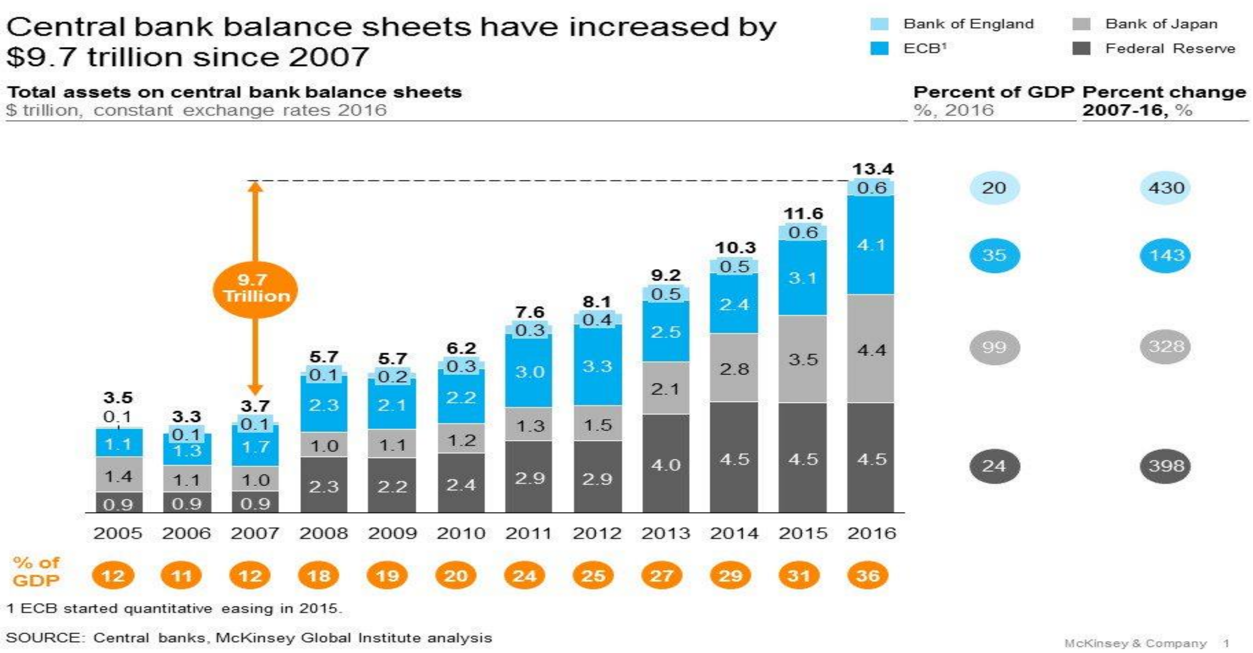

**June 5th, 2017**

**Disconnects aplenty…**

Investors were on the receiving end of a heavy dose of economic data last week where, collectively, it can perhaps be best characterized as 'good enough'? There is a question mark at the end of that sentence for good reason, as I am finding it more challenging by the week to square the price action in the stock market with contradicting evidence in the economic data and other capital market price signals that are not confirming the "everything is awesome" melt-up in global equity markets.

We'll get to the data in a moment, but the narrative that continues to make more sense to me as we move deeper into the late stages of this bull market is that index and ETF buyers have become (knowingly or unknowingly) price agnostic speculators in pursuit of price momentum that thus far this year has been a one-way street higher, and in so doing these same investors have abandoned steadfast principles such as margin of safety and risk management as barbaric relics.

