September 18th, 2017

Nothing matters until it all matters…

Global equity markets were in rally mode last week with U.S. equities logging one of their strongest weekly gains for the year. What is noticeable is how quickly investors have adapted to shrugging off concerns over the North Korean file – it was only a couple weeks ago when missile launches triggered risk-off market behavior (stocks sold off, gold and bonds rallied), but last week had a much different flavor. At the start of the week stock markets rallied on the back of a lack of missile launches out of North Korea over the weekend, and then at the end of the week stocks continued to rally following a mid-week missile launch. Perhaps this makes the most sense given the stakes for all parties involved are highly skewed towards this never amounting to anything more than a game of chicken, where the U.S. has all the leverage, but the wildcard is that this game is being played against an unpredictable man-child who has nothing more going for him than to retain the spotlight as long as he can.

However, what is getting overlooked in the maelstrom of the S&P 500 eclipsing 2,500 for the first time and the Dow Jones Industrial Average logging new all-time highs is the broadening loss of momentum in the U.S. economy – namely on the consumer front as was front and center in last week's retail sales report. In addition to the weak retail sales report we got Industrial Production data which plunged 0.9% in August (consensus was looking for 0.1%) and as a result we saw a wave of cuts to Q3 GDP estimates: Atlanta Fed cut its number for real GDP to a 2.2% annual rate from its most recent estimate of 3.0% and far below the 4.0% number it was forecasting in early August, and the New York Fed chopped its estimate to 1.3% from 2.1% and its 1.8% estimate for Q4 isn't showing much in the way of a meaningful pickup in growth as we close out the year.

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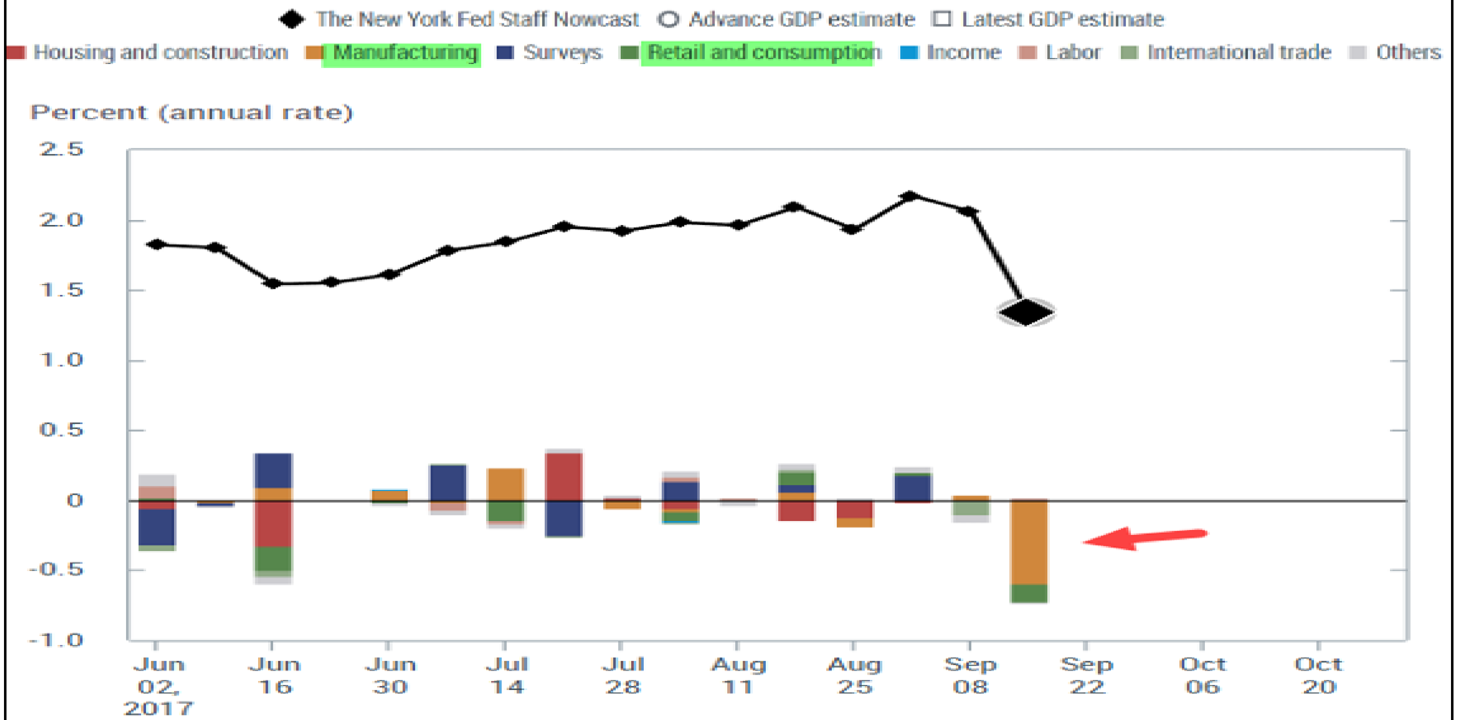

