September 11th, 2017

Who said money can't buy happiness…

Global equity markets are moving higher as we start off the week as the worst-case scenarios for the impacts from Hurricane Irma look to have been avoided (estimated damages have been lowered to $50 billion from worst-case forecasts of $150 billion) and a rather quiet weekend on the North Korean front as the widely expected missile test this weekend never materialized. If it seems illogical to you that markets are rallying on these events not really playing out in the dramatic fashion they were built up to possibly be, given that markets never really sold off in advance, you're not alone because it is illogical – but this is the environment we're in.

Also adding to the overall constructive equity market backdrop was the supportive tone out of the ECB and various Fed speakers last week with both contingents making it clear that they are in no rush to remove the punchbowl of liquidity that has been the fuel for asset prices throughout this bull market cycle. After all, according to the latest accounting from BofA's Michael Hartnett global central banks have purchased $1.96 trillion in financial assets so far in 2017 alone, and this brings the cumulative tally in the size of central bank balance sheets in this post-GFC era to $15.6 trillion (an increase of almost $11.3 trillion in roughly an eight-year window).

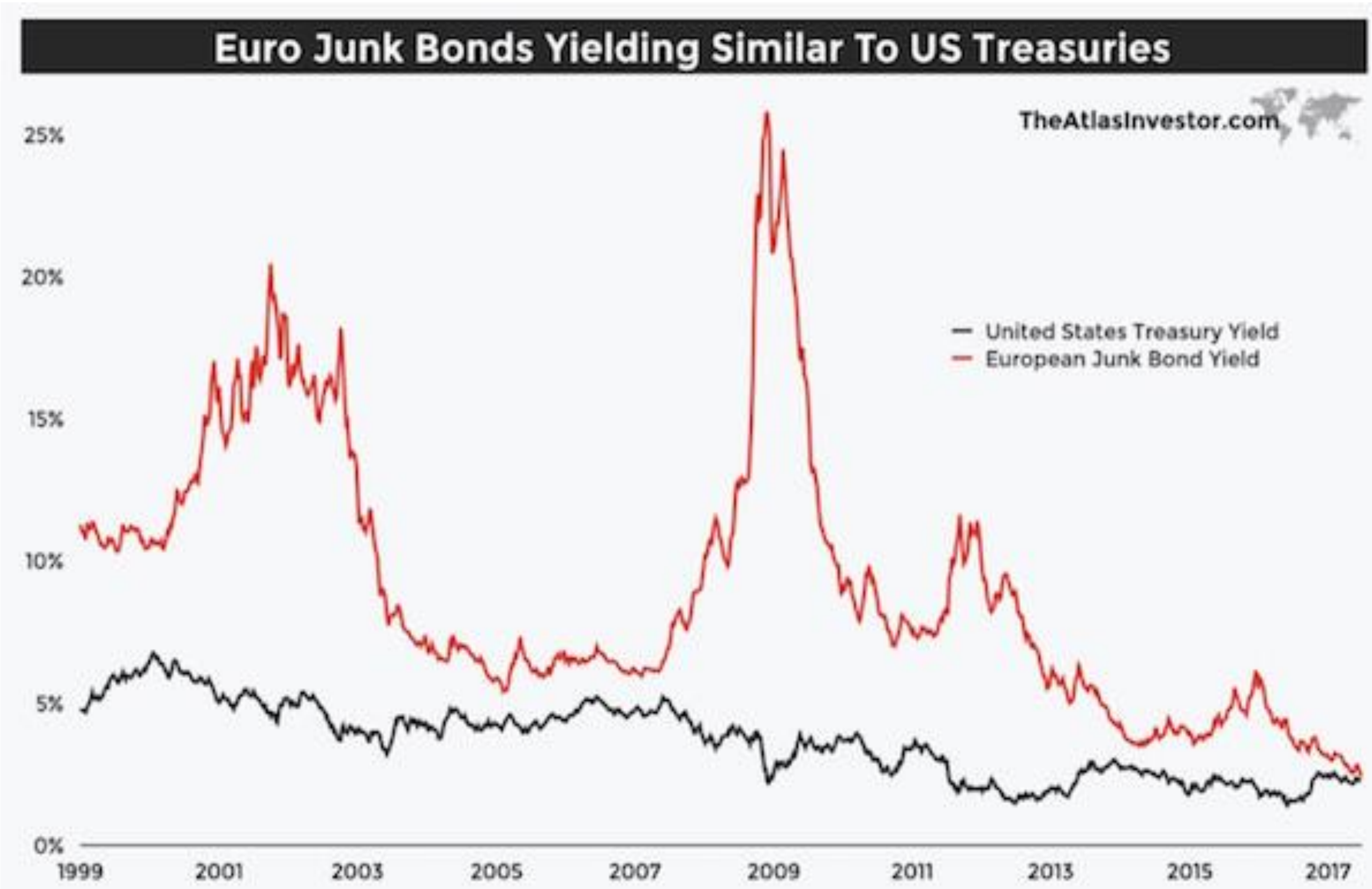
What is perhaps most fascinating is that the confidence in these policies by the heads of these major central banks is growing and they are unwilling to even entertain the possibility that there could (will be) unintended consequences of these actions in the future. Below is an excerpt from ECB President Mario Draghi at his press conference last week:

