June 12th, 2017

A potential change of market complexion at play…

In what was a rather quiet week on the data front in terms of earnings or economic releases, it was chock-full of political satire that, depending on one's perspective, exceeded or fell well short of the hype. The Trump-Comey saga appears to be nothing more than a "he said / he said" showdown, and this isn't to say there aren't implications on a societal and geopolitical level, but from a capital markets standpoint it's much ado about nothing. What it does do is continues to distract and hamper this administration from proactively moving forward on the pro-growth policy initiatives that could give the economy (that with each passing day is showing more and more of its late-cycle age) a much-needed jolt.

Let's face it – until we see otherwise, here we are coming up on the six-month anniversary of this administration's term with very little to show for it. I know, I know… Corey, you're missing all the executive orders Trump has signed off on to remove the heavy hand of overregulation from the prior administration that has become so burdensome on the economy. I can very easily see how this viewpoint is conceived by the casual observer, but what the photo-op of the President signing an executive order misses is the actual action it creates – which is little to nothing. Trump's Executive Order on Reducing Regulation and Controlling Regulatory Costs, which says that "agencies must identify two regulations for repeal for each new one they issue", does not actually identify any regulation(s) to repeal.

Why this Executive Order is so broadly worded is because the President doesn't have the authority to just wipe out any regulation he/she wants with the stroke of a pen. There is a legal process that must be adhered to in both making and repealing regulations which includes leveraging agencies to gather information, study the costs and benefits, allow public comment, etc.… before concrete action can be enacted. All of this takes time, and for good reason.

Yes, it has stopped the creation of additional regulations which is a net positive for business confidence, but according to many of the recent business survey responses – regulation isn't the biggest problem as it falls below taxes and is in line with their inability to find qualified labor. While I sympathize with businesses on the tax front and who wouldn't like lower taxes, it's hard for me to wrap my head around the statement that we are an over-taxed society. While it very well may be an accurate statement, I find it inaccurate in principle, when you consider that our government runs a deficit year in and year out. I think a more accurate statement would be that we overspend and a byproduct of that creates the potential reality of being over-taxed. You can't fix one without getting the other into alignment.

While it's still early in this administration's term, to my casual eye I see a lot of parallels between this administration and the last – it's just that the pendulum has shifted from the left to the right in terms of political partisanship. After the honeymoon was over for Obama, the task of governing and leading was at hand, but in a highly polarized political community it became very difficult for him to pursue the path of unifying the parities, so his administration pivoted to focus on what his party could get done on their own. As a result, most of the legislation that was passed was one sided and it was the Republicans that were labeled as the obstructionist party – the fall guys/gals for impeding legislative progress.

Fast forward to today and you can see the rolls reversed where it's the Republicans in power and they're the ones doing the finger pointing in the other direction as the Democrats dawn the obstructionist cloak. This should not lead anyone to conclude that nothing can get done, as much did get done during the last administration's tenure, but anyone who hasn't moderated their expectations for expedient and impactful passing of legislation should recalibrate for the here and now. Moreover, this also raises the expectation that the only way big legislative action will occur is when a crisis unfolds – nothing elevates the motivation and incentive of elected officials to put party loyalty aside more than a crisis that is hitting all constituents.

What was more interesting to me last week than the U.S. political reality show was the surprising parliamentary results out of the U.K. where Theresa May's political gamble to call snap elections and leverage her perceived strong poll numbers coming out of the Brexit vote last summer turned out to backfire with her Conservative party not only losing seats, but also losing their majority position. These results only elevate the level of uncertainty and political fragility in the U.K. as they head into exit negotiations with the E.U. and potentially open the door for a soft Brexit or no Brexit at all (the negotiating power has definitely shifted to the E.U. and it all depends on what type of message they want to send to the rest of the E.U. members who were/are curious about leaving the E.U.).

