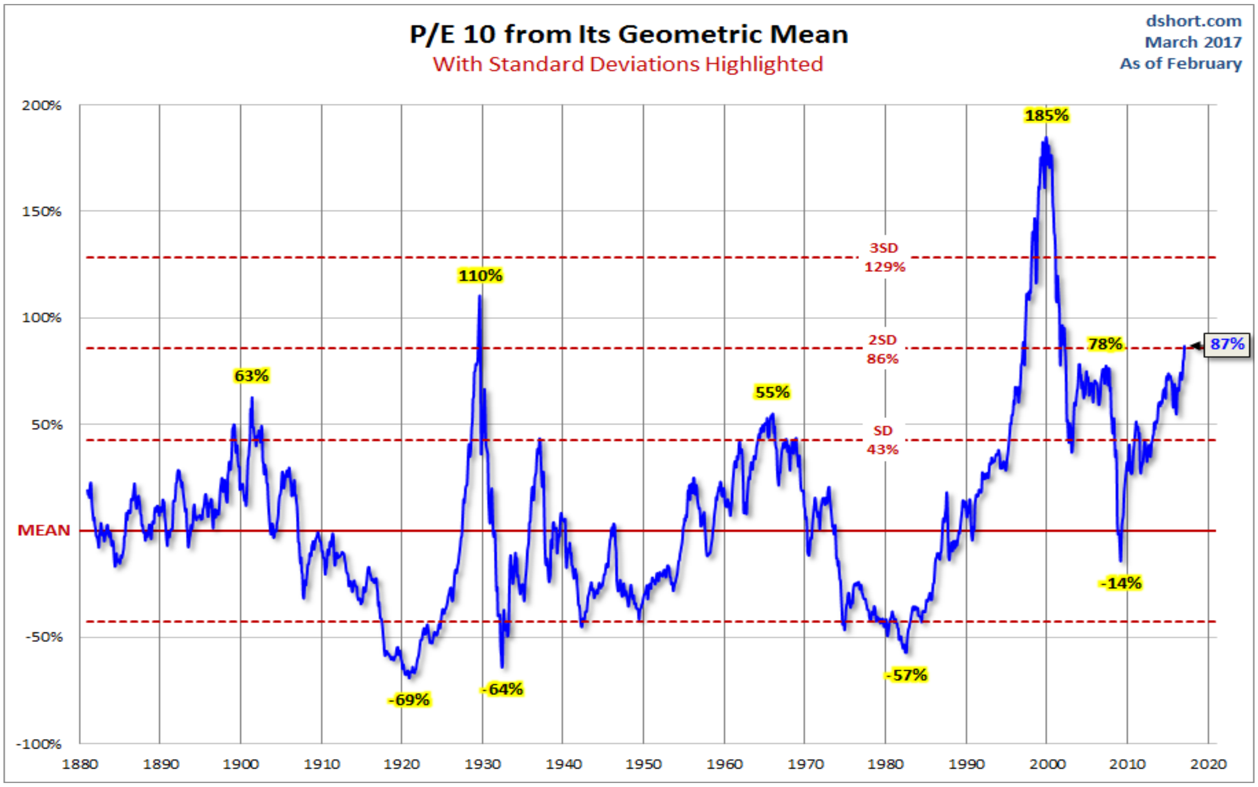
April 3rd, 2017

'Helicopter Parenting'…

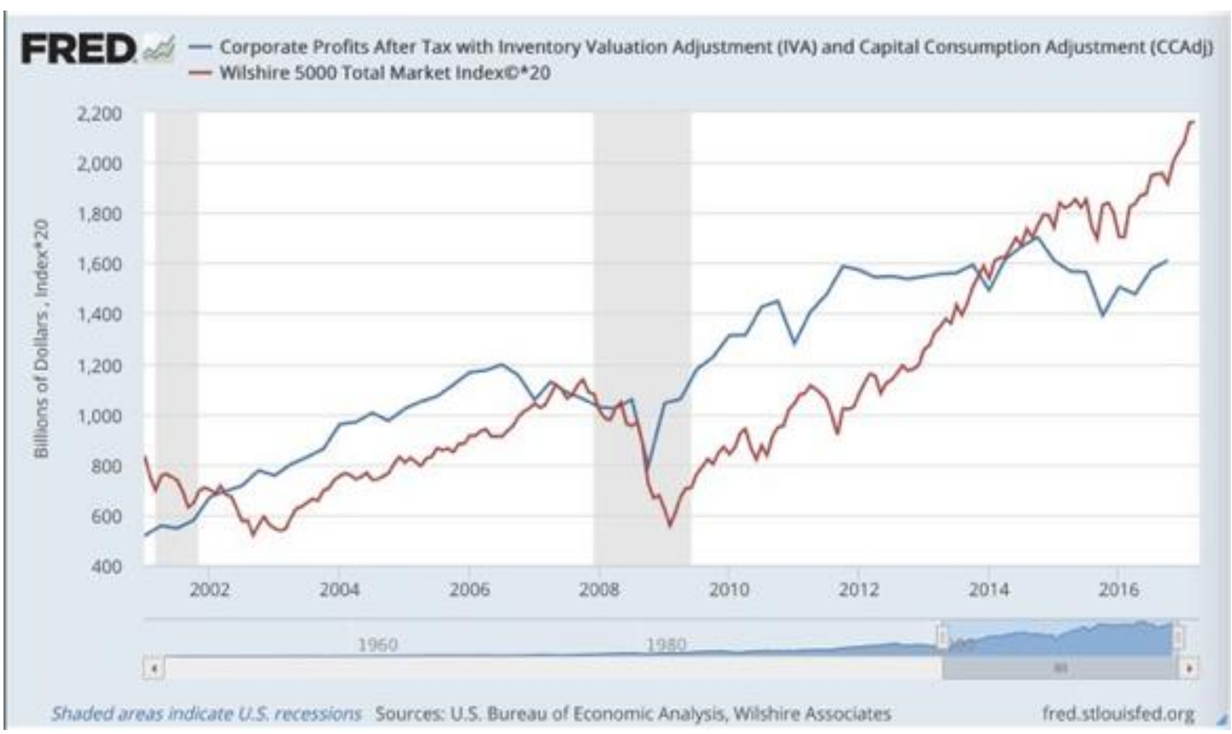
The first quarter is in the books and while it was strong for the reflation trade, what seems to have gotten lost in the shuffle is that all of the gains occurred in January and February. For the quarter the S&P 500 gained +5.5%, the Dow Jones Industrial Average climbed +4.5% and the Nasdaq Composite surged +9.8%. However, this momentum screeched to a halt in March with the S&P 500 and the Dow registering modest declines as the "Trump Trade" was replaced with the "Trump Fade" with the Financials, Energy, and Industrial sectors (widely viewed as the major beneficiaries of the administrative agenda) all lagging over the last month. Not to mention the Dow Transports Index fell -3.2% in March and are now drastically underperforming the Dow Utilities Index year-to-date (+0.8% versus +5.71%).

For sure, the quarter as a whole was solid for U.S. equity investors, but the bigger winners were the anti-consensus markets coming into the year where the MSCI All-Cap World Index gained nearly +7%, Emerging Markets ramped almost +13%, Germany +8.5%, Spain +14.7%, China +14%, and Mexico (yes, the punching bag economy to the South) ripped higher by more than +16%. Heck, gold gained almost +9% on the quarter en route to almost doubling the performance of the S&P 500 as the U.S. dollar fell almost -2% in the first three months of 2017.

I understand the psychological impediment investors face by attempting to drive forward while looking through the rearview mirror, but that is precisely what they are doing today by extrapolating past results into the future. The bull market in U.S. equities that began in 2009 is now in the top five bull markets all-time in terms of returns and duration, but to believe that the next eight years will come anywhere close to rivaling the last eight years is foolhardy. At the current time U.S. equity valuation levels are in rarefied air with only the most over-valued periods in history as relevant comparisons (1929 & 2000).



What's more is that the most recent leg of this bull market is creating an even larger divergence between fundamentals and prices than at any point since the Tech Bubble. In the following chart the blue line is the tally of "Corporate Profits After Tax with Inventory Val. Adj. and Cap. Consumption Adjustment" (think of it as one of the truest reads on organic corporate profits across the entire economy – including non-public businesses) which is plotted against the Wilshire 5000 Total Market Index (the broadest equity market index). What's obvious from the below chart is that while corporate profits have started to recover over the last two quarters they still remain meaningfully below their 2014 peak with a stock market that raced nearly +20% higher over that time period.