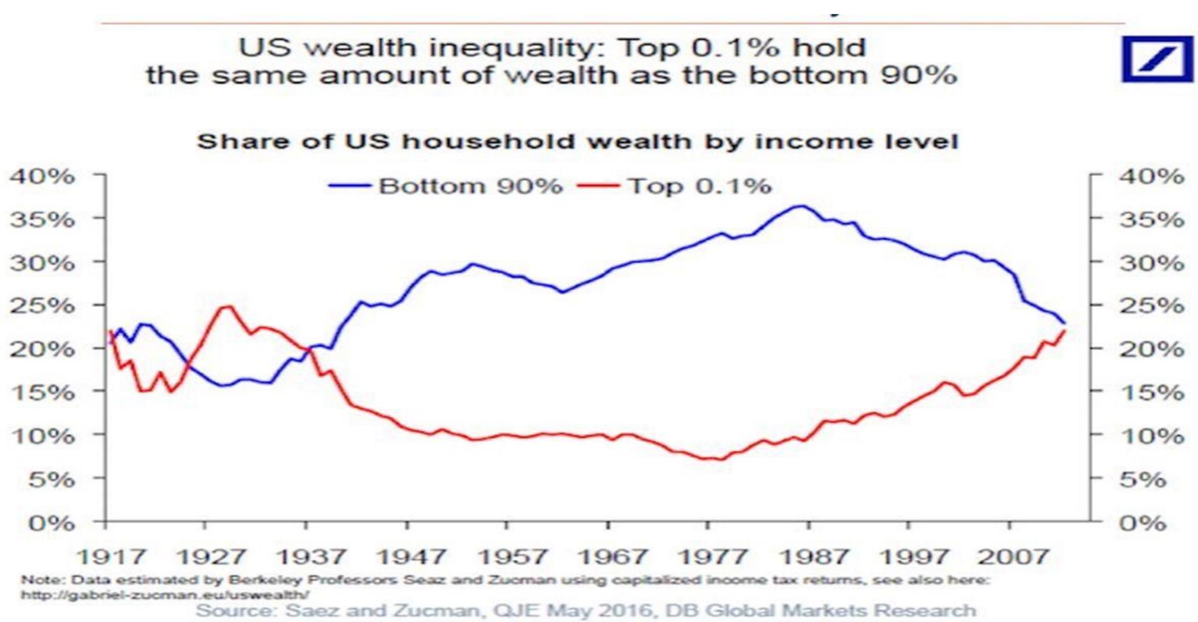
However, it's unfair to fault those market participants who are acting in a speculative manner today as if they're acting alone, when their actions continue to be encouraged and rewarded by central bank policies focused on backstopping asset prices. After all, as pointed out in the FT last week global central banks have purchased $1.8 trillion in assets over the past twelve months which, I guess, should come as no surprise given this wealth effect strategy on the part of central banks has been an ongoing experiment that has increased the size of their balance sheets by almost $10 trillion since the Global Financial Crisis in 2007.



There is no bigger perpetrator of central bank incursion into capital markets than the Bank of Japan, where the recent data through the end of Q1 shows that the BOJ has almost doubled its ETF holdings over the last year. I would be remiss if I didn't share my concern with the potential broad ramifications this passive investing bubble will have on markets and investors when this trend eventually swings the other way – here I'm talking about when the selling comes. Of particular concern is the use of leveraged passive-indexed funds (just an FYI: the SEC recently approved the first 4x leveraged ETF at the begging of May – what good could possibly come from putting this in the hands of individual investors, let alone professional traders?), because when the selling comes and overwhelms buying on the other side this will only compound the retrenchment.

Anyone denying that a downturn or economic recession will ultimately come is denying history, and I have no intention of coming off as brash, brazen, or negative, but how I know this is because history shows that bull markets are followed by bear markets. It's beyond hubris for central bankers to think that they can indefinitely suspend the business cycle and economic gravity without creating some unintended consequences. Just for anyone unaware of what some of these unintended consequences might look like, here are a couple graphics to chew on:

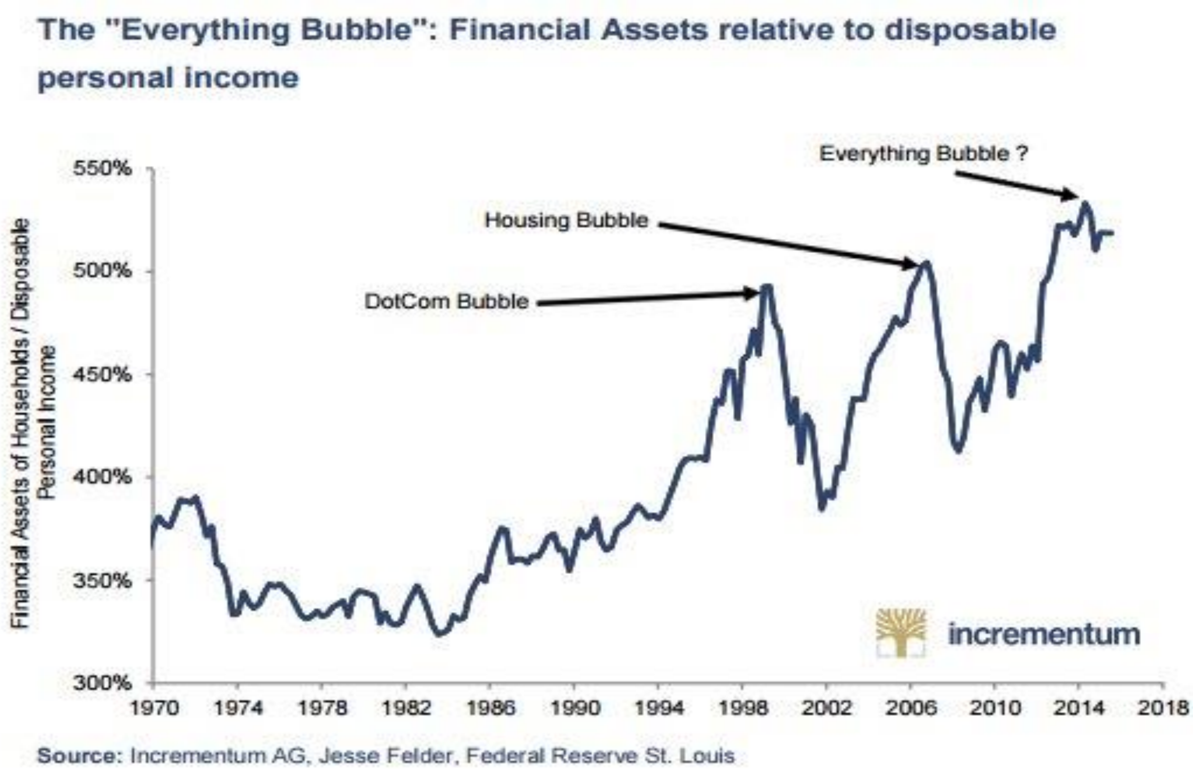
- Inequality is back to its worst level since just before the Great Depression, where the top 0.1% hold as much wealth as the bottom 90%. Surly as you can see from the below chart this has been a trend that has been in place since the late eighties, but the context that is missing in this chart is that it was during "Black Monday" in 1987 that the Federal Reserve under then Fed Chair Alan Greenspan stepped in and backstopped capital markets with their central bank put.




During every economic downturn or severe market dislocation since, central bank action has become bolder and more involved to backstop the system and stave off a true clearing level for asset prices. Just have a look at interest rates as a case in point: this is a price that the central banks have meaningful control over in which it has moved from all-time highs during the early 80's to all-time lows last summer. What is wrong with this? Nothing for those that hold these financial assets as they have learned to become patient in waiting out the pain and never have to relinquish control of their respective assets with only the most extreme speculators being held to account as they are forced out of their positions. However, this hampers the transition of wealth / control of financial assets to those have nots that are deserving of climbing up the ranks of wealth equality because price levels fail to come down to a market clearing level at which they can get their foot in the door.

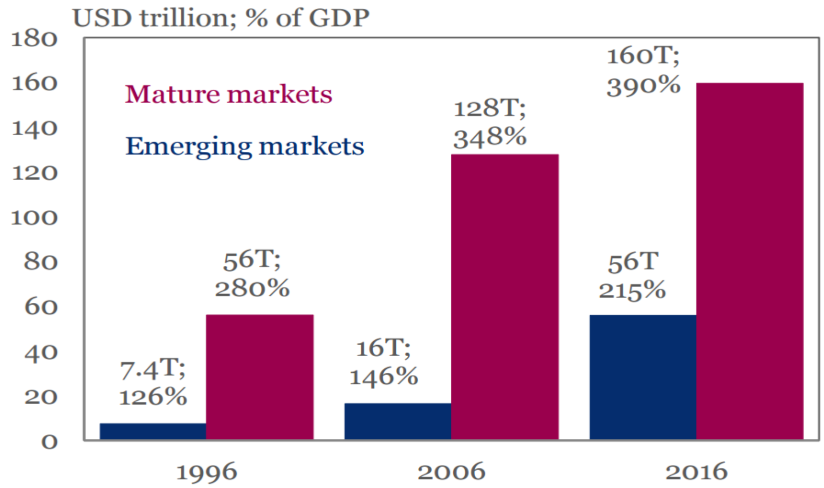
It will be interesting to look back at this time twenty to thirty years from now and ponder whether it was worth it for former Chair Ben Bernanke to stake his reputation on a wealth effect that quadrupled the stock market and increased the Fed's balance sheet nearly fivefold. Yet one of the undeniable effects was to make wealth inequality even more acute and likely set us up for a deeper fall once the lagged effects of the Fed's tightening program work their way through the system.

