December 4th, 2017

Actions have consequences…

U.S. equity markets are in a festive mood on the expectation that the passage of a tax bill is almost assured following the Senate procuring 51 votes in the wee hours of Saturday morning to pass their version of tax reform legislation. With the House having already passed their bill, the next step in the process is for the two to meet to reach a compromise on their respective versions before taking up another vote that, once passed, will move on to the President for his signature. Given the strong advance in stocks last week along with the rally to kick off this week it appears that not all of this is priced in, even in the face of an equity market that is trading at valuations last seen just prior to the peak of the 2000 Tech Bubble.

It seems as though after the weekend investors have had time to process the latest ripple in the Mueller investigation with news coming out on Friday of Michael Flynn accepting a plea agreement, but from what is known thus far this development offers little proof of wrongdoing by the White House. This isn't a personal view, but rather just a market observation that the jitters that riled algos and traders on Friday have completely subsided in what with hindsight now looks like headlines that had more bark than bite. The North Korea file is another issue that investors have become accustomed to filing away in the "doesn't matter until it does" folder even in the face of last week's missile launch that showed in terms of distance and accuracy that U.S. soil is a reachable target. Perhaps what is the most encouraging development on this file is more nations are stepping to the fore (Germany being the latest) in an attempt to diffuse the tension that has been steadily building. Unfortunately, sanctions and tightening the noose around the financial and resource capacity of North Korea are the only viable options outside of going to war.

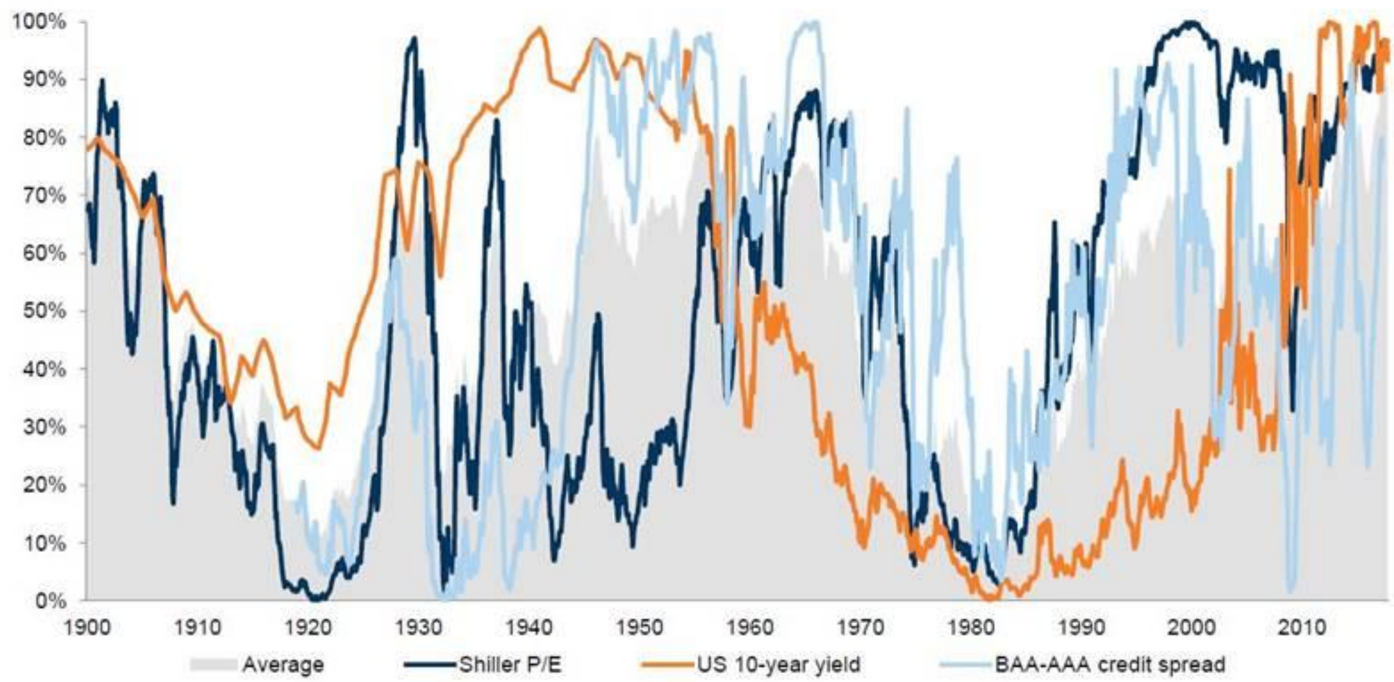
One of the other major policy hurdles that remains unsettled as we head towards year end is the deadline to raise the debt ceiling which expires on December 8th. This is another event that markets have become accustomed to fading as past experience shows it ends up proving to be nothing more than blips on the radar with the debt ceiling inevitably getting raised. Overshadowed last week by the prospects for tax cuts was the latest OPEC meeting where the cartel agreed to extend the production cut agreement for another nine months. This comes at a time when the global crude market is moving closer to being in balance, crude prices in the futures market are in backwardation, and the marginal cost in the U.S. shale industry is on the rise – all factors that are constructive for the energy sector. Not to mention that Russia signed on to the OPEC accord while Libya and Nigeria (two regions that were exempt from the initial production freeze) agreed to maintain their 2017 production levels.

