June 26th, 2017

A change in tone that needs to be respected, but is currently being ignored…
It what was a rather quiet and boring week in the capital markets last week with stocks and bonds, while open for business, ending the week little changed from the week prior. There was however a ton of interesting content littering the information superhighway that should garner more attention in the weeks and months ahead. In particular the Bank of International Settlements (BIS), an umbrella body for leading central banks, released its annual report in what was one of its most upbeat assessments of the global economy in years. However, it wasn't its optimistic global economic growth forecast that grabbed my attention (they, like the Fed, have a checkered track record in routinely penciling in overly optimistic expectations only to then have to revise them lower throughout the entirety of this expansion), but rather their vocal urging of central banks to press ahead with interest rate increases and monetary policy normalization.

They acknowledged that the "great unwinding" of quantitative easing programs and low interest rates had to strike a delicate balance between a stable yet still vulnerable economic recovery and the potential for "bumps" along the way in this retrenchment of unprecedented monetary policy accommodation .

> "Since we are now emerging from a very long period of very accommodative monetary policy, whatever we do, we will have to do it in a very careful way."
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> "If we leave it too late, it is going to be much more difficult to accomplish that unwinding. Even if there are some short-term bumps in the road it would be much more advisable to stay the course and begin that process of normalization." BIS's head of research, Hyun Song Shin went as far as to comment that it will be "very difficult, if not impossible" to remove all of those bumps.
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> "Over long horizons, failing to constrain financial booms but easing aggressively and persistently during busts could lead to successive episodes of serious financial stress, a progressive loss of policy ammunition and a debt trap. Along this path, for instance, interest rates would decline and debt continue to increase, eventually making it hard to raise interest rates without damaging the economy."
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> "From this perspective, there are some uncomfortable signs: monetary policy has been hitting its limits; fiscal positions in a number of economies look unsustainable, especially if one considers the burden of ageing populations; and global debt-to-GDP ratios have kept rising."

In the report the BIS goes on to list four main risks that could undermine the sustainablity of the upswing:

1. A significant rise in inflation could choke the expansion by forcing central banks to tighten policy more than expected.
2. Serious financial stress could materialize as financial cycles mature if their contraction phase were to turn into a more serious bust.
3. Weaker consumption that is not offset by strong investment.
4. A rise in protectionism could challenge the open global economic order.

This, my friends, is the biggest risk markets face going forward, and that is the looming loss of support from the one variable that has been a constant source of support in this 9+ year bull market – central bank assistance. Sure you can look back at the data over the last several years and script a narrative to fit the price action in the stock market in hopes of intelligently articulating an explanation for why they did what they did, but that narrative would have as many plot twists as a season of "Game of Thrones".

What ulimately unfolded is the weakest economic recovery in the past 70 years that to this day still doesn't fundamentally justify current asset price levels (national home prices at all-time highs, bond prices at all-time highs, stocks, art, collectibles, new car prices, college tuition… all at all-time highs), but the historically unparalleled level of money printing that was adopted by almost every central bank around the world has remained the one constant that can undeniably be referenced as a plausible explanatory variable.

However, it is looking more and more likly that this backstop is not going to remain in place for too much longer. What has become more obvious throughout the balance of 2017 is the phase transition on the part of the Federal Reserve from focusing on data dependence to financial stability. Consider that in the past month, I can find only two economic data points that have surprised expectations to the upside (the ISM manufacturing index – keep in mind this is a survey based indicator – and the new home sales number last week) and hence why the Citigroup Economic Surprise Index has retreated back to levels last seen in 2011, a period where everyone was worried about the growing potential of a double dip recession, yet the Fed appears to becoming even more emboldened to tigthen policy.

Mind you none of these indicators are falling off a cliff, but they are clearly signaling a meaningful deceleration is underway with the Fed taking the view that it is transitory. To be fair, we've seen several of these stop and start spurts in the economic data since the growth rate of this expansion peaked back in Q1 of 2015, but what is different today than prior to then is that the Fed wasn't four rate hikes into its normalization cycle and as a result didn't have to evaluate whether its tightening actions were a potential catalyst for the slowdown.

