
**July 24th, 2017**

**Some quick takes**…

**Economic data:** It was a quiet week on the data front, but as has been the case over the last several months the data we did get was mixed at best and continues to disappoint on an absolute basis, as well as relative to expectations:

- NY Fed Empire State Index: The region's manufacturing diffusion index was rather disappointing as it came in at 9.8 in July (consensus was expecting 15.0) versus a reading of 19.8 in June.

This was a meaningful haircut and the softness extended well beyond the headline number with new orders sliding to 13.3 from 18.1 in June, backlogs dropped to their lowest level for the year at -4.7 from 4.6 last month, shipments were cut in half to 10.5 from 22.3 (lowest reading since January), and employment continued its multi-month weakening trend coming in at 3.9 from 7.7 in June, 11.9 in May, and 13.9 in April.

Also in the report, we learned that the forward looking six-month outlook fell to 34.9 from 41.7 in June and now is at its lowest level since last November. Hiring plans fell for the fourth consecutive month to 11.8 (its lowest level since November) and capex intentions fell to 15.0 from 20.8 (this component has been nearly cut in half from its nearby peak of 27.7 in April).

- Philly Fed Manufacturing Index: Like the Empire reading, disappointed coming in at 19.5 for July versus expectations of 23.0, a decent slide relative to the 27.6 level in June. It's a little ironic that we're seeing most of the "animal spirit" soft survey indicators retracing their post-election moves with the Philly Fed the most recent example of an index now back to its lowest level since November. The internals of this report were also weak with the new orders component plunging to 2.1 in July from 25.9 in July, shipments fell to 12.2 from 28.5 in June and 39.1 in May (notice a trend there?), employment slid to 10.9 from 16.1 (this is the lowest reading on the year for this component and, you guessed it, the lowest level since last November), and backlogs as well as delivery times were both cut roughly in half over the last month to 7.2 and 7.4 respectively.

So here we are with four economic survey data points out for July and all of them showing a continued deceleration (slight exception in the NY Fed number) over the prior three months: University of Michigan Consumer Sentiment Index at 93.1 in July versus 95.1 in June and 97.1 in May, NAHB Housing Market Index at 64.0 versus 66.0 in June and 69.0 in May, NY Fed Manufacturing Index at 9.8 versus 19.8 in June and -1.0 in May, and the Philly Fed Manufacturing Index coming in at 19.5 for July versus 27.6 in June and a reading of 38.8 in May.

What is becoming clearer as we flip the calendar into the second half of the year is that the U.S. economy is losing momentum, not gaining it. For sure, signposts of an imminent recession are lacking, but the reality is that the fundamental underpinnings necessary to ignite what has been a feeble economic expansion remain elusive and will remain so for some time to come. The forces that have retarded this recovery since the GFC, which are demographics, debt, and deflation haven't been extinguished and if anything have only become more acute throughout this recovery. And, unfortunately, none of these secular forces can be solved with short-sighted policy solutions. Take demographics as an example, the eldest of the 80 million 'pig-in-a-python' boomer population turned 70 this year and 1.5 million of this population set will turn 65 each year for the next 15 years. You can't stop an aging population from aging and it's not for another six years that the math inflects positive for the 25 – 54 age cohort (the most important age cohort in terms of spending) as the millennials move into full-swing with household formation and family rearing.

The labor force is growing at a pedestrian 0.8% year over year and for the prime working age population (25 -54 years of age) the growth rate is a meager 0.5%. When you consider that economic growth is a function of labor force growth plus productivity growth (which also is running around 0.7%) you can only begin to grasp how anemic potential future GDP growth has become.

More than anything what this implies is that an economic recovery as sluggish and sanguine as the one we're in can feel very much like a recession to a whole lot of folks.

I get the ‘no need to worry about a recession at the moment’ thesis, but I also think this belief fosters complacency and laziness among market practitioners over objective and balanced analysis. Emotion and confirmation bias follow price in investing, and equity prices have been in an uninterrupted move higher for eight months which has made it convenient to easily dismiss any data point that runs counter to this trend. I can pull up all the recession models just like anyone else and see that most of them peg the odds of recession in the next twelve months at 5% - 15% and then there is the fact that the yield curve hasn’t inverted which it has done 100% of the time prior to the last seven recessions. So, there you go – we have an indicator that has 100% certainty in foreshadowing the next recession, so until that occurs no one should worry. But, for arguments sake let’s just humor the idea that perhaps this indicator may not be the canary in the coal mine that it's been in the past. After all, I've now been around long enough to understand that when everyone is focusing on the same thing then that one thing becomes less relevant to the analysis. One should consider that this recovery with all of its unconventional monetary policy stimulus is anything but normal and for anyone who has taken the time to look at Japan as a proxy you'd learn that they've been implementing various forms of monetary and fiscal stimulus for the last 25 years in which during this period their yield curve has never inverted, yet they've experienced seven recessions over that span. Not a forecast, just an observation.

