May 8th, 2017

Why so much cash Mr. Buffett?

Markets received the outcome they were expecting in the second round of the French elections as Emmanuel Macron won in decisive fashion over the weekend, thereby removing the tail risk of a possible exit of France from the Eurozone and the European Monetary Union should Le Pen have pulled off another surprise election upset (a la Brexit and Trump). And while this removes a bit of the pressure on EU leaders in the near-term and allows them some time to take strategic steps to improve upon an integrated Europe that has been better for some than others, it by no means affords them the luxury of resting on their laurels. The fact that Le Pen garnered 34% of the vote is unprecedented and attests to the support behind the anti-EU movement which looks to be a force that likely only grows stronger in the years to come.

Up next for France are the parliamentary elections in mid-June which will decide the extent to which Macron can fulfill his mandate, depending on how the deck chairs get rearranged among party constituencies.

The U.S. economy was on the receiving end of some welcome and overdue good news with the April payroll report coming in better than expected when it was released on Friday. Job growth got back on trend with +211k new jobs being added in April, and although the weak March jobs report was revised even lower (down to +79k from +98k) it looks to be an outlier with the labor market averaging +185k in new jobs on a monthly basis so far in 2017 – roughly matching 2016's pace and a bit slower than 2014 and 2015.

There was little not to like in this report as job growth was broad based, the household survey showed employment grew by +156k (substantiating the headline figure in the establishment survey), full-time employment surged by +480k, and the unemployment rate declined to 4.4% from 4.5% in March. This is the lowest jobless rate since May 2007 and before that you have to go back to May 2001. The broader U-6 unemployment rate rubber stamped this decline as it shrank to 8.6% from 8.9%, in what is the lowest level since November 2007.

A note of caution is warranted when thinking about these low unemployment rate readings in that these are classic late-cycle metrics. For example, the low print on the unemployment rate of 4.4% in May 2007 was the trough in the last expansion (the same goes for the 8.6% U-6 reading in November 2007) which we now know in hindsight the stock market peaked in October 2007 and the economic expansion started to turn down in December 2007. It was a similar story in the expansion leading up to the popping of the Tech Bubble where the unemployment rate troughed at 3.8% in April 2000 (a month after the stock market peaked in March 2000) and the economy entered into a recession in March of 2001.

Reminiscent of the optimist decrying, "things can't possibly get any better", to which the pessimist responds, "I think you're probably right."

I could go on in peeling back the onion on this jobs report, detailing just how constructive it truly was, but I think it would detract from the bigger picture of what I believe will be important for investors going forward. The one blemish in this report was once again the lack of momentum in wage growth. Yes, average hourly earnings did jump by +0.3% month-over-month, but with downward revisions to prior months the 12-month trend receded to +2.5% from +2.6% (the low end of the recent range and a far cry from the +3% to 4% level that Janet Yellen mentioned as being consistent with inflation being sustained around 2%).

It is worth noting that the workweek rebounded to 34.4 hours as did aggregate hours worked which increased at a healthy +0.5% month-over-month, but both of these improvements are coming off of soft (flattish) levels in February and March. So, cobbling together the last three months is perhaps a better gauge to use in determining what the trend is suggesting and this is a pace of about +1.5% at an annual rate. Build this in with productivity running at +1% (even that may be on the generous side given Q1 productivity came in at -0.6%...) and you have an economy that is expanding at a +2% real-GDP growth rate – not decelerating from what we've experienced so far this cycle, but showing little sign of accelerating to the 3% to 4% level many are hoping for.

However, while the BLS employment report isn't indicating that wage gains are accelerating other measures are signaling that wage pressures are mounting. Notably the Employment Cost Index and unit labor costs both rose at +3% annual rates in Q1. Not to mention the growing acknowledgements in the

Small Business, Manufacturing and Non-manufacturing, and Fed Beige Book survey responses that a shortage of skilled workers is becoming a real problem.

