August 21st, 2017

How do you exit from a decade of excesses?
U.S. equity markets have been going through a bout of corrective actions over the last several weeks with the Dow Jones Industrial Average experiencing its second consecutive week of declines, the Nasdaq has faltered for four straight weeks, and the Small Cap Russell 2000 Index has now tipped over into negative territory for 2017. As for the S&P 500, it has broken below its 50-day moving average and is flirting with its 100-day moving average at 2,417 where many technicians think if this level is broken, a retest of the 200dma at 2,350 is a distinct possibility. Looking at the internals, an objective observer might very well take solace in the fact that the S&P 500 is still within 3% of its all-time high given that just 41% of its constituents are above their 50dma. The breadth within the Nasdaq and NYSE is even worse with 33% and 38% of stocks respectively above their 50 dma's (the lowest readings since early November just before the election).

So U.S. equity markets are nearing short-term oversold readings which may intrigue the algo's and day traders to step in and create a bounce, but given weak seasonality, lethargic economic data, continued uncertainty in D.C., and historically rich valuations, investors should retain a cautious view as this corrective phase plays out.

One area where investors have been handsomely rewarded this year for taking risk has been in overseas markets with European equities doubling the year-to-date gains of U.S. equities, Emerging Markets are up threefold, and Frontier Markets are just behind EM. The recent economic data hasn't disappointed either with the Eurozone economic expansion becoming much more broadly based per the recent GDP data for Q2, where growth in Spain is running at its best level in two years, the highest in six years in France, and Italy has seen its economy expand for 10 consecutive quarters. Keeping with the winning streak trend was Japan which logged its sixth straight quarter of GDP growth led by domestic demand growth in both consumer spending and capex.

Relative to the U.S., which is now entering its 97th month of this economic recovery (the third longest expansion on record) and by the day showing its age more and more, foreign regions have much stronger tailwinds at their backs relative to the U.S., not to mention more policy levers to pull on to extend their respective expansions. Japan is just three years into its expansion while Europe is just over 52 months in and investors are starting to take notice of the opportunity in EM with its cheaper relative valuations, superior growth profile, and currency valuations that are trading slightly below long-run valuation measures.

However, it's important to note that the global financial markets are as interconnected as they've ever been and any meaningful disruption to economic growth, credit dynamics, and / or investor confidence in the major economic engines (U.S., EU, Japan, and China) will have ripple effects that transcend regional capital markets. As an example, some of the leading indicators we track in Europe suggest that this bout of economic acceleration over the last year is peaking out and the strength in the Euro relative to the dollar this year is now having a noticeable impact on the German economy which is so heavily reliant on export activity. China has been pulling out all the stops as it continues to insulate its economic data from any weakness by continuing to fuel its credit bubble in advance of the 19th Party Congressional Elections in early November so Xi Jingping can further consolidate his power under this regime.

And then there are global central banks, which have been one of the major drivers of both economic activity and asset prices since we exited the GFC back in 2009. Anyone doubting the extent of their involvement need only reference the article in last week's FT, "Central banks hold a fifth of their governments' debt", which only skims the surface in regards to what some prominent thinkers have argued as the central banks' nationalizing of private assets. Consider the following (data source, Daniel Lacalle):

- We are now nearly 9 years removed from the nadir of the Global Financial Crisis where at that time there was legitimate concern that the financial system was at risk of failure – nothing like the docile, calm, economic and capital market backdrop today, yet major central banks are purchasing more than $200 billion a month in government and private debt – the highest level of monthly asset purchases since the GFC.
- The Federal Reserve owns more than 14% of the U.S. total public debt.
- The ECB and BOJ balance sheets exceed 35% and 70% of their respective GDP's.
- The BOE (Bank of England) owns between 25 – 30% of the UK's sovereign debt.
- The ECB owns just shy of 10% of the European corporate bond market and more than 10% of the main European countries' total sovereign debt.
- The BOJ is a top 10 shareholder in 90% of the companies in the Nikkei 225 and accounts for 60% of the ETF market share in Japan.