The bigger message coming out of this as well as the recent Macron victory in France is that the peak in anti-establishment and anti-globalization is likely in the rearview mirror. Perhaps the election of Trump last fall and his inauguration in late January is where this short-lived trend inflected with most elections since (Dutch, French, recent Italian results with Renzi polling well, and now U.K. parliamentary results) shifting the pendulum back the other way.

If anything else, the aftermath of Brexit and Trump has put the rest of the world on notice and forced those nations who favor continued global coordination and synchronization to unite. Germany and France is a classic example where they appear to be more aligned in the collective success of the E.U. than they've been in decades, and don't overlook China taking on the leadership post in championing the benefits of a continued pursuit of a globalized world.

While it's still early days, the height of the "populism" and "nationalistic" vision (outside of the right-wing fringe in Europe and the hardcore Stephen Bannon followers in the U.S.) looks to be about six months past its expiration date.

As for the capital markets, on the surface last week looked a lot like any other week with most equity markets little changed. However, this description would misrepresent a potential material change in character to unfolded in the U.S. equity market last Friday. The Nasdaq Composite index posted its steepest decline since the U.S. Presidential election in what ultimately was a 238-point intraday swing that when all was said and done sent S&P 500 Tech stocks plunging to a -2.7% loss. It was the big five tech stocks (Apple, Alphabet – formerly called Google, Amazon, Facebook, and Microsoft) that came under significant pressure on Friday and this was an about-face from this group having accounted for nearly 40% of the year-to-date gain in the S&P 500.

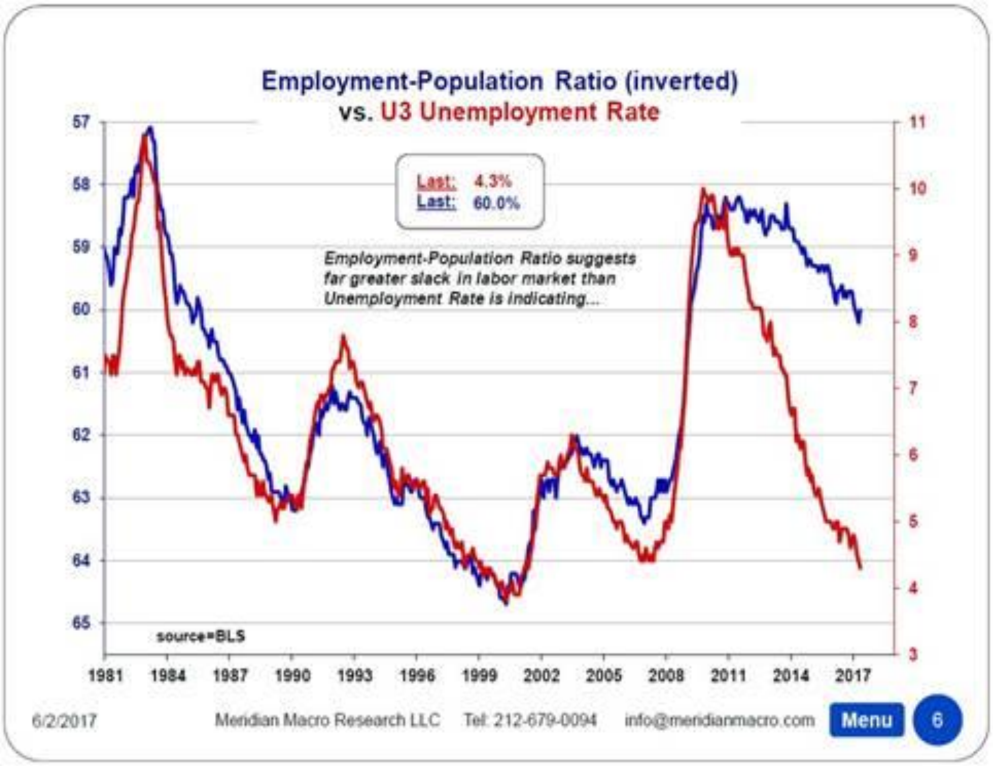
Even with Friday's sell-off the Nasdaq is still up 15% on the year, but with this group's collective market cap recently approaching $3 trillion dollars and market leadership narrowing to such a small group, it's all very reminiscent of the peak 50% share of the market cap commanded by Microsoft, Qualcomm, Cisco, Intel, and Oracle just ahead of the bursting of the Tech Bubble in 2000 (not a forecast, just an observation). The similarities between today and then go beyond just the concentrated make-up and today's rich broad market valuations having only been exceeded one other time in history (that was in the obscene valuation excesses experienced in 1999 – 2000), but also in the manner that fundamentals today are unable to keep pace with the rise in share prices.