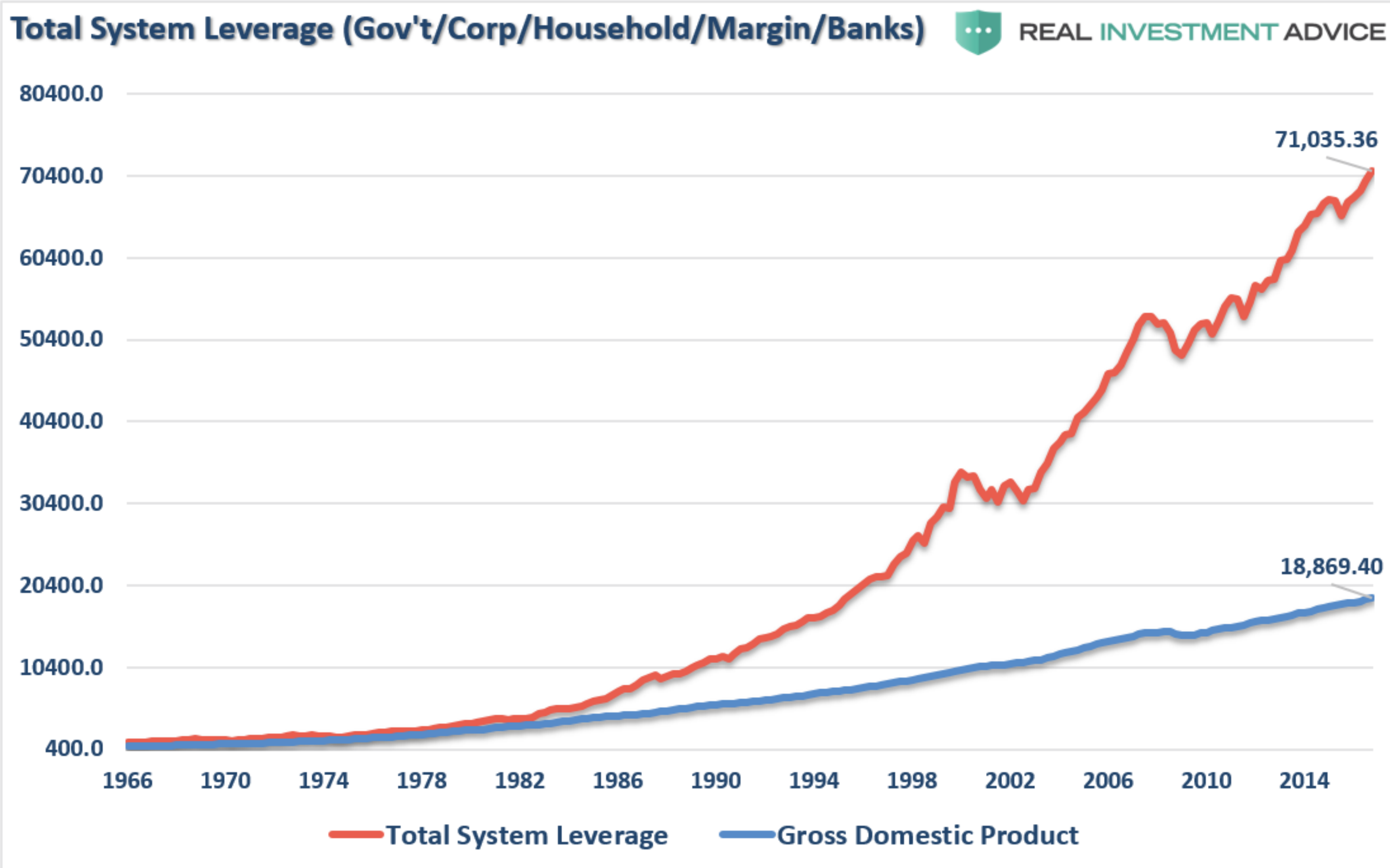
With the unemployment rate at cycle lows and businesses having a hard time finding available workers that meet the skill set they're looking to employ, this suggests that there is very little slack in the labor force. Should businesses react by starting to compete with each other for already employed workers then we could see a breakout in wage inflation which will put pressure on the Fed's current plans for a measured and gradual pace of interest rate normalization.

Following Friday's jobs report the futures market has priced in a June rate hike by the Fed as a virtual lock. This would be the third hike of 25 basis points inside of seven months, and would only be the fourth hike of this cycle which would take the Fed Funds rate up to 1%. In comparison to the last Fed tightening cycle this is akin to lobbing a pebble into the ocean where over the course of two years (June ’04 – June ’06) the Fed hiked rates 17 times by 25 basis points, raising the Fed Funds rate from 1% to 5.25%.

