



May 1st, 2017

Quantifying a trillion...

Equity markets capped off the end of April with a nice spring in their step, pushing the major averages to new all-time highs (in the case of the Nasdaq Composite and the Russell 2000 Small Cap Index) or within a sliver of all-time highs (in the case of the Dow Jones Industrial Average and the S&P 500). Who would have guessed that a short 14 months ago, back in mid-February of 2016, with the major U.S. equity indices down double digits to start the year and recessionary risks on the rise, that we'd see the S&P 500 log gains in 13 of the past 14 months?

As they say, hindsight is 20/20 and as such, there are many factors investors could reference to explain why markets did what they did, be it the fabled Shanghai Accord which set off a sequence of coordinated central bank actions, the bottoming and recovery in commodity prices (oil in particular), a meaningful and sustained pick-up in industrial activity (U.S. ISM manufacturing index increased from 50.2 in January 2016 to 62.90 in March 2017), corporate earnings growth returning after five consecutive quarters of decline, and/or the spike in optimism on the back of a pro-growth fiscal policy agenda.

Any one of these explanations would have both validity and a fundamental footprint to support it. After all, markets are where they are – at or near all-time highs – irrespective of the why. In fact, one of the biggest take-aways over the last year has been for investors to ignore the noise and embrace the mantra that has worked since this recovery began back in June 2009 – a higher level of sustained growth is right around the corner.

Yes, there is a hint of sarcasm in that last comment, but there is also a lot of substance to it as well. Here we are coming up on the eight-year anniversary of this expansion (making it the 3rd longest in history) yet this remains the weakest expansion in terms of economic growth in the last seven decades. Nevertheless, each year there is renewed hope espoused by the Fed, global leaders, and even influential market prognosticators that the expansion so many are longing for, but not experiencing, is going to materialize. Earlier in the cycle it was all about the stimulus that could be created by the Fed and after +8 years of zero interest rates and a quintupling of the Fed's balance sheet, the 'hopium' baton is being passed to fiscal policy.

On that front, last week the new administration finally released the "phenomenal" tax plan Trump had been promising since mid-February. Better late than never, and I don't fault him for wanting to feed off of and provide some validation to the surge in optimism that followed his victory in November. Nor can I fault him for coming out swinging with this opening bid on tax reform with a proposal to cut the top corporate marginal rate to 15% from 35% and narrow the individual tax brackets from seven to three (35%, 25%, and 15%). As good as all this may appear on the surface it is extremely lacking in detail, and as a result it's hard to make any conclusions.

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The reality is that this proposal has virtually no chance of becoming legislation as it currently stands given the estimates I've seen from the number crunchers who had the courage to score it, which range from a \$2 – \$5 trillion increase in the size of Federal debt over the next decade. Even when allowing for “dynamic scoring” by including economic growth in the estimates, the math doesn't add up where the national debt still increases over the next decade, and as such subjects this proposal to reconciliation procedural rules. Without the 60 necessary votes in the Senate any tax proposal that has ambitions of passing will not be allowed to add to the national debt beyond 10 years.

Just as this administration has found out on healthcare and as Trump acknowledged in an interview over the weekend, being the President is a lot harder than he thought it was going to be. Once again, understanding where he came from in the business world, where he was used to getting things done when and how he wanted them, is relevant in order to assess the divide between expectations and reality when it comes to Washington politics and investor expectations.

Which brings me full circle to where I started this missive and the expanding gap between expectations and reality as it pertains to markets and the economy.

The two biggest challenges facing this economy today are debt and demographics. Unfortunately, there is very little to almost nothing that any government policy can do to change that in the near future. Let's start with debt, as this is perhaps the one variable that has either been grossly underestimated by the Fed or ignorantly discarded as it pertains to a side effect of their unprecedented monetary policy experiment over the last eight years. You see, at this late stage of the economic cycle, all of the pent-up demand that exists in the early innings of an economic recovery is used up and by cutting the cost of debt to the lowest level in history the incentive to pull forward demand through increased borrowing is also exhausted.

