January 23rd, 2017

Separating the cyclical from the secular…

It was another mild week in the capital markets last week with most of the major averages registering modest declines in the range of -0.15% to -0.35%, the one exception was the Russell 2000 Small Cap Index which fell almost -1.5%. This has pretty much been the case for the last six weeks, where following the election, the S&P 500 hit a high of 2,277 on December 13th and a low of 2,233 on December 30th , but hasn't been able to break out of this trading range ever since with the S&P 500 closing out last week at 2,271.

Call it a case of cognitive dissonance among investors as they await the details to be unveiled from a Trump administration that is not backing off of an "America First" campaign agenda. President Trump's inauguration speech put to rest any doubts that this vision was just campaign lip service and also dashed expectations that he would shift to the center once he took office. Peggy Noonan's piece in this weekend's Wall St. Journal, "President Trump Declares Independence" perhaps captured it best:

> *(…) The inaugural address was utterly and uncompromisingly Trumpian. The man who ran is the man who'll reign. It was plain, unfancy and blunt to the point of blistering. A little humility would have gone a long way, but that's not the path he took. Nor did he attempt to reassure. It was pow, right in the face. Most important, he*

did not in any way align himself with the proud Democrats and Republicans arrayed around him. He looked out at the crowd and said he was allied with them. (…)

"From this day forward it's going to be only America first—America first." To American workers and families: "You will never be ignored again." (…)

This was a declaration that the president is going his own way and they'd best follow. (…)

Anyway, it was a remarkable speech, like none before it, and it marked, I think, yet another break point in the two-party reality that has dominated our politics for many decades.

And so, now, it begins. And it simply has to be repeated: We have never had a political moment like this in our lives. We have never had a president like this, such a norm-breaker, in all the ways we know. We are in uncharted seas. (...)

No one knows what he'll be like as president, how this will go. Including, probably, him. (...)

Normally a new president has someone backing him up, someone publicly behind him. Mr. Obama had the mainstream media—the big broadcast networks, big newspapers, activists and intellectuals, pundits and columnists of the left—the whole shebang. He had a unified, passionate party. Mr. Trump in comparison has almost nothing. The mainstream legacy media oppose him, even *hate him, and will not let up. The columnists, thinkers and magazines of the right were mostly Never Trump; some came reluctantly to support him. His party is split or splitting. The new president has gradations of sympathy, respect or support from exactly one cable news channel, and some websites.*

He really has no one but those who voted for him.

Do they understand what a lift daily governance is going to be, and how long the odds are, with so much arrayed against him, and them?

Over the last several weeks I've received a lot of feedback suggesting that I'm being too hard on President Trump and in some respects my comments are lacking in objectivity. While I surely do appreciate and welcome the feedback, as I'm always open minded and respectful of understanding opposing views, but I have to say that perhaps I've failed in appropriately communicating my viewpoint.

It's not the person, nor the administration that I view as the problem, but rather the structural and secular headwinds facing the U.S. at the current time. Irrespective of what I think of Donald Trump the person or his policies (the latter of which I openly acknowledge and celebrate as a potential tailwind for economic growth), how can you not be optimistic about the possibilities of efficient and effective deregulation (the adjectives 'efficient' and 'effective' are important), lower corporate and personal tax rates, and refurbishing a decaying infrastructure?

However, while many investors are focusing on these positives like a thoroughbred with blinders on, they are conveniently ignoring the other policies that accompany these endeavors, such as protectionism, anti-immigration, and heightened uncertainty (after all this is a man that thought it necessary to bring focus to the size – or lack thereof, depending on one's perspective – of his inauguration crowd).

A very rational and fundamentally justified case can be made that on a long-term basis the potential changes he intends to implement could be precisely what is needed to ensure that the U.S. remains the world's most powerful nation. But, keep in mind some of the changes that are being considered and likely to be implemented will have a profound impact on what has been a progressive evolution of commerce towards globalization that has been in the making for more than five decades.