> "Question: Do you have any information on negative side-effects of the quantitative easing program yet that you can tell us?"
>
> "Draghi: The negative side effects of the quantitative easing program I don't have. It's not that I don't have any information, we don't see negative effects of this program."

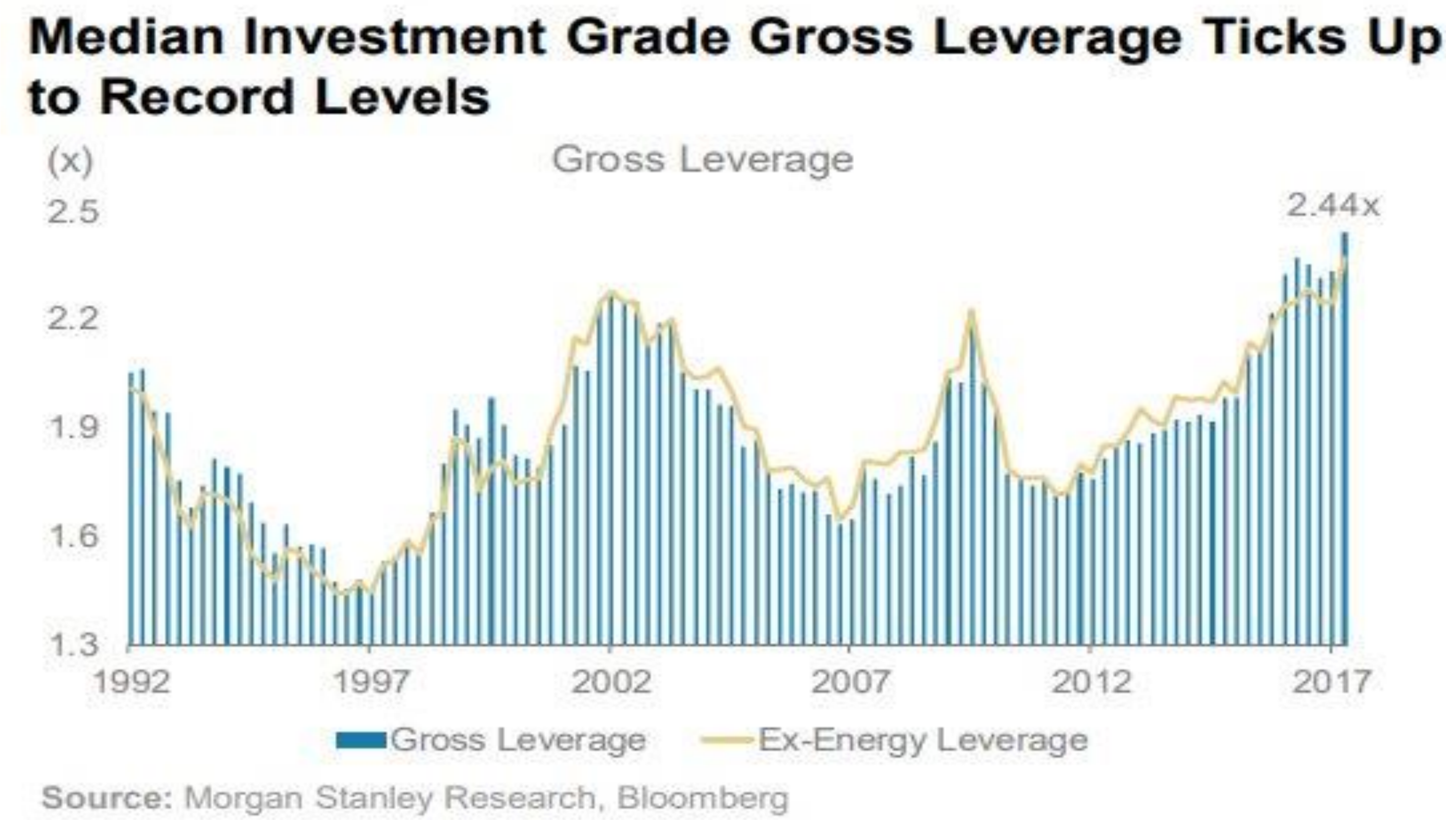
Well, the only logical follow up to this level of cavalier thinking is if these polices are so exceptional then why have we only begun to employ them over the last eight years? Why haven't we been printing money and pushing up asset prices over the last seven decades? If we had, then we could have avoided the 10 recessions the U.S. has experienced in the post-WWII era.

