August 28th, 2017

Investing vs. Speculation…

There was a lot of hype and hope leading up to the central banker's gathering at Jackson Hole this past weekend with the expectation that Yellen and Draghi would provide investors with some market moving insight into future policy actions when they spoke on Friday, but instead each of them (in their own way) chose to deflect attention away from monetary policy and geared their statements in the direction of macro prudential policies and regulatory initiatives. So, unlike the viewers of the big Mayweather and McGregor fight in Las Vegas this weekend, investors looking for something actionable coming out of the latest central banker confab were a bit disappointed.

However, those charged with the humbling endeavor of deciphering Fed speak could perhaps conclude that since Chair Yellen chose to steer clear of any mention on current monetary policy that she is comfortable with current market expectations that pin only a 40% probability that markets will see another rate hike this calendar year. Couple this with Dr. Draghi making no mention or concern regarding the recent strength in the Euro (which at $1.19 is acting as a meaningful tourniquet to European economic growth) and it's understandable to see markets react in the way they are: gains in the equity markets faded into Friday's close, the yield on the 10-year T-note declined to 2.17% and are now within 5 basis points of the low for the year, the dollar plunged by -0.8%, and gold rose.

It wasn't too long ago when investors would have rejoiced and bought stocks hand over fist in the aftermath of a dovish interpretation of Chair Yellen's public statements, yet this wasn't the case with the price action in the stock market late Friday and to kick off this week. Perhaps the lofty valuation levels, persistently lethargic economic data, and growing uncertainty over fiscal policy initiatives are starting to weigh on investor enthusiasm.

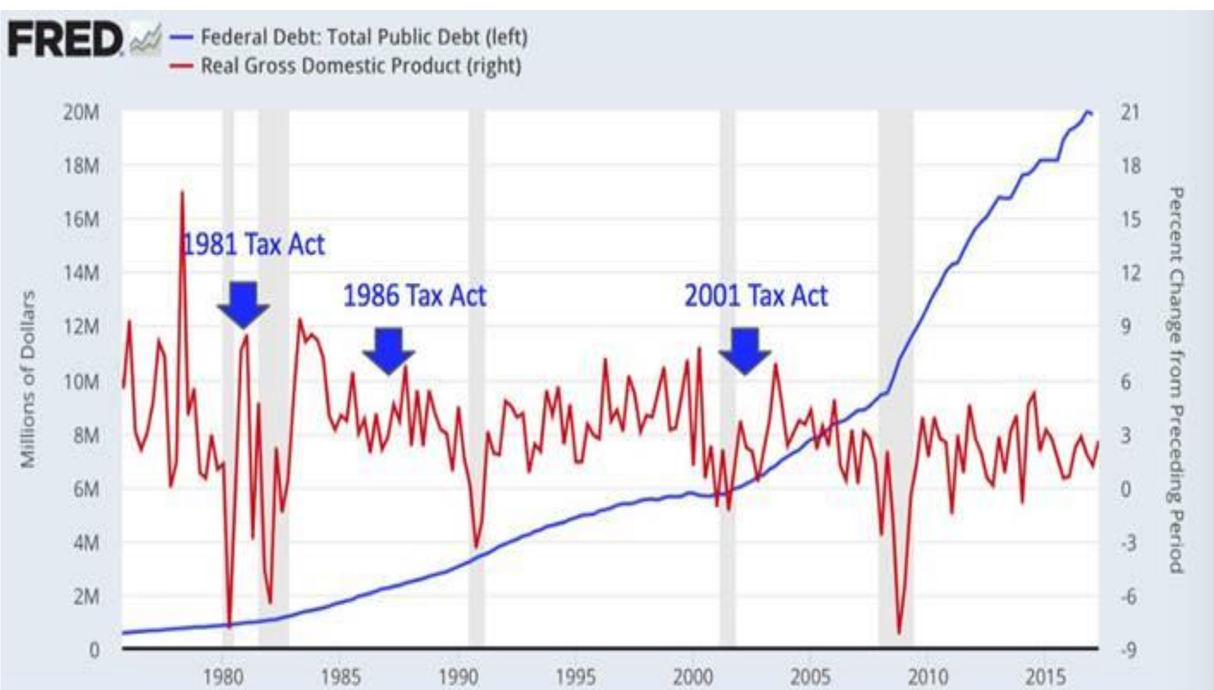
As for the stock market, it remains in a state of indecision with the major averages such as the Dow Jones Industrial Average, S&P 500, and Nasdaq holding within a couple percent of their all-time highs, but the tenor, make-up, and internals of the overall market are telling a much more troubling story. Both the S&P 500 and Nasdaq closed out the week below their 50-day moving averages with less than 50% of stocks in the S&P 500 now trading below their 50-day exponential moving averages. Further adding to this change in market complexion is a Dow Transports Index that is down -6.5% from its mid-July high, the Russell 2000 Small Cap Index that is underperforming the Dow by 9% on the year, and a breakdown in the FANG names that have pulled the market higher all year (Amazon and Netflix are -13% off of their highs for the year, Alphabet is -8% from its high, and Facebook is roughly -5% below its high).