With that being said, it’s my opinion that the transition from point A to point B is sure to create some ripples that in the heat of the moment will not be all that comfortable. Also, keep in mind that while there are optimistic scenarios and outcomes to this path we are potentially going down there are pessimistic outcomes as well. Economies, markets, and societies are adaptive, complex, and intelligent ecosystems that evolve and adjust to the marginal changes they experience. There is no assurance or guarantee that point B in this journey is going to be superior to point A.

It may be, but we’ve been down this path of protectionism and tariffs before with Hebert Hoover, which many academic works argue that it was the Smoot-Hartley tariff policies implemented during the 30's that accentuated the then ongoing recession and turned it into a depression. Not a forecast, but rather just an observation and to quote George Santayana, "Those who cannot remember the past are condemned to repeat it."

So, here we have a situation where the fundamental starting point for this administration and some of the profound changes they intend to implement could hardly be more challenging. Let me first start with the more myopic shorter-term set up.

The S&P 500 has rallied +5.8% since President Trump was elected, which is almost double the median average of +3.2% from election to inauguration. One of the most dangerous things an investor can do is extrapolate the "honeymoon" period into the future. Two of the more extreme examples to highlight this point are Herbert Hoover, who was on the receiving end of the biggest post-election bump of all-time with a +13% run-up in 1928 (we all know what happened after that). President Obama was on the other side of this history lesson when he experienced an almost -20% plunge following his victory in 2008 (who at that time thought the market would go on to triple under his Presidency?).

Think of the present day irony where Obama's legacy through the Trump lens is being viewed as a heavy handed, over regulated economy where the economic expansion that spanned his 8-year term is the weakest economic recovery in the post-WWII era. Until recently it's been a wage-less expansion where corporate profit margins hit record highs and political gridlock rendered any form of fiscal policy as a non-starter in terms of supporting the recovery. Yet, this wasn't exactly bearish for a stock market that is now one of the top three in the record books in terms of return and duration (go figure).

This just goes to show you that Mr. Market didn't need much assistance from Obama's policies because it had the Fed who ushered in the most aggressive and unprecedented monetary policy in U.S. history. Little did anyone realize at the time just how effective zero interest rate policy and repeated quantitative easing would be at pushing up asset prices of all kinds – stocks, bonds, and real estate are all at or near all-time highs.

It's almost the polar opposite set-up today as President Trump takes office:

- The economy is entering its 91st month of this expansion which is well past the average of 59 months for all expansions dating back to 1929. When Obama was inaugurated the first time in 2009, the U.S. economy was at the depths of the worst economic recession since the Great Depression and a short five months away from it coming to an end.

- At present the S&P 500 is within 1% of its all-time high whereas back in 2009 the S&P 500 was within six weeks of hitting the bottom of what ended up being a -57% peak-to-trough decline.
- The Fed is in year two of its rate hiking cycle (admittedly a prolonged one at that) whereas in December ’08 (just before Obama took office) the Fed had already cut interest rates to zero for the first time in history. The Fed would go on to implement various forms of QE for the next five years while increasing the size of

its balance sheet nearly five-fold from $880 billion to $4.5 trillion.

I could go on and on with these bullet points, but you get the gist – from an investing standpoint, it would be hard to find a more challenging set-up for a President to take office. It's not to say that Trump can't succeed or end up being a great President, but from an investor's perspective it's more probable that he's lumped in with the Bush's (both Sr. and Jr.) in terms of success than it is that he'll receive the acclaim of Clinton or Obama.

It's very difficult to definitively conclude whether the prior successes or failures of these past four Presidents is more a figment of their policies or luck. It just so happens the last two Democratic Presidents came into office at the tail-end of a recession and the start of a new expansion, while the last two Republican Presidents came into office with the exact opposite set-up – as they say it's better to be lucky than good.