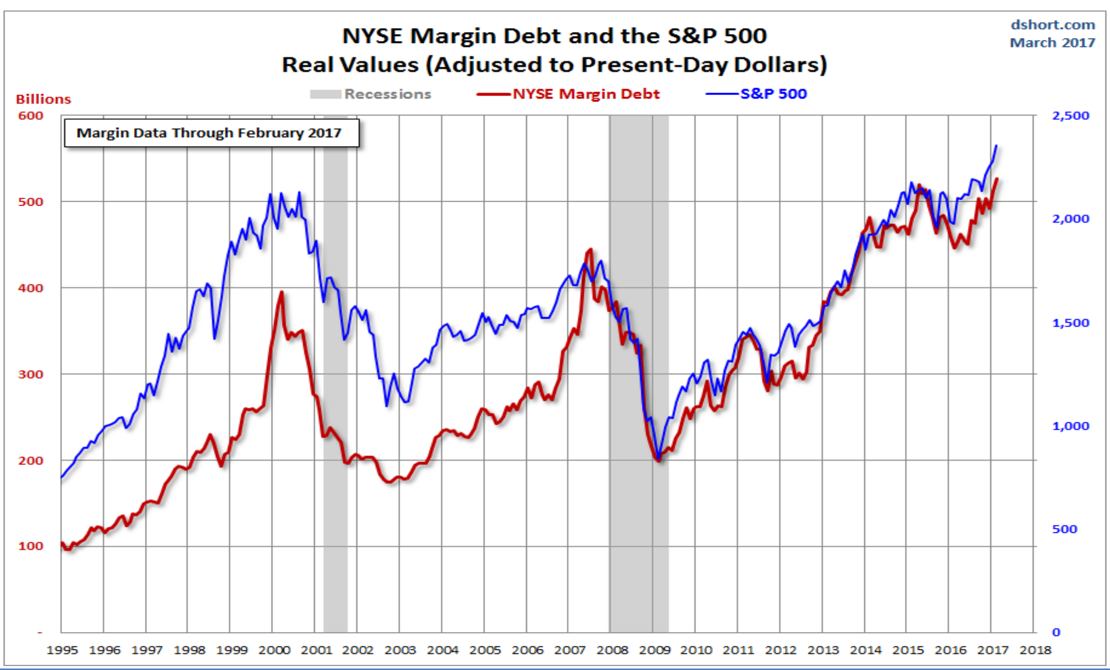


Those willing to broaden their investment horizons may find comfort in Euro area stocks that have lagged the U.S. by roughly 150% over this eight year bull market, Japan has lagged by 80%, and Asia ex-Japan has underperformed the U.S. by more than 100%. Not to mention these markets trade at much cheaper valuations – ranging from P/E's of 12.5x to 14.5x – and are much earlier in their economic recoveries than the U.S. with monetary policy that remains as a tailwind.

The stalling out in the reflation rally throughout March is nothing more than a healthy dose of skepticism setting in over the extent and timing of tax reform legislation working its way through Washington. I must say that the noise coming out of D.C. is grossly outstripping any substance as it relates to items that can move the needle for the economy or markets. What looks to be an increasing probability is that much of the administration's grand plans on tax reform and infrastructure spending will inevitably be watered down versions of their original drafts given the resilient divide not only between Republicans and Democrats, but within the GOP itself.

This puts a richly valued stock market in a precarious position given the post-election levitation to these stretched levels came on the back of hope and expectations that this administration could overcome the powerful structural forces of over-indebtedness and poor demographics that have weighed on this sanguine post-financial crisis recovery. Then there is the belief that fiscal policy could become a more dominate force than monetary policy by counterbalancing the tightening effects of a Fed that appears to be more comfortable pushing forward on normalizing interest rates. Don't mind the fact that this rate hiking cycle is occurring at a time when the U.S. economy has never been more indebted which only furthers what I believe to be the most important question today: What interest rate level is too high for the economy to handle?