- Asset bubbles have become a more regular occurrence since the 1990's with many astute market observers suggesting we are in the midst of the third asset bubble in the last two decades (myself included – although one could argue about the 'astute' adjective). A person or entity's ability to acquire another's asset is through disposable income – it is with that relationship in mind that the following has some context as it measures the level of financial asset values as a percentage of disposable personal income. This percentage is now approaching 550% and well beyond the peaks of what we call in hindsight the Tech Bubble in 2000 and the Housing Bubble in 2007. The "Everything Bubble" label is the result of stocks, housing, and bond prices all being at or near all-time highs.




- The last unintended consequence I'll highlight is the excessive indebtedness that has overtaken the global economy. The Institute of International Finance (IIF) released a report earlier this year where they said that total debt levels (including household, government, and corporate debt) climbed by more than $70 trillion over the last 10 years to a record high of $215 trillion at the end of 2016. This is equivalent to 390% of global gross domestic product (GDP).

**Chart 1: Total Global Debt (all sectors)**




*Source: IIF, BIS, Haver.*

As I've noted in the past, no one knows how or when this all unravels, but it's best to at least be aware of the instability of the situation so as to be sure and do what can prudently be done to safeguard one's nest egg in advance. This by no means implies the end of the financial system is nigh, but a meaningful reset and cleanse is more likely to happen than not (and necessary, I might add). How these cycles typically end is with the Fed hiking rates and tightening financial conditions to the point where it tips the economy into a contraction – this has been the case in 10 of the last 13 Fed rate hiking cycles. Although, if the Fed abandons its rate hiking course without causing a recession it is likely the result of material financial stress occurring somewhere in the system that caused the Fed to alter its path, like the Asian Contagion and LTCM fiasco back in '97-'98 or the Orange County insolvency and Mexican Peso crisis before that in '94, or the stock market crash in '87.

What is very clear in the chronicles of history is that there is no "get out of jail free" card and timing markets precisely is next to impossible, but investors, the markets, and the economy ultimately all fall victim to the unraveling of wherever the financial excesses are manifested and more times than not an economic downturn ensues. One thing is for sure and that is you can't rely on Mr. Market to ring a bell or wave a white flag to tell you it's coming, as he lives in the present as was the case back in 2000 and 2007 when stock prices were racing to new highs with little reverence for what was to come in the following year.

As for last week's economic data, it was a mixed bag and that's putting it kindly in that the overall tenor of it is not even in the zip code of the narrative that growth is set to break out of the eight years of malaise that has come to define this recovery. But it didn't offer much for the imminent recession camp either in that while overall it was pretty lackluster, none of it is consistent with an economy sliding off the rails.

Let's start with Friday's nonfarm payroll report which I say was the worst of all the data we received last week. The economy added +138k jobs in May, well below consensus expectations for a +180k print, and really flying in the face of the +253k print from ADP earlier in the week. It's not just that the May payroll reading came in at a sub-par +138k, but there were also negative revisions to the tune of a cumulative -66k for March and April which made the trend in payroll growth slump to +121k versus +189k over the past 12 months. There's no way to sugar coat that as anything more than a discernable decline in payroll growth. However, this moderation in payroll growth should be expected this deep into an economic cycle along with the U3 unemployment rate falling to a 16 year low of 4.3%.