As a result, we have household debt about to breach the all-time high it hit back in Q3 2008, corporate debt is at an all-time high, and Federal debt is also at an all-time high. So here we are, with the total claim on U.S. assets at an all-time high of \$68 trillion dollars. Let me put a couple things into perspective, because it's so easy for that 'trillion' number to roll off of our tongues today. First, in a dollars and cents context: if you were to pay (or receive) \$1 million per day, it would take you 2,700 years to get to \$1 trillion. How about in terms of time:

- 1 million seconds is equivalent to about 11 days
- 1 billion seconds is equivalent to about 31 years
- 1 trillion seconds is equivalent to about 31,700 years

So let's intertwine this with a simple example to help illustrate the relationship between the level of debt and the cost on that debt:

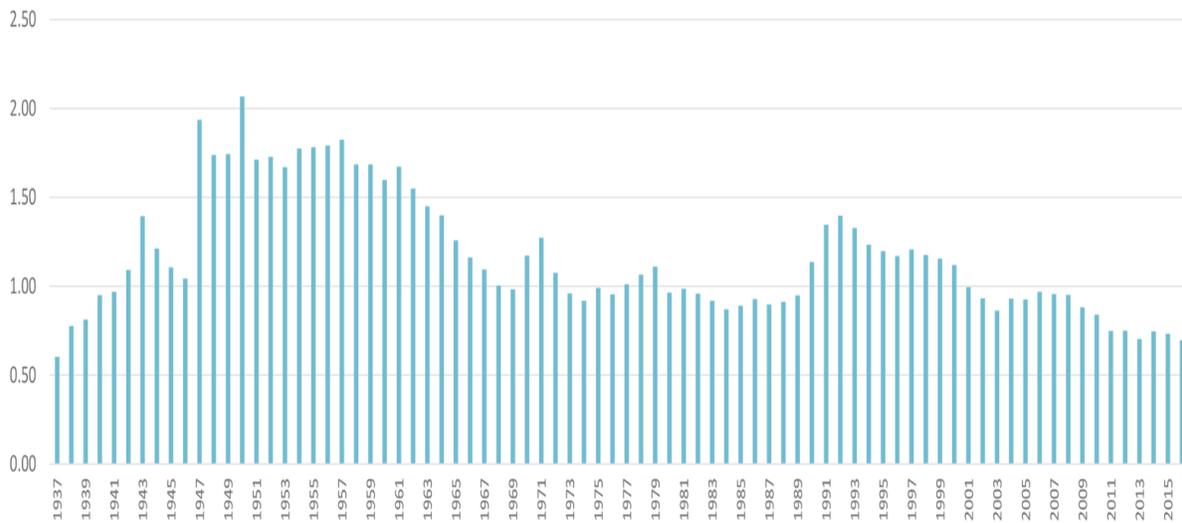
- At the end of fiscal year 1988 U.S. Federal debt outstanding was \$2.6 trillion in which Uncle Sam spent \$214 billion that year to service the cost (interest expense) of that outstanding debt level.
- 2008 Federal debt outstanding was \$10 trillion and debt service that year was \$450 billion
- 2016 Federal debt outstanding was \$19 trillion and debt service last year was \$432 billion

So over the course of the last eight years Federal debt almost doubled yet the cost to service that debt modestly declined. The only way this was possible was because interest rates declined to the lowest levels in history. For further context consider that total debt outstanding in the U.S. peaked at just shy of \$55 trillion in Q1 2009 and has increased to \$68 trillion at last check while U.S. nominal GDP has increased from \$14.4

trillion to \$19 trillion – that is \$13 trillion in additional debt for \$4.5 trillion in additional output. This is what makes the intersection of present day political and central bank ambitions with present day financial reality extremely vexing. If the politicians chose to ignore the debt situation and push full steam ahead on their belief that their policies will create the growth they estimate, but if this growth fails to come to fruition then they risk undermining the credibility of the U.S. being able to repay their outstanding liabilities. Conversely, if they were to do nothing and focus on an austerity program (a la Greece and other heavily indebted European countries) to pay down the debt then they risk elevated unemployment levels, contracting economic growth, and deflation.