The collective market caps of Facebook, Amazon, Netflix, and Alphabet have increased by $343 billion since the start of 2017, a gain of +27% versus a little more than +8% for the S&P 500. However, the respective increase in earnings estimates, while solid, are lagging considerably behind. Earnings estimates for Facebook have increased +18% for 2017 and +10% for 2018 (stock is up nearly +30%), Netflix estimates are up +11% and +2% respectively (stock is up +25%), and Alphabet estimates are up +3% and +4% respectively with its share price surging +22%.

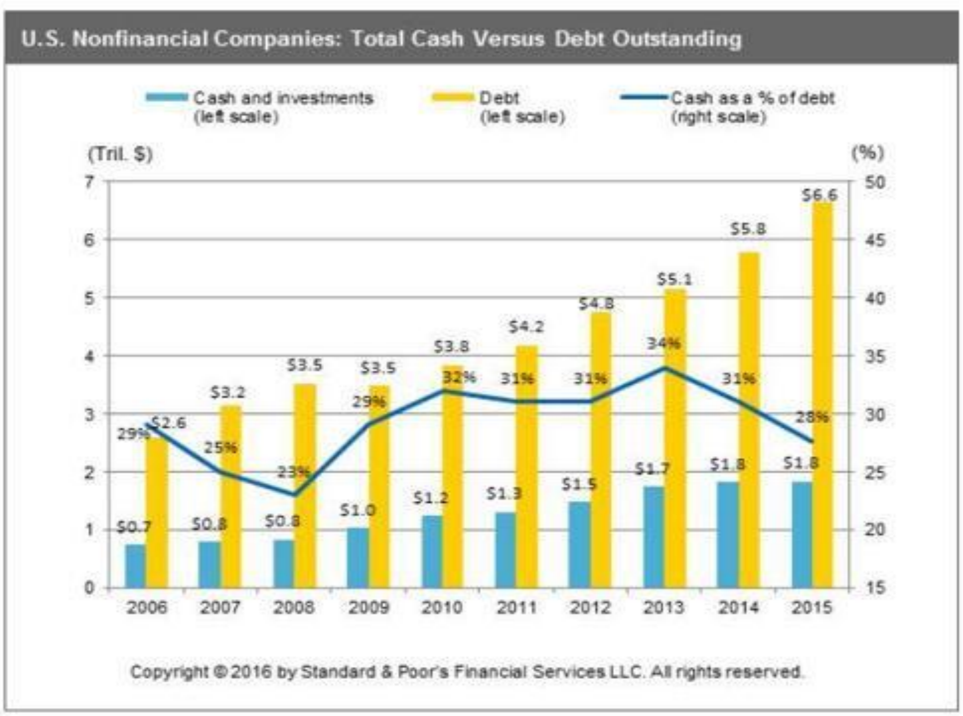
What's more is that this group has become quite the concentrated bet by market participants with net inflows of $6 billion going into the Tech sector this year – the most of any sector. This is a classic sign of late cycle investor behavior where greed drastically exceeds fear and the "greater fool theory" (investors buying with the belief that there is greater fool out there that is willing to buy your shares at a higher price) comes into full bloom.