And that, my friends, is where the good news ends for this jobs report as late cycle fingerprints were all over it and actually points to an economy that is downshifting – a stark contrast to the prevailing narrative of things speeding up. Average hourly earnings came in at +0.2% month over month which took the year over year rate to +2.5% (below expectations for +2.6%) and this level of wage growth gives very little indication that the pick-up in compensation (which the Fed is longing for as confirmation for hiking rates) is around the corner. For context, when the unemployment rate was at 4.4% in May 2007, wages for non-managerial workers were growing better than 4% annually and in the cycle before that in May 2001 (the last time the unemployment rate was as low as it is today) wages were up 4% from a year earlier.

What should one make of the fact that in October 2009, with the unemployment rate at 10%, wage growth was running at +2.5% on a year-over-year basis – basically where we are today? This is just another example in a growing list of anomalies that are incongruent with equity prices at all-time highs, but are congruent with bond yields and the yield curve pushing back toward cycle lows.

Speaking of that low 4.3% unemployment rate, it fell for all the wrong reasons as 429k people left the labor force which pulled the labor force participation rate down to a five-month low of 62.7% from 62.9% (if the participation rate had stayed constant then the unemployment rate would have risen to 4.6% and that would have been a three-month high – go figure). The Household survey showed that employment actually shrank by -233k which only looks good relative to the more troubling fact that all of that loss and then some was in full-time positions (-367k full-time job losses).

There is simply no way to put lipstick on this pig of a report and that is not too harsh of a statement. Perhaps the most accurate statistic any of us can use to gauge and provide some explanation to the angst being felt around the country is the employment-to-population ratio and this metric dropped to a three-month low of 60.0% from 60.2% in April (which is the cycle high to this point). However, this metric requires some context for reference as it peaked at 63.4% in the last cycle (December 2006), 64.7% in the cycle prior (April 2000), and 63.2% in the cycle before that (March 1990). Think about that for a moment and then consider that never in the past four decades has the employment-to-population ratio peaked at such a shallow level – possible explanations: demographics, automation, robotics, skills mismatches…

Beyond the jobs report we got auto sales for May which came in below consensus again as sales fell -1.4% sequentially and failed to reach the 17 million annualized (SAAR) pace once again. This marked the fourth decline in the last five months and the fifth straight month of YoY declines which last happened in mid-2009 (mind you the level at which this trend is occurring today is meaningfully higher than '09 – so keep that in context). The current sales rate still shows an auto sector that is functioning quite strongly, but it's only a matter of time before the slowdown becomes more entrenched given the record level of incentives (averaging $3,650) it's taking to move inventory and the mounting inventory glut on the lots as the inventory to sales ratio hovers at cycle highs. Moreover, this month's sales activity had all the hallmarks of channel stuffing and included a meaningful step up in fleet sales which covered up the fact that actual retail sales were the worst results for the month of May since 2013.

We also got the latest read on the health of the manufacturing sector as the ISM manufacturing survey unexpectedly ticked up in May to 54.9 from 54.8 with the details of the report encouraging as well. The new orders, employment, and inventories sub-segments all improved on the month and this was more than enough to offset the declines in production and supplier deliveries. But, leave it to me to pour a little cold water on this file given it looks increasingly likely that the post-election euphoria that sent this metric spiking on grandiose ambitions of a quick implementation of the administration's pro-growth policies have petered out, as has this index which looks to have peaked in January (at north of 61) and has since rolled over.

Manufacturing activity around the globe actually took a step back in May with PMI readings falling below the 50 breakeven level in China, Taiwan, Korea, & Malaysia. Given my affinity and preference for global equity exposure at this point relative to U.S. equities, this is something that bears watching in the months ahead.

Perhaps the best way I can articulate an explanation for the disconnect between weak economic data and the rallying stock markets is the bullish community being able to collectively breathe a sigh of relief that things are not getting materially worse. They aren't getting any better either, but we've been in this eight year malaise where a more robust recovery was always 'just around corner' and that has been enough to keep the Fed as a tailwind and the liquidity spigot running.

Although, how anyone can look at the following chart detailing the breakdown between the Citigroup Economic Surprise Index and the S&P 500 and not conclude that something beyond fundamentals and long-held market price relationships is driving the ship is beyond me. After all, if investors can no longer rely on analysis, history, and data to provide a cue for how and where to allocate capital, what should investors be using to guide their investment decision making process?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