Add to this the lowest level of global interest rates in recorded history with the highest level of outstanding global debt on record (total global debt has soared to 325% of GDP compared to just 276% in 2007) and it begs the question of what would economic and asset price reality look like without this epic level of artificial support? This is a question that investors need to consider as the Federal Reserve gets set to start tapering the size of its balance sheet and expectations are that Mario Draghi and the ECB will not be too far behind (likely a 2018 story). With the annual gathering of central bank heads taking place at Jackson Hole this weekend, investor attention will be focused on what (if any) guidance comes out of the confab that will provide more clarity on the timing, duration, and path of monetary policy normalization in the months and years ahead.

From a big picture framework, the financial and economic system that exists at present continues to look extremely vulnerable and unsustainable. Look, I am by no means pessimistic on the long-term potential of the global economy, the resourcefulness and adaptability of human nature, and success of future generations – but I must admit that that long-term optimism is tempered by my growing concern that a fundamental economic reset is necessary in the short-term to achieve a more prosperous future.

To put this economic recovery in perspective, consider that U.S. nominal GDP totaled $14.7 trillion at the end of 2007 and total nonfinancial debt outstanding was approximately $52 trillion. Now fast forward to the end of 2016 where nominal GDP has grown to approximately $19 trillion with total nonfinancial debt outstanding having risen to approximately $70 trillion. So the U.S. economy added a little over $4 trillion in output while growing total debt by $18 trillion – not exactly the recipe for fiscal responsibility if this was considered a common household. The following chart from Lacy Hunt puts this level of debt growth relative to GDP in historical context, where it is taking ever greater levels of debt per unit of output to generate economic growth.