Consider for a moment that should the NY Fed GDP estimates for the rest of the year prove to be accurate then we're talking about a U.S. economy that expanded at 1.2% real GDP growth in Q1, 3.0% in Q2, 1.3% in Q3 (estimate) and 1.8% in Q4 (estimate) which equates to 2017 real GDP growth of just over 1.8%. This would fall just slightly ahead last year's 1.5% real GDP growth rate which was the worst calendar year for this expansion – not quite the robust pick-up so many were calling for coming into the year.

And it wasn't just the U.S. economic data that disappointed last week as the Chinese economy showed signs of cooling off with retail sales, fixed asset investment, and Industrial Production all coming in below expectations. This data should be taken with a grain of salt as all it indicates at this point is that the momentum in the second largest economy in the world is slowing, but it's slowing from levels that are the envy of the rest of the world, with perhaps India being the sole exception (although they too are seeing a modest cooling in their economy). However, given the downturn we're seeing in China's credit impulse it is suggesting that the loss of momentum in the Chinese economy still has some ways to go before we expect to see this bout of weakness abate.

Nevertheless, investors shouldn't expect anything out of the ordinary to come out of China until the 19th Party Elections are over, which were just recently announced to take place on October 18th. President Xi Jinping has made 2017 all about stability leading up to this election where he is looking to further consolidate his power in leading China over the next five-year term.

I want to go back to last week's dismal retail sales number for August which, for anyone who actually does any analysis in this era of passive ETF investing and price agnostic momentum chasers, should cause them some pause in regards to what it is telling us about the U.S. consumer and overall health of the U.S. economy. To my eyes it is less about the 0.2% decline in retail sales for the month of August or the

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downward revision to 0.3% in July from the initial estimate of 0.6%, but more about the trend in the data over the course of this year.

In aggregate, retail sales have been flat or down in three of the last four months and in four of the past seven. So far in 2017 with data on hand that runs through August, retail sales growth is a miniscule 0.5% annual rate which compares to a run rate of 5% at this same juncture in 2016. Yeah, how about that, and what would you expect when work-based income has declined 0.2% in nominal terms and 0.6% in real terms – households living beyond their means can only stretch so long. As you can see in the chart below, Personal Consumption Expenditures have been outpacing Disposable Income since early 2016.

And what has been allowing consumption to stay elevated in the face of what are lackluster wage gains is a consumer base that has been tapping the credit spigots to fill this gap (as can be seen in the chart below plotting the difference between the YoY change in consumer credit relative to the YoY change in Disposable Income).