Only time and hindsight will afford investors and historians the proper context to evaluate the long-term impacts of the monetary policies being employed today, but I have a couple of examples of distortions that are percolating in capital markets of late. How they should be classified, "negative effects" or "distortions", is a moot point in my mind, but they should cause any investor objectively evaluating capital markets to stop and think.

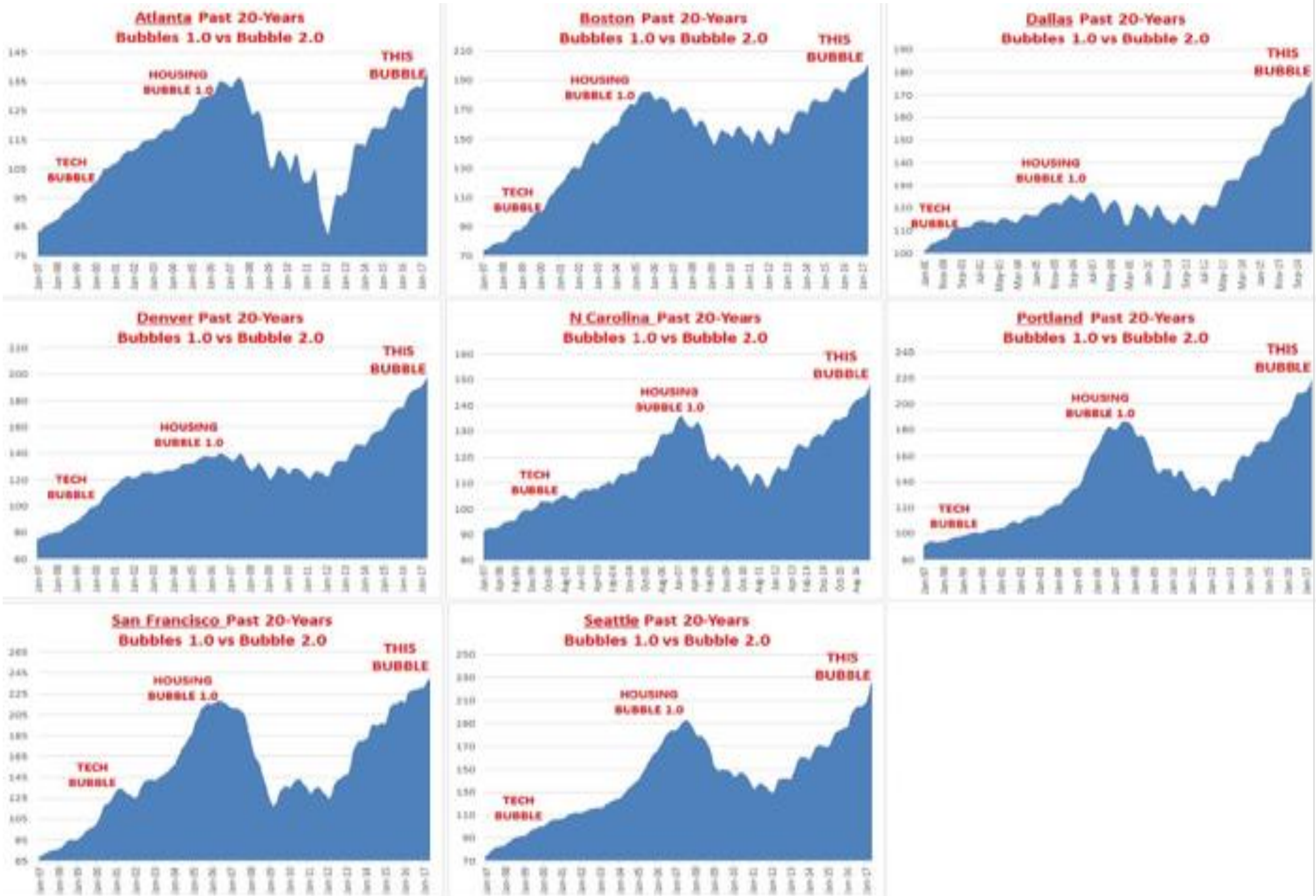
European junk bonds are paying the same level of interest rates to investors today as U.S. Treasury bonds with a comparable maturity.