As for demographics, the U.S. population grew by 0.7% last year according to the Census Bureau and this was the smallest annual expansion in 80 years. This isn't just a one-off year as U.S. population growth is averaging just over 0.7% so far in the 2010's, below the 1% annual rate in the 2000's and the 1.2% rate in the 1990's. As you could surmise, the 1950's was the best decade for population growth, with a 1.8% growth rate as the Baby Boomer generation was entering the world. With labor force growth (which is a function of population growth) acting as one of the key ingredients for economic growth, this demographic profile will be a material headwind to overcome over the ensuing decade, during which the math starts to inflect back the other way as the Millennial generation becomes the key demographic driver.

Figure 1. U.S. annual population growth, 1937-2016

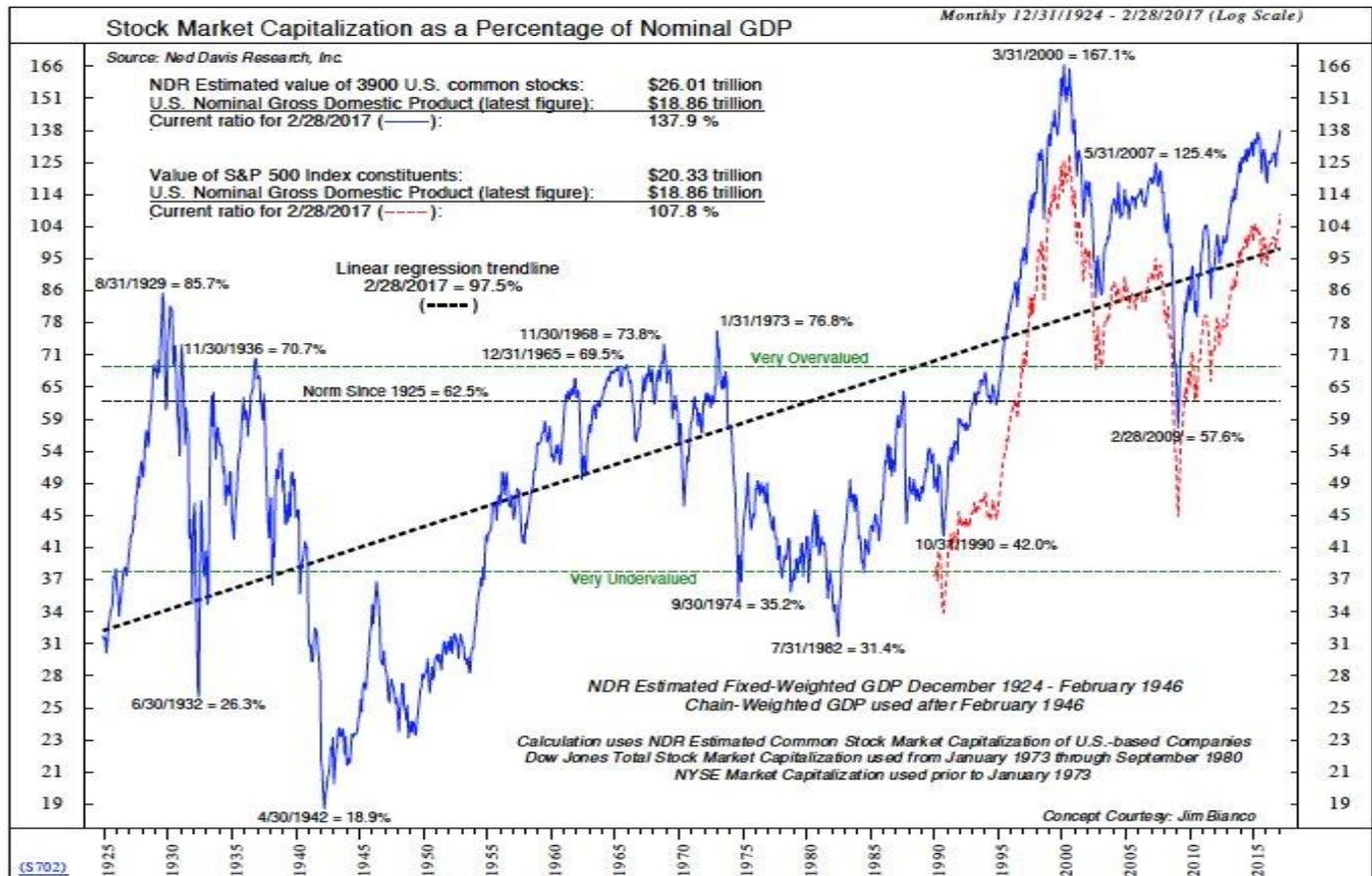


Source: William H Frey analysis of U.S. Census Bureau historical population estimates