It will be interesting to see if Friday's price action is a one-off and market leadership resorts back to its previous form, or if an actual change of market complexion is at hand. After all it's been 15 months since the equity market has experienced anything close to a meaningful correction (February 2016) and this overall level of complacency is not just encapsulated with the recent two-decade low VIX reading of 9.4x, but the fact that here we are almost a full six months into this calendar year and we've had just five trading sessions with a more than 1% move in the S&P 500 (up or down). A typical year experiences about 50 moves of +/- 1% on a given trading day which leaves one to wonder what the second half of the year could look like if we were to experience some mean-reversion.

Which brings me to the economy and according to my lens a broadening swath of data that adds up to the view that this cycle is in its latter stages. How late? Eighth or ninth inning is my best guess when tallying up the message from the various indicators I follow. It looks as though the unemployment rate has bottomed and if last month's jobs report is any indication, the deterioration in the labor market is spreading with the potential for it to materially weaken in very short order. What's more is that one has to wonder whether we ever did experience a full recovery in the labor market with the employment to population ratio peaking at just over 60% this cycle, well below the 63 – 65% level of the last three economic expansions and never coming close to confirming the strength of the jobs market as viewed through the prism of the 4.3% unemployment rate.



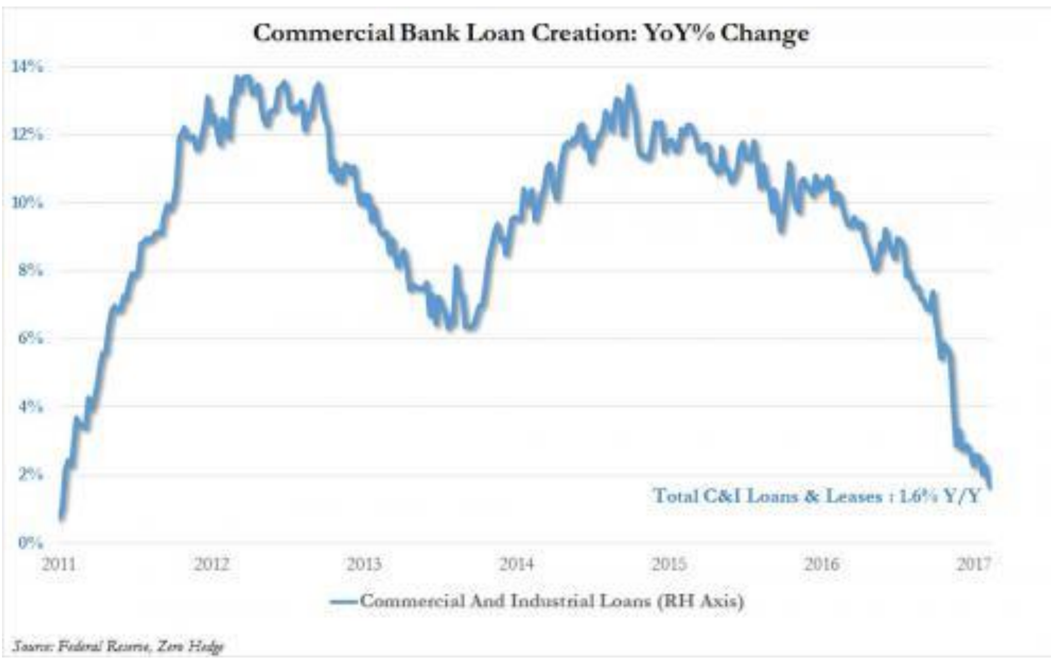
In addition to the unemployment rate bottoming, auto sales have peaked, housing has peaked, and consumer confidence has peaked for the cycle. S&P 500 corporate profits may still have a quarter or two of growth left in them, but economy-wide corporate profits according to NIPA accounting peaked back in 2014 and profit margins are in the midst of peaking for the cycle. As you can see from the following table, cash and investments on corporate balance sheets has flat-lined over the last couple of years, and most of the gain in earnings per share is coming at the hands of increased debt loads used to fund buybacks to reduce outstanding share counts. This game can only go on for so long, but with Nominal GDP growth at 4% it provides very little of a tailwind on the revenue front which ultimately is the most important metric to sustainably refill the coffers.



