April 10th, 2017

Yes Mr. Dimon, something is wrong…

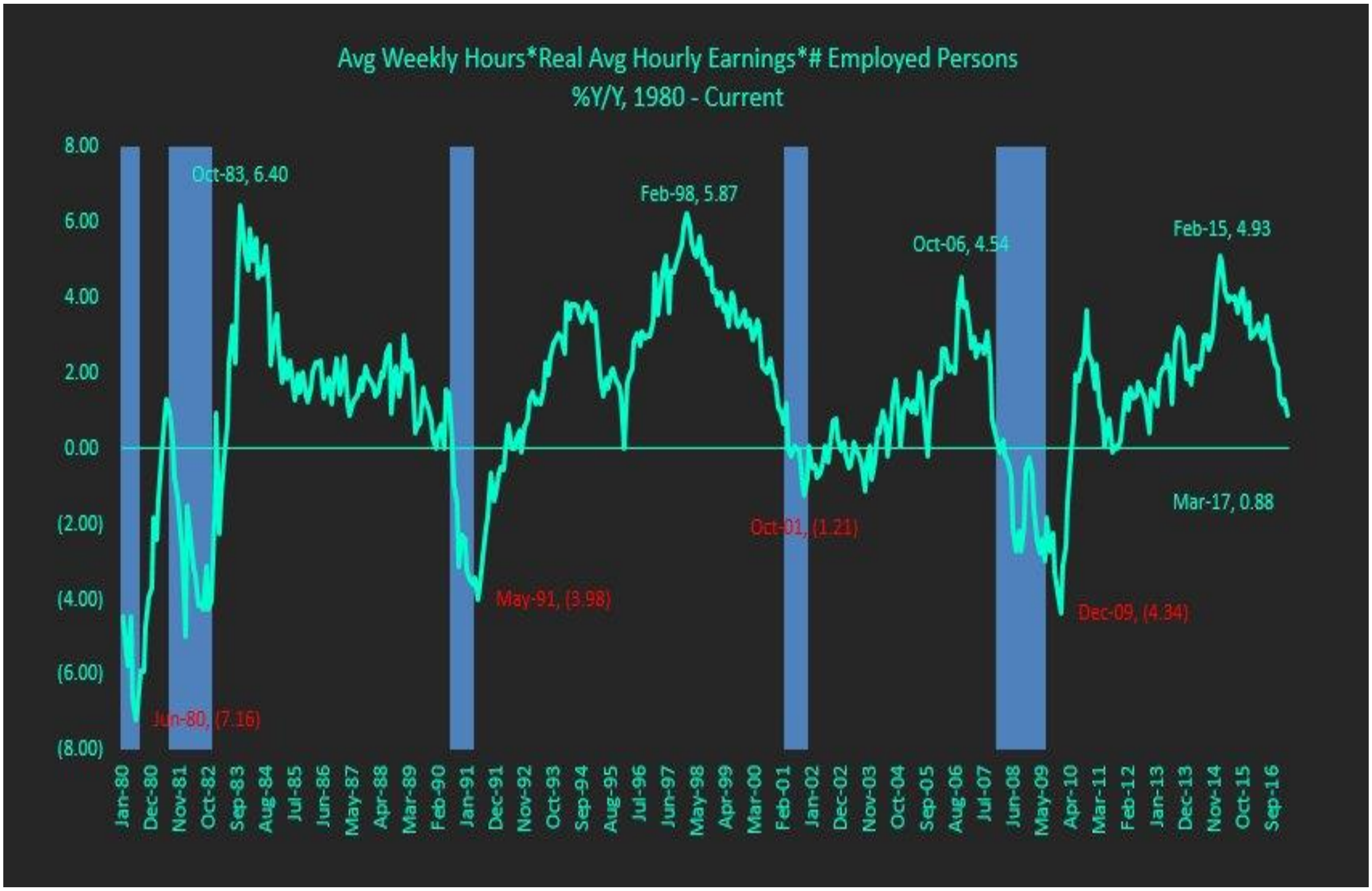
It was all about the economic data last week and when taking it all into account it could at best be interpreted as "sluggish" and at worst "pathetic" as almost every piece of economic data came in below consensus expectations. The great divide between the survey data and the hard data remained intact, but those out there making the case that it's only a matter of time before the latter catches up to the former have their work cut out for them given the reality that this latest batch of data had late-cycle fingerprints all over it.

Let's start with Friday's employment report where the headline print of +98k new jobs created in March was well below consensus expectations of +175k and the lowest month of job gains since May of last year. The easy scapegoat for such a weak report (especially following the strong ADP employment report of +263k jobs that was released on Wednesday) was the weather impact given the northeast was hit by Winter Storm Stella which landed during the payroll survey week. But using the weather looks to be too easy of an excuse given there were material pockets of weakness that suggest this report may not be just a one-off.