In an investment environment where valuations are stretched in most asset classes and it's difficult to find long-term investments with a comfortable margin of safety, the energy sector is proving to be fertile ground to identify opportunities. Another area that continues to look constructive is Japan where signs are broadening out that the multi-year period of deflation are abating with companies announcing price increases in response to expanding domestic demand. In the emerging markets sphere, India looks to have the most constructive fundamental underpinnings for investors willing to entertain a long-term investment horizon – the biggest drawback to this region's equity market today is that valuations are near cycle highs. Lost in all the headlines of the major U.S. averages raging higher with each passing day is the not insignificant 5% decline in the Chinese stock market since early November as Beijing moves to reign in excess liquidity and credit.

Chinese equities have been a leadership market in 2017, as has been the U.S. Tech sector – both of which have been showing indications of rolling over recently. This bears watching going forward as to whether this is yet another in a continuous sequence of rotations within the equity market or a signal of a more meaningful change of market character, a la a cyclical market top.

Speaking of excesses, there is a growing list of entities and respected minds that for one reason or another have felt compelled to become more public in flagging some warning signs about capital markets at the current time. Goldman Sachs put out a note last week contextualizing how abnormal the current investment environment is, stating "*it has seldom been the case that equities, bonds and credit have been similarly expensive at the same time, only in the Roaring '20s and the Golden '50s…The average valuation percentile across equity, bonds and credit in the U.S. is 90 percent, an all-time high*."

Exhibit 12: Valuation frustration - both bonds and equities appear expensive
Valuation percentile (since 1871 for S&P 500 & US 10-year yields, 1919 for BAA spreads)



Source: Shiller, Goldman Sachs Global Investment Research

In addition to Goldman, Morgan Stanley's 2018 US Credit Outlook report, titled "When the Levee Breaks", was rather somber in its conclusion. Strategist Adam Richmond distilled down among all the noise the three biggest headwinds for credit going forward: "*Fed policy should become a material headwind, markets seem very late cycle, and valuations look extremely rich.*"

But it was Dallas Fed President Robert Kaplan's recent speech that was most striking, yet refreshing in its frank admission and observation of where markets are at present (Link to: A Balanced Approach to Monetary Policy):

> *"As a central banker, I want to be vigilant to imbalances and distortions that can build as a result of accommodative monetary policy. I have argued that monetary policy accommodation is not "free" —there are costs to accommodation in the form of distortions and imbalances in consumer decisions as well as in investing, hiring and other business decisions. More specifically, experience suggests that the greater the overshoot of full employment, the more difficult it is to*

unwind imbalances when growth ultimately slows—as it certainly must.

When excesses ultimately need to be unwound, this can result in a sudden downward shift in demand for investment and consumer-related durable goods. There are surprisingly few historical examples of "soft landings" in cases where employment has risen above its maximum sustainable level.