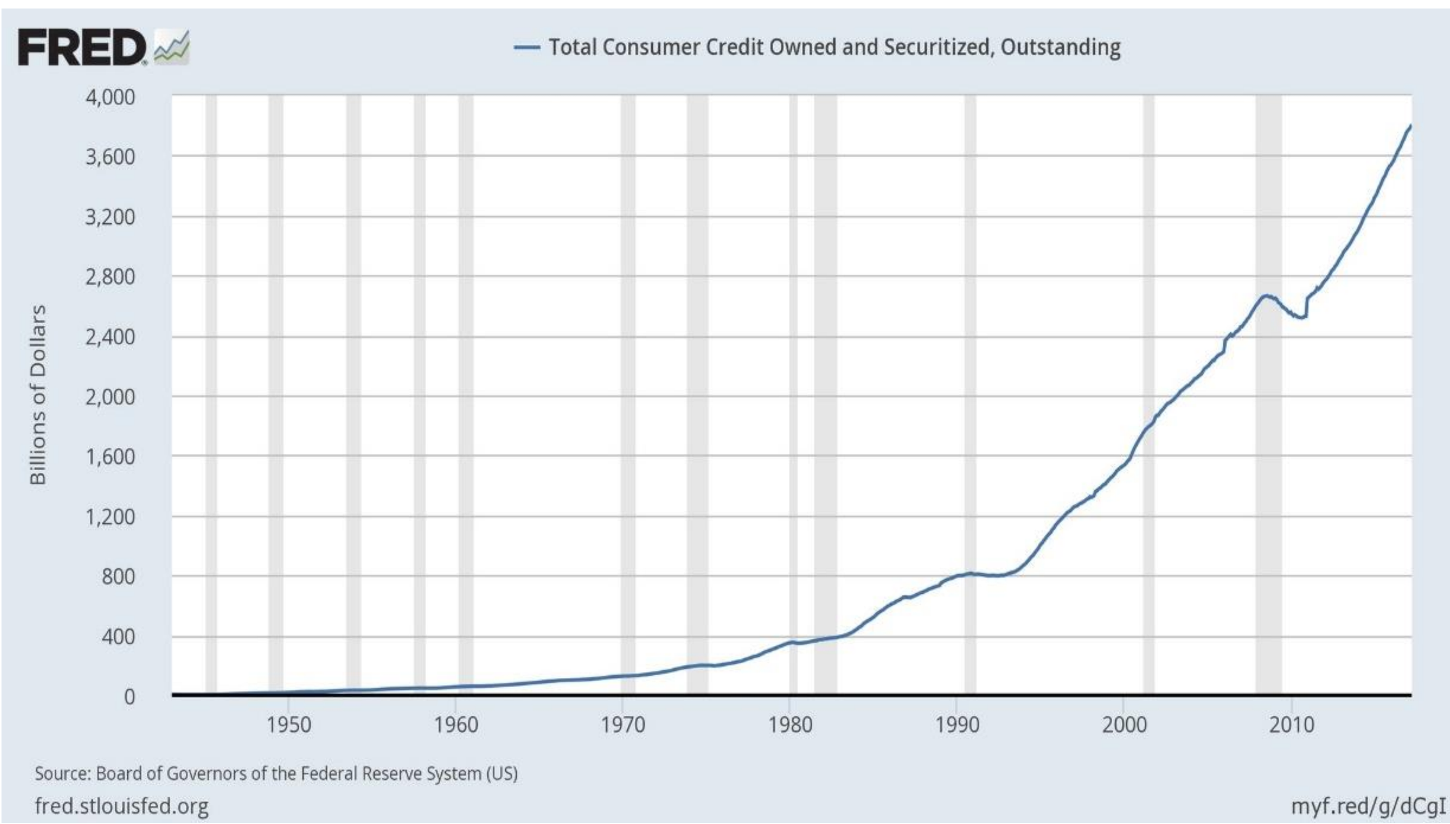
However, one has to consider where this rate hiking cycle is starting from relative to past hiking cycles. From late 2008 until December 2015 the Fed kept rates at 0% and throughout that period implemented four asset purchase programs (QE) in which they increased their balance sheet from about $900 billion to $4.5 trillion. In the last tightening cycle, the Fed started to normalize rates within 24 months of when the 2001 recession ended and was tightening into accelerating growth in both the economy and credit markets.

What is interesting and different today relative to the last cycle is:

- As with most things, it's not only the rate of change that matters, but the starting point or in this case the level from which the change is occurring that is meaningful. Whereas in the last tightening cycle the economy still had room to take on leverage and debt until it got to the point of over indulgence and then imploded upon itself, just as there is no bell that rings to tell investors markets are at rock bottom or hitting the peak, the same goes for how much leverage the financial system can handle. If it was obvious to investors in 2010 and 2011 to look back at the period from '06 – '08 and identify that the system was in a credit bubble – is anyone having similar thoughts today?

