July 17th, 2017

Strong asset prices versus a weak economy…

It was a widespread rally across the spectrum of asset prices last week with the major U.S. equity market averages registering new all-time highs, bonds modestly in the green, but the big move was in Emerging Market equities which ripped higher by more than 5% on the week. It's hard to identify a specific fundamental catalyst (or catalysts) that drove the move, but nonetheless it was impressive. Emerging markets have been a space I've been constructive on coming into the year and continue to remain so at this point, and while the long-term investment thesis remains firmly intact, I'm seeing some near-term headwinds that I expect will restrain returns over the balance of the year:

1. Global liquidity has likely peaked for the cycle, which suggests that EM economies could face a more difficult time financing their current account deficits as financial conditions tighten.
2. The reflation impulse, led by a meaningful credit injection by Chinese leadership into their system last spring, has peaked and monetary policy across the globe is getting tighter (started with China last fall, continued by the U.S. Fed with its three rate hikes since last December, and now the Fed, ECB, and BoE are all elaborating on plans for reducing their QE policies).
3. Investor optimism on the Emerging Markets space has risen dramatically over the last 18 months as was accentuated recently in the BofA Global Fund Manager Survey where investors' overweight positions in EM stocks are at the highest level in five years (+44% overweight compared to -33% underweight at the January 2016 low).
4. Earnings growth should remain superior in EM relative to the U.S. and other Developed Markets, but the favorable benefits from positive foreign exchange pass-through effects are set to diminish.

Even considering that forward returns from current levels will be harder to come by in the short-term, the potential return for investors with long-term time horizons is very constructive relative to Developed Markets given their more favorable inflation dynamics, superior real rates, better external balances, bolstered FX reserves, and for the most part Emerging Markets have a more constructive demographic profile.

The commodities markets have been showing some signs of life as of late with agricultural commodities pushing up against some key technical levels that, if broken, could suggest an end is nigh for the multi-year bear market in this space. Crude seems to have found some stability in the mid $40's and while the supply and inventory glut remains a near-term headwind, global demand appears to be holding up. Make no mistake, there are meaningful structural shifts afoot for the energy industry, but this sector has been through a depression over the last three years and ultimately many weak players will eventually go out of business before this cycle ends (likely in the next several years as credit and funding gets tighter) that will set-up a very favorable environment for the strong hands that remain.

Gold prices managed to tick above its 200-day moving average at $1,230 per ounce and to me remains a solid investment for investors to have in their portfolio as a hedge against geopolitical risk, a possible Fed policy error (not to mention a potential return to a currency war in a world that remains constrained for growth), and future inflationary or deflationary risk (a case could be made for either depending on the path for fiscal and monetary policy).

As an aside, one investment area that is looking less and less constructive is the UK as the data is starting to take a turn for the worst and it looks as though the political discord with the EU is rising which is undermining Britain's negotiating capabilities ahead of the Brexit talks. Not helping matters is the strengthening alliance between Germany's Chancellor Merkel and France's President Macron (Macron coming off a strong election showing and Merkel looking as though she is coasting towards reelection in the fall), not to mention these are two economies that appear to be firing on all cylinders at the moment which is only further integrating their political and economic alliance.

China's economic data over the weekend was strong as Q2 GDP came in above expectations at +6.9% year-over-year. The internals were sound as well with industrial output, retail sales, and fixed asset investment all coming in better than expectations. This data came on the heels of some very strong import and export data and it was nice to see services account for 54.1% of GDP in the first half of the year, so growth is reasonably broad-based. Suffice it to say the Chinese 'hard landing' narrative continues to get pushed further to the back burner – not that imbalances (namely high debt levels) have been vanquished, but it's not until after the 19th National Congress elections are over this fall that investors should expect any material reform that may upset the current status quo.

As for the U.S. stock market, it continues to defy gravity and makes one wonder what, if anything, can ever cause it to correct. After all, it's been a full calendar year since the S&P 500 has experienced a 5% correction during trading hours (we did have the big overnight decline during the U.S. election but that was wiped away by the opening tick…) when the historical norm is approximately four such 5% declines in a calendar year and one to two 10% drawdowns. And it's not as though markets haven't been presented with excuses to get worried: failed policy initiatives in both Congress and the Presidency, escalating global tensions, and a meaningful pivot in Fed policy from what was the norm for the last seven years. Not to mention the complete lack of validation from various market signals, i.e. a bond market that refuses to price in a reflationary backdrop, U.S. dollar weakness that is emblematic of slower (not faster) economic growth, and a corporate earnings / sales backdrop for Q2 that is expected to come in below +4% YoY (when stripping out the energy sector which is benefitting from an extremely low comparison to this time last year) yet the S&P 500 has spiked more than +15% over the past year.

