November 20th, 2017

Little margin for error…

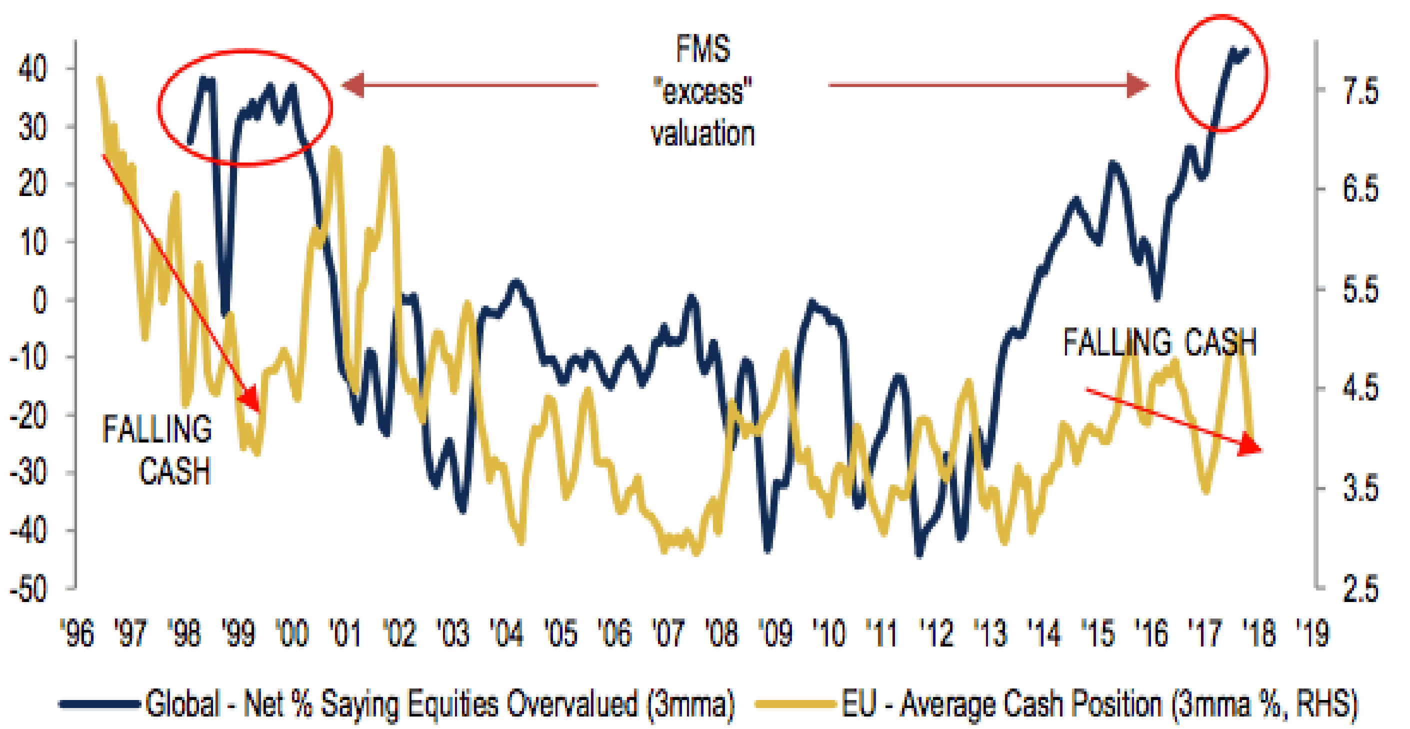
Capital markets have been fairly lifeless over the last couple of weeks with the S&P 500 notching a rare weekly decline last week, but let's get real given it's hard to consider a four-point slide as much to get alarmed about. It just goes to show how relentless the upside momentum has been in risk assets over the last twelve months, and while the price action and market internals have raised some yellow caution flags over the last couple of weeks they remain too early and docile to sound any alarm bells. Without question there is no shortage of current events deserving of investor attention that will impact (upset) the prevailing tenor of capital markets going forward.