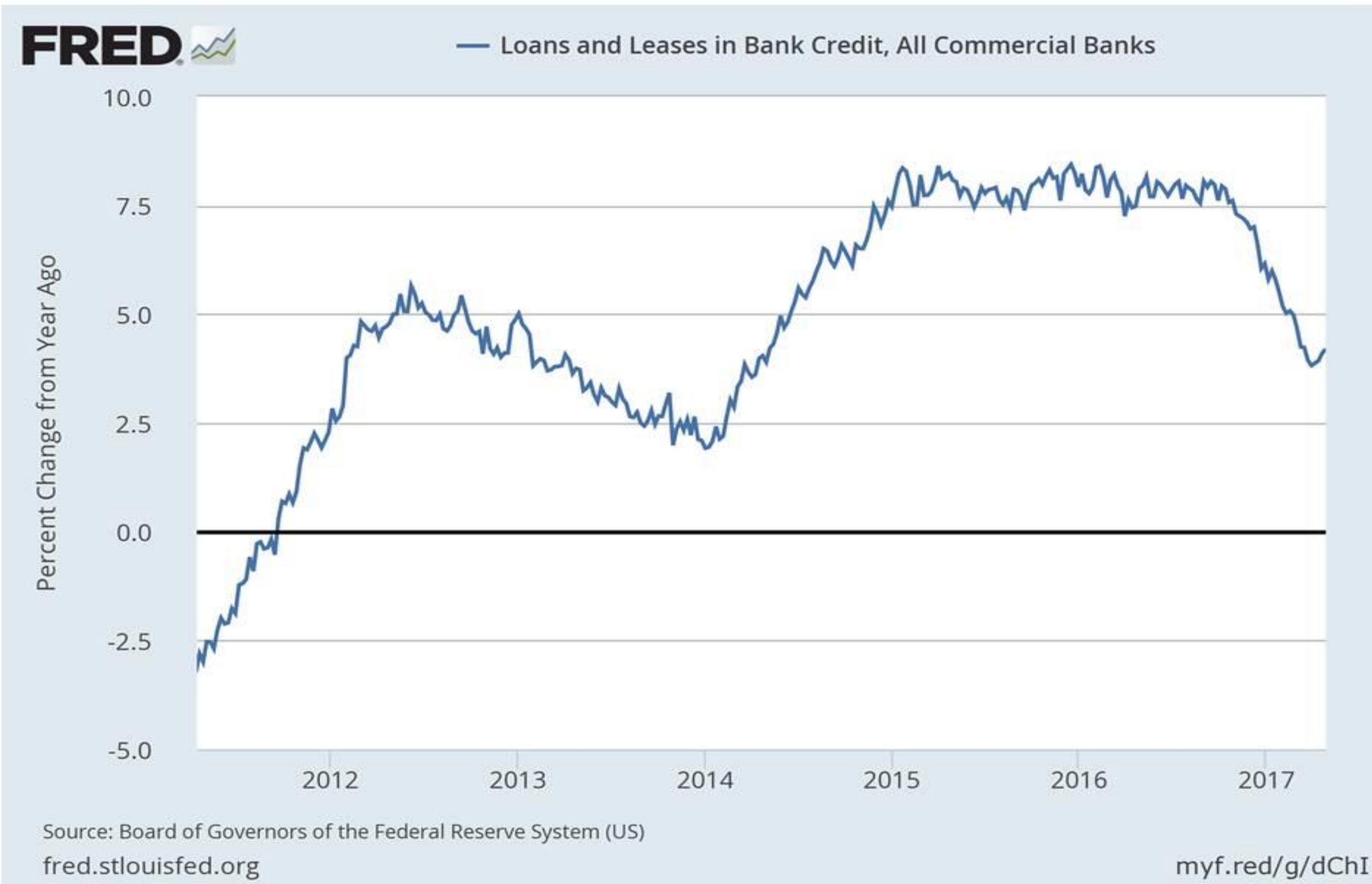


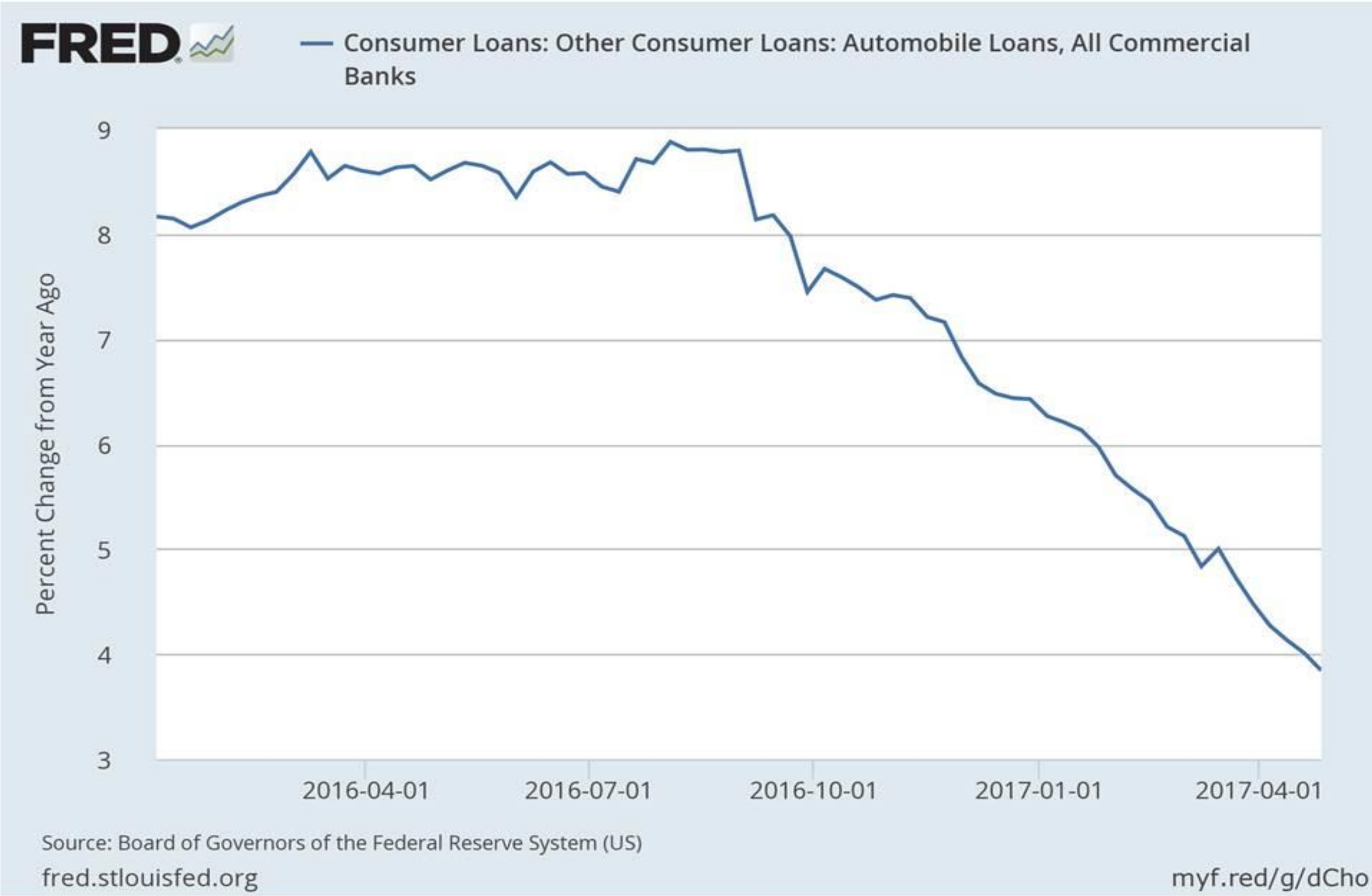
Total System Leverage (Gov't/Corp/Household/Margin/Banks)
REAL INVESTMENT ADVICE
80400.0
70400.0
60400.0
50400.0
40400.0
30400.0
20400.0
10400.0
400.0
71,035.36
18,869.40
1966
1970
1974
1978
1982
1986
1990
1994
1998
2002
2006
2010
2014
Total System Leverage
Gross Domestic Product



FRED
Total Consumer Credit Owned and Securitized, Outstanding
Billions of Dollars
4,000
3,600
3,200
2,800
2,400
2,000
1,600
1,200
800
400
0
1950
1960
1970
1980
1990
2000
2010
Source: Board of Governors of the Federal Reserve System (US)
fred.stlouisfed.org
myf.red/g/dCgI

- After just two hikes over the course of three months (December 2016 hike and March 2017 hike) credit growth (both supply and demand) has meaningfully wobbled in the last six months.