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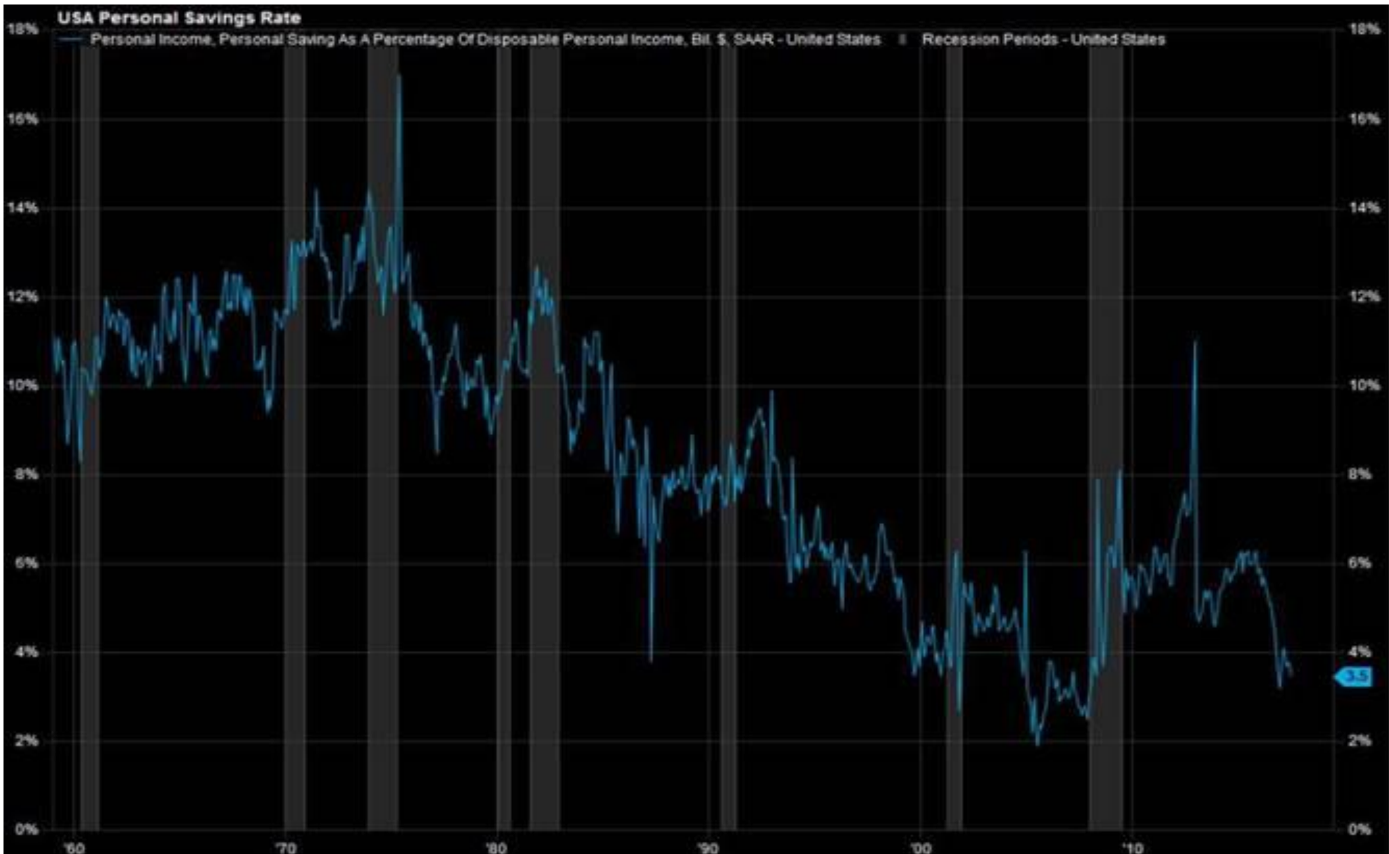
For those households that have exhausted their credit lines, they've turned to digging into their savings which has pulled the personal savings rate as a % of Disposable Income to the lowest levels of this cycle and the lowest level since the onset of the GFC in 2008.