With the majority of the second quarter economic data points coming in below expectations we are seeing second quarter GDP estimates being revised lower by the week with the NY Fed's latest estimate slipping below +2% (so much for the residual seasonality effect being used as an excuse for the weak Q1 print) and their latest estimate for Q3 GDP is down to +1.5%. As an aside, the Atlanta Fed's GDPNow estimate is at +2.9%, but this is down from a +4.3% estimate at the start of the quarter. We also know that the inflation data is rolling over and falling further below the Fed's 2% target which is only being confirmed by the bond market with the yield on the 10-year T-Note falling to 2.12% (its lowest level on the year).

So what is happening is that the Fed is flattening the yield curve in the face of receding inflation pressures, a weakening in economic activity, and a notable slowing in the money and credit aggregates in recent weeks. The question is, why?

While I am critical of the Fed from time to time, they are far from dummies and I think it's foolish to believe that they don't see what is transpiring in real-time. So, why over the last several weeks – starting with Chair Yellen's press conference following the June FOMC's decision to raise rates and detail plans to reduce the size of their balance sheet later this year – have they not backed off of this hawkish posture? Over the weekend NY Fed Board Governor William Dudley participated in a panel where he provided no indication of backing off this hawkish stance, citing the continuous easing in financial conditions following the last three rate hikes and how this result "can provide the impetus for the decision to continue to remove monetary policy accommodation". It's as though Dudley is pondering the age old question, 'if a tree falls in the forrest and no one hears it, does it make a sound'? If the Fed hikes interest rates in an attempt to tighten policy, but financial conditions loosen, did the Fed really hike rates? The below chart says it all with financial conditions having been looser only two other times in the last 36 years.

San Francisco Fed Bank President Williams was also on the speaking circuit last week making comments in a speech in Austrailia about fears that further declines in the unemployment rate could trigger a bout of wage pressures.

What this makes clear to me is that the Fed is growing increasingly concerned about their implicit third mandate, which is promoting financial stablity, and the gravity defying ascent in asset prices in the face of their intent to tighten monetary policy. So now the Fed is moving back into the unenviable position that they've found themselves in in the past and that is fighting financial asset bubbles – a history I might add that hasn't been very kind to them, nor investors in financial assets. Consider the commerical real estate bubble in the late 80's that led to the S&L Crisis, the Tech Bubble in the late 90's, and the Housing Bubble in the last cycle – all of which ended with the economy slipping into recession.