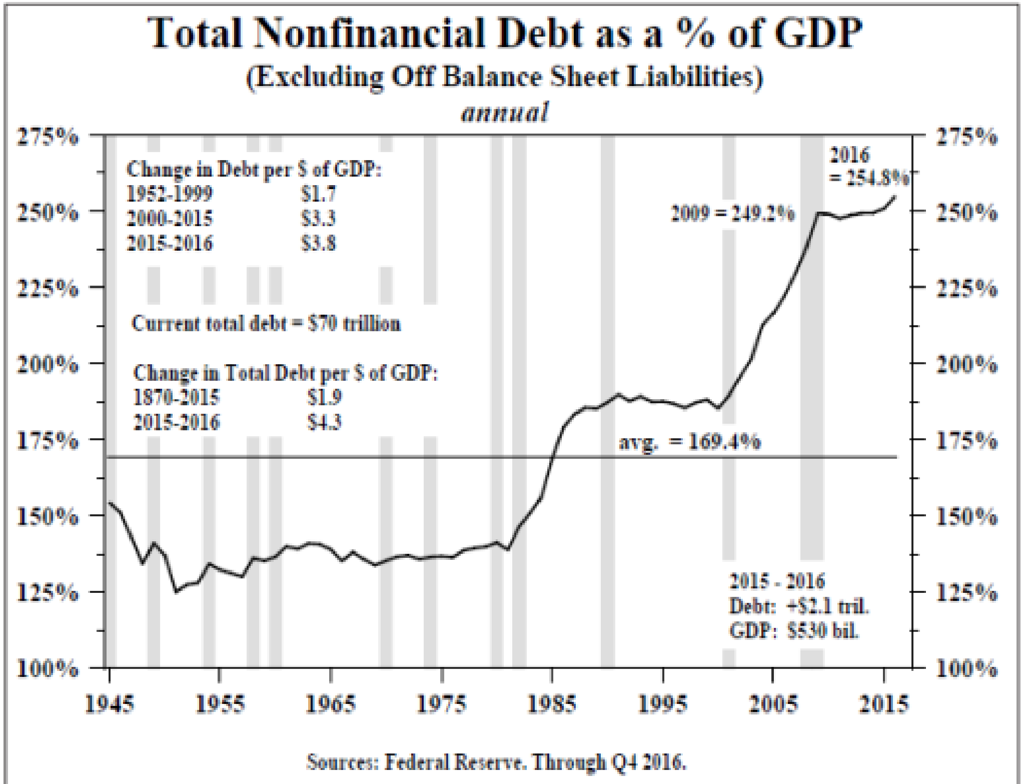


Chart 2

Come on, really? Theoretically, and even empirically, any economy can create activity (growth) if it is goosed by spending on credit. Think of it from a household's perspective – if any household had an unlimited credit line (as central banks do, given they have access to a printing press…) it would be easy to go out and spend frivolously on anything and everything. However, households don't act this way because they are constrained by their ability (or inability) to repay the debt that they've taken on for the current consumption which they have borrowed from the future. How is this any different than what epitomizes this expansion? It's not, it's just that we have yet to see the long-term impacts from these short-term measures. The true measuring stick in terms of success or failure won't be known for years.

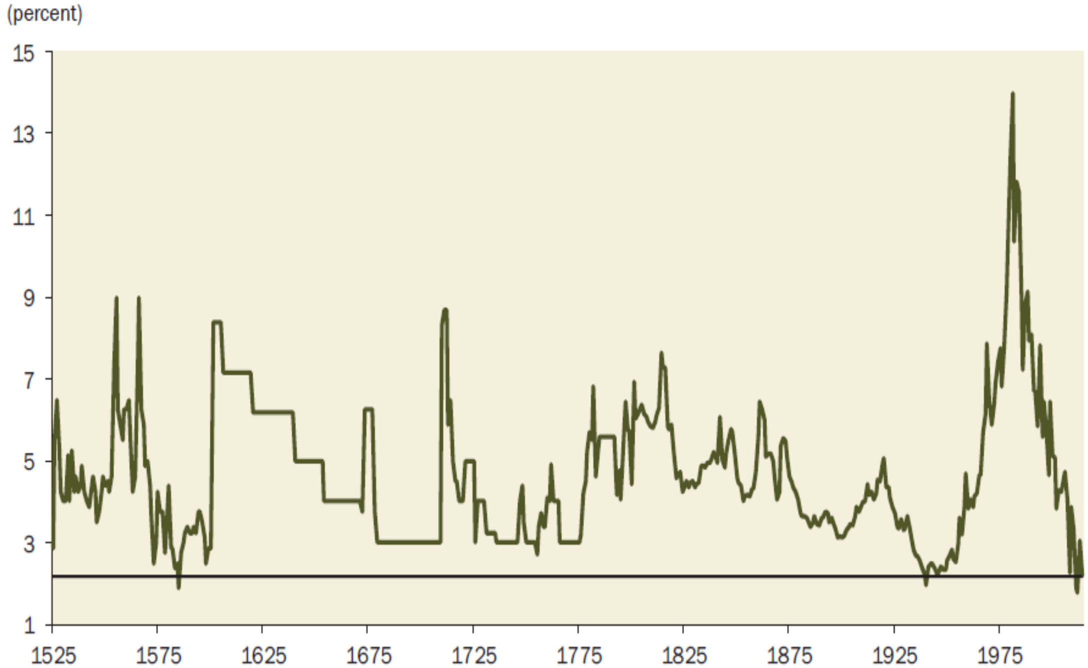
All that we've experienced thus far is the constructive elements of unprecedented monetary policy experimentation, with Japan being the only empirical reference point (as they've been administering these policies for the last twenty-five years) and it's hard to conclude they have achieved what the objectives were at the outset. One undeniable conclusion is that they've got themselves trapped in a vortex that they can't get out of, as they have been repeatedly implementing QE and fiscal policy stimulus measures with little economic and equity market success: Japan's nominal GDP is at the same level today that it was in 1997 and its main equity index (the Nikkei 225) is 50% lower today than its 1990 peak and at the same level it was trading at in the year 2000.