It is of course possible that "this time will be different," but as I assess the condition of the U.S. economy, I am carefully monitoring evidence that might suggest growing risks of real imbalances, which could threaten the sustainability of the current economic expansion. For example, the headline unemployment rate has fallen by 70 basis points over the past *year, nearly matching the average rate of decline over the prior seven years of the expansion. If this rate of decline continues, this will further tighten labor market conditions and would likely add to excesses and imbalances accumulating in the economy.*

Excesses can also manifest themselves in financial imbalances. While I would prefer to rely primarily on macroprudential policy tools to manage financial imbalances, I am nevertheless monitoring various measures of potential financial excess. I monitor these and other market measures because I am aware that, as excesses build, we are more vulnerable to reversals which have the potential to cause a rapid tightening in financial conditions, which in turn, can lead to a slowing in *economic activity. Examples of potential excesses might include:*

- *The U.S. stock market capitalization now stands at approximately 135 percent of GDP, the highest since 1999/2000.[3]Correspondingly, commercial real estate cap rates and valuation measures of debt and other markets appear notably extended.*

- *Measures of stock market volatility are historically low.[4] We have now gone 12 months without a 3 percent correction in the U.S. market.[5] This is extraordinarily unusual.*

- *While household debt to GDP has improved over the past eight years, corporate debt is now at record highs.[6] I am not overly concerned* *about current levels of corporate debt because, importantly, financial sector leverage has declined substantially since the Great Recession. However, U.S. government debt now stands at approximately 75 percent of GDP,[7] and the present value of unfunded entitlements now stands at approximately $49 trillion.[8] In my view, the projected path of U.S. government debt to GDP is unlikely to be sustainable—and has been made to appear more manageable due to today's historically low interest rates.*

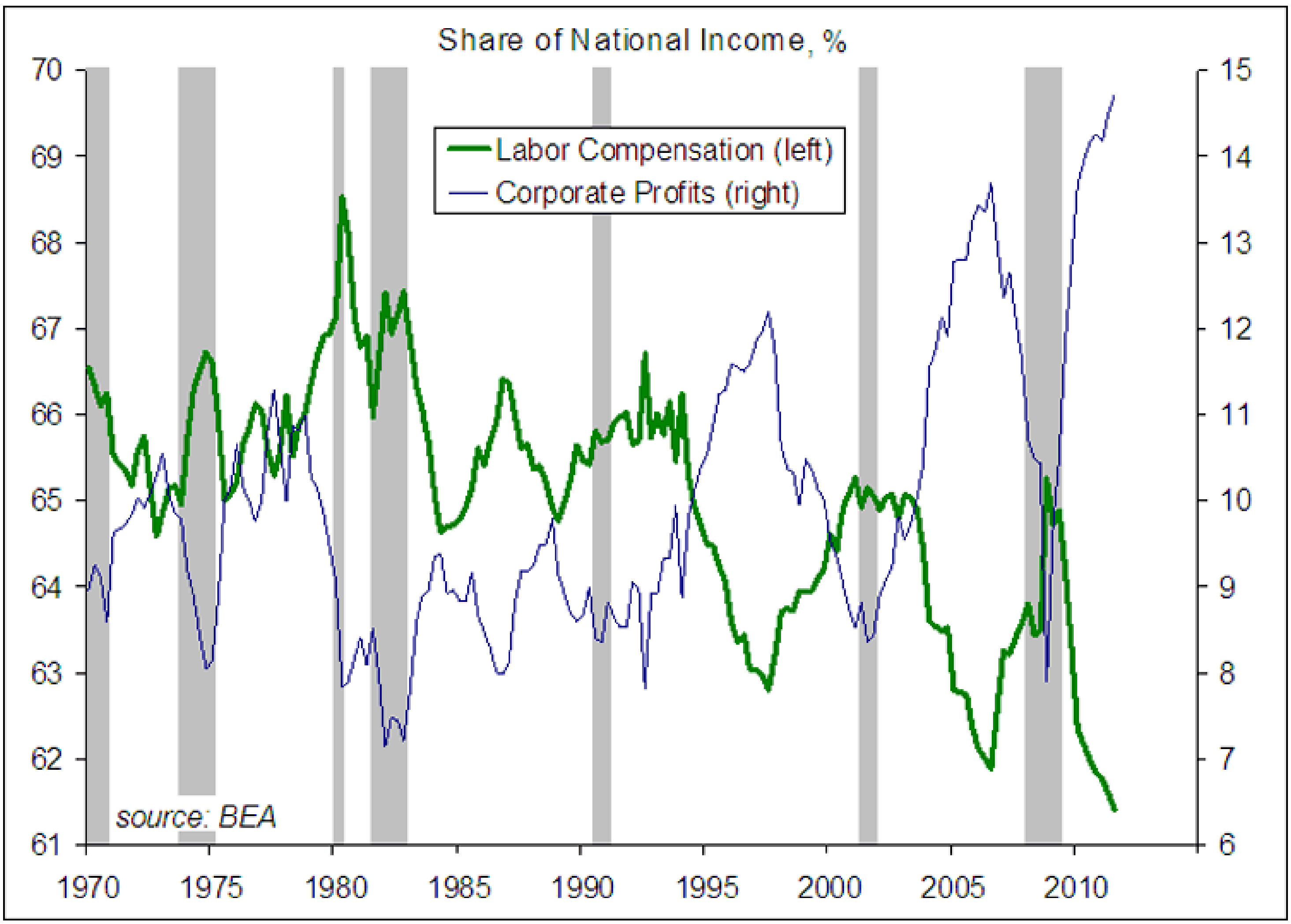
- *Debt and equity securities trading volumes have markedly declined over the past several years. For example, NYSE equity trading volume on average for 2017 is down 51 percent from 2007 levels, while the NYSE market cap has* *increased 28 percent over the same time period.[9] I would also note that margin debt is now at record-high levels.[10] In the event of a sell-off, high levels of margin debt can encourage additional selling, which could, in turn, lead to a more rapid tightening of financial conditions. Sufficient market trading liquidity is key to managing the resulting increased volume. I am cognizant that lower trading volumes may be due, in part, to low levels of market volatility and may also be due to regulations such as the Volcker rule."*