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I by no means want to be an alarmist or moribund in this missive, but I also think it is important for individuals to be aware of the secular forces that provide some explanation for why this recovery feels like anything but to so many people. But Corey, the stock market is at an all-time high, interest rates are low, consumer sentiment is at a cycle high, and unemployment is at a cycle low... All true, but that is always the case at the end of a business cycle expansion:

Valuations:



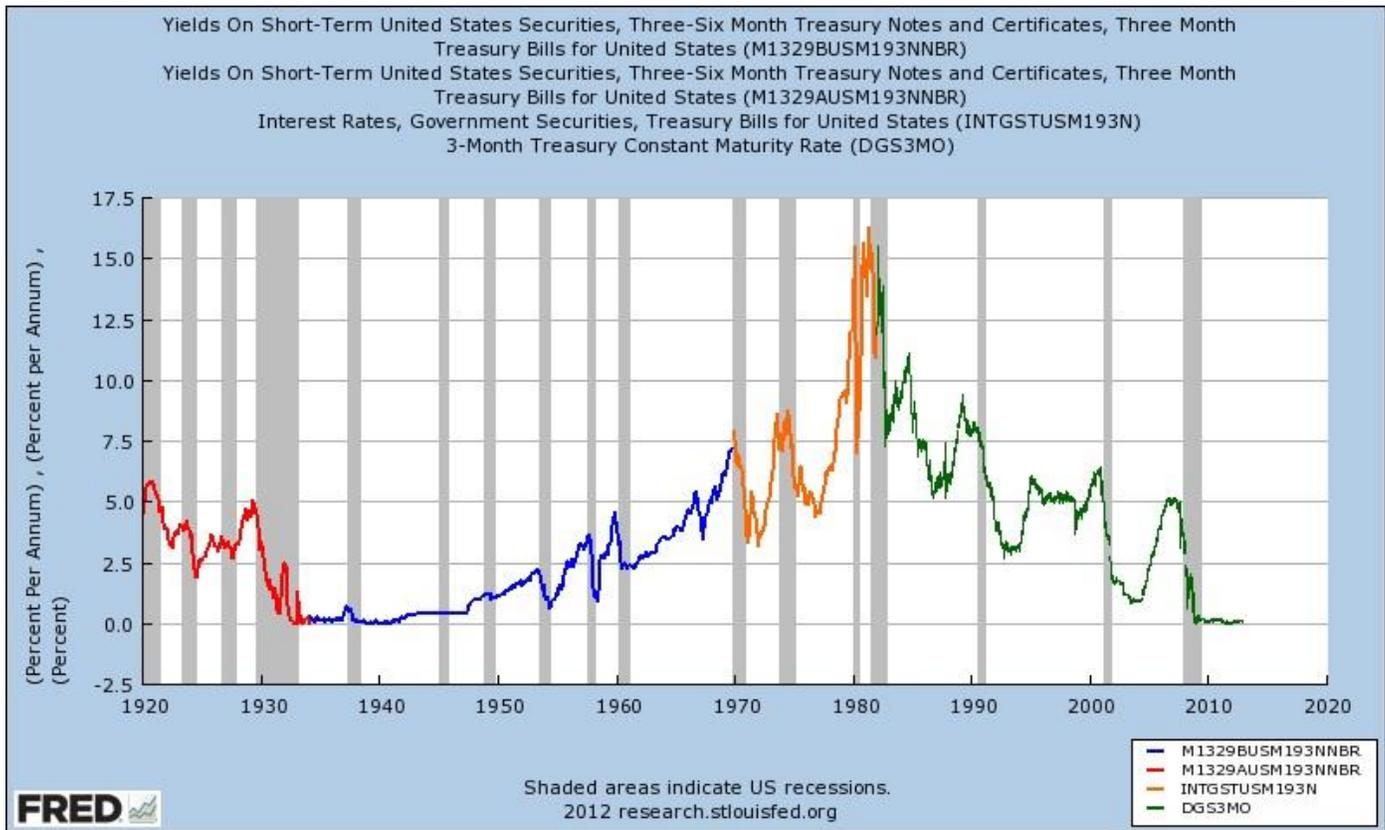
No denying that Q1 earnings are outpacing analyst's expectations with year-over-year earnings growth coming in around +12% and sales growth running at +7%. On the surface these are great results, but what makes them a bit misleading is that if you look at the trailing four quarter earnings tally (including this current quarter) for the S&P 500, earnings are back to the same level (\$111.34) they first reached at the end of Q2 2014 when the S&P 500 was trading at 1,960 versus 2,390 today. So in this almost three year period the S&P 500 has experienced no earnings growth, but the P/E multiple has expanded from 17.5x in June of 2014 to 21.4x today (outside of a recession which caused a dramatic fall in earnings, this is the highest level since 1997).