For example, the private payroll diffusion index dropping from 66.9% in February to 58% in March to stand at its lowest level since last November attests to the breadth of the weakness across many sectors, both in the goods-producing and the service sectors. What's more is that the key segments of the employment market that cater to the 70% of the overall economy otherwise known as the American consumer continued on what has become a multi-month decelerating trend. The retail sector shed -30k jobs last month following a similar decline of -31k jobs in February and while the leisure and hospitality sector added +9k jobs in March, this was about half the average gain of the past three months. Employment growth in the private service-providing industries slowed sharply to +61k in March from +125k in February and +153k in January.

Now there was some good news with the unemployment rate falling to 4.5% from 4.7% last month and this marked the lowest reading since May of 2007 (4.4%). Additionally, the U6 number (the broadest measure of underemployment) fell to 8.9% from 9.2% in February and 9.4% in January (lowest since December 2007), however in the past full-employment was considered to be reached when this metric broke below 8.0%, so still a little further to go.

So yes, an unemployment rate at 4.5% is the lowest it's been for this cycle (it's been under 5% for 11 straight months), yet the best that wages could do was inch up +0.2% month-over-month which left the year-over-year reading on average hourly earnings growth at a tepid +2.7% level (only +2.3% for production and nonsupervisory workers). The chart below perhaps most aptly sums up what Jamie Dimon is eluding to when he says "something is wrong with the U.S." where the growth rate of aggregate income (hours worked x hourly earnings x number of jobs) has plunged to +0.88% year-over-year and is well off the +4.93% Y/Y cycle high back in Q1 of 2015.



Every previous cycle has seen wage gains pick up strongly as the labor slack disappears and this allows real wage growth to offset the deceleration in employment growth, boosting real income and supporting aggregate demand. For context, it’s estimated that a +1% increase in real wage growth is equivalent to

+120k/month in additional jobs being created over the course of a year. This is why the above chart is so troubling, because at this stage of the economic cycle (94 months into this expansion) aggregate earnings is much more relevant than the monthly headline payroll reading. Herein lies the conundrum at this stage of the business cycle with total hours worked decelerating while the unemployment rate is hitting cycle lows (hinting that were at full employment), yet aggregate nominal income growth is approaching levels consistent with a recession.

Beyond the jobs report we were on the receiving end of the ISM manufacturing index which dipped to an as expected 57.2 reading in March from 57.7 in February. There wasn't much new in this report other than it looks like February marked the peak in this cyclically sensitive pulse on the economy and as such likely put a cap on the reflationary surge working its way through the economy since March of last year. As I've highlighted over the last several weeks this March, April, and May period for economic data will be very important in measuring when the lagged impacts of global monetary and fiscal policy injections into the economy from this time last year through Q3 2016 have run their course. From what we've seen over the span of the last two months, as well as the sharp downturn in credit supply and demand in Q4, it looks as though this reflationary impulse is in the process of rolling over, where the important question for investors going forward isn't whether or not economic growth slips further below +2% trend growth, but rather the speed at which this deceleration occurs.

If the March auto sales numbers are any indication of what's to come then one has to be open minded to the notion that the consumer is flat tapped out. For sure, one month does not a trend make, but a -5.4% month-over-month slide to a 16.6 million unit annual sales pace (well below consensus expectations for 17.3 million unit tally) from February's 17.6 million unit reading is a data point that dents the full-speed ahead economic narrative. This was the softest headline since February 2015 (when the economic growth rate peaked for this cycle), and it's not as if dealers were sitting idly by thinking sales would take care of themselves as incentives were up roughly +13% year-over-year.

This is a canary in the coal mine type of indicator as a peak in auto sales historically is a very late cycle indicator and with the March sales data in hand we now know that the YoY trend in motor vehicle sales is negative, which makes it the third such instance in the last four quarters. The automotive sector is perhaps one of the broadest segments of the U.S. economy with tentacles that touch everything from powdered metal fabrication, technology, industrial metals, mining production, textile manufacturing… whereas rare is the day that auto sales drop on a YoY basis and economic growth accelerated one year out. What's more is that this sales slowdown is coming at a time when inventory levels are already abundant with inventory-to-sales ratios at cycle highs.