While I applaud the enthusiasm and truly hope that this administration is successful at improving the lives of the many workers that have been displaced and left behind in the fallout of what was the worst economic recession since the Great Depression, however I have my doubts that the potential changes required to fulfill these objectives and their ability to be implemented can occur without as much as a hiccup to the present day reality that has been very beneficial to Wall St. at the expense of Main St. Mean reverting this trend is surely more complicated than I believe is currently being considered.

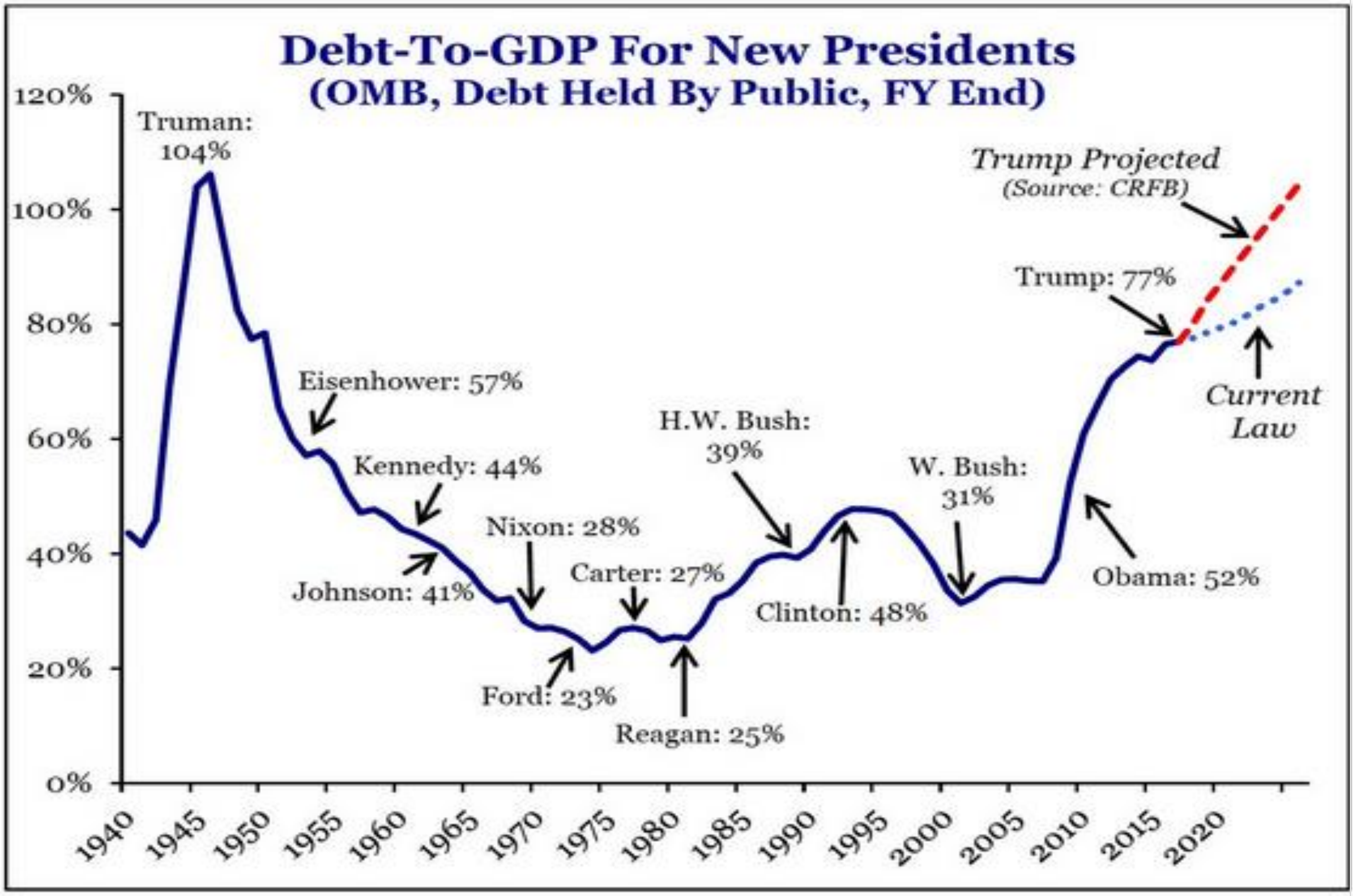
Reversing globalization will depress returns on capital, and that's a tall order to overcome for a U.S. equity market that is dominated by multinational companies. A U.S. equity market that is at peak multiples and peak profit margins with nearly 40% of S&P 500 revenues derived from overseas, and this coincides with a time when monetary policy has shifted from a tailwind to a liquidity headwind. With all due respect to Kellyanne Conway, but these aren't 'alternative facts' – and we all must play the hand we're dealt.