- Even though the Fed has hiked just three times so far in this tightening cycle the “shadow” federal funds rate as measured by Wu-Xia suggests that the Fed has implemented nearly 400 basis points of tightening when you account for the withdrawal of QE (if accurate, and this is only a model, but this is pushing up against the 425 basis points of tightening in the previous cycle).

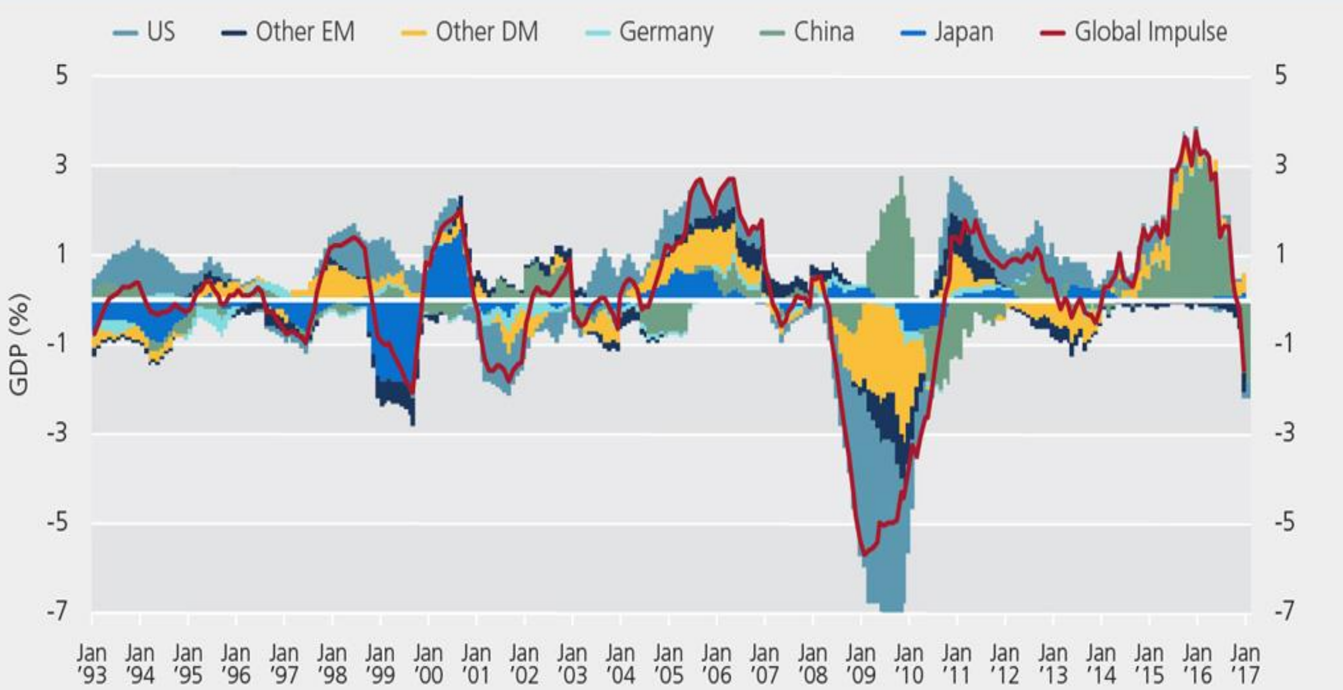
Now as much as it may make things simpler, you can't look at the Fed, capital markets, and the economy in a vacuum as financial markets are more integrated today than at any other time in history. As a result, this makes economies as interlinked as ever – even considering the potential shift afoot of the more inward looking and nationalistic preferences emanating out of recent political events. It is this integration that makes the recent price signals in markets and happenings in China important for investors to monitor, because along with the Fed the Chinese are tightening the credit spigot. So here we are at an interesting juncture where the two largest economies in the world are moving down the path of tightening policy, and in China it's not only through higher interest rates but also through the reigning in of credit excesses that went into hyperdrive over the last 18 months.

Pimco was out with an interesting piece last week titled "*A less 'Impulsive' China: Bracing for Lower Growth*", where they tabulated the extent to which credit creation out of China accounted for almost all of the credit injected into the global financial system over the last several years. To wit, they added the following commentary:

> "The relevance of the Chinese credit impulse to global reflation cannot be overstated (see Figure 2). China's massive credit stimulus starting in 2014 initially put a floor under commodity prices and emerging market (EM) growth. Then, the unexpected acceleration in Chinese real estate investment drove both commodity prices and volume demand higher. EM

growth subsequently bounced, and with it, global trade volumes. The key driver of realized global reflation, then, has been China – not the promise of fiscal stimulus and deregulation that has helped boost confidence and other soft data in the U.S."