As if that wasn't enough to worry about, we've already seen distress picking up in the auto loan market with delinquencies and defaults on the rise, and the following data from Larry McDonald's blog on the increase in the percentage of auto loans with negative equity also raising a cautionary tone:

Average Percentage of Auto Loans with Negative Equity:

2017: 34.1%*

2016: 32.2%

2015: 28.3%

2014: 27.1%

2013: 24.6%

2012: 23.3%

2011: 21.8%

2010: 19.2%

2009: 24.1%

2008: 26.1%**

2007: 25.9%

Source: Edmunds, FED Data

** Financial Crisis high

* At the current pace of defaults, 2017 projection

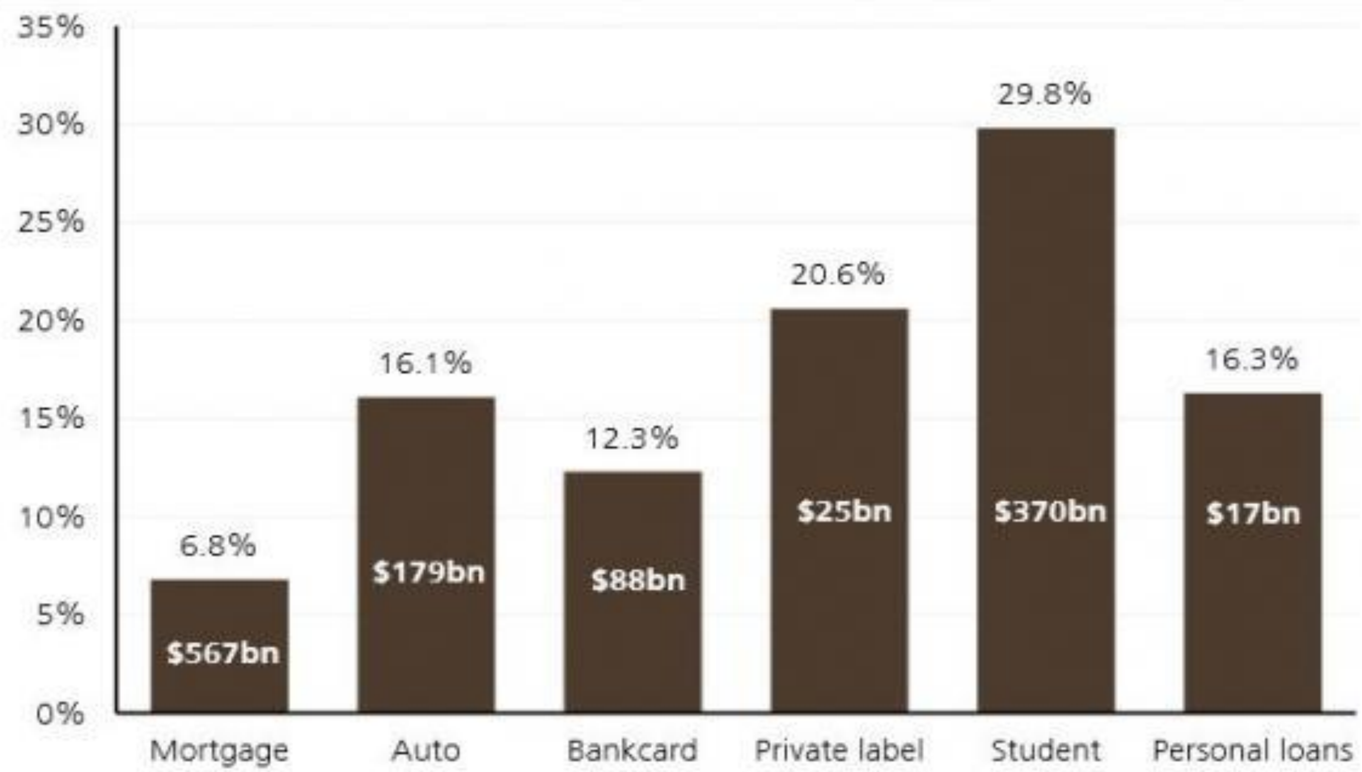
The rise of auto debt to north of $1 trillion along with subprime defaults increasing at a worrying rate has led some to the view that this could be the housing crisis all over again. I think this view is misplaced as the total value of subprime auto lending balances outstanding amount to $179 billion (data according to Transunion) or 16% of all auto loans outstanding. This pales in comparison to the $1.3 trillion level subprime mortgages got to in 2007.

However it's worth noting that the latest data out from the Federal Reserve last week showed that credit card debt just eclipsed $1 trillion dollars at the end of February and stands at its highest level since January 2009. Total consumer debt (including mortgages) is now within 1% of the all-time high it reached back in Q3 2008, but mortgage debt is not the epicenter of the burgeoning debt problem today that it was during the housing crisis (outstanding mortgage debt today is roughly

$1 trillion less than at the peak of the housing market).