I must say, the one thing I've been delinquent in calling attention to over the last several months is the pick-up in economic activity. The acceleration in a broad array of data that started in September and has continued coming into this year is as much deserving of the credit for the rally in risk assets as the election results. The jump we've seen across the board in almost every sentiment survey – CFO Business Confidence, Consumer Confidence, Investor Sentiment Surveys… – cannot be ignored, but these are considered soft data metrics whereas the results on hard data metrics (retail sales, housing starts and sales, industrial production, and trade) have been much more mixed.

What is of more interest to me is how the data comes in over the next couple of months, starting with the January data which will be reported in February. This is the data that will start to show if the 'animal spirits' bump in the survey data is actually translating into business activity. Additionally, this data will encapsulate any impact the much stronger dollar and higher interest rates are having on the economy. Some of the models and economic work I follow suggest that we could have a couple more months of this cyclical reflationary run in the data (perhaps through March or April) before we lose some momentum in terms of the calendar, central bank liquidity (negative changes in the money supply and velocity), and easier year-over-year comparison metrics on some economic data series (inflation is the most obvious one on this front).

I mentioned earlier that it wasn't just the short-term cyclical forces that represented a meaningful headwind to the success of the incoming administration, but there is also a more significant headwind from secular / structural forces. The biggest of these impediments are Debt and Demographics, and these are not new anomalies to those who have done the work to understand how strong of a headwind for growth they will be.

First on debt: gross federal debt is at 105.5% of GDP (sometimes you'll see this quoted on a net basis at 75% of GDP because the Fed holds a large portion of Treasury securities) which compares to 32% and 57% of GDP in 1981 and 2002.



The reason for the reference to '81 and '02 is because that is the last time we had an administration that was focused on material tax cuts with Reagan and Bush Jr. This creates quite the dilemma for the current administration and why there is surely going to be complications when it comes to logistics and the math of putting together tax reform and infrastructure spending while maintaining credibility in the backing of U.S. debt.

Please don't misunderstand this as an extremist statement, as I think there is little question on the solvency and credibility of our willingness and ability to service our debt – no matter what sound bite Trump likes to throw out there as an opening negotiation tactic. But this does put the policy makers in a bind whereas they must craft policy reform that is offset by other budget measures that will meaningfully undermine their impact on economic growth.

If it was that easy, where one could just cut taxes and whimsically spend their way to prosperity, then Japan would be the largest and most financially secure nation in the world. But that's not the reality, and they represent a real life test case of how over-indebtedness acts as a tourniquet to long-term growth, not as an accelerant. In 1997, the Japanese debt-to-GDP ratio was 69% and over the next decade (data through Q3 2016) debt-to-GDP has increased to just shy of 200%. Want to guess what nominal GDP did in Japan over that period? Nada, nothing – as in flat or unchanged from where it started in 1997.