Look, it's a humbling and foolhardy endeavor to try and predict when a recession will occur as history shows there is no one single indicator or signal that has a track record of doing so. But that doesn't mean investors should be lazy about assessing and evaluating the risks that one could occur given the accumulation of information from a variety of data points. For instance, just as the New York Fed's model assigns a 10% probability of a recession starting in the next twelve months, the Philly Fed one-month economic activity diffusion index fell to a reading of 58 in May – about the same level it was at in November 2000 and again in November 2007. The list of economic data points that are popping up on my worry list continue to increase whether one wants to look at the sharp deceleration in bank loan growth, contracting federal tax receipts, increasing credit card and auto loan delinquency rates, flat NIPA profits since Q4 2012 and down 15% from the peak in the summer of 2014, weak wage growth this late in an economic cycle with the unemployment rate sub 5% for thirteen straight months, weakening inflationary trends, and broadening signs of strains on the consumer.

**Central Banks:** It was only a short four weeks ago in late June when comments from various FOMC voters (Yellen, Dudley, Fischer, and Brainard) gave investors the impression that the interest rate hiking cycle and balance sheet normalization was set to continue (in regards to rate hikes) and commence (in regards to starting the unwind of the bond holdings on the Fed's balance sheet) in the second half of the year. How quickly things have changed with a couple of these officials recently walking back some of this hawkish tone. In particular it was Chair Yellen's prepared remarks during her congressional testimony that accentuated this recent twist where she said:

> "…based on our view that the federal funds rate remains somewhat below its neutral level – that is, the level of the federal funds rate that is neither expansionary nor contractionary and keeps the economy operating on an even keel. Because the neutral rate is currently quite low by historical standards, the federal funds rate would not have to rise all that much further to get to a neutral policy stance."

As far as Fed speak goes, this is about as clear as the language gets in terms of saying that the Fed is very close to being done with its rate hiking cycle, if not done already. Surely, the facts could change and they would adjust their thinking if that were the case, but the material weakening in the inflation data over the last three months looks to have them either worried or perplexed (perhaps both). The head of the ECB Mario Draghi followed a similar tone in his recent comments where he expressed optimism on the European economy, but he refrained from providing any details on the timing of any "normalization" in ECB policy.

Of the three developed market central banks (Fed, ECB, and BoJ) that have been at the center and forefront of this multi-year QE experiment, what does it say that none of them are even remotely close to their inflation targets? The markets have been quick to pick up on this recent dovish pivot with stocks pushing to new highs and bonds trading higher as yields moved lower, but are investors pushing the "bad news is good news" investment thesis too far? One would think that investors at some point will start to consider the impact on asset prices should the economy encounter another bought of soft growth or an outright recession given central banks inability to remove any of the accommodation they have supplied through low rates and QE since the GFC.  The implication is that this provides central banks with very limited ammunition to ease from either a monetary or fiscal policy standpoint.

**Fiscal Policy:** The inability for this administration to make any headway on the health care reform bill is a major blow to the overall agenda that was so celebrated following the election.  This isn't to say that it is dead, but with no repeal and replace of the ACA it makes the optimistic scenarios around tax reform virtually impossible.  It becomes more difficult by the day for any investor to consider with a high level of confidence anything meaningful on fiscal policy materializing this year.  After all, the history books show even the most effective presidents only get about half of their campaign proposals into actual legislation, so the euphoria coming out of last November was destined for disappointment.  More importantly in my opinion, is that the political noise and finger pointing is distracting people from the bigger picture and that is the constraints any and all future legislation will face in terms of the structural imbalances on the U.S. system at the current time.

The outstanding debt levels at the Federal level is the highest in history outside of war-times and this constraint only gets more challenging over the next three decades as the baby boomer population transitions into their golden years and taps the entitlements that the government promised them will be there at this stage of their lives.  This asset / liability mismatch isn't unique to just the Federal government as recent estimates indicate that state and local pensions are carrying an unfunded pension liability of nearly $4 trillion.