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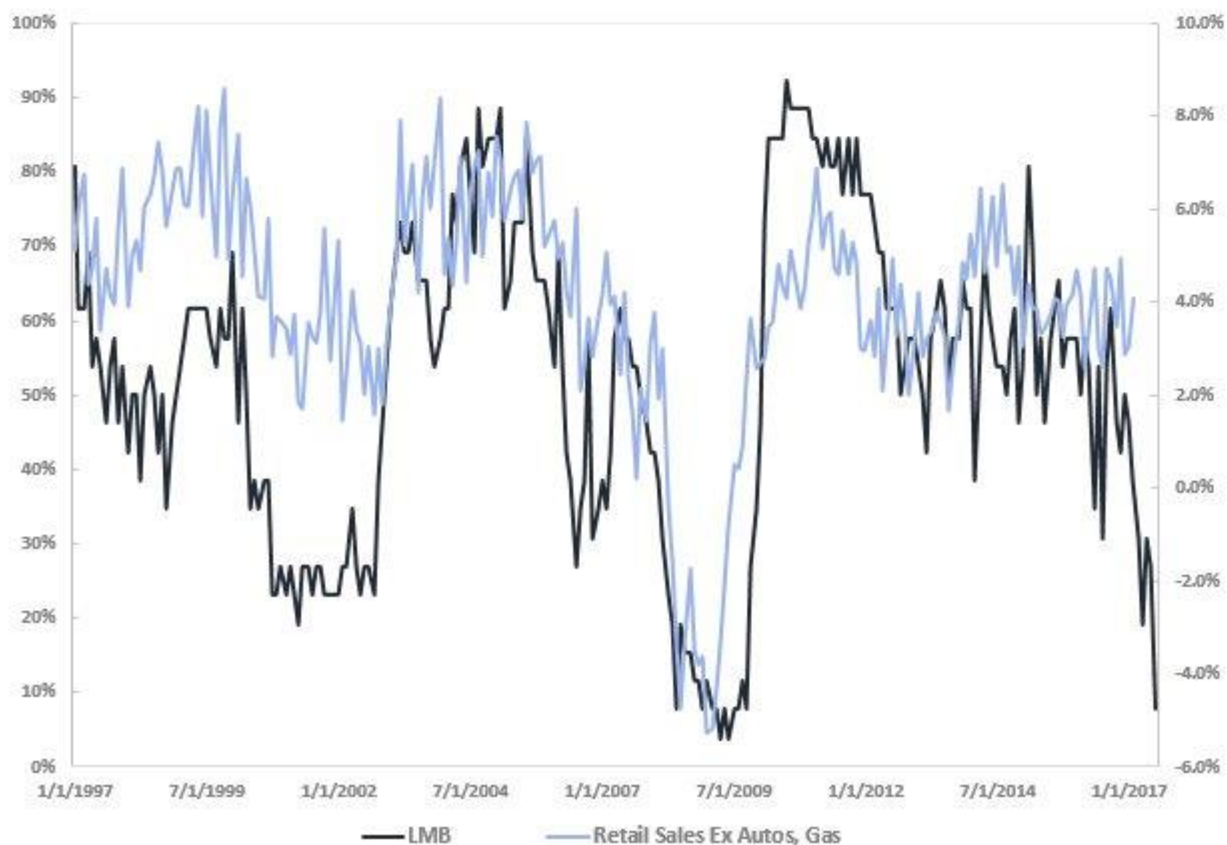
One more thing on this file that I think is more than noteworthy is the trend in retail sales volumes so far year-to-date which are down just over 0.1% at an annual rate. Why this caught my eye is because such a weak annualized trend last occurred back in 2007, before that it was 2000, prior to that 1990 & '91, also in 1979, '80,'81, and '82. What do all these years have in common? Yup, you guessed it: they either all coincided with or were just months ahead of the onset of recession.

This is not a forecast, but rather still just an observation. However, the list of observations (outside of ebullient stock market action) indicating risks of economic weakness are growing and although it doesn't appear to matter at present, it will in due time if history is any guide. Sure, some may argue that hurricane Harvey and Irma are negatively impacting the data and will continue to do so over the next several months – this is a point that I won't refute while I don't think it will be as additive (when the rebuild begins) as many expect when all is said and done. But this risks missing the "forest for the trees" in my opinion just as consensus has been so accepting of the decent headline payroll prints so far this year, but few have shown much respect for the broadening deterioration in the internals of the labor market. Have a look at the following chart from Teddy Vallee plotting Labor Market Breadth vs. Retail Sales and what this foretells (5-month lead) for retail sales looking forward.