Add to this a U.S. economy that looks to be getting weaker, not stronger, with each new piece of economic data that gets released. This isn't me cherry picking data to comport with the cautious stance I've maintained throughout the last year, this is reality and perhaps is best encapsulated with the recent widespread downward revisions to the Q2 GDP estimates. Within the last week the Atlanta Fed's GDP tracker was lowered to +2.4% (this estimate was as high as +4.3% at the start of Q2), Macro Advisors (usually an optimistic forecaster) cut their estimate to +2.3%, BofA ML and Goldman Sachs moved their forecasts down to +1.9%, and the New York Fed is also at +1.9% with an estimate of +1.8% for Q3. Recall all the naysayers clamoring after the weak Q1 GDP report about how it was just seasonal impacts that have continually disrupted the first-quarter and there is nothing to worry about because we always get a big snap-back bounce in Q2.

Alright, so this doesn't appear to be playing out as expected and when you look back through this cycle you typically see the rebound in Q2 following a soft Q1 average out to about a 3% annual rate. It's well known at this point that this is the weakest expansion on record, so it's become commonplace to dismiss a string of so-so economic data with the view that you just have to wait a little bit longer for a jolt of activity to hit all at once and reignite the animal spirits that the good old growth days of yesteryear are upon us. Or the other view that has proven prescient throughout this expansion and bull market in asset prices is that if economic momentum didn't gain steam then the Fed would step up with more QE.

What happens if we're reaching the end of the rope on both of these fronts? What if the 1.4% annual growth rate of manufacturing output in Q2 (versus an average pace of 2.1% so far this cycle) and the 1.3% annual rate of retail sales for Q2 are a harbinger of a more meaningful slowing in the economy? Sure, we're not in a recession, but the current underlying growth profile is weak and showing little sign of improvement. Overlooked in the better than expected industrial production data last week (the beat was in large part the result of the pick-up in oil and gas drilling activity) was super soft results in capital spending. Over the past six months business equipment output, which carries a very high correlation with business capex, has managed to expand at a pedestrian 0.7% annual rate. So, if the new reality is that flat is the new up, then there is little to worry about, but anyone banking their hopes on a robust acceleration into the second half of the year may want to revisit their thesis.

The recent trend in the smoothed ECRI leading economic indicator says it all in terms of whether the real-time economy is heating up or cooling down, whereas it has been down for the last seven weeks: 5.1 to 4.5 to 3.7 to 3.4 to 3.0 to 2.6 to 2.4 as of July 7th (the lowest level in 15 months). The biggest difference of late in the economic data has been that the soft survey data has begun to rollover to where much of the hard data has been since the election.

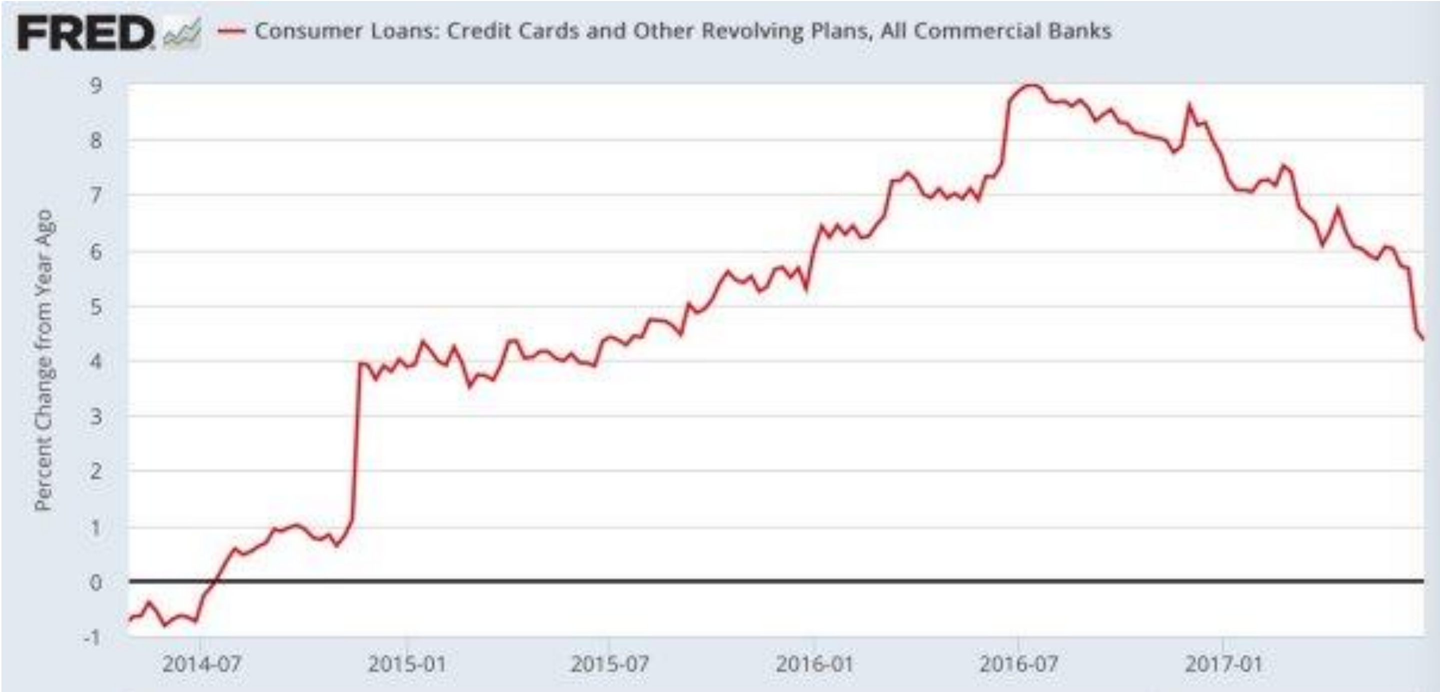
In hindsight, coming out of the surprise election results it was hard not to see why business owners (which is who are surveyed in the NFIB Small Business Survey) were optimistic with the expected repeal of Obamacare and all the tax increases that came with it, deregulation, tax cuts, and infrastructure spending. But as reality has set in over the last several months so has the constraints on growth that have hampered businesses throughout this expansion. The NFIB index came in last week at 103.6 in June (still a high absolute level), but this represents a seven-month low and many of the internals of the report were even weaker than the headline:

- Index assessing whether "now is a good time to expand" declined to 21 from 23 in May and 24 in April
- The net share saying they expect the "economy to improve" has dropped like a rock over the last six months as it hit 33 in June after starting the year at 50.
- "Firms expecting higher real sales" over the next six months dropped to 17 in June from 22 in May and now is nearly half of the 31 level it started the year at.
- The index assessing job growth in the past three months sunk from +5 to -1 (another seven-month low).
- The average net change in employment was -0.04 for June, down from +0.34 in May and yet again, another seven-month low.
- The index assessing wage growth dropped to 24 from 28 – you guessed it, a seven-month low.
- The only constructive data point in this report was the increase in capex intentions from 28 in May to 30 in June and this is the highest level for this subcomponent since September 2007.

Okay, so businesses have lost a little bit of their optimism. What did we learn from the University of Michigan consumer sentiment index that was released last week? The headline declined to 93.1 for July from 95.1 in June and 97.1 in May with the July reading being the weakest level since October (reversing almost half the post-election run-up). The internals of the report were a bit mixed with the "current conditions" index actually firming up to a four-month high of 113.2 from 112.5 in June, but the "expectations component fell to 80.2 in June (lowest since October) from 83.9 in June and 87.7 in May. Why this is important is because it's "expectations" that drives consumer behavior and this comports with the recent run of weak retail sales reports we've experienced throughout Q2.