But it's not just Europe as the entire globe has been chasing yield in this low rate environment where just last week we learned that high-grade U.S. corporate debt issuance topped $1 trillion for the year, marking the strongest annual performance on record. The average yield on this haul of new issuance? 3.05% – hard to believe that a 3% yield appropriately compensates an investor for default risk, but this is where we are today. The reach for yield is working its way down the credit rating channel as total high yield debt offerings are 12% above the level they were at in 2016, which I may add was a record year for junk bond issuance. It's the same story in Emerging Market High Yield where these bonds now trade at levels that hardly seem commensurate with the inherent risks (albeit even with an improved economic environment behind them). The below chart provides all the context one would need to see just what this implies for overall corporate credit quality, as in it's not very high with investment grade debt levels at their highest levels in the last two and a half decades.



It's interesting that in 2011 it was obvious in hindsight to look back to the lead up to the Housing Bubble in '05 -'07 and conclude that home prices were in a bubble. But here we are not even ten years later with national home prices back at all-time highs as many regions experience price levels above those prior peaks, yet the consensus opinion is that it's normal this time with median income among households little changed from a decade ago.



Then you have U.S. equity market valuations that are in rarified air relative to their historical averages.

S&P 500 index and median stock trades at high valuation on all metrics except free cash flow yield

Metric (Aggregate index)	Aggregate Index Current	Aggregate Index Long-term average	Aggregate Index Historical %ile	Median Stock Current	Median Stock Long-term average	Median Stock Historical %ile
EV / Sales	2.2 x	1.3 x	**94 %**	2.7 x	1.4 x	98 %
Forward P/E	17.5 x	12.8 x	**87**	17.7 x	13.1 x	94
Cash flow yield (CFO)	7.4 %	9.4 %	**87**	7.2 %	9.0 %	96
Cyclically adjusted P/E (CAPE)	25.4 x	18.7 x	**87**	NA	NA	NA
P/E to growth (PEG)	1.4 x	1.1 x	**87**	1.8 x	1.2 x	100
EV / EBITDA	11.2 x	8.2 x	**86**	11.7 x	8.1 x	98
Price / Book	3.1 x	2.5 x	**83**	3.3 x	2.2 x	98
Adjusted free cash flow yield (AFCF)	6.6 %	7.6 %	**79**	5.9 %	7.1 %	82
Free cash flow yield (FCF)	4.2 %	4.0 %	**52**	4.3 %	4.1 %	47
Median			**87 %**			**97 %**

This is the asset price environment that has been created in the wake of a massive wave of money printing that has only further exacerbated the inequality divide among the public and put investors into an unwinnable quandary in terms of expected future returns from current price levels. Never in history have global interest rates been lower or have home prices been higher, and rarely have median U.S. equity market valuation levels ever been higher – a 'pick your poison' type of investment environment that affords so few prudent options.

