September 25th, 2017

Adjusting to late-cycle investment characteristics…

There are plenty of things going on around the world, but if one was only to look at the equity market you'd hardly know it. The S&P 500 traded within a 12-point range last week which made it the smallest weekly range since 1972 (as an aside this type of price action was just before the stock market peaked at that time). Not an omen, as we've had plenty of cyclical market tops since then without a similar dormant trading pattern taking hold, but it does illustrate the Teflon nature of today’s stock market – ‘complacency’ is another way of looking at it.

It really is remarkable that in a week that encapsulated what historically have been market moving events:

- A Fed meeting where the FOMC made the decision to start reducing the size of its balance sheet after nine years of expanding and then maintaining the outstanding size…
- Escalating geopolitical tensions (punctuated by overtures of war) …
- Iran poking the beehive as it tested a medium range ballistic missile (not a breach of the Iran agreement, but it’s the signal it sends that is noteworthy) …
- More clarity on the cost and impact in the aftermath of several natural disasters where the tally appears to be less than

worst case expectations, but the recovery and rebuild looks to be spread out over an extended period of time…

- And what appears to be another failure by the GOP to repeal and replace the ACA which according to forecasters dampens the leeway they hoped to have in pushing through their tax reform agenda…

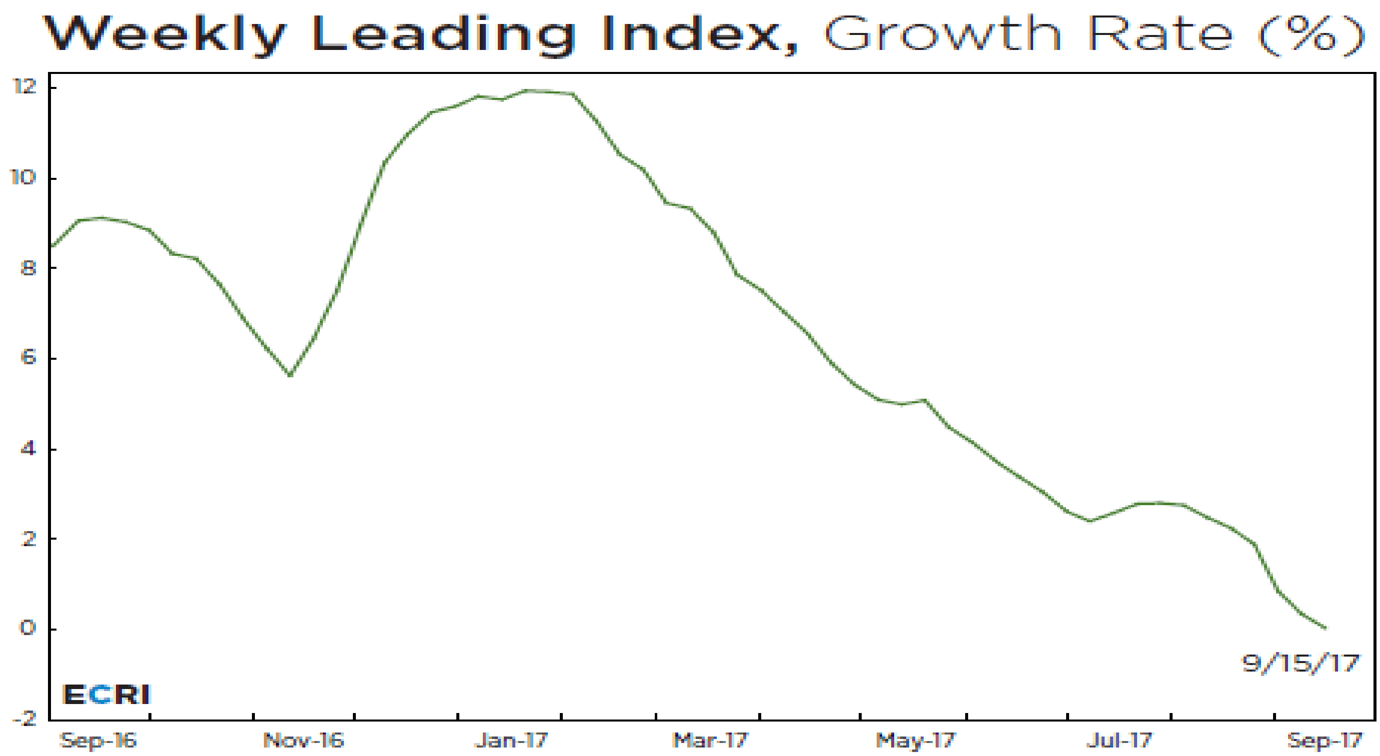
…yet markets barely budged, and this showcases just how imbedded the view that equity markets are 'risk-free' has become. I've opined plenty in prior missives on the growing imbalances and risks in the equity market, be it stretched valuations, aggressive investor positioning, broadening signs of late cycle economic indicators, and/or burgeoning debt levels across the household, corporate, and government sectors, but none of these metrics matter to the short-term momentum chasing tenor that is dictating the market action at the current time.