All this implies is that the path to progress and improvement is going to be a challenging one and will require intelligent, long-term thinkers to assess not only the near-term impacts of any policy action, but more importantly the long-term ramifications as well. You see, prior leadership classes have just about used up all the can kicking strategies the largest economy in the world can afford – so from this point going forward the successes and failures of future policy decisions will have significant implications.

**Corporate earnings**: Second quarter earnings season looks to be off to a good start with 97 S&P 500 companies already reporting with 74% beating on the bottom line and 72%

reporting better than expected revenue numbers according to data from Thomson Reuters.  After this week, we will have a much more conclusive view of what is going on with nearly 200 S&P 500 companies slated to report results, including a number of heavyweights – Boeing, Chevron, Exxon, Alphabet, Facebook, Amazon, Ford, GM, McDonald's…

Of the companies that reported in the past week what stood out to me was the so-so results out of the large money center banks. Everyone was all excited following the stress test results a couple weeks ago where dividend hikes and increased stock buybacks were all the rage, but it was some deep-thinking analysts in the financial space that grabbed my attention by highlighting that banks that intend to payout 100% of their earnings through stock buybacks or dividends aren't retaining much capital on hand to increase lending (a pretty important function for a bank in an economy that needs growth). Also, the results out of Capital One and Synchrony Financial (the largest store credit card issuer in the U.S.) validated the stress we're seeing in the consumer segments of the economic data. Capital One's charge off rate increased for the third consecutive quarter to stand at 5.11% and this is notably above the 3.7% level it was at in Q3 2016. What's more is that they provided zero guidance for expectations of anticipated defaults for the coming year. Let's see, a company whose major function is to underwrite consumer debt doesn't know what to expect over the next twelve months? Or perhaps investors should just read between the lines and follow the trend in the almost doubling of credit loss provisions in the last year.

It was a similar story for Synchrony Financial where the charge off rate increased to 5.42% in Q2 (up from 4.51% this time last year) and loan loss provisions spiked 30%. Then there was American Express who reported solid results on the top and bottom line, but it too increased its loan loss provisions by 26% YoY. Just so everyone is clear, these levels of provisioning are not extreme by any stretch of the imagination, but it's what they signal and the acceleration in the trend that warrants consideration. This is the type of activity you see on a micro level when you get into the late stages of an expansion and credit quality starts to erode.

Lastly, it's hard to say what anyone should make of General Electric as it has disappointed investors for years and perhaps that is more telling of it as a company than what it may suggest for the overall economy.

From a big picture perspective, you'd be hard pressed to find a company in the U.S. that touches more pieces of the whole economy than GE, so when it reports a 45% YoY decline in earnings on a 12% plunge in revenues it is hard to ignore.

As for other markets, the 10-year T-note refuses to confirm the optimism espoused from the S&P 500 being at new all-time highs as it sits at 2.25% and the charts suggest the next move is likely that yields go lower. European equities which have been the darling of Wall St. over the last three months (and a market I favored over U.S. equities since the start of the year) look to be rolling over with the German DAX having declined some 700 points (nearly -6%) from just a month ago and the French CAC has given back 100% of the post-Macron victory as it's off more than -5% in the last six weeks. Not helping matters for the Eurozone is the recent rollover of the economic data for a region that has been leading the charge in the 'global growth is broadening' investment view.  The fact that the Euro has rallied and is up nearly 11% year-to-date isn't helping matters for a region that is highly dependent on export activity to drive profits for its industrial complex as well is the overall economy.

One last item to note before signing off on this week's missive is that the price action in last week's stock market moves was very much inconsistent with the expectation one would have for a stock market making new all-time highs.  Utilities were the sector leaders gaining +2.6% on the week with Tech and Healthcare next in line, and these latter two make sense in an environment where growth is hard to come by.  Also, cyclically sensitive sectors like the Industrials (-1%) and

Financials (-0.8%) were laggards last week while safe havens like Gold rallied +2.1% and the 10s/2s curve flattened by 8 basis points. At this point you can chalk it up to nothing more than the reoccurring rotation that has kept the major indices pinned near their highs so far this year, but it is a distinction within market internals that's worth monitoring to see if a more meaningful change in leadership is afoot.

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