For the here and now these divergences from historical norms are having little bearing on the momentum pushing prices to ever higher levels and this in part is a result of a stable global economic backdrop. Overseas economic data over the last couple months has continued to be strong, in particular out of China, but Europe has been able to maintain its high levels of growth data as has been the case with Japan. This has been the story for the last twelve months, and so far this year, while U.S. economic data has been rather somber, it has been more than offset by the strength from abroad. Illustrating the lack of verve in the U.S. economy at the moment was the 1.4% plunge in the ECRI leading economic index last week (largest setback since October 9th 2015) which was the third straight weekly decline and the fourth in the past five weeks. The smoothed index slipped from 2.0% to 0.9% (its fifth straight weekly decline) and is now back to the levels it was at in March of last year.

This is just another example in a growing list of data points indicating that the U.S. economy is losing momentum and still the Fed is adamant about starting to taper its balance sheet in Q4. We'll know more after next week's Fed meeting, but the decline in bond yields and the weakness in the U.S. dollar are telling a very different story in terms of the direction and pace of economic activity in the months ahead than what the equity market is suggesting. Seeing as these divergences between price signals have come and gone with little long-term impact on the equity market as it is within a whisker of all-time highs at the moment is likely reinforcing to investors to ignore this as noise once again – I wouldn't be so sure at this juncture with what is looking more and more like a tired and very mature bull market cycle. The fact that coming into today just 56% of stocks in the S&P 500 are trading above their 200-day moving averages indicates that the major averages are masking a greater degree of weakness taking shape within the overall equity market.

The U.S. inflation data due to be released this week (PPI on Wednesday, CPI on Thursday, and then retail sales and industrial production on Friday) will be key in regards to the Fed as they have been more vocal about the conundrum they are witnessing with low unemployment readings yet very little signs of inflation in their measurement gauges. This is really throwing a wrench into their aspirations to tighten policy in this window of calm capital markets and stable economic numbers.

Consider that here we are a full eight years into this economic recovery with global central bank balance sheets continuing to expand at a pace of $200 billion per month (never mind that they continue to proclaim that all is well), interest rates remaining near all-time lows, equity markets at all-time highs, and the unemployment rate at 17-year lows – yet every government measure of U.S. inflation is in decline at the current time. This low inflation environment is one of the main reasons that central banks have been able to carry out these unprecedented levels of monetary policy support for as long as they have given there has been little recourse (outside of asset prices) through the typical conduit of higher inflation readings that economic theory would have suggested would be an eventual consequence when they started implementing these policies. The article on page B1 of today's NYT, "As Amazon Pushes Forward with Robots, Workers Find New Roles" perhaps epitomizes the disinflationary environment we are seeing today where for every new human they add to their staff the company is adding almost a full robot – don't tell me this isn't having an impact on wages. The article goes on to say that the company now employs more than 100k robots, each with two arms and a few fingers where the robots are increasingly mastering a wide array of specialized tasks – with one Amazon official saying in the article, "the robot will work the same all day long…their stomachs don't rumble".

Couple this technological revolution with the expanding excessive debt burden and ageing demographics and it's not difficult to surmise why we are likely trapped in a structurally low inflation and interest rate environment for the foreseeable future. The main risk to this view would be a pivot by the rest of the world away from funding our massive over-indebtedness by backing away from buying our Treasury debt, which would force rates higher until they reached a level where interested investors became enticed to step in.

One of the main themes I'm focused on as we head into the back half of this year and early next year is the growing signs of strain among the 70% of the U.S. economy we call the consumer. For sure, I'm talking about the broad 'thirty thousand foot' view, but this view is encapsulated by a myriad of small data points such as some company specific news at the end of last week where Disney and Comcast warned about weakening trends they are seeing in their businesses. Nothing catastrophic, but we're talking about two of the big boys in the media and broadcast space that have spent many decades becoming the titans of this industry – when signs of strain and deterioration start impacting industry leaders, it's something to pay attention too. This cuts both ways with these guys as well, given they are premier franchises for long-term investors if valuations get beat up too much that a prudent investor can't pass scooping them up.

There was also Kroger's stock getting hit by 7.5% last week on an earnings miss, the restaurant chain Dave and Busters lowered its growth forecast after Q2 earnings fell short and its stock got hammered by 12%, and finally we had Target announce it was cutting prices on “thousands” of items in what one can only assume is due to stiff competition in the retail space (its stock traded lower by 2% and the domino effect took Walmart down by 1.5%).

