March 20th, 2017

Look beyond the obvious and think long-term…

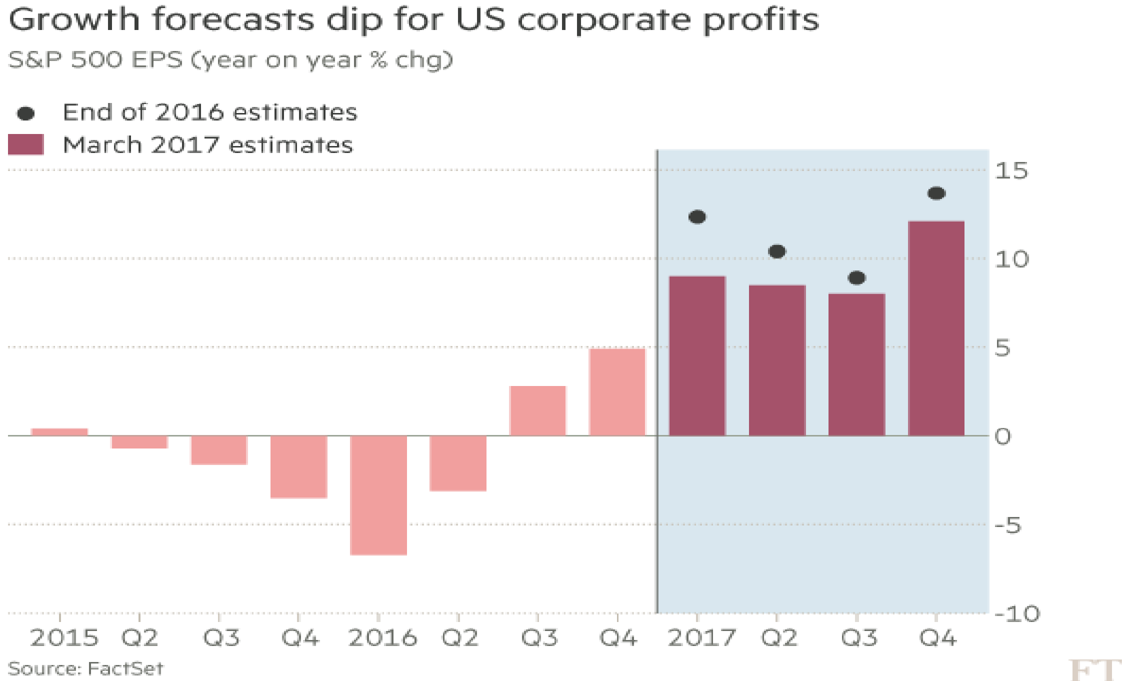
U.S. equity markets drifted modestly higher last week with the Dow Jones Industrial Average gaining +0.1% and the S&P 500 logging a gain of +0.2%. It was the higher beta segments that were last week's big winners as the Russell 2000 Small Cap Index ripped higher by +1.9% and the Nasdaq Composite appreciated +0.7%. However at this point it's hard to draw any other conclusion about the outsized gain in the Russell 2000 other than it represented an aberration in an otherwise developing trend that the reflationary rally in many of the post-election asset class beneficiaries are coming under siege.

Small cap stocks, which were one of the earliest movers and best performers following the Trump victory, have meaningfully underperformed both the Dow (+6.0%) and the S&P 500 (+6.2%), gaining only +2.0% year-to-date. Other indications that a potential change in trend is afoot are visible through the growing divergences in a broadening array of asset classes: the U.S. dollar index rolling over as it tests five week lows, spreads widening in the high yield and investment grade credit markets, 10-year Treasury yields failing to sustain a break-out above the 2.60% level (which has acted as the upper end of its trading range), and a flattening in the yield curve, which is the bond markets way of not buying into optimistic U.S. economic growth forecasts.

A similar tale of the waning reflationary trade is the underperformance of the Dow Jones Transportation Average (+1.2% ytd) relative to the Dow Jones Utilities Average (+5.6% ytd) and don't tell anyone, but outside of the Energy sector (-7.3%) the Financial sector (+5.2%) is the worst performing equity sector this year. This has to come as a rather large surprise to the consensus community that came into the year all bulled up on the Financial sector with aspirations of GDP growth eclipsing 3, 4, or even 5% which would fatten Net Interest Margins through a steeper yield curve and promises of massive deregulation through the roll back of Dodd-Frank.

More than anything what the recent price action suggests is that the economic and investment community got way ahead of itself in pricing in the near-term benefits of tax reform, deregulation, and infrastructure spending. All we've seen thus far is that the sausage making process in Washington remains a challenging and ugly endeavor which has pushed out any potential legislative goodies further out into the future. Given the pace and complications of getting healthcare reform pushed through Congress it should come as little surprise to see the market losing patience on the expectation that any positive needle moving economic growth legislation will be implemented this year.