Recall that the Fed has engineered 13 tightening cycles in the post-WWII era with 10 of them ending with a recession. Already we are seeing broadening signs of cracks in the credit markets, be it the sharp deterioration in C&I lending since December, rising U.S. credit card delinquencies, and a meaningful 70 basis point widening in junk bond yield spreads since late February. This latter point is worth watching as it is the credit markets that lead the equity markets, and while this is a relatively mild move thus far and isn't deserving of alarm bells at present, anyone ignoring it is doing so at their own peril. Although when you see margin debt climb to an all-time high of $528.2 billion in February you have to wonder if investors are worried about anything at all – which in-and-of-itself should send chills up a contrarian investor's spine.

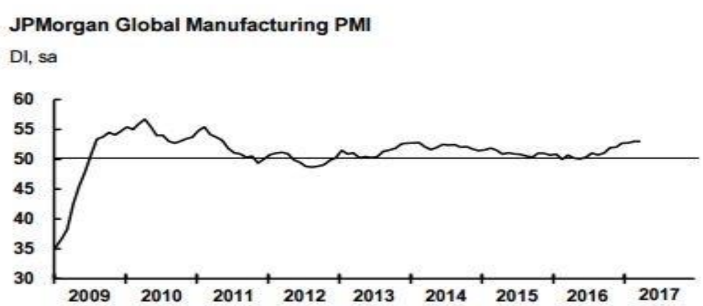


As for the economy, this will be a big week of data with both manufacturing and non-manufacturing ISM, auto sales, ADP employment report, Challenger layoffs, initial jobless claims, and the BLS labor report on Friday. What will be most interesting in the results will be whether the ‘animal spirits’ that have been prevalent in the survey data since the election (consumer and business confidence surveys) translate into tangible business and economic activity. As it pertains to measuring the contours of economic and financial data one of the most important variables for investors is growth – in particular the rate of change of growth, i.e. is it accelerating or decelerating? I think of growth in a very simplistic manner in terms of measurement – for an economy or a company, growth is doing what you did last year plus a little more. Seems simple enough.

Recall that at this time last year the global economy was working its way out of a growth scare as oil prices breached the $30/bbl level in February, global equity markets were in steep decline, and global PMI’s were tracking below the 50 breakeven level. It was in February/March of last year that a significant shift in global monetary policy got underway as China injected $1 trillion in credit into their economy over a four week period, the ECB and BOJ increased their QE policies, and the Fed started walking back the four rate hikes they guided markets to expect in 2016. When you look back at 2016 you realize that on a calendar year basis it was the most significant increase in global central bank balance sheets in this post-Financial Crisis recovery.

What I’m getting at (and this dovetails in with measuring the growth dynamics of the economy) is that from this point in 2017 going forward, economic data on a year-over-year basis will be comparing to results that were steadily improving from this time last year throughout the balance 2016, results that had the benefit of substantial monetary policy accommodation. Already we’ve seen China tightening policy starting in Q4 2016, the Fed has hiked rates twice in the last four months, and the ECB started tapering its QE policy by 25% this month. This is what it feeding into the theory that the ‘reflation rally’ has perhaps already peaked or is coming to an end. The level of monetary accommodation in 2016 is not sustainable nor repeatable without creating extremely challenging consequences.

Hence, when you look at the table below of the JPM Global Manufacturing PMI, your attention should not be focused on the absolute level (while informative and it does have some use), but the rate of change (‘same rate’, ‘slower rate’, or ‘faster rate’) in which you see all the subcomponents ‘Rising’, but all but one doing so at a ‘slower rate’.