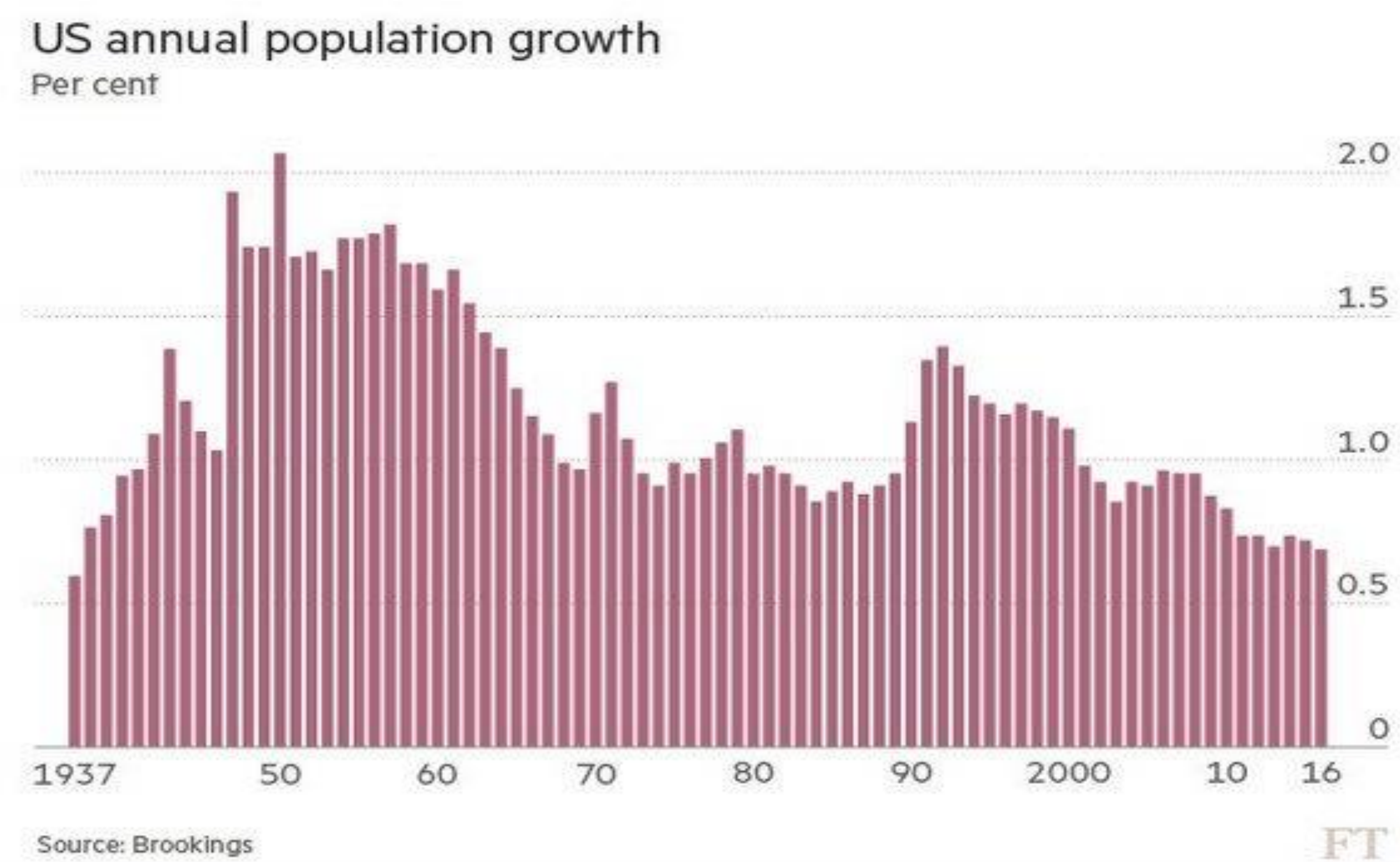
The debt problem in the U.S isn't just a government phenomenon, as the largesse has made its way through the entire system on the back of eight plus years of virtually zero interest rates. Data through the end of Q3 2016 shows domestic non-financial debt and total debt reached $47 and $69.4 trillion, respectively. In its simplest form, borrowing is nothing more than deferred payment for current consumption or investment – what these large figures indicate is that there is a lot of future consumption that has been pulled forward to the present. The servicing of this debt is not an issue at the moment because interest rates remain historically low, and I would argue that this is one of the major variables that will prevent interest rates from a material increase. However, if for whatever reason (an inflationary scare, the Fed being behind the curve, or a breakdown in the confidence of a creditor's ability to pay) interest rates were to rise in a meaningful way then the servicing of this outstanding debt (which isn't all fixed nor is the majority financed with a long-term maturity…) won't be so easy.