We're already seeing earnings revisions moving squarely to the downside, where at the start of the year consensus estimates for Q1 were for EPS to grow to a bit north of +12% year-over-year, but those expectations have since been pared to +9%. Surely, a 9% growth rate isn't a bad number especially given how the game is played where executives do their best leading up to quarter-end to guide analysts to pencil in a number they can then beat when they report, but at some point you would think that a market trading near some of the richest valuation levels in history would actually require the fundamentals to corroborate the hype.



Recall that it took five years (1986) for Ronald Reagan to get his tax reform package passed and this was a President that history shows knew how to find compromise across party lines – hence the coining of the term "Reagan Democrats". This isn't an indictment on the current administration's inability to, in time, unify the legislative branch for the greater good of the American people, but from what we have observed over the first eight weeks it doesn't look as though this is a high priority on his agenda.

What we are seeing is that "America First" continues to be a top priority and this was on full display at the G20 finance minister's meeting over the weekend where Secretary Mnuchin rubber stamped the administration's intentions of walking back from free trade policies. Folks, in my opinion, the evolution of globalization in the years ahead will be the most important development for investors to monitor as we move forward. I know we live in a 'what have you done for me lately?' world where it has become commonplace to favor short-term instant gratification outcomes versus delicately balancing strategic short-term pain against long-term gains.

In the first commentary I put out this year, "Opportunities Abroad", I highlighted the favorable set-up of foreign markets versus U.S. markets, but as I've continued to deepen the research on this opportunity I'm warming to the idea that this thesis is more than just a relative market call. You see, in my opinion, I see some dynamics at play (while perhaps early or maybe even I'm late to the party in identifying them) that potentially set the stage for a long-term rebalancing of global economic and financial order. Please don't get ahead of yourself here with this statement as these shifts tend to move at a glacial pace, but it's difficult to ignore that a potential shift may be afoot. Consider that Emerging Markets now account for more than 50% of global GDP, but their stock markets equate to only roughly 10% of the world stock market capitalization. China now accounts for roughly 15% of world GDP yet its stock market is only 3%, and India is 3% of World GDP with a market cap of 1%.

Don’t overlook the fact that the Asia Pacific region is home to nearly 4.5 billion people which represents 60% of the world’s population.

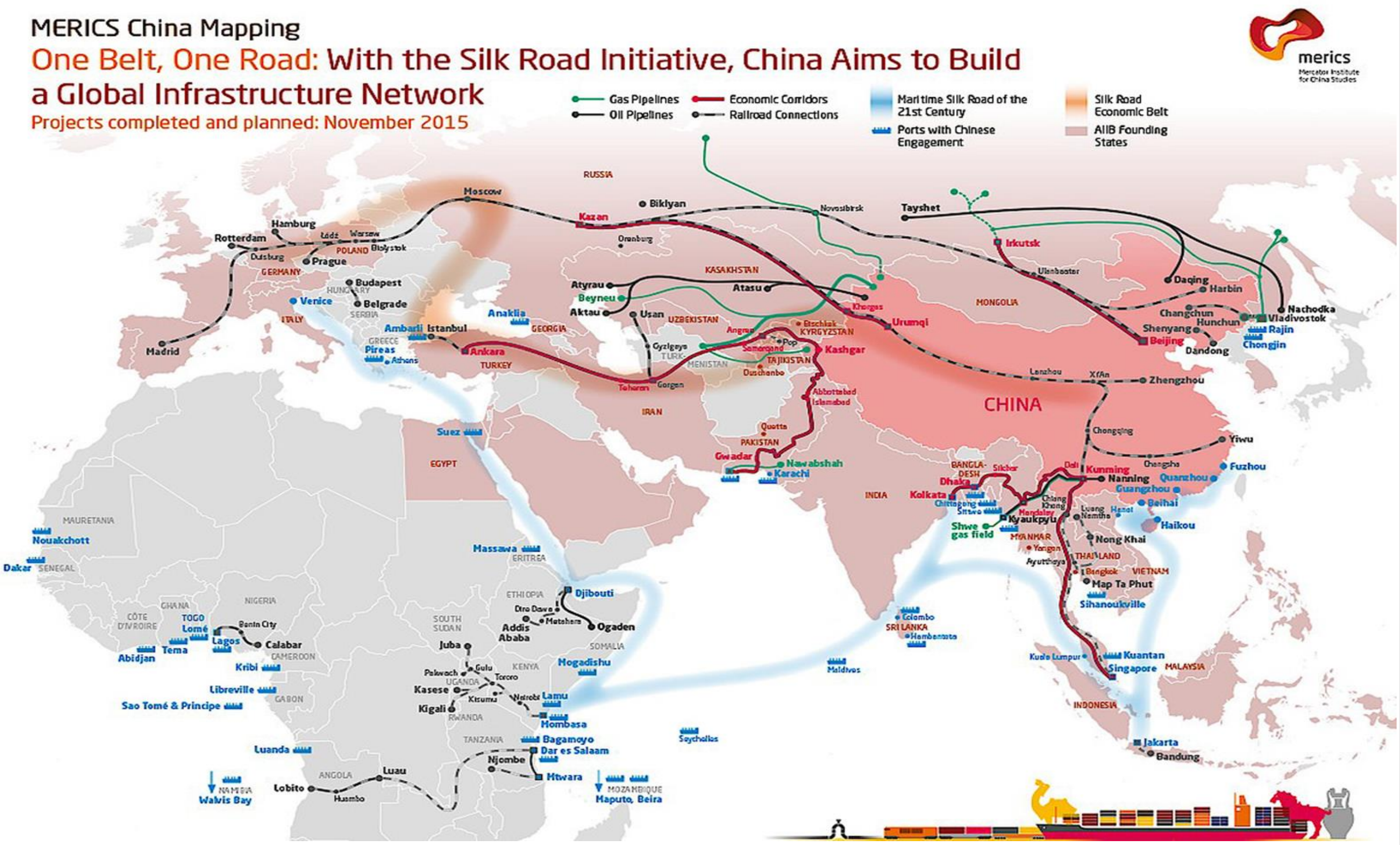
This commentary is perhaps a bit off the beaten path of my usual weekly missives, but it’s a purposeful digression to encourage investors to take some time to consider and evaluate their investment thesis on a longer-term time horizon rather than what has become the norm of short-sighted thinking today. We are operating in a world today that is perhaps more complex than at any time in history – a time where the decisions made on both domestic and foreign policy will have lasting and meaningful economic and societal impacts.