Just as is the case in life, timing in investing is everything, and price signals emanating from the market at the current juncture are very much "late cycle" market metrics that should not be ignored: value and small cap stocks are lagging, companies beating EPS estimates this quarter are seeing their stock prices decline, stocks hitting new lows are outnumbering stocks hitting new highs by 609 in the week of August 22nd (compared to new highs outpacing new lows by 1,650 just four weeks ago). The fact that this change of complexion is occurring in what is historically the weakest part of the calendar year from a seasonality standpoint is even more of a reason for investors to tread cautiously at the current time.

Not to mention the expanding list of outstanding land mines, whether it be a North Korean file that just won't go away (let alone an issue where there simply is no easy solution), or continued dysfunction within the Trump administration with defections and firings almost daily now and the latest scuttlebutt indicating some of the most respected cabinet members (Cohn and Tillerson) are distancing themselves from the White House. Also on the political file is the upcoming showdown on the debt ceiling which should fodder little concern among investors fearing a potential U.S. default, but the issue at hand is how this situation will likely further erode the credibility of the U.S. on the global stage. Sure, we can all harken back to a United States that on a relative basis has a whole lot to offer to the rest of the world, but with each passing day it becomes more obvious that the rest of the world is making preparations for a future that is not nearly as reliant on the U.S. being at its financial, economic, and security center than was the case in the past.

President Trump still doesn't seem to grasp this whole governing thing, and as much as he talks about draining the swamp, he's getting a crash course on just how impossible this task may be – singling out Congressmen in his own party whom he will need to help push his ambitious legislative agenda through is surely not helping his cause. Threating to shut-down the government over the funding for the border wall or terminating NAFTA ("I don't think we can make a deal") via his twitter account are yet additional examples of noise and distractions that are unnecessary. As for the agenda, the GoP is now in a full court press on tax reform, but all the heavy lifting remains as we know little in the way of whether it will be revenue-neutral or deficit financed, which loopholes stay and which ones go, and will these changes be permanent or temporary?

I must say that at least once a day I get a chuckle when I hear a pundit proclaim that tax cuts will pay for themselves through the additional economic growth they create. To this all anyone needs to do is take a look down memory lane as history speaks for itself in regards to how previous tax policies were also supposed to pay for themselves.



You see the blue-line in the chart above, that's total public federal debt which has done nothing but increase over the last four decades, irrespective of tax cuts! Look I'm not against tax cuts or putting more into the pockets of those inclined to spend or save, but please provide the public with a dose of reality or genuine honesty when presenting the case for what the future may look like. Maybe this time is different, maybe this time will work, but show both sides of the analysis as there is no sure thing and tax payers should be just as aware of the upside of such policies as well as the downside to future generations.

The one thing this administration can hang its hat on is its impact on the deregulation file which is an easy to understand argument for the bulls as it is helping to move the needle in terms of economic growth, but let's not put the cart too far in front of the horse in terms of how much of an impact this has had on a $19 trillion economy. Like deregulation, repatriation gets way more credit than it deserves in terms of impact, in the case of the latter just look back to how fleeting an impact the repatriation policy had for Bush 43 back in '03 – '04. A completely separate debate is just how trapped overseas cash balances are when large corporations (those that have the cash) can issue debt at historically low interest rates in almost any currency and any capital market in the world while using their cash as collateral and make investments in their business should they deem these investments to be a benefit to shareholders. The fact that this isn't being done today should tell you all you need to know about how much of a growth initiative this repatriation policy will be when/if it goes into effect – my guess is it will be no different than the last time where shareholders benefit through one-time dividend and stock repurchases with only a subtle token increase in business investment.

