly difficult to find much beauty in the broad U.S. equity market today given the way the math stacks up – we are in one of if not the most expensively valued equity markets in history. And no, this isn't an exaggeration for anyone willing to put in the work and evaluate the fundamental make up of stocks with an objective lens.

This isn't news to anyone who has been reading these musings over the past year, so I'll save you the litany of valuation metrics I could transcribe at this time, but I will point out that the S&P 500 is trading at a forward P/E multiple of 19.5x which is more than 4 multiple points above the historical norm. I'll also push back on the common view today that multiples deserve to be higher given the low interest rate environment when one considers that today's 19.5x P/E multiple is a full 2 points above where it was this time last year with interest rates nearly 70 basis points higher. There is also the theory that corporate earnings are growing and reaching all-time highs which is 100% true, but what is misleading about this statement is that S&P 500 profits are up 7.5% since the end of 2015 compared to a price gain for the index of 26%. And this isn't to say that the S&P 500 was trading at a cheap historical valuation back then when it had a trailing P/E multiple of 17.5x (compared to the historical average of 16.5x).

As for bonds, it's hard to suggest that they present themselves with much more of a compelling opportunity given credit spreads in the investment grade or high yield segment of the market are nearing their tightest level of this cycle and are within a whisper of their '07 cycle lows. What's more is that credit underwriting standards for new issuance has reached a new fever pitch with high-risk covenant lite loans equaling 72% of outstanding leveraged loans – this is up from 30% in '07. Add to this European junk bonds yielding as much as U.S. treasury bonds and you can only surmise that we're nearing an investment paradigm of pure imagination.

So, what do I like? For starters, a diversified portfolio targeting a defined return objective with as much of a focus on risk management as return achievement. The one thing history has shown is that the potential for permanent impairment of capital is much greater when valuation levels are reaching extremes. To me this is the biggest risk being brushed aside by many investors – the notion that it would be completely within the bounds of statistical analysis for several asset classes to be cut in half and still not register a more than one standard deviation move in the context of historical average valuation levels.

Within this diversified portfolio, I think a tilt towards quality is prudent at this part of the business cycle. So in the equity markets it's a greater focus on earnings quality and stability, heightened attention to balance sheet quality, and an operating history of generating strong returns on capital. Same philosophy plays well in the fixed income space regarding quality and higher interest coverage ratios, but I'm also more constructive on long-term Treasury debt than most as an asset class that has shown itself to be a very friendly diversifier of risk during times of geopolitical risk-off episodes and economic recessions. Lastly, I continue to prefer overseas equity markets relative to U.S. equity markets and am growing more constructive on the secular opportunity in Japan. First off, the major averages in Japan have just broken above what has been a 25-year downtrend line, and female participation rates in the labor force are in a secular uptrend which goes a long way in offsetting the immigration challenge. Additionally, Shinzo Abe came out as a big winner in his recent snap-election bet and this will set the stage to build further momentum in rewriting parts of the constitution to unlock additional potential in what is a retooled and highly efficient industrial economy. Lastly, Japan is on the cutting edge of robotic technology and this is a massive disruption that is taking shape all around the world. Oh, and one more thing: the present equity fundamental footprint is perhaps one of the strongest in the world with EPS growth in the region surpassing all other developed markets and even some high growth Emerging Markets. Not to mention this is a region that is under-owned globally and among the locales with more individual investor money sitting in 0% interest-earning bank accounts than in Japanese equities. Cheap relative valuations, ample liquidity from a very market friendly central bank, coming structural reforms, and a lack of global ownership – leaves a lot to like in a world of dwindling opportunities.

Europe remains in an earlier part of their economic cycle relative to the U.S., but the growing tension in holding the EU together is likely to worsen over the next year, economic growth looks to be peaking here in Q4, and interest rates perhaps more than any other region overly distorted to the downside – all of which I think will be a headwind for meaningful gains in European equities from this point going forward.

Asia is another market that represents a very strong investment case for all long-term investors, and a region that I think will represent the best return opportunities for investors over the next several decades. However, the near-term path could prove to be a little bumpy with the recent completion of China's 19th Party Congress and Xi having consolidated the power he was looking to procure, so it should be expected that they will allow for a little bit of air to come out of what has become a pretty frothy market leading up to this Party Congress. Also, it's worth watching that the Chinese yield curve is now inverted and the mountain of debt this economy has taken on over the last 18 months is more than it took on coming out of the Global Financial Crisis.

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