These are not developments that should be feared, but rather they should be embraced. However, they should not be considered in a vacuum because in whatever which way they evolve it will set in motion a course that will be very difficult to alter.

Two concepts/themes/abstracts (quite frankly, I’m not sure how best to describe them) that continue to come up in my research and resonate in my thoughts going forward are Pax Americana and One Belt One Road (OBOR).

As for Pax Americana, which is a framework that has been in place for the world we know since World War II, which put the U.S. at the center of dictating foreign policy around the globe: is this concept, which started to fray under President Bush Jr. following the 9/11 terrorist attacks and experienced further decay under President Obama, about to become completely dissolved under President Trump?

As for the latter, OBOR, can it be pulled off? Is it appropriate to draw parallels to this being a Chinese equivalent of the United States “Marshall Plan” following WWII? Are the dreams and ambitions for an ‘Empirical China’ realistic and if so what are the impacts for the rest of the world?



I can't stress enough how critical I think it is today for investors to fight the urge towards short-term thinking and measurement in favor of a long-term perspective and vision.

Another example where longer-term thinking is necessary for investment decision makers today is in evaluating where we go from here with the Federal Reserve moving further down the path of attempting to unwind the most significant and unprecedented monetary policy experiment in history.

For the last three decades the Federal Reserve has taken the approach that the appropriate remedy to every recession or systemic financial dislocation (LTCM in the late '90's) was to cut interest rates, add liquidity to the financial system, and incentivize borrowers to pull consumption forward so as to counteract downside cyclical forces. This has brought us to the point we are at today where beyond the challenging demographic headwinds the economy faces today (a variable they have little control over), we are faced with an over-indebted society that has never been more financially unequal.

One of the consequences of this reliance on cheap money through low interest rates is the economy's growing dependence on debt to assist with economic growth. Since the turn of the century real GDP in the U.S. has increased from roughly $10.5 trillion to $18.6 trillion, an increase of 77%. Over this same time frame government debt has spiked from $5.7 trillion to $19.9 trillion (a 250% increase), or a rise in debt-to-GDP from 54% to over 100% today. This increase in indebtedness requires a perpetual state of economic growth to maintain American household's standard of living and social order.

According to work from Lacy Hunt, from 1952 – 1999 it took $1.70 in debt to generate $1.00 in GDP, from 2000 – 2015 it took $3.30 in debt to generate $1.00 in GDP, and in 2016 this ratio surged to $5.00 in debt generated $1.00 in GDP. Folks, I don't know of a household or corporation in the world where this trend would be considered sustainable.