FIGURE 2: CHINA'S CONTRIBUTION TO THE GLOBAL CREDIT IMPULSE (MARKET GDP WEIGHTED)



Source: UBS as of 31 January 2017

PIMCO

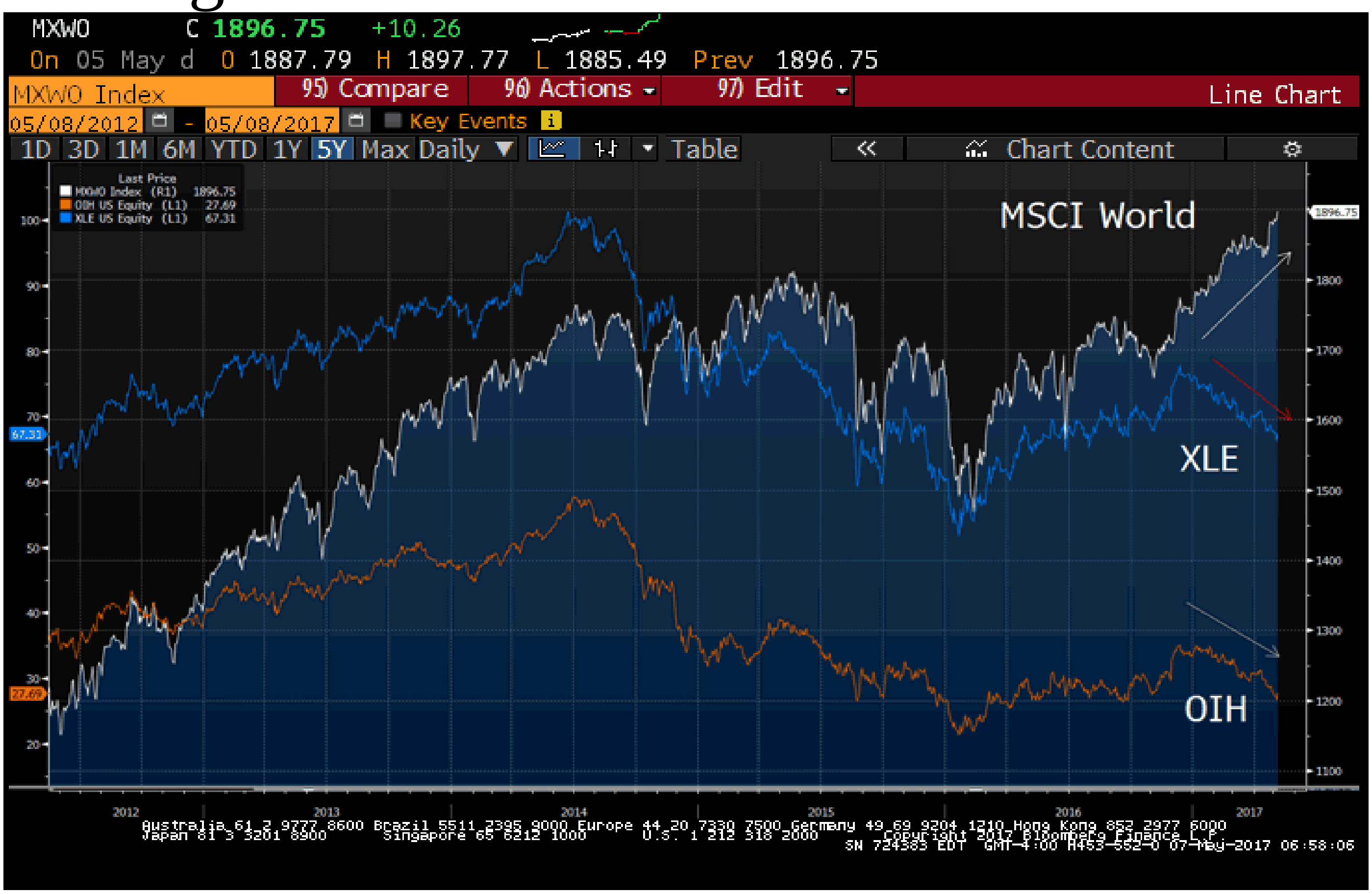
They went on to add the following: "When will China's credit drop affect growth?"