Gold is flourishing in the current environment whereas of this morning it has broken through the $1,300/oz resistance level that has constrained its upside all year long. Don't look now, but it is handily outperforming the S&P 500 on a year to date basis (+13%) with what appears to be more tailwinds than headwinds. Look, gold is a very challenging asset to value given it doesn't generate a cash flow stream, but in the face of unprecedented global money printing, heightened geopolitical uncertainty, disinflation, and low interest rates it takes on the characteristics of an alternative currency and therefore a store of value which has always been the case for this 'pet rock' dating back to Egyptian mythology in 3000 B.C. Another example of investors seeking out an asset as a store of value is the mad rush into crypto-currencies which now commands a market cap of some $150 billion. Bitcoin appears to be the beneficiary of being the "first to market" in this space and as a result commands an almost 50% market share in the crypto space – not to mention it has skyrocketed almost 400% this year alone and is up 17-fold in the last two years.

I'm not versed enough in this space to proffer an opinion one way or the other on this new technology, so I would encourage anyone interested in this asset class to do their research before jumping into an investment that has taken on many of the characteristics of a "bubble" in terms of its price movement. However, the bigger question that arises to me in terms of gold and crypto-currencies is what it is implying about investors' interest and willingness to swap some of their fiat currency holdings into alternative stores of value. Something to think about.

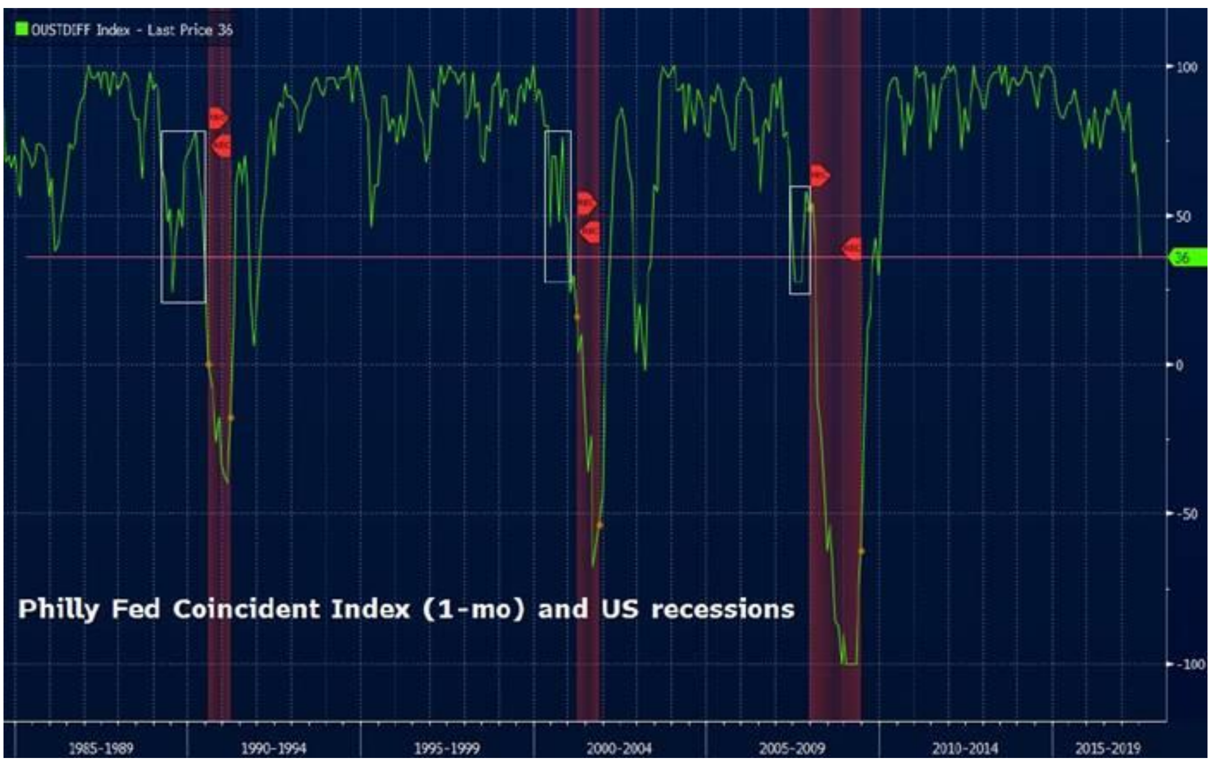
As for the economic backdrop, not a whole lot has changed in the last several months where most data points point to further confirmation of an economic cycle that is looking very tired. The housing data out last week was awful with mortgage applications for new purchases sliding to six-month lows (down four of the last five weeks) which validated the weakness in both the new home and existing home sales data. New home sales fell -9.4% MoM in July to a 571k annual rate which was well below consensus expectations for a print of 610k. July's reading marks the low point for the year with sales down -8.9% from this time last year – it appears we may be nearing a tipping point in terms of how long house price increases can outstrip wage gains before buyers just throw in the towel. For sure, credit was filling this gap leading up to this point, but we also saw existing home sales fall -1.3% in July with the number of units sold dialed all the way back to August 2016 levels.