While I think everything he wrote should be read and reread by all investors, it's the following comment that is worthy of deeper analysis for investors: "*There are surprisingly few historical examples of 'soft landings' in cases where employment has risen above its* *maximum sustainable level*." This is something I've been talking about for months, but markets have readily ignored up to this point while being hypnotized by the notion of tax cuts – the Federal Reserve is not going to stand idly by and accommodate a late-cycle attempt at large scale deficit financed stimulus. New York Fed President William Dudley in his latest comments came right out and said it: "*It would be a reasonable question to ask*, *is this the best time to apply fiscal stimulus, when the economy's already close to full employment? It's probably not the best time*".

Enough said – so while most everyone is focused on the short-term sugar rush boost this tax cut bill will provide to corporate profits and economic momentum, they are being too complacent with the indirect impacts of a more aggressive Fed interest rate hiking cycle and potentially inflation. Recall that 10 of the last 13 Fed tightening cycles have resulted in a recession. Forewarned is forearmed.

While I'm on the tax cut topic, let's get another thing straight – U.S. companies are not in desperate need of a tax cut. They are already flush with cash and have had no problem getting access to cheap capital should they want to access it. One of the most defining elements of this muted economic expansion is what little financial constraints companies have faced when considering capital projects – it's been weak end-demand that has hampered companies from taking on new projects, not a lack of liquidity, a shortage of profits, or being strapped for cash. This weak end-demand is coming from a fragile, stretched and strapped consumer profile where too many have yet to fully recover from the aftermath of the GFC.

Have a look at the following graphic from the Bureau of Economic Analysis which plots the divergence between corporate profits, which are at multi-decade highs, while labor compensation is at multi-decade lows. This by no way paints the picture that corporations are the ones in dire need of financial assistance from lower taxes.



So, while we don't know if companies will choose to increase wages, hire workers, or take on capital projects that they have until this point deferred, we do know from every economic analysis I've seen that this plan will not pay for itself and according to the Joint Committee on Taxation, it will add a trillion dollars to the national debt over the next decade. This isn't about left versus right or conservative versus liberal – when objectively observing the past it's obvious that both parties have abused the fiscal responsibility they were expected to respect when taking office. What we're all witnessing today is a perfect example of the party IN power versus the party OUT of power, where it's the party IN power that makes the rules (as has been the case for several decades now).