Here's some perspective on the diminishing marginal return of a higher debt load. In 2016 domestic financial debt increased by $2.6 trillion which equated to a debt increase of five times the amount of the corresponding increase in GDP ($5 of debt for every $1 of GDP). Let me put this into a historical context: from 1870-2015 it took $1.90 in debt to generate $1.00 in GDP, from 1952-1999 it took $1.70 in debt to generate $1.00 in GDP, and from 2000-2015 it took $3.30 in debt to generate $1.00 in GDP (data from Hoisington Fourth Quarter Review and Outlook).

Folks this isn't a very uplifting trend, nor does it afford us the latitude to make any meaningful policy errors that further exaggerates this imbalance.

As for demographics, it's a similar story in its origin as it relates to the debt burden, in that it’s just math. We are in the midst of a demographic gap where the oldest of the 80 million strong Baby Boomer population cohort are turning 70, with 1.5 million of them turning this age every year for more than the next decade. The generation that follows the Boomers (the Gen X’ers) is little more than 50 million in size, and it’s not until we get into the early 2020’s that the Millennials – which is a population pool that is bigger than the Boomers – will be reaching the start of their most productive years (35-54).

What’s more is that as the dependence ratio rises for the U.S. population, we are not recreating at a level that will be able to sustainably afford the legacy benefits of older generations. In the fiscal year ending July 1, 2016, U.S. population increased by 0.7%, which the smallest increase on record since the Great Depression years of 1936-37 (data from the Census Bureau). The National Center for Health Statistics data indicate that the fertility rate (number of live births per 1,000 women ages 15-44) reached all-time lows in 2015 at 62.9 (matching a level also reached in 2013).



Seeing these statistics magnifies our economy's need for a future flow of immigration – legal immigration, I might add.

If one simplifies economic growth down to (population growth + productivity growth) = economic growth, with population growth sub 1% and productivity growth about the same, it's not hard to see how we are in one of the weakest economic expansions in history.

Look, I don't want to end this week's missive on a somber and negative tone, as what isn't included in any of these dry data sets is the magnificence of the human species. Nor can any model fit the dynamics of human behavior and our ability to come together during tough times to solve and slay our most severe challenges. Betting against the U.S. economy or the people in it is a loser's bet, full stop.

However, at this current juncture I think it is important and prudent to not look at the prevailing landscape with only rose-colored glasses. The current set-up for investors, from valuations to fundamentals, to sentiment, to history, to geopolitical uncertainty, to global leadership transitions… could hardly be more unfavorable for asset prices. That doesn't mean it falls apart overnight or that it falls apart at all. It does mean that while the equity market hasn't experienced a 1% move in almost 70 trading days and while in the midst of the second longest bull market in stock market history, that there is still risk in the system, however dormant it may seem. The biggest risk to any investor's long-term success isn't catching every percent return in a bull market, it's being too complacent when the probabilities are not in your favor and experiencing a material erosion to your capital base that takes years to recover from.

So, be optimistic. Embrace the future, and hope for the best. But have a plan, adapt it when necessary, and don't dismiss worst case outcomes because that is where your biggest risk lies.

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