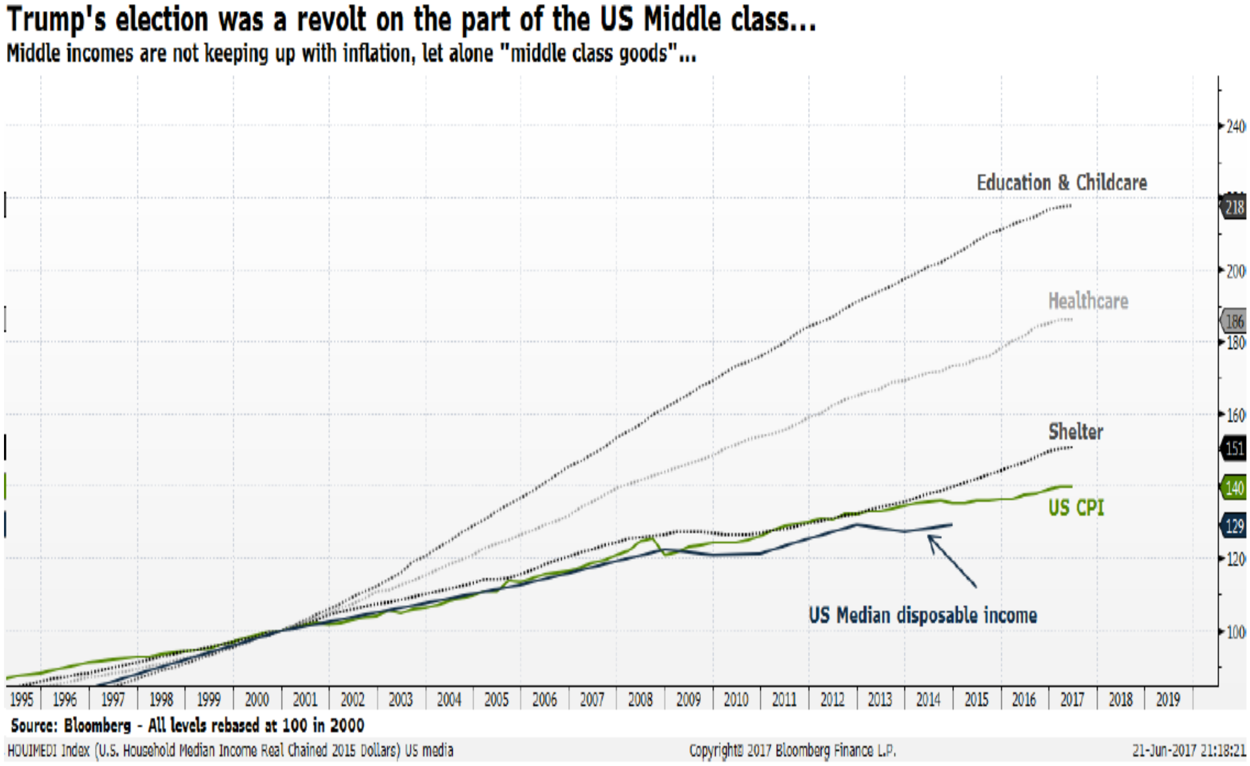
In other words when the Fed is fighting market excesses, it is usually too late, and they usually go further than is necessary – especially when they tighten into a clearly fragile economy (while they would never admit it publicly). Keep in mind that the Fed is not acting in unison with other central banks as China has been tightening the liquidity spigot since last fall which is showing through in its softening trend in the M2 money supply measure (slowed in May to +9.6% YoY from +10.5% in April). This is the first foray into single digit terrain for this metric since the PBoC began publishing data back in 1986. Add to this the ECB is no longer running at full throttle with them beginning the tapering process in April and likely to announce further action in this direction later this fall as the pool of available debt for them to buy becomes ever more shallow.

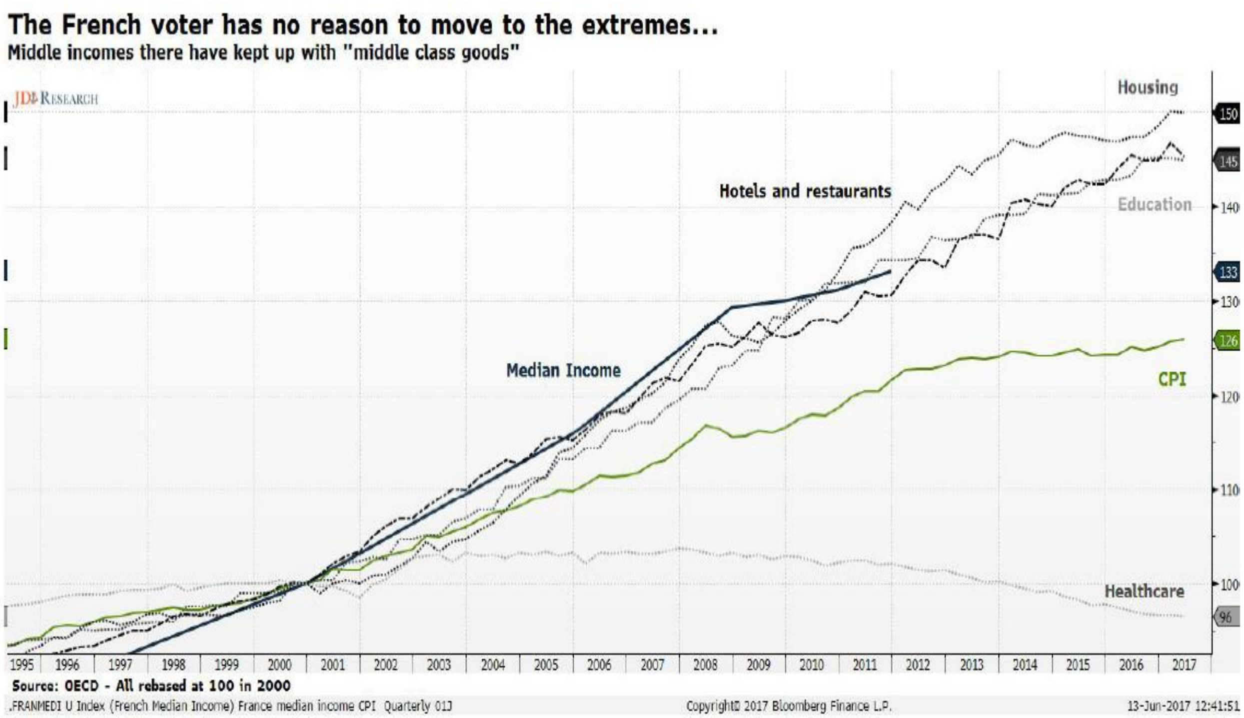
Even with oil slipping the Bank of Canada is signaling that it may hike its key interest rate as early as the fall and Norway just recently dropped its easing policy bias. So you see, the central banks, as a group, don't seem to be as interested in holding Mr. Market's hand any longer.