This may seem like subtle one-off events, but they are very consistent with the weak wage growth numbers we saw in the employment report two weeks ago. Sure the U.S. economy added 156k jobs in August which was a bit below expectations, but when doing a full autopsy on the report it was one of the weakest on the year. Once again, the birth-death model accounted for 69k of the 156k jobs added (take that out and we’re looking at a job gain for August of 87k), but the real disappointment was the workweek being cut to a three-month low (34.4 hours from 34.5) and average hourly earnings eking out a gain of 0.1% MoM (2.5% on a YoY basis – the fifth straight month at this level). Why the decline in the workweek and the modest wage gains are so important is because when combined they are a monthly proxy for work-based income, which declined 0.2% in August (the second decline in the past four months).

The YoY trend in average weekly earnings held in at 2.8% for the third straight month, and if it weren't for the low inflationary environment we are in today this modest level of wage growth would translate into negative readings in real terms. I tell you what – if it weren't for the low levels of inflation at present then it's likely we would have a preponderance of economic data prints suggesting we are already in a recession. This weakness in wage growth is consistent with what we've been seeing in the savings rate falling to 3.5% at last look and if not for the consumer dipping into their piggybank over the last year to fund their consumption, then we are talking about an economic growth level of around 1% – 1.5%, less than half the upwardly revised 3% reading we saw in Q2.

Add to this the recent trends in virtually all aspects of consumer and housing related credit which have softened in tandem with the decline in the 13-week pace of lending in banking sector credit to a mere 1.7% annualized rate over the past 4 weeks (down below a 4% annual rate for 2017 as of August 23rd) and we have a profile of 2/3rds of the U.S. economy that is running on fumes.

All of this adds up to a complicated mess, but let me try and simplify it as best I can. We have asset prices and valuations stretched to historical extremes – pricing in the mother of all "Goldilocks" environments. U.S economic growth is stable around this +/- 2% level (global growth around 3.5% – 4.0%) which is strong enough to keep the economic growth train rolling down the tracks, but it's not too strong to take much of the excess capacity out of the system and therefore create higher inflation readings. As a result the Fed and other central banks have been able to just continue on singing the same tune they've been singing for the last several years while taking little to no action to alter the course of the unprecedented monetary policies they've been implementing since the GFC.

This has bred an investment mentality of unflappable complacency where any signs of potential sustained economic weakness elicits a conditional response by investors to expect that central banks will walk back any efforts they've made at readying the markets for potential tightening. As a result, we continue to trend in this state of utopia of low rates (high bond prices) begetting high stock prices. It's not until this nirvana investment state gets disturbed that asset prices will react in a meaningful way. What might some of these winds of change be, you ask? It seems counterintuitive, but stronger economic growth would be one catalyst. More robust economic growth would force the Fed's hand as they would have to react by tightening policy much faster than asset markets are expecting. As for Europe, actual or signs of a sustained move higher in inflation would force ECB President Draghi to quicken his pace in removing accommodation.

Yeah, it sounds like opposite world, but we've been in this perpetual investment state of "bad news is good news" for almost ten years now. It keeps the monetary liquidity spigot flowing where the actual reality of "good news" would cause the biggest adjustment to asset prices, in my opinion. While I would expect this to bring about an adjustment to widespread overvaluation across many asset classes, I would consider it to be a healthy long-term adjustment that would build up some ammunition and wiggle room going into the next economic downturn.

The other scenario, and one I'd rather not see is that the business cycle just rolls over on its own as high asset prices, low interest rates, high debt levels, and ageing demographics become too large of headwinds that they overwhelm organic demand without any catalyst. In this case central banks have very little resources left in the toolkit that will foster much credibility from investors (sure they can and will revert back to more QE, but 'been there done that') and fiscal policy (while an option) will only exacerbate the debt situation at a time when entitlement expenses will be approaching a crescendo.

This aptly defines the meaning of the phrase "pushing on a string" or even Newton's Third Law of motion, "for every action there is an equal and opposite reaction." Central banks have succeeded in elevating asset prices to levels few thought was possible, and are now attempting to convince everyone that unwinding these policies (if they can) will have a minimal impact. If it sounds like it defies the laws of motion or gravity – you're right, it does and it is prudent to be aware of the potential risk this presents.

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