You don't have to look much further than last week's University of Michigan Survey of Consumers for September to get a sense of the level of exhaustion hitting the U.S. consumer. Here are some of the highlights from the report:

- The 'current conditions index' jumped to 113.9 from 110.9 in August while 'expectations' dropped to 83.4 from 87.7 – think of 'expectations' as viewing the world through the windshield while 'current conditions' is a look through the review mirror.

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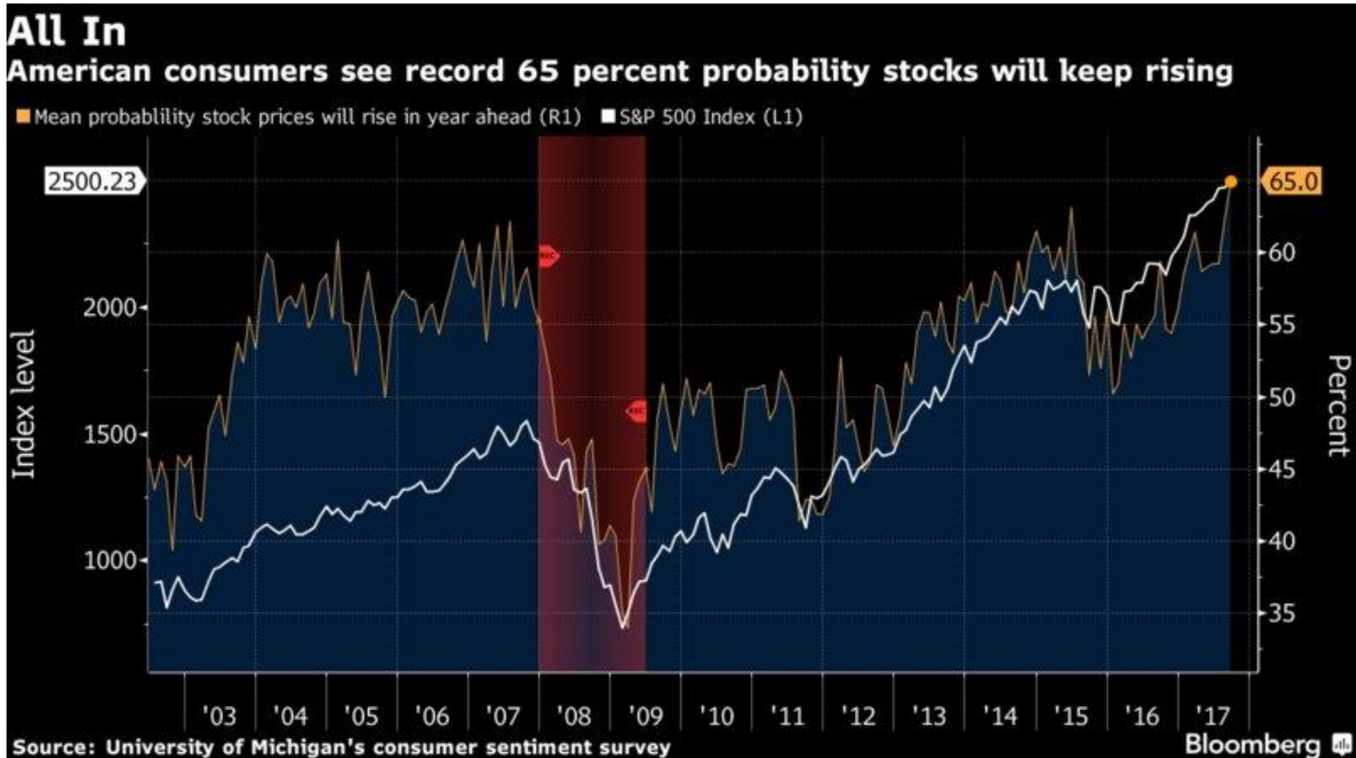
- Buying intentions for autos dropped to 136 from 139 in August and the nearby high of 152 reached in April – that 136 reading is close to the softest level in more than three years.
- Buying intentions for a home slipped once again in September to 138 from 140 and like autos this is down from the April high reading of 155 – that 138 reading is the lowest in six years.