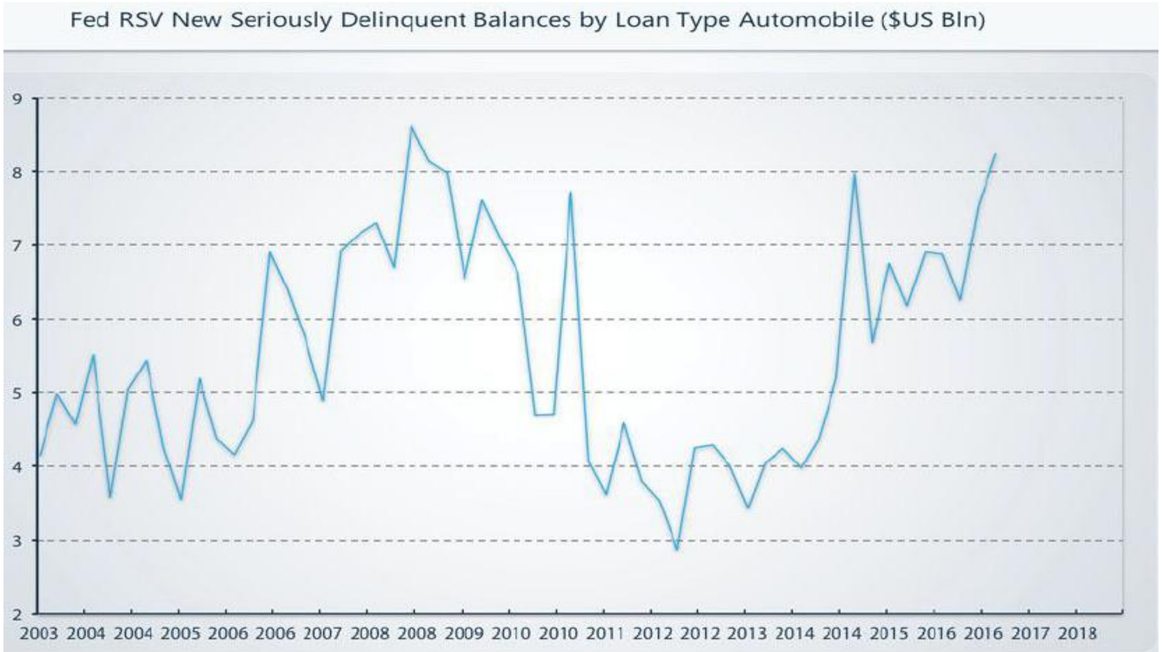
The last item I want to hit on is the material slowdown we are seeing across the board in the lending data which is not painting a very rosy sign for economic activity. The headline earnings results from the major money center banks that we got last week were great and bested Wall St. estimates, but that begs the question of why did they all sell-off after posting results? I'm no bank analyst to say the least, but piecing together the collective results can give you a good pulse on what's going on with the economy. Within JP Morgan's quarter we saw that profits in the consumer bank division dropped to $2.22 billion from $2.66 billion a year ago and that new mortgage loans extended were down 4.4% from a year earlier. Not to mention net provisioning for future loan losses increased and this is consistent with the increase in credit card delinquencies we are seeing on the consumer front.

So not only are credit card delinquencies at cycle highs and rivaling the level we hit going into the Global Financial Crisis, but as you see below lending institutions are well under way in materially paring back the amount of credit card issuance they are willing to underwrite.



A similar story was playing out with Wells Fargo's results last week, but what stuck out most to me in their numbers was the drastic 45% reduction in car loan originations over the past year. Without question, the automotive sector has been one of the biggest beneficiaries of the Fed's ultra-loose monetary policy regime over the last eight years and after just a modest level of interest rate increases over the last year, lending to this space is drying up quickly.

And it's hard to blame banks for pulling back on auto loans when you see the latest Fed data that indicates 'new seriously delinquent balances' in the auto loan segment are nearing their Global Financial Crisis high.



No matter how you slice it when digging through the monetary and credit aggregates they all show the same pattern and that is one of a meaningful slowdown in credit creation and loan growth. Whether it be M2, MZM, bank credit, or C&I loans shown below, none of them have ticked over into negative territory, but the trend line this deep into an economic expansion with very little policy wiggle room is something that shouldn't be so readily dismissed.

So, it's fair to assume that since nominal GDP tends to gravitate in the same direction as credit trends that a pick-up in near-term growth is likely not in the cards. As has been the case since the start of the year, so far any weakening in the economic data has been ignored on the auspice that it didn't matter because of the expectation that fiscal policy levers were soon to be unleashed and that would provide the spark needed to jolt the economy out of this lethargic state. Thus far, it looks as though this administration's agenda is going to take longer to implement than most expected, but investors have been resistant to giving up on the potential positive impacts when it does occur. I continue to have more doubts than most, not only on the policies, but also the potential impact (including negative consequences), however one must keep an open mind.

Recent price action in the equity markets seems as though we are shifting back into the pattern that was exhibited earlier on in this expansion where 'weak economic data' implied higher asset prices because the Fed and monetary policy would remain accommodative. I know this seems counterintuitive with the Fed pushing forward on its interest rate normalization path and guidance that it will begin reducing the size of its balance sheet by year end, but what other explanation consistently fits with what has been the second-best equity bull market in history juxtaposed against the weakest economic recovery on record?

My interpretation of the market action over the last few weeks is that investors are calling Chair Yellen's and the Fed's bluff in a fascinating game of chicken. Astute investors see the soft economic data and are reverting to their conditioned Pavlovian response of "buy everything". However, the stakes are much higher at this juncture than years past with asset prices and valuations in most asset classes at cycle highs if not pushing up against all-time highs and this is what has caused the Fed to highlight in recent speeches that financial stability has moved above data dependence in terms of positioning on their worry list.

Time will be the ultimate arbiter for how this works out, but it is looking increasingly likely that either the Fed will be forced into making a policy misstep (tightening financial conditions further when they should) or asset prices recalibrate with long-standing fundamental relationships.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215

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