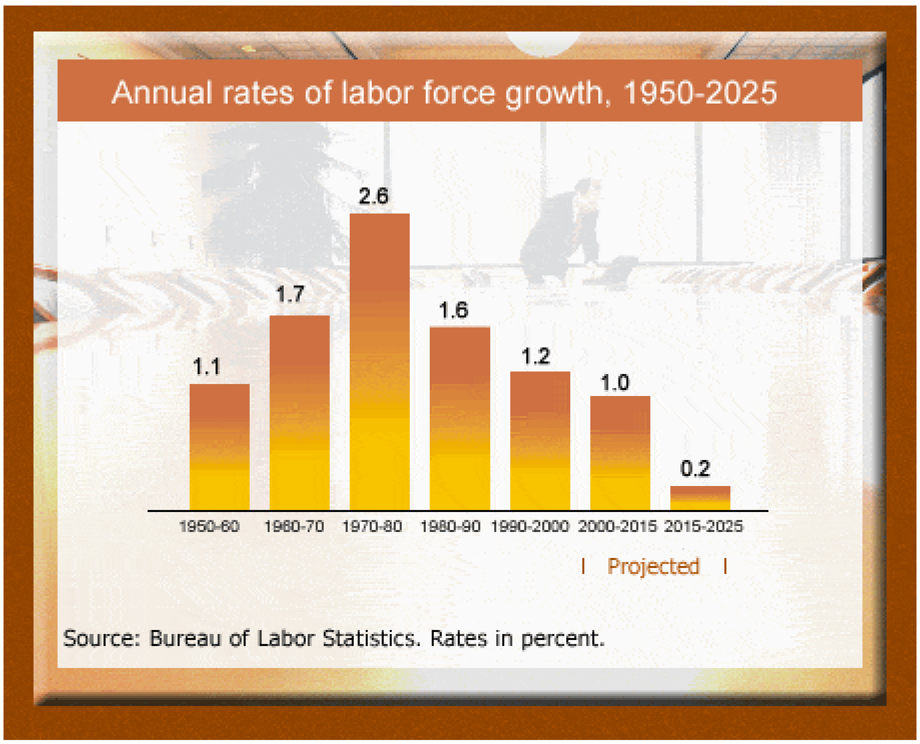
Global Manufacturing PMI™ Summary

50 = no change on prior month.

Index	Feb.	Mar.	+/–	Summary
Global PMI	53.0	53.0	=	Rising, same rate
Output	54.3	54.2	–	Rising, slower rate
New Orders	54.2	54.2	=	Rising, same rate
New Exports	52.8	52.5	–	Rising, slower rate
Employment	51.8	51.5	–	Rising, slower rate
Input Prices	61.0	60.0	–	Rising, slower rate
Output Prices	53.6	53.3	–	Rising, slower rate
Future Output	64.6	63.7	–	Positive, lesser extent

As of now, with fully two months of data in the books for Q1 (January and February data) it looks as though GDP growth is tracking around a 1.5 -2.0% level. That's far from a good reading, but those choosing to have a glass half full perspective may have confidence in the view that it is in-line with the trend rate of growth throughout this expansion. But that is also the point – this is likely all that the U.S. economy is capable of generating in terms of growth at this time.

Consider this – real U.S. GDP growth is driven by two main components: the growth rate of the labor force plus the growth rate of output per worker (productivity). On the labor side, the U.S Bureau of Labor Statistics (BLS) projects that the U.S. labor force (the number of people working or looking for work) will reach 163.8 million in 2024 versus 160.1 million as of the end of February, which implies a +0.3% annual growth rate over the next seven years. The decade from 2015 – 2025 will mark the lowest annual rate of labor force growth in the post-WWII era.



The BLS provided the following explanation for this trend:

> "During the 1970s and 1980s, the labor force grew vigorously as women's labor force participation rates surged and the baby-boom generation entered the labor market. However, the dynamic demographic, economic, and social forces that once spurred the level, growth, and composition of the labor force have changed and are now damping labor force growth. The labor force participation rate of women, which peaked in 1999, has been on a declining trend. In addition, instead of entering the labor force, baby boomers are retiring in large numbers and exiting the workforce. Once again, the baby-boom generation has become a generator of change, this time in its retirement."

As for the other driver of GDP growth, productivity growth, over the past decade it has declined from a post-war average of +2% to a growth rate of just +1% annually, with growth of just +0.5% annually over the past 5 years. The gap between dismal productivity and the most productive economic environment in U.S. history is only about 2.5% annually.

Which brings us to the Fed, who in their latest Summary of Economic Expectations (SEP) estimated the central tendency of long-run real GDP growth to average just +1.85% annually. Understand that even a +1.85% average economic growth rate in the coming years already builds in some optimistic assumptions as it implies that the +0.3% labor force growth rate projection by the BLS will be entirely absorbed, but that can only occur if the current 4.7% level of unemployment stays constant or moves lower.