Also found within the University of Michigan survey was the mean probability of consumers expectations that the stock market will go up over the next year hitting 65% (all aboard the one-way train), up from 62.7% in August, 59.2% in July and June, 59% in May, and 58.7% in April. This is the highest ever reading for this response, taking out the previous record high of 63.1% in June 2015, and the 62.2% peak in July 2007 which was just 3 ½ months before the peak in the stock market before the onset of the GFC.



Look, I know how easy it is to ignore these troublesome signs of peak autos, peak housing, a weakening consumer footprint, a deteriorating labor market and historically stretched valuation levels (both in stocks and bonds) in favor of the growing consensus narrative of synchronized global growth and record high stock markets. Moreover, none of this is a harbinger that a correction, crash, or recession is imminent, but it does suggest that the risk / reward payoff for future investment returns is becoming more skewed towards risk than reward as these trends become more entrenched.

Take the latest reading in the University of Michigan survey on stock market expectations and peak market pricing as an example, where history provides a pretty clear road map indicating the two tend to coincide with each other, and why not given human nature is to extrapolate the most recent experience into the future.

At the same time as these data points are flashing amber cautionary signals, we have a Federal Reserve that is pushing further down the path of interest rate normalization. On the back of last week's higher than expected CPI inflation print the Fed Funds Futures market has pushed the odds of a December rate hike up to a 63% probability (was sitting at a 31% probability as recently as September 8th). But before we start looking too far ahead into December, we have the Fed concluding its two-day policy meeting on Wednesday where it is widely expected that they will announce the start of reducing the size of their balance sheet by not

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reinvesting all the proceeds from maturing securities (to the tune of $10 billion per month), and then will monitor and assess the impact this has before announcing further increases in the future.

It will be interesting to see how the global economy is able to digest any further rise in interest rates when here we are a full nine years into what is approaching the second longest economic expansion in U.S. history, yet the world economy (and the U.S) is more indebted than it's ever been. The most recent lending data on hand from August is showing no signs of moderation to the year-to-date decline in both the demand for and supply of credit and this is after only three 25 basis point hikes since December 2016 (the first hike was back in December 2015 and then the Fed went on a rate hiking sabbatical for a year). It's unknown whether this is entirely the result of higher rates or just exhaustion and/or borrowers reaching the limits of the debt they are able to take on, but in the world of markets and economics everything works off the marginal change. So, any further marginal tightening from this point could potentially be 'a bridge too far'.

More than anything what I want investors to take away from the current setup as I see it is that all may not be as rosy as what it looks like on the surface. Consider the late cycle indicators that are permeating and act accordingly:

- Headline unemployment is low at 4.4% at last read but no longer declining and as of now the cycle low was reached in May at 4.3%.
- Global bond yields are just above the lowest levels every recorded over the last 5,000 years.
- On several metrics, the U.S. equity market is the most expensively valued it's ever been and on most metrics the only time stocks have been as expensive was in 1929 and 2000 – two periods from which it took 25 and 14 years, respectively, to recoup the levels reached at the peak of these excesses.
- Investor sentiment and investor positioning, i.e. equity allocations at cycle highs, fixed income and cash allocations at cycle lows, margin debt at all-time highs, belief of future gains in stocks at all-time highs…
- Thus far all investors have experienced from the implementation of these experimental monetary policies is the easy part – cutting interest rates, expanding their balance sheets, buying assets… all of which have been a meaningful tailwind to asset prices. We're now moving into the next stage of these policies, beginning to reverse what has been nine years of unprecedented accommodation.
- The Killer D's of Demographics, Debt, and Deflation: U.S. demographics at an inflection point with the transition of baby boomers from working class to the retirement class. U.S. debt and global debt is at an all-time high, and deflation (not inflation) remains the structural path of least resistance.

For many of you, your time-horizon and investment objectives are likely drastically different than the short-term and algorithmic traders that are dominating the current market momentum in the late stages of this bull market cycle. With that said, be proactive and adjust accordingly.

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