In my opinion, one parameter is above all others as it relates to this tug-of-war in the future direction of capital markets: investor time horizons. Those with an investment strategy and philosophy geared more towards trading and short-term price movements have been vindicated so far in 2017 to ignore any erratic spasms in the price action or softness in the incoming economic data as just noise. Fading any headline risks and buying on the dips (as shallow as they've been this year) has proved prescient even in the face of a U.S. economy that has shown signs of losing momentum, but it is also an economy that remains in expansion mode.

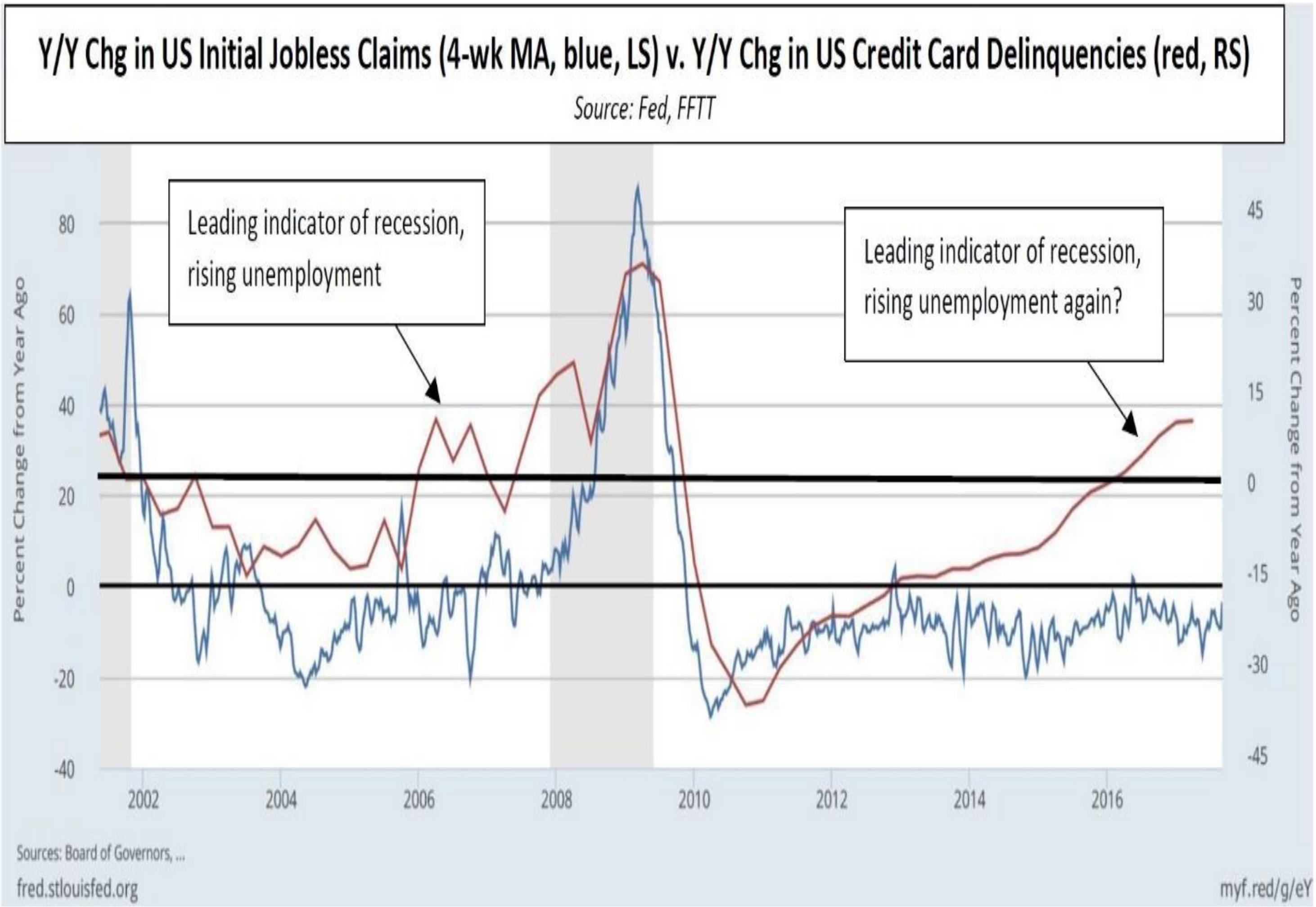
Come October this current expansion will turn 100 months old and if it were to make it to next May, it would move into second place in terms of the longest expansions in U.S. history (only behind the 120-month long expansion during the 1990's). At the moment, the indications that this expansion won't make it until then are sparse, and this is a tailwind for tactical and algorithmic trading strategies that are geared towards riding the tailwinds of strong PMI numbers and job growth continuing through then. However, just as expansions and bull markets never die of old age, there has never been one that lasted indefinitely, and I don't suspect that this one will be any different.

One metric highlighting just how acute the loss in economic momentum since the spring has become is the ECRI smoothed leading economic indicator which last week declined for the seventh week in a row. The Weekly Leading Index growth rate now stands at a 78-

week low of 0.0% and while this reading coincides with the weak data flow we've seen in August for employment, wages, retail sales, housing starts, and industrial production, it is suggesting that things are set to get even weaker before they get better.



Another item that grabbed my attention last week and has late-cycle thumb prints all over it is an increase in credit card delinquency rates (at least 30 days past due) across the spectrum of the main credit card issuers (Capital One up to 4% from 3.5% in April, Synchrony up to 4.5% from 4.3%, and Alliance Data up to 5.3% from 4.7%). For context, these levels on an absolute basis are nothing to be alarmed about, but they do represent the highest levels since early 2011 and when looking at them from a 'rate of change' stand point (the red line in the chart below measures the Year-over-Year change in these metrics), it suggests this is a trend that warrants close monitoring in the months ahead.



The fact that the Federal Reserve continues to push forward undeterred on their quest to tighten monetary policy in the face of economic data (inflation, wage, IP, and retail sales) coming in at levels that in the past ushered in the initiation of QE2, QE3, and Operation Twist perhaps signals the level of concern the Fed has for financial stability at the current time.

So, just as the macroeconomic picture is muddled with the spread between downside surprises far outpacing upside surprises over the past six months, could this be spilling over into corporate profitability as we get set for Q3 earnings season? FactSet, who is one of the major aggregators of corporate earnings data (Thomson Reuters and Standard and Poor's are two others) had this to say in their latest note regarding expectations for Q3 earnings growth (text underlined for emphasis):

> "Overall, <u>the estimated earnings growth rate for Q3 2017 of 4.2% today is below the estimated earnings growth rate of 7.5% at the start of the quarter (June 30)</u>. Ten sectors have recorded a decline in expected

earnings growth since the beginning of the quarter due to downward revisions to earnings estimates, led by the Energy and Materials sectors…

“Eight sectors are expected to report year-over-year growth in earnings, led by the Energy, Information Technology, and Real Estate sectors. On the other hand, three sectors are expected to report a year-over-year decline in earnings, led by Consumer Discretionary sector.”

“The Energy sector is projected to report the highest (year-over-year) earnings growth of all eleven sectors at 108.4%. The unusually high growth rate for the sector is mainly due to unusually low earnings in the year-ago quarter. On a dollar-level basis, the Energy sector is predicted to report earnings of $9.5

billion in Q3 2017, compared to earnings of $4.6 billion in Q3 2016. <u>If this sector were excluded, the estimated earnings growth rate for the remaining ten sectors would fall to 2.5% from 4.2%</u>."

This late stage divergence between those investors interested in catching every last wiggle of this cyclical bull market versus those investors playing the long-game creates an advantage for the latter relative to the former. Not only for the remainder of this up-move, but also in putting these investors in a strong position to weather the eventual storm and then take advantage of great long-term investment opportunities for the next up-cycle when they present themselves. As for this cycle, my best guess according to the models we track is that the probabilities remain high that this expansion is still intact into next spring. However, after that all bets are off and my doubts are growing that we make it through year end 2018 without a recession commencing.

How monetary and fiscal policy evolve over this time-horizon will play a pivotal role in the ebbs and flows, but the path forward looks a lot more challenging for the growth bulls than I believe many are anticipating. For investors with a long-term investment horizon that focuses on the contours of an entire cycle, not just the half-life that encompasses the upside of a bull market, then portfolio adjustments should be made to mold the portfolio in the direction of late cycle characteristics.

This doesn't mean one abandon's ship or goes all to cash, but more so to adjust the risk profile and cyclicality of a portfolio – an adjustment, in hindsight, that we've pivoted towards too early. What this means for equity investors is to focus on companies with a strong balance sheet, high earnings visibility, low earnings volatility, and that have little sensitivity to GDP. Companies with high levels of free cash flow should garner increased attention as it allows for a cushion to maintain dividend payments which will act as an important cushion and support for investor returns. The same quality step-up should be considered in the fixed income market with less focus on interest rate sensitivity and more focus on strong underlying credit profiles. Furthermore, there remain parts of the world that offer cheaper relative valuations, are much earlier on in terms of their cyclical expansions, and have additional monetary policy levers to pull on.

Regarding foreign markets and in particular emerging markets, it's looking increasingly likely that the shift in economic and financial power from west to east is afoot and one that promises to play out over the course of years and decades (not weeks and months). The historical archives show that the India/China Asian corridor was the power center of the world for centuries prior to the rise in Europe and then the U.S., but just as history rhymes it appears as this origin of power is on its way back. This is by no means a suggestion for the obsolescence or demise of the U.S. but rather just an objective analysis of the future potential of global geographies.

But the more important point I want to highlight is just as these regions should (over time) command a larger exposure to a portfolio's allocation, it must be understood that these regions have historically carried a higher risk profile than developed economies. Stated simply, the path to superior long-term returns in this asset class is sure to be accompanied by tense bouts of downside volatility en route to the ultimate destination. Moreover, as much as some might like to believe in the decoupling of global markets throughout time, history suggests this is not always the case and in the event that the U.S. or EU would experience an economic downturn, it is sure to impact Emerging Markets as well.

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