> “The sharp downturn in the Chinese credit impulse starting in 2016 portends a material drag on Chinese growth in the year ahead. Looking back on the past three years, the Chinese credit impulse turned positive sometime between late 2014 and mid-2015. Given China’s exchange rate volatility in August 2015, it took longer than normal for credit to gain traction. The Chinese credit impulse peaked in March 2016 and slowed sharply after the second quarter. It is only now that the impact of that reduced stimulus should be felt. PIMCO has already factored credit-related drag into its Chinese growth outlook, but the decline in the credit impulse has been sharper and more extreme than many expected.”

In retrospect, it is my opinion that it was the lagged impact of global monetary stimulus (and not the outcome of the U.S. election) that started to work its way through the global economy in the Spring of last year that was the driving force behind the reflation rally that caused markets to break out of what was a two-year malaise from the end of 2014 through Q4 2016. Without question, the Trump victory and Republican sweep in November further ignited what was an already developing situation with the hopes and expectations of tax cuts, infrastructure spending, and deregulation, or perhaps you may want to chalk it up to the anti-Hillary outcome. Either one works for me, but unfortunately for this administration they received too much credit for an environment that was unlikely to persist, and since they embraced it, it's likely they will shoulder more blame than they deserve should it falter.

Back to China and the message being portrayed by some of the price signals in the market. Overnight we got the latest trade data out of China where exports rose just +8.0% year-over-year (short of consensus expectations for growth of +11.3%) and a deep slide from the +16.4% increase in March. Import growth moderated to +11.9% YoY in April from +20.3% in March and well below consensus expectations for +18.0%. These numbers are consistent with the larger than expected declines in China's PMI readings (both manufacturing and the service sector) out last week where it looks as though the lagged impacts in credit growth are starting to work their way through the system.

The markets are sniffing out something with the Shanghai Index sliding by -6.5% since early April and this is taking the wind out of the sails of a lot of cyclically sensitive commodity prices, where from their February highs iron ore is off nearly -40%, nickel is down nearly -20%, and copper is lower by -12%. Also consider the $10/barrel decline in WTI from its February high of $55 (it's off about -15% from its recent high in early April), and you can concoct whatever explanation you want for the decline, be it cheating on the OPEC cut agreements, ramping U.S. production, or stubbornly high inventory levels, but the biggest concern, if confirmed, is what we are to interpret from softer global oil demand.



Outside of the commodity space there remains too many inconsistent price signals by Mr. Market to ignore in the face of record high index levels. Yes, the S&P 500 hit a new all-time high to close out the week, but when 40% of the index's year-to-date gain comes from just six large cap names, it lacks the breadth one would like to see to have confidence that these gains will be sustained. Like the S&P 500 the Nasdaq Composite continues to make new highs, but over 40% of the index is trading below their 50 day moving averages. The VIX Index (equity market Volatility Index) trading below 10 epitomizes the complacency overtaking investors at this moment and just to give you some context on this point – Merrill Lynch's derivatives research team was out with a note last week saying that stocks have been this calm on just

3% of trading days since 1928 (read: lack of price change, aka volatility).

Yet, when you see the Dow Jones Transportation index hovering around the flat-line on the year, and the Russell 2000 Small Cap index up just over 2% (two very pro-cyclical market segments) it provides some credence to those exhibiting a semblance of caution. Remember coming out of the Trump victory, one of the central investment themes was to focus on domestic oriented companies as they would be the ones to benefit the most from this administration's policies – well according to this weekend's Barron's publication that hasn't worked out so well as the 50 U.S. stocks with the highest foreign exposure are up +12.7% for the year while the 50 with the highest domestic exposure are up only +0.7%. As is typically the case in this profession it is challenging to keep up with the bouncing ball or in this case the shift in narrative from one message to the other of what is happening and why.

One final note to leave you with before signing off on this week's missive, and it's regarding Warren Buffett given he held his annual shareholder meeting this past weekend. I can't say I've ever met Mr. Buffett personally, but he has made himself very available and approachable for the public to gain insight to his thinking on a wide array of fascinating topics. His personality comes off as infectious, in a manner of speaking, the perpetual optimist – how could one spend 15 minutes with that man and not walk away feeling like the world is in perfect harmony? That being said, he is also one of the world's greatest investors and you don't procure a title like that without knowing a thing or two, while at all times exhibiting a high level of vigilance, prudence, and discipline. So with all of that eternal optimism what should one take away from the fact that his company is holding onto a cash pile exceeding $90 billion at the current time –the highest level of cash or cash equivalent holdings in the history of Berkshire Hathaway?

At a minimum, it speaks to the challenge investors face today with historically high equity market valuations and historically low interest rates.

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