Which reminds me of the numerous articles I've read over the past couple weeks talking about how this time is different and that stocks can still go higher because we're not at the all-time high valuation levels that were reached during the Tech Bubble. The problem (and there are many) I have with this explanation to justify why investors should not fear current valuations is the Tech Bubble valuation extremes were distorted by one segment of the equity market (Technology sector) which led to the Nasdaq plunging more than -80% when that bubble unwound versus the S&P 500 declining much less, but still a very painful -50%. The rich valuations today are much more widespread and pervasive where on a median stock basis (versus the more customarily used average calculation) the major averages are as expensive today as they were in the Tech Bubble.

Also reminiscent of the 2000 Tech Bubble is the growing concentration of today's market leaders, where the top five companies by market cap in the S&P 500 (Apple, Google, Microsoft, Amazon, and Facebook) are

worth more than the annual GDP of every country in the world outside of the top four (U.S., China, Japan, and Germany) – yes, even bigger than the U.K.

Low Interest Rates:

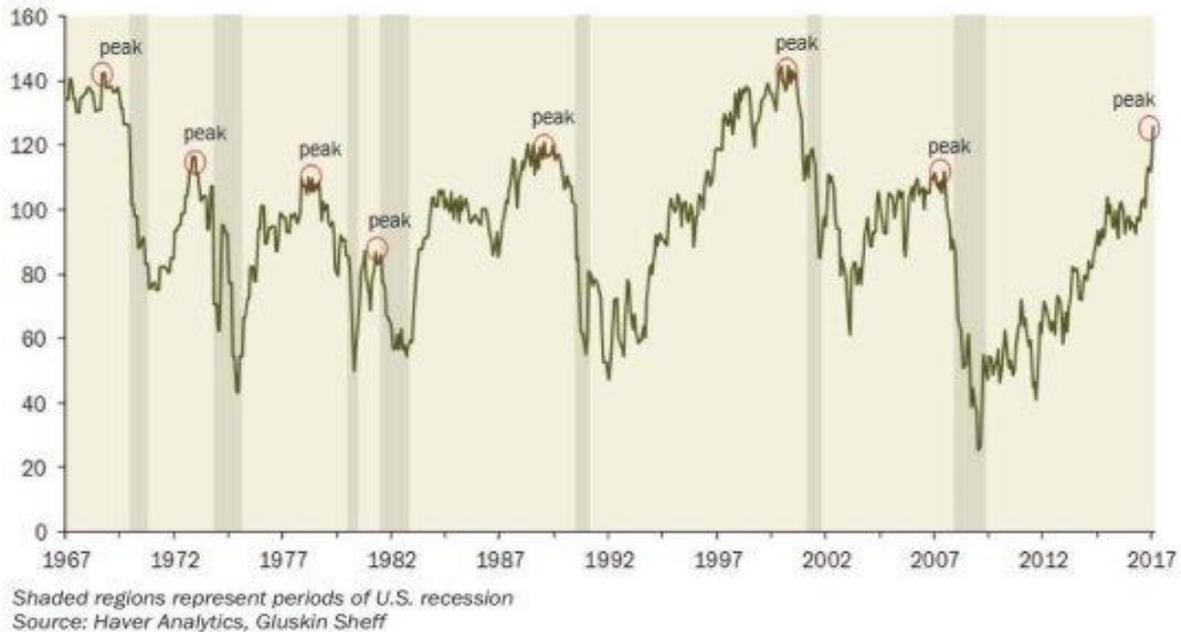


Perhaps it's time for investors today to start asking themselves why interest rates remain so low if everything is so great? Why is it that the yield curve has compressed to levels they were at before the U.S. elections? After all, if the global economy is really all that healthy, why is it that global central bank asset purchases are still running at more than \$200 billion per month?

Consumer sentiment and the unemployment rate:

CHART 11: CONFIDENCE PEAKS — RECESSION A YEAR LATER!

United States: Conference Board Consumer Confidence
(index; 1985 = 100)



As you can clearly see from the charts – when these data points look their best is the time when investors should start to consider that the end of the current business cycle is approaching.