But consider the hypocrisy being displayed today where during the election campaign, Mitch McConnell said, "*I think this level of national debt is dangerous and unacceptable, my preference on tax reform is that it be revenue neutral*". He went on to add, "*what I hope we will clearly avoid, and I'm confident we will, is a trillion dollar stimulus…take you back to 2009. We borrowed $1 trillion and nobody could find that it did much of anything. So we need to do this carefully and correctly and the issue of how to pay for it needs to be dealt with responsibly*".

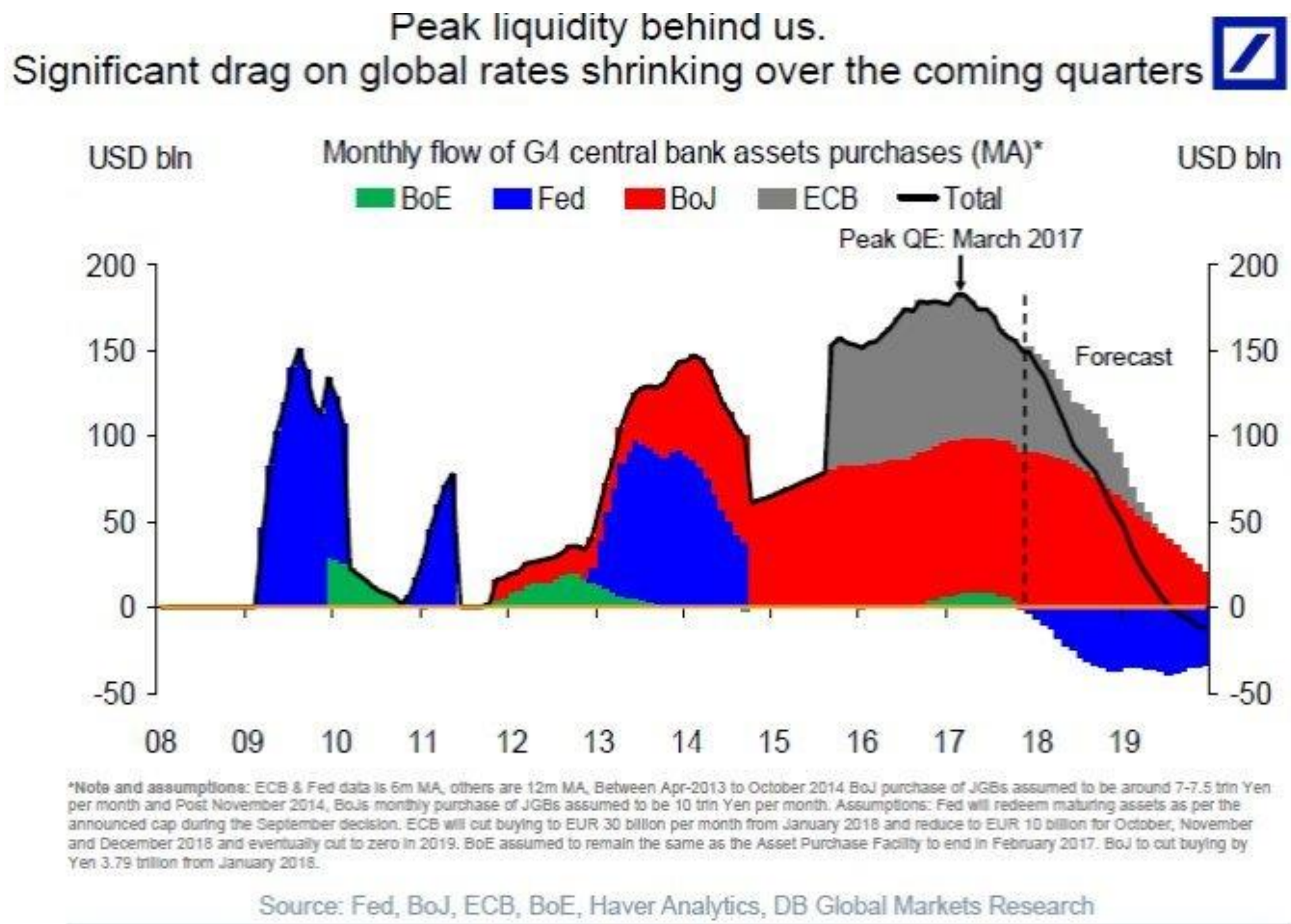
Thanks Mitch. I'm sorry, but you just can't make this stuff up.