Let me remind you, though, that the Fed in particular has tried going down this tightening path before (in both 2015 and 2016), but found plenty of excuses to back-off: global economic weakness, election uncertainties, inflation and unemployment not meeting their mandate… so that is something worth monitoring as they move forward. But let's be honest, will there ever be a good time to remove policy accommodation when history suggests a high probablity of doing so inevitably leads to recession?

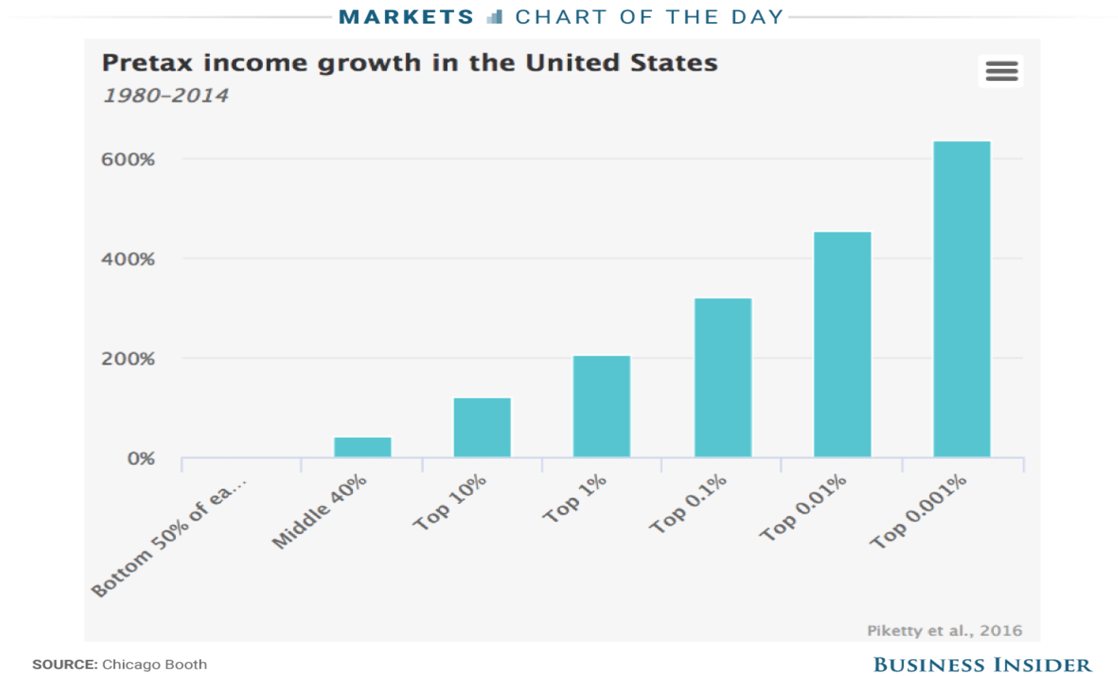
One additional thought on this front before moving on, as it intertwines Fed policy over the past two decades and it speaks volumes to the current animosity we are seeing on the political front and that has to do with the issue of inequality. To put it bluntly as I don't think it's fair to point the finger at any one entity, leader, or governing party (as they/we've all played a part in its occurrence), but the rise of inequality is one of the most disturbing societal trends that is shaping public discourse at the moment. Perhaps some can't quite put their finger on it or lack the data to explain it, but this is what is dictating the push back against the establishment agenda that we've witnessed with the Brexit vote in the U.K. and the election of Trump in the U.S. In my opinion, it's not a coincidence that we're seeing it boil over in the U.K. and the U.S. as both of these country's respective middle class populations have a strong claim to feeling left behind.