Meanwhile, with labor productivity growing at only about +0.5% annually, well below the post-war average of +2%, the baseline expectation for U.S. GDP growth, given no change in the present trajectory, is actually just 0.8% (0.3% + 0.5%). So a 1.85% growth trajectory for real GDP assumes that some combination of labor force growth and productivity growth will accelerate from the current baseline. I think it's reasonable to think the U.S. economy could get a bump from a meaningful improvement in productivity, but it is also critical for investors to distinguish between cyclical pick-ups (i.e. short term jolts) and the long-term trend line. Moreover, you have to keep in mind that birth rates in the U.S. are running at historically low levels which increases the importance of immigration filling the void in slow labor force growth. Unfortunately, the policies being considered by this administration don't consider immigration or trade as levers that will enhance economic potential in the U.S.

I'll leave you with one final thought and it's more of a philosophical thought exercise, but it does tie into the current capital market environment. I'm the proud parent of two healthy, delightful (at times), and exhausting (at other times) children. That being said, and I have a long road ahead of me, parenting just might be the hardest job in the world. Where I'm coming from is how does a parent ever know if they are striking the delicate balance of raising such a gift: where you do your best to encourage bravery, but not recklessness? Build their confidence, but keep them humble? Allowing them to blossom into who they want to be, not who my wife and I want them to be, but being sure to lay a solid foundation of morality and values? Raise them to succeed with class as well as to fail with class? Inspire creativity and curiosity yet make sure they understand responsibility and prudence? Embolden them to be outgoing and approachable, but not obnoxious?

In all of these relationships there is a tradeoff, without knowing from the outset whether your tactics will have the desired result. The one thing I do know is that I don't want to be a 'helicopter parent' – the concept of hovering over your child, attending to their every need and micro managing all of their formative experiences. Patience, honesty, selflessness, independence… all these characteristics can be encouraged and taught, but they are only reinforced through actual experience and the most impactful lessons are more times than not learned in challenging times. Perhaps the most valuable learning experiences a child can have is through failure, trial and error, pushing themselves in a way that no outsider can so they can figure out for themselves what they can achieve.

My intention was not to turn this week's missive into a parenting guide, but rather draw a parallel between 'helicopter parenting' and 'helicopter central banks'. While there are certain parallels and symmetries to all economic cycles, there are also unique characteristics that make them different. When I look back over the last two cycles – the one that ended with the Tech Bubble in 2000 and the Credit Crisis in 2008 – I see one constant that has grown in importance and stands even more prominent today in this cycle: an over-involved and hovering Fed.

One of the defining moments that pushed the Tech Bubble into a euphoric state was when then Fed Chair Alan Greenspan chose to bail-out the hedge fund Long Term Capital Management following the Russian Ruble Crisis in 1998. When Russia decided to devalue the ruble and default on their debt, the Fed stepped in, cut interest rates, and injected liquidity into the system in an attempt to forestall any further economic and financial market effects. This caused the last leg of the blow-off top in equity markets that were already at extreme valuations, but pushed even further into euphoria until they started to pop in March of 2000.

It was the fallout from the Tech Bubble that caused the Fed to cut rates to 1% by June of 2003 and ever so slowly increase them to 5.25% by June 2006 which set in motion the foundation for what become a financial crisis that nearly collapsed the financial system.

Now here we are today with a Federal Funds rate at 0.825% after seven years of zero interest rate policy and a Federal Reserve that talks as though they want to normalize rates, yet their actions say otherwise. Going into 2015 the Fed's dot plot indicated that three rate hikes were to be expected – they hiked once. Going into 2016 the Fed indicated that four rate hikes were likely – they hiked once. Now here we are again with the Fed earlier this year dancing between three or four rate hikes for 2017 and we'll just have to wait and see how it ends up. All the while we have a financial system that has never been more indebted in history with broadening indications that the economy is even less sustainable today than it was at the peak of the last two cycles.

As a result we have an investment environment where on an ongoing basis investors get further emboldened by the 'helicopter parenting' actions by the Fed and now the growing belief that fiscal policy will likely be there to backstop asset prices. So far, this has been a successful strategy for investors, but keep in mind that throughout the annals of history there has never been a parent that has never erred in their guidance, just as there has never been an economic cycle that didn't end.

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