Today we have the three-headed monster of student loan debt ($1.4 trillion), auto debt ($1.1 trillion), and credit card debt all exceeding $1 trillion. According to a report from UBS they estimate that when you add up all the subprime segments between mortgage loans ($567 billion), auto loans ($179 billion), student loans ($370 billion), credit cards ($113 billion), and personal loans ($17 billion) you get to $1.25 trillion which puts it on par with what subprime mortgage debt reached back in 2007. So yes, this could be a difficult obstacle for markets and the economy to digest if distress continues in this space, but to extrapolate the Global Financial Crisis part deux is still a bit of a stretch at this point.

Figure 7: Subprime balances (% of total outstanding by product)



Source: UBS, TransUnion

Here we are with a U.S. economy that is losing traction as the Atlanta Fed is confirming in real-time with what seems like a weekly downgrading of its Q1 GDP estimate – last week bringing it all the way down to +0.6% growth from an initial estimate north of +3.0% back in January. Furthermore, the narrative that there is nothing to worry about, as this is just a typical seasonal soft-patch that has mired Q1 GDP results for the last several years loses more and more validity with each successive data point as the hand-off from Q1 to Q2 in terms of economic momentum just isn’t there. We’re coming off a nonfarm payroll report that was sub-100k for just the fourth time in the past four years, aggregate hours worked is stagnating, real consumer spending has declined for two consecutive months, the ‘hopium’ legislative agenda of tax cuts and infrastructure spending continues to be pushed further out on the calendar, and the Federal Reserve is not only sticking to its rate hike plans but continues to play up the notion that they want to start reducing the size of its balance sheet as early as the end of this year.

In addition to household debt being at all-time highs we learned from HomeServe in their latest survey results that American households are so stretched that nearly 20% have no money reserved to cover emergency costs.

These late cycle signals are what I believe the bond market is sniffing out and why the 10-year Treasury yield continues to hover around the 2.30 – 2.40% level with growing pressure that it makes a run at 2.0% rather than 3.0%. Perhaps the stock market is just starting to take notice that cracks are showing up in the broadening bullish chorus as it has done little more than tread water since mid-February. The S&P 500 closed at 2,355 last week and first broke the 2,350 level on February 15th – yup, almost eight weeks of chop.

In the meantime market strength has narrowed with the number of stocks hitting New 52 Week Highs on the NYSE declining to 54 as of today from 203 in February, 240 in January, and 484 in December (via BearTrapsReport). Speaking of a narrow market, its eerily reminiscent of the 1999 Tech

Bubble when you see that the combined market cap of the five largest companies in the world – Apple (AAPL), Google (GOOGL), Microsoft (MSFT), Amazon (AMZN), and Facebook (FB) – exceeds the total annual GDP of every economy in the world outside of the top four (U.S., China, Japan, and Germany).

Also, consider that the total U.S. stock market capitalization is now equivalent to 207% of GDP, easily exceeding the 181% level it reached in the 2007 peak, and now above the 202% level it reached at the peak of the Tech Bubble in 2000.

Look it's never fun being one of the few sober participants at a great party, and when it comes to the matter of one's wealth I can assure you that the long-term financial impacts of being mispositioned at the end of bull-market cycle are much worse than a 24-hour hangover. There is no magic formula that triggers and signals to all participants that a cycle is over, and this one very well might have a little life in it but there is a growing list of indicators that suggest this cycle is stretched and yet with history suggesting that there is a 90% chance we see a recession coming in the next year, very few are willing to acknowledge it's even a possibility.

This isn't to suggest that an investor should abandon their long-term plan, but I do believe it is prudent for investors to refrain from chasing this market any higher at this time. Let the speculators, day-traders, and irrational players have their fun the rest of the way as history shows they could chase this a bit higher. Hope is not an investment strategy, and it's hope on the back of an unrepeatable injection of monetary and fiscal stimulus that created a fleeting acceleration in prices over the last 12 months that gave the appearance of organic growth. This price effect from the bottoming in oil prices and an array of other commodities last February caused a dead cat bounce in global activity that will be moving into the rearview mirror over the ensuing months.

The surprising U.S. election results ushered in a whole other leg of optimism with pro-business campaign promises artificially amplifying a reflationary impulse that was already underway and added to the illusion of a real sustainable cycle. However, the legislation and implementation of this pro-business/pro-growth agenda looks more and more likely that it will come too little, too late and the tailwinds from China's credit injection and global central banks walking back on monetary tightening at this time last year are showing definitive signs of fading away.

This market has been outpacing fundamental reality for nearly two years now, and while fundamentals have not materially deteriorated over this period they have not improved, with the probability increasing that the rate of change is to the downside going forward, not the upside.

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