Coming into the beginning of the 21st century median income in the U.S. was keeping pace with the rising cost of living, but as can be seen in the below chartf from JD Research, median income has failed to keep pace with CPI inflation let alone the likes of shelter, healthcare, and education and childcare. Chart the same data in the U.K. and the picture is a virtual match, however the picture is considerably different for France which would likely surprise most individuals given this region's socialist policies. But the irony is that these socialist policies have provided a higher floor of aggregate income for the middle class and as a result precluded inequality from becoming as widespread in this region as it is in the U.K. and the U.S.





Please don't interpret these observations as anything more than that, mere observations, as I personally don't find myself abandoning the benefits of a capitalist system in favor of socialism. But, data and information like this provides some perspective and context for why Bernie Sanders was able to garner such a following going into last year's election. What investors and citizens alike should take notice of is that the system as it exists today isn't working for many and the longer it persists the bigger and potentially more destablizing it will become. You have to acknowledge that instability exists in a society where pretax income growth has been nonexistent for the bottom 50% of wage earners, nearly eluded the next 40%, and greatly benefitted the top 10%.



Me thinks this is a dilemma the Fed is much more aware of than they are leading on, but unfortunately (or fortunately depending on how you look at it), neither do they have the tools to deal with it, nor should they. This is a fiscal policy issue and can best be addressed through the legislative branch (whether it will be and in what manner is a completely separate question and not a debate I want to throw my two cents in on).

Back to the markets, and for all the talk of a daily record setting stock market I must say that it's a bit of a dramatization. Looking at the S&P 500, it hit 2,400 on March 1st and here we are almost a full four months later and it's hanging around at 2,440. Not a bad thing by any means, but based upon the cheerleading you hear on bubblevision you'd think we were up 15% since then, not +1.7%. Stepping back and looking at a broader segment of the overall equity market, and here I'm talking about the Value Line Arithmetic Index which includes roughly 1,675 stocks (excluding closed end funds) and it is no higher today than it was in the middle of February (the Value Line Geometric Index is actually about the same level it was back in the first week of January and hasn't made a new high since February 21st).

What this chart looks like to me is a market that is in a topping process and very reminiscent of what was observed back in the summer of 2007. And while, admittedly, I've been wrongly cautious on the market for the last year, but with a VIX index at sub 10x, the S&P 500 trading at its second highest valuation level in history, a rapid flattening of the yeild curve, speculative market activity (investors crowding into very narrow segments of the market), and the economy doing something that has only happened 1% of the time in past expansions (which is to possibly record three quarters in a row of sub-2% real GDP growth) it's hard for me to see anything other than a very dangerous market confronting investors.

Speaking of 2007, an astute industry contact sent along the following comment from former Fed Chair Alan Greenspan back in February 2007, but what was as interesting to me as the statement made by the former Fed Chair was the flat-lining and potentially severe deterioration across the spectrum in corporate profit margins in the second quarter relative to the last several quarters.

Greenspan Feb 2007:

"When you get this far away from a recession invariably forces build up for the next recession, and indeed we are beginning to see that sign," Greenspan said via satellite link to a business conference in Hong Kong. "For example in the U.S., profit margins ... have begun to stabilize, which is an early sign we are in the later stages of a cycle."