Unfortunately throughout the 21st century the U.S. economy has experienced two recessions (the most recent one being the worst economic contraction since the Great Depression) and what is now well known as being the weakest economic expansion in the post-WWII era. As a result real GDP growth has averaged 1.78% per year in the sixteen years that makeup this century. This pales in comparison to the 3.43% annual growth rate of real GDP in the preceding 16 years leading up to the 21st century.

When you consider that an economy that expands at a 3% annual rate will double the average living standard every 24 years, versus a doubling in the average living standard lengthening to 36 years if the economy is only expanding at 2% per annum, you start to gain perspective on the importance and focus of reigniting economic growth. You have to go back to 2005 to find the last calendar year in which the U.S. economy generated a real GDP growth rate of greater than 3% (2003, 2004, and 2005 are the only three years this century that have a growth rate above 3%).

I'm sorry, I know this isn't uplifting or optimistic data, but they are the facts as they exist today (and not of the alternative variety) and it brings rise to the unenviable position of the Federal Reserve as they attempt to move forward on their interest rate normalization efforts. At the FOMC meeting that concluded last Wednesday the Federal Reserved decided to hike the fed funds rate for the second time in three months, but the reactions in capital market prices were more synonymous with what one would expect if the Fed cut rates – interest rates fell across the Treasury curve, the dollar got slammed by almost a full point, gold spiked and the stock market rallied.

The narrative being used to explain such a reaction was that the forward guidance in both the Fed statement and by Chair Yellen in her press conference was that they didn't shift their view from three hikes this year to four hikes. So, it was interpreted as a dovish hike with markets going into the announcement having somewhat positioned for the possibility that they would lay out a more aggressive hiking path.

Perhaps the biggest head scratcher for me was in the post-meeting Q&A session where Chair Yellen stated that the "simple message is the economy is doing well", which confirms to me that they are just winging it at this point. So as not to be too harsh or misinterpreted with this critique, this statement is just flat out inconsistent with the Atlanta Fed's Q1 GDP estimate coming in at +0.9% which follows on the heels of a Q4 GDP growth rate of +1.9%. If the Q1 estimate is even in the vicinity of the Atlanta Fed tracker or even closer to the Wall St. consensus estimate of +1.5% it would mark the seventh out of the last eight quarters that real growth has come in below a 2% annual rate.

What's more is that the Summary of Economic Projections (SEP) showed FOMC participants forecasting 2017 GDP growth of 2.1% (unchanged from the last SEP update), and estimates for 2018 rose a barely visible +0.1% (from 2.0% previously to 2.1%).

Look I have a lot of respect for the Fed and truly believe their hearts and minds are in the right place, but this just shows that they are making it up as they go at this point. They are now of the view that they have achieved their goals of price stability and full employment, hence they feel as though they have the cover to start gradually increasing interest rates. But don't lose sight of the fact that 2016 was the weakest year of economic growth (+1.6%) since this expansion began back in 2009, and the hand-off from monetary policy to fiscal policy might be a lot further off than most people expect.

The reality is that the U.S. economy is in the very late stages of this cyclical expansion with the only question remaining being what level of interest rates is too high that it causes the largest level of outstanding debt in history to topple over on itself? We've reached a critical point where 8 years of ZIRP worked wonders for asset prices and those fortunate enough to own them, but it has been much less effective on the economic front.

Now when you combine what looks to be a concerted shift in monetary policy with the rising policy uncertainty from the fiscal end, to me it seems to be a potentially toxic mix. Thus far, the focus has been entirely on the positive impacts of deregulation, tax reform, and infrastructure spending with the rather complacent ('lazy' is another word that comes to mind) assumption that these benefits will more than offset a tightening of monetary policy. I hate to spoil the ending but irrespective of who or what party was in power or what their policy agenda entailed, 10 of the last 13 tightening cycles ended with a recession – so it is the Fed that is the dominate force, not the other way around.

What also continues to be naively overlooked by investors (in my opinion) is the pivot by the largest economy in the world (the U.S.) towards a more nationalistic and anti-globalization agenda. The impacts of such a shift are sure to create ripple effects that could potentially have profound long-term impacts on the global economic landscape.

The mere fact that we have gone 109 trading days without the S&P 500 closing down more than 1% given the uncertainty and potential change that is afoot is just astonishing to me. I don't know how or when this ends, but anyone with a time horizon and attention span that stems further out than the next trading day, week, month, or year may want to start working up a scenario analysis and consider what this portends for the world economy in the future.

Especially when you are seeing more and more signs that the rest of the world has no intentions of sitting on their hands as the U.S. moves more to an isolationist state. It is interesting to see (yet not a surprise) Japan's Prime Minister Shinzo Abe decide to host trade talks with the European Union. To the surprise of many it was China’s President Xi Jingping that led the globalization discussion earlier this year at a gathering of global leaders in Davos.

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