The hypocrisy isn't isolated to just one body of government when you consider the irony of the recent comments made by soon to be former Fed Chair Janet Yellen, when she said "*in my view, the projected path of U.S. government debt to GDP is unlikely to be sustainable – and has been made to appear more manageable due to today's historically low interest rates*". Well imagine that, the body that controls the price level of the most important instrument in finance – interest rates – is choosing the present day to highlight the risks inherent in running high debt levels. This after ten years of suppressing interest rates near 0% and on the back of what we now consider to be a credit crisis brought about by excess debt and leverage.

What do you expect when you incentivize a debt driven system to take on even more debt through the lowest offered price in history? Why we are just now figuring out that you can't fix a debt problem by taking on even more debt is beyond me, but that is the situation we face today in the U.S. as government, corporate, and household debt balances are at all-time highs. What's more is that this isn't just a U.S. phenomena as global debt has surged to a record $226 trillion – more than three times global annual economic output. When the history books are written that reflect back on this time it will be interesting to see how kind or cruel they judge the efficacy of these central bank policies. As of this point all we have experienced as investors and citizens is the easy part of providing unprecedented levels of accommodation through interest rate cuts and asset purchases – we're just getting started on the hard part of removing this accommodation where we have little to no reference point to know how this will all work out.

In its most simplistic form, what this all means for investors is to be cautious and don't abandon discipline. Never in the history of investing has it been easier and cheaper for investors to gain exposure to investments via passive index funds. These are great instruments for sure, but they are not ‘get out of jail free’ cards. Those investors willing to abdicate the responsibility of analyzing the fundamentals and/or valuations of investments by buying an index today, be it one that tracks the Dow Jones Industrial Average, S&P 500, or Barclays Aggregate Bond Index, need to understand that they are making this investment at one of the most expensive valuation levels these indices have ever traded at in their history.

We are also at a time where, for the first time since the GFC, global central banks are tightening monetary policy via interest rate hikes and reducing the flow of liquidity into the economy by reducing the size of their balance sheets (Federal Reserve) or tapering asset purchases (ECB & BOJ).



This is happening at a time where debt has never been higher, equity and credit valuations have rarely been more expensive, and global economic growth may be as good as it gets. That last point is important as it's been an evolving view of mine that it's economic strength that ultimately forces the central banks' hand in not being able to back away from tightening policy.

I continue to have my doubts on the sustainability of the acceleration in economic growth here in the U.S. (and abroad) as real final sales to domestic producers slowed from a 2.7% annual rate in Q2 to 2% in Q3 which marked the softest pace since Q1 2016. Additionally, the fact that the average annual growth rate in real final sales over the past four quarters came in at 2.3% which is barely above the 2.1% of the entire nine-year cycle, suggests that there has been little in the way of any meaningful acceleration in this recent growth pick-up. Not to mention this has occurred with the savings rate being pared down to a decade low of 3.1% and on the back of two destructive hurricanes that have provided a healthy lift to activity.

But nevertheless, my doubts aside, U.S. GDP has gripped a 3-handle for two straight quarters and there is an outside chance Q4 could be another. Meanwhile, Europe and Japan are growing at their best pace since the GFC while Emerging markets on the back of China's credit induced splurge are humming along.

Which brings me back to central banks and them no longer having the ability to make excuses for not tightening monetary policy. The hand-off from monetary to fiscal policy is underway and while a smooth transition could prolong this economic cycle even longer, but if it is fumbled or impotent then perhaps for the first time in a long-time investors will find out what their investments are worth without the artificial