Carrying on with this peaking theme is inflation, and with it real rates which is perhaps what is being sniffed out by the gold market which has flown under the radar of many as it has outperformed the S&P 500 so far this year (up more than +10% ytd).

This view also hasn't been lost on the bond market which even in the aftermath of all the excitement following the election (with the euphoric celebration of tax cuts, deregulation, and infrastructure spending…) could barely get the yield on the 10-year T-note beyond 2.6%. I mean think about it, we had the Philly Fed index soar to 44 month highs, commodity prices breaking out of what was a five-year bear market, consumer confidence spiking, and economists tripping over themselves to raise their economic growth projections. Yet, all the 10-year Treasury yield could do was get to 2.64% and now here we sit, a full 44 basis points below that level at last check.

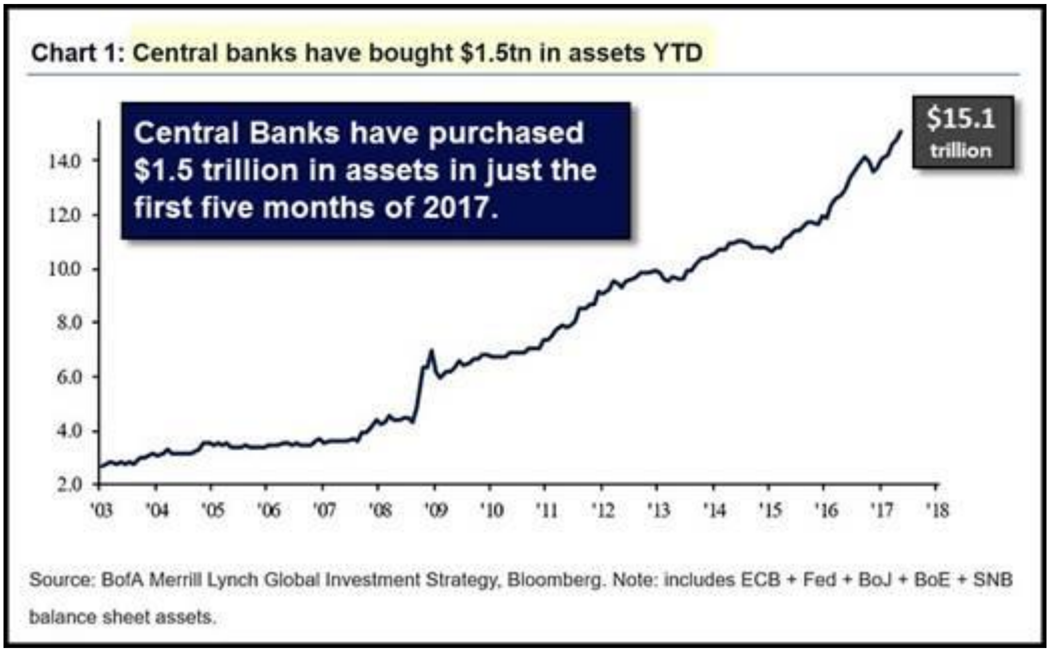
Add on to this the discernible downshifting taking place not only in the supply of credit but also in the demand for credit as the lending market has slowed to its slowest pace since 2011 – a time period when everyone was fearful of a double-dip recession and a sovereign debt crisis in Europe was a legitimate risk. After growing at a +7% Y/Y pace at the start of the year, which declined to +3% at the end of March and +2.6% at the end of April, the latest bank loan update from the Fed showed that the annual rate of increase in C&I loans is now down to just +1.6% (the lowest since 2011) after slowing to +2.3% and +1.8% in the previous two weeks.