This sets up to be an interesting week in that we'll get the latest check on the health of the economy with a bevy of instructive economic data being released. This morning we got the April read of the ISM manufacturing survey which fell to 54.8 from 57.2 in March and is back down to the level it was at in December. This moderation is in line with what has been transpiring with a lot of the survey based data releases over the last six weeks, where the bloom is coming off the rose as optimism slams up against the reality that change will take time. That's not to say that it's not coming, but expectations (in terms of timing) got well out in front of a realistic legislative timeline. Not that the administration didn't feed into this during their many speaking engagements, but they chose the path of overpromising and under-delivering – a tactic that appears to be in reverse with recent comments from key officials.

What investors should be on the look-out for is whether the weakness that was on full display in Friday's Q1 GDP report (the U.S. economy expanded by a measly +0.7%) was a one-off and can be easily explained away by seasonality or that this stagnant activity is carrying over into Q2. When looking at the data so far this year, we're talking about a trend where economic momentum has softened each month and the hand off to Q2 is looking quite weak. The market was on to the end of the deflation rally well before the data turned down with most of the cyclical commodities (i.e. copper, iron ore, oil...) rolling over in mid-February and interest rates hitting their highs in mid-March.

It's no surprise then to see the Citigroup Economic Surprise Index in freefall since mid-March where it has gone from 57.90 to -20.6 (lowest level since October 21st) following this morning's worse than expected construction spending and manufacturing data. Friday's employment report will be the main headline, especially coming off a sluggish March report where only +98k jobs were created (expectations are for a print of +190k). Should we get another weak number it will cast a lot of doubt among the growth bulls out there and while stocks have been undeterred by the weak data over the last six weeks, two consecutive poor employment reports will be difficult to ignore.



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