One thing is for sure, and that is that high debt levels are only a problem when the ability to service the interest and principle schedule on the debt becomes impaired, and we are not at that juncture yet in the U.S. economy. At this point the U.S. economy continues to expand with only minor pockets of weakness (sub-prime auto loans, a subtle rise in credit card delinquencies and defaults, and student loans) so as long as the cash flow spigot to service this outstanding debt burden continues to flow, harmony can be maintained. But with the economy operating at quasi-full employment (4.3% unemployment rate) and economic growth having peaked back in Q1 2015, it's only logical to conclude that this state of harmony is nearing its expiration.

Furthermore, there is very little wiggle room in terms of the Fed's ability to lower interest rates any further than they already have during this expansion – so households, sovereigns, and corporations perhaps have already experienced the lowest level of interest rates at which they will ever be able to borrow, so very little relief can be garnered from this counter-cyclical force in the future.

BOND YIELDS AT HISTORICAL LOWS

Historic Global Interest Rates



Notes:
Source: Homer & Sylla's "A History of Interest Rates", Shiller's "Irrational Exuberance", Gluskin Sheff

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With little wiggle room in terms of monetary policy, investors embraced the highly anticipated pivot to fiscal policy following the pro-growth / pro-business agenda of the Republican Party in last fall's election. While gridlock and dysfunction has been a hallmark of U.S. leadership for the better part of the last decade, what wasn't anticipated by many (not I) was that this dysfunction would continue to the extent it has given Republican control of all branches of government. However, in my opinion this just shines a light on the significant structural challenges facing the U.S. economy at this time. We've reached a point where there are no easy choices left and this administration doesn't have the luxury of kicking the can down the road like prior administrations.

Further complicating what is already an extremely challenging setup is this administration's uncanny ability to trip over their own feet with self-inflicted wounds and an inability to come up with, let alone communicate, a coherent strategy on almost any policy front. I don't even want to attempt to touch upon the latest hysteria following the events in Charlottesville, other than to share my opinion that it illustrates a growing divide and rising social unrest in this country. I'm not just talking about race, politics, gender, equality… you name the issue, but it's the accumulation of angst on both sides of a growing number of principles that is eating at the fabric of American values. What worries me most is that this social hostility is building during what many consider to be a vibrant economy – what will this look like when the economy goes through its next recession?

A perfect illustration of the type of divide that is measurable through polls is Trump's approval ratings of 35% (low by any historical metric), but this approval rating is made up of 79% support among Republicans and 7% support among Democrats (Gallup numbers). Among President Trump's supporters, 61% say they can't think of anything Trump could do that would make them disapprove of his job as President, and 57% who disapprove say they will never change their minds on the President's job performance (Monmouth numbers). What do I know, but in my view, this is fostering an environment where the extreme sides on many fronts are willing to dig in their heels and fight rather than entertain objective dialogue as a way to meet a productive end.

All of this melds into the complicated complexion of asset prices across the spectrum of capital markets that, based upon historical valuation metrics, seem to be pricing in very little in the way of geopolitical or policy risk. And a big reason for this is the fact that central banks continue to be highly involved in financial markets by supplying liquidity to the system, but the risk is increasing that the central banks (either by choice or by force from markets and growing inequality) will begin pulling back in a more meaningful way. The message communicated out of Jackson Hole this weekend will be important to gauge if a change is afoot and the timeline it would follow, but if that is the case, investors may want to think about just how much of an impact the fourfold increase in central bank balance sheets over the last nine years has had on today's asset price levels. Moreover, will the gradual unwinding of these policies have a symmetrical effect?

Jamie Dimon summed this up best (and refreshingly honest) in some recent comments he made about Quantitative Tapering (QT):

> *"We've never had QE like this before; we've never had unwinding like this before. Obviously, that should say something to you about the risk that might mean, because we've never lived with it before."*

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