What is a concern of mine heading into the end of this year is that we are seeing weakness in housing, weakness in autos, and we are also seeing the initial signs that U.S. oil production may be plateauing. No question the U.S. is a service based economy and that will dictate the overall direction of economic growth, but when you think in terms of what is left of the U.S. manufacturing base it is autos, airplanes, and oil – with the latter being the latest engine of growth to run out of steam. The latest Baker Hughes rig count data showed a decline for the second consecutive week, but more troubling is that with the overall number of new oil rigs at 759, they are little changed from the week of June 23rd when they were at 758 (nine weeks of stagnation). A similar story is playing out with gas rigs as well, which declined once again last week to 180 (3rd decline in the last four weeks) and they're at the same level they were back in the week of May 19th. Recession odds and probabilities are widely open for debate, but the reality is that there is nothing in the U.S. economy that I can find that will fill the void for the lack of growth from these valves.

So, while the bulls continue to take comfort in the fact that the market remains near all-time highs and the GDP numbers look solid on the surface (given they are calculated versus very easy base effects from prior periods), the road ahead is much less clear. If you haven't noticed the "Citigroup Economic Surprise Index" has been negative since the end of April and has failed to bounce back in the typical mean reversion fashion most economists were expecting. Yes, even I am growing weary of carrying the cautionary torch in an environment where it seems as though nothing matters to the price action in the equity market. Sure, bonds can trade down to the low yields for the year, but rarely do you hear about the cautionary message this sends in terms of economic growth – rather you hear the age-old refrain that low interest rates justify a higher valuation premium for stocks. Oh, don't worry about the yield curve flattening to its tightest level since before the election as it's lost its forecasting appeal in today's central bank controlled markets, moreover it's still positive and everyone knows that you don't need to worry about anything until it inverts… (that's sarcasm for anyone not picking up on the tone).

Yep, ignore any analysis that doesn't comport with a bullish outlook on the economy and stock market which is probably why the article on page A1 of last Thursday's WSJ, "Growth Takes off Across the World", was eye candy for investors seeking confirmation for their view. But, the fact that this is a front-page story should tell you that this view is more than priced into markets at this point. However, imagine the irony that on the same front cover was an article titled, "Ad Industry Woes Deepen" where it highlighted the decline in advertising revenue at London based WPP PLC, the world's largest advertising company. Seeing as this is a highly economic sensitive sector I think it's prudent to give this news its due respect as it's yet another data point in a growing list of late cycle indicators. Just have a look at the correlation between WPP's stock price the S&P 500 over the last two full business cycles:

Another ‘canary in the coal mine’ economic indicator that should catch investor’s attention given it just recently declined into recessionary territory is the monthly Philly Fed Coincident Economic Activity Index. The diffusion index fell for the second straight month in July to 36 from 56 in June, was at 68 in May, and now stands at less than half of the recent high of 88 in March. As far as recessionary indicators go this one has a pretty strong track record where only two times in the last 37 years has this indicator fallen below 36 and the economy was not in an outright recession (1992 and 2002, where in both cases the economy was just emerging from a recession and there were legitimate concerns about a ‘double dip’).



To put this indicator into perspective relative to the last several recessions:

- It hit a reading of 36 in June of 1990 and the recession began one month later.
- It was at 48 in December 2000 (twelve points above where we are today) and the recession started in March 2001.
- It fell to 40 in October of 2007 with the start of the most recent recession just around the corner in January 2008.

As concerning as this perhaps looks, it’s not something that one should panic over at this time. It’s one of the lone soldiers at the moment signaling recessionary warnings and it would be prudent to wait for additional confirmation from other sources before getting too defensive with positioning. More than anything investors should continue to foster an investment strategy that on the margin continues to shift in a more risk averse profile. With valuations in both the equity and fixed income markets near all-time highs, investors should revisit the origin of what it means to be an investor or speculator. My simple definition is that investing is buying an asset at less than intrinsic value and holding it until it appreciates to a price level above intrinsic value. Speculating is buying an asset at a price level above intrinsic value and hoping another speculator comes along to buy it from you at a higher price. In my opinion, current market dynamics have more in common with speculation and less in common with investing, which is an important distinction to consider.

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