All of this lines up fairly consistently with what the end of an economic expansion looks like, and this one is no different other than it's been much shallower in amplitude and longer in duration than most of the others in the past. If you're taking your cue from the stock market, you're focusing on the wrong reference point – not that it's not a useful input, but the equity market is usually the last to know and almost begrudgingly ignores the underlying weakness until it slaps it in the face. I find the recent breakdown between the S&P 500 and the S&P Retail sector a bit of a conundrum. After all, the consumer is almost 70% of U.S. GDP and while surely Amazon is having a disrupting impact on the industry, it isn't enough to explain the rate of sales declines and store closings taking place in the retail space. Especially when you consider that Q2 earnings estimates for the S&P 500 are expected to grow +6.6%, mostly on the back of the Energy and Tech sectors. When you dig a little deeper into the 6 consumer-centric sectors in terms of Q2 earnings expectations you see that analysts are penciling in a modest +0.2% growth rate for EPS and this is down from +2.4% just one week ago.

The upcoming week is sure to be busy not only because it includes the Fed meeting and an accompanying press conference where they will update their dot plot, but it will also include the most up to date assessment of how they view the economy. The biggest change in the Fed's philosophy this year is their distancing themselves from 'data dependence' to 'interest rate path dependence' as it is becoming clearer that they are intent on trying to refill the till as much as they can before the next recession. At this point it is almost a given that they hike rates for the third time since December, but there is now only a little more than a 40% chance priced in by the futures market that they hike at all again the rest of the year.

What will be of most interest to risk oriented investors at this point is the extent to which they provide more guidance on the how and when they begin the process of reducing the size of their balance sheet. Why this is of such importance to investors is because of the most recently updated report put out by BofA Merrill Lynch Chief Market Strategist Michael Hartnett showing that global central banks through the first five months of this year have purchased $1.5 trillion in financial assets. Now the Fed has much less to do with this than the BoJ and ECB as they only account for roughly $30 billion per month in QE with the reinvestment of the assets maturing off their balance sheet. But with asset prices that have become dependent on ever increasing liquidity and asset purchases by central banks, any marginal change to this foundation for asset price levitation is significant.



Beyond the Fed we'll get data that covers a wide swath of the economy that will encompass the consumer (retail sales), inflation (PPI and CPI readings), manufacturing (industrial production, Empire survey, and Philly Fed survey), and housing (May housing starts). If ever there was a week in the recent past that could be market moving in terms of data, this is it.

So, if we are as I estimate in the last inning or so of this economic expansion and you are inclined to employ some risk management tactics into your portfolio, what do you do? For starters take some profits, and this by no means implies selling everything, but more so harvesting some gains and shifting the portfolio into a more defensive posture. Within your equity holdings shift the focus to less cyclically oriented equity sectors and focus on companies with strong balance sheets and a history of generating dependable reoccurring cash flow streams.

One area that value oriented investors can find some opportunities in is the Energy sector, not because I think the broad fundamentals are pristine, but because I think this industry has already been through its depression. And this isn't to say they are in the clear because I still think there is some runway before the outstanding inventory imbalances come back into some alignment with historical averages, but I do think there is a solid basis for the oil price to trade in a range of $40 - $55 per barrel for the foreseeable future. At the current time, we are nearing the lower end of this range and beyond just the oil price, there is a lot of bad news priced into this sector where even the subtlest of positive change can have a meaningful impact on some high-quality names.

Additionally, I remain of the view that overseas markets continue to offer a more favorable risk / reward set-up relative to U.S. equities given many of them are earlier on in their business cycles and there remain some monetary policy levers to pull that could act as tailwinds. However, my thinking and constructive relative view is naïve to the fact that global equities have been and will continue to be highly correlated to U.S. equities. If the waters get choppy in the U.S. equity market it's likely these turbulent waters will find their way into foreign equity markets and vice versa. But, foreign markets trade at meaningfully cheaper valuation levels which provide a more favorable margin of safety for value investors.

The two other asset classes I like and think are worthy of consideration for investors are gold and cash. Cash is an investment and while it pays little to nothing for investors who hold it today, it is an asset class that has no correlation to the equity market and provides tactical investors with optionality to take advantage of price dislocations in capital markets when they present themselves.

** Please note, Capital Market Musings & Commentary will be taking a brief hiatus next week, but will be back with a fresh missive the following week. **

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