I'm going to hit on some of these below, but what I think is the most important theme for investors to understand at the current time is just how tightly wound capital markets and the financial system are today. Understanding this theme and premise (tightly wound) is by no means predictive of the how, when, or why of future outcomes, but by acknowledging and understanding its existence, investors can calibrate how they position their capital across the risk/reward spectrum.

As the bull market in everything continues its uninterrupted ascent, it is pushing valuation levels into some historically expensive territory and as a result elevates the risk that sooner or later something has got to give where the potential unwind from such a stretched state will be painful. Consider the current state of cognitive dissonance matriculating its way through the money management industry where in the latest release of the Merrill Lynch Global Fund Manager Survey, a survey record high 48% of respondents said that equities were overvalued, yet cash levels have declined to their lowest levels since October 2013.

Exhibit 2: Record FMS "excess" valuation

Global FMS Net % Saying Equities Overvalued (3mma) and EU Average Cash Position (3mma %)



If that didn't resurrect memories of "irrational exuberance" then the fact that the "Net % of Fund Manager Survey participants taking higher than normal risk" hit its highest level in the history of this survey should surely do the trick.

Exhibit 1: Record number of FMS participants taking higher than normal risk

Source: BofA Merrill Lynch Global Fund Manager Survey

An objective, open minded thinker would look at the results from these survey responses and be completely rational in concluding that this makes no sense whatsoever – these are some of the biggest, most informed, and smartest financial minds in the industry and nearly half of them conclude that the equity market is overvalued, yet collectively they are taking more risk than at any point this century. What gives? The simple answer is that they have to take these actions otherwise they run the risk of lagging their benchmarks and that puts their careers at risk. It's the classic agent / principle dilemma that haunts many industries where the self-survival incentive supersedes the fiduciary responsibility to whom these agents are employed to serve.

This is a double-edged sword and I am in no position to condemn the actions these money managers are taking given I fully understand the position they are in: you have a market that has been on a one-way tear, given the growth of passive index strategies through ETF's it's never been easier for investors to get exposure to the major indices, and as a result if you don't keep up then you're out of a job. Add to this an unprecedented environment of monetary policy experimentation with the explicit target of elevating asset prices, which has been extended to such an extreme that it has rendered historically relevant price signals from capital markets or fundamental data unreliable.

So with 20/20 hindsight being as clear as it is, why should anyone be surprised that a $15 trillion increase in global central bank balance sheets – with much of this money finding its way into financial assets – has elevated asset prices and pushed valuations to levels that historically have never been sustained? Moreover, this goes a long way in explaining why financial industry professionals – those that are charged with the responsibility of prudently allocating other people's capital – are making what looks to be unsound investment decisions. Hat tip to Grant Williams (author of "Things that make you go hmm…) on the following chart plotting the U.S. stock market cap to GDP closing in on its all-time high reached at the height of the Dotcom Bubble – describing the current valuation backdrop in such a colorful way that only he can: "a world of pure imagination."