S&P 500 Profitability Ratios	2 Q 2017	1 Q 2017	4 Q 2016	3 Q 2016
	2017	2017	2016	2016
Gross Margin	**31.1 %**	42.02 %	46.14 %	42.96 %
Gross Margin Annual (TTM)	**29.92 %**	41.95 %	42.49 %	42.47 %
EBITDA Margin	**11.46 %**	18.83 %	20.75 %	18.41 %
EBITDA Margin Annual (TTM)	**15.41 %**	17.13 %	18.33 %	17.47 %
Operating Margin	**9.25 %**	15.89 %	15.79 %	17.33 %
Operating Margin Annual (TTM)	**12.56 %**	15.18 %	13.66 %	13.36 %
Pre-Tax Margin	**9.35 %**	11.55 %	10.65 %	11.85 %

It goes without saying that I'm finding less and less opportunities in the U.S. equity markets, and of late finding myself paring back more exposure. Correspondingly I'm finding it more difficult to find investment opportunities that meet the margin of safety I'm looking for to redeploy the proceeds. I remain of the view that the energy industry is becoming more intriguing, not because the OPEC cuts have worked, or that I have any idea when the abundance of oversupply comes back into balance, but more so because of the severe cuts that have been made to exploration projects over the last couple of years that I believe will create an imbalance the other way (meaning a lack of needed production) once the market works through the current level of excess supply.

As a result I think it is imperative for investors looking for opportunities in this space to view it through a longer time horizon than the next several months, but focus on companies that have strong balance sheets and the ability to endure the financial pain they'll have to incur to make it through this downturn. While I do think the very long-term investment thesis is in flux due to technology (electronic vehicles, alternative energy potential, environmental conscientiousness…), these threats are a cycle or two away before we should be considering the obsolescence of oil.

The financial sector has some allure with the potential for deregulation that will free up some flexibility for both business growth and shareholder friendly activities when enacted, and it is one part of a broadly expensive equity market that carries a below market valuation. However, investors need to be aware of the overall weakening credit cycle and the implications this could have for not only earnings, but capital levels for companies that haven't appropriately provisioned.

And, as has been a theme for me all year long and hasn't changed at this point, is the attractiveness of foreign markets relative to the U.S. Valuations are cheaper on a relative basis, performance has drastically lagged the U.S. over the last five years, and they are earlier on in their cyclical recovery than the U.S. Europe looks intriguing on a multi-year basis for a rerating, and while I'm cautious over the near-term that the economic data may have peaked and is starting to rollover, this remains an area I'd like to build a higher exposure to if prices were to pull back. Asia, while not without warts given China's high debt levels and their intent on reigning in excesses, Japan's inablity to get any inflationary traction, and the instablity in North Korea that could ensnare a large swath of the Asia-Pacific region if a war were to unfold, but any hiccups (which there are sure to be) over the next several years should be considered opportunities to evaluate gaining more exposure to these regions.

As the U.S. turns inward and leans more protectionist, the rest of the world is not standing still as they push towards deeper integration. I'm not making a political call here, it is what it is, but the European Union and Japan are on the cusp of inking the most important trade deal since NAFTA. These talks have been underway since 2013, and we're talking about two regions that collectively comprise more than $23 trillion in GDP (a comparable size to NAFTA).

Likewise, with the U.S. stepping back from TPP we see China pursuing its own free trade agreement with a 16 member bloc (including Japan) of Asia-Pacific countries which will cover 3 billion people. These are large secular shifts that are underway and have been for sometime with China first laying out its "One Belt, One Road" initiative earlier this decade. This transition of power from West to East was inevitable and for sure it will play out over years and decades, but it shouldn't cause anyone to become scared that the U.S. is becoming obsolete. It's just a reality, empires eventually fall, as was the case with the Persian Empire, the Roman Empire, the Arab (Caliphate) Empire, the British Empire, and the current United States Empire.

Keep in mind that global financial markets are more linked than they have ever been, so should the U.S. economy or markets stumble it will likely impact the capital markets in these regions as well (and vice versa depending on the significance of the country from which the ripple emanates) – so risk management and portfolio exposure remains important when framing out a prudent allocation given your investment objectives.

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