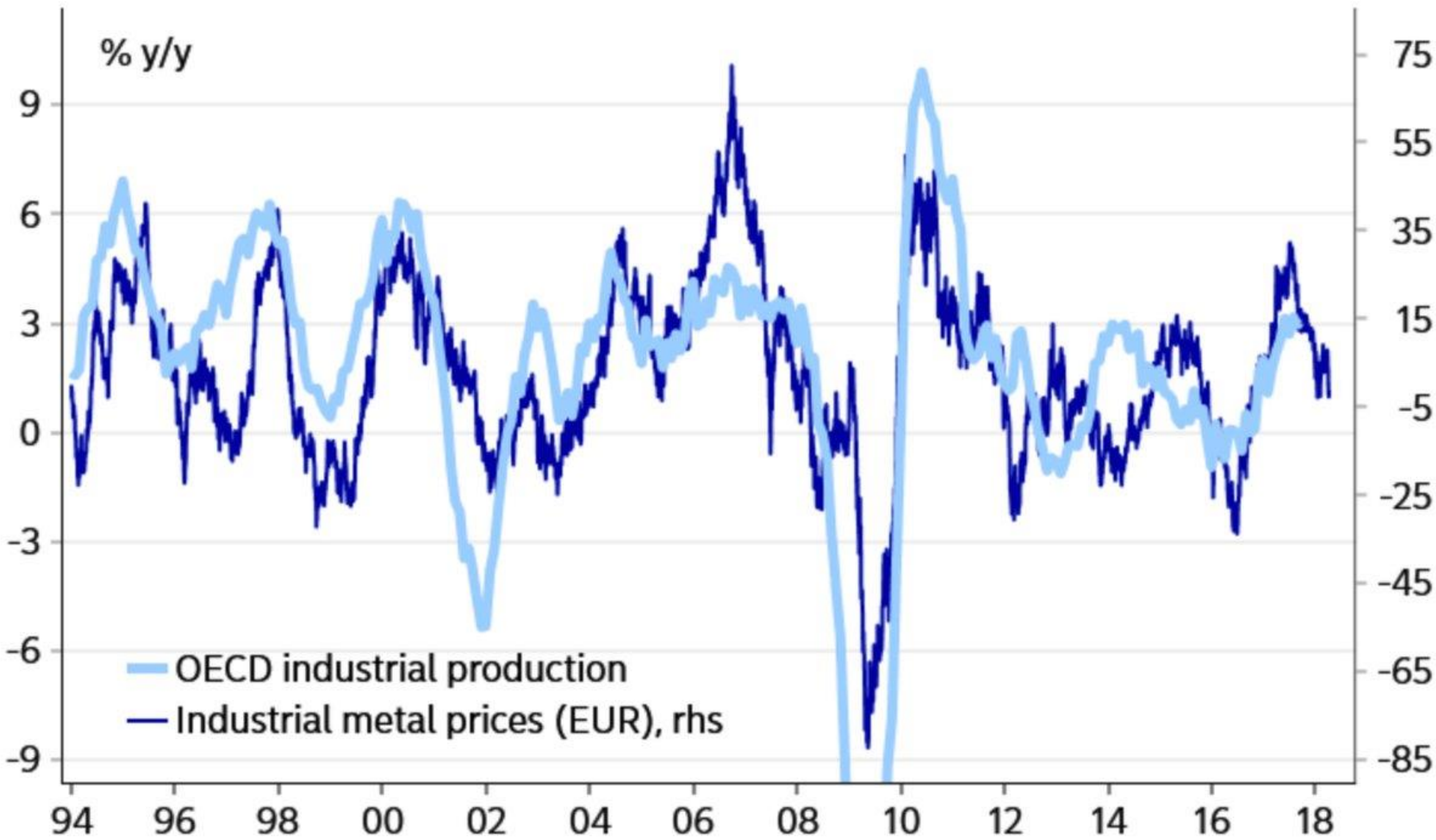
It’s this forced behavior that creates an environment where nearly $11 trillion of global debt still trades at a negative interest rate. Or how just last week a French company, Veolia, who carries a BBB credit rating (a rating one notch above junk status) can issue a 500 million 3-year Euro bond for a negative yield of -0.026% – the first time ever for a BBB rated issuer. Ladies and Gentlemen this is the definition of complacency which is punctuated by the S&P 500 experiencing the lowest 12-month period of volatility since 1965 – a year that has had no shortage of unknown outcomes and unexpected events (fiscal policy failures, natural disasters, threats of nuclear war, a pivot away from globalization from the world’s largest and most powerful economy…).

Okay Corey, so what? None of this has mattered up to this point, why should investors bother to think this is set to change going forward? In short, I don't know that it will and nor does anyone else, but in the game of musical chairs it's always important to be aware of where the closest chair is for when the music stops. So, while no one knows when the music will stop, we are able to survey the landscape to size up the opportunity set:

- Credit spreads for both investment grade and high yield debt are near their lowest levels of this business cycle. European High Yield bonds yield less than 10-year U.S. Treasury bonds. To my eyes corporate credit is the market to watch moving forward and while the weakness in U.S. high yield over the last several weeks has raised some eyebrows, it has been rather controlled and hasn't violated levels that would warrant concern.

- Global equities have been the big winners this year and for the first time in the last several years it's foreign equities that are leading U.S. equities. Broadly speaking, foreign equities trade at cheaper relative and historical valuations to U.S. equities (which as I've highlighted many times, trade near some of their highest valuation levels in history), but it's Europe and China that I think will provide the bread crumbs for equity markets going forward. The political backdrop in Europe is growing more complex with Angela Merkel unable to form a coalition government, Italian elections are set to reemerge as an unknown this coming spring, and while monetary policy remains a tailwind the ECB is reducing by half its asset purchase program in January and ECB President Mario Draghi's term is up in 2019 with expectations that a less aggressive Northern European leader will be appointed as his successor. As for China, the 19th Party Congress has wrapped up so everyone will be watching to see how serious policymakers are about reform and deleveraging the system given that according to BIS data, nonfinancial debt to GDP has surged over the last five years from 185% to nearly 260%. Already in the last month we've seen most of the Chinese economic data disappoint to the downside (mind you the absolute level of their results remain solid) and the 10-year sovereign bond yield reached 4% for the first time in three years.

It would be a mistake for investors to underestimate the significance China has played in driving the reflationary rally across the globe over the last 18 months, where it is estimated that they have injected upwards of $1 trillion in new credit into the system over this period. This is an injection that won't be repeated going forward and already I've seen several data sources indicating that internal demand and production out of China is starting to slow. If the base metal complex is to be believed (and this market price signal doesn't break down like so many others have) then it's reasonable to expect that the best of this recent global synchronized growth cycle is behind us.



Source: Nordea Markets and Macrobond

Emerging markets also bear watching and there's no question that they've had a great run this year, but as is typically the case with emerging markets it's the weakest links in the chain that crack and break first – there are some indications that cracks are percolating in Latin America, South Africa, and Turkey.

- Lastly, volatility and correlations. With the global stretch for yield in this low interest rate environment, a lot of big money pools of capital have moved into the volatility arena to capture the allure of selling volatility to collect premiums as a way to augment returns. This has become one of the most crowded investments in the capital markets at this time and while like most things there is nothing suggesting that a problem is imminent, but should a shock occur and with so much capital being allocated to volatility targeting strategies, it will create a cascading effect on all asset classes should this snowball get rolling downhill. As for correlations, the prevailing view is that the negative correlation relationship between stocks and bonds that has persisted for the last twenty years will remain constant going forward. While this very much could remain the case, it shouldn't be blindly expected as a given. There have been periods of time throughout history where the correlation between stocks and bonds has been positive where yields rose (bonds prices decline) and stocks go down (mid 70's through the early 80's).

All I'm getting at is that this is a relationship that has become entrenched in the collective mindset of investors today, so it's worthwhile to consider the impacts and alternative solutions should this relationship change.

In summary, while everything on the surface for investors today looks solid (corporate earnings continue to grow and that is a trend that looks like it will continue through year end, economic growth has picked up some steam in the 2nd half of the year thanks in part to the hurricanes, interest rates while rising are doing so in stair-step fashion, and central banks so far appear to be effectively removing accommodation without any hiccups) there are no assurances that this utopian state cannot be interrupted without warning. It's been more than a year since U.S. equities have experienced more than even a 3% correction (longest streak since 1994), so it's a reasonable assumption that a lot of weak handed speculative money has poured into investment areas that it otherwise wouldn't be in if we didn't have such a forgiving environment. So, stay alert and know what you own and why because we are in an environment where the margin of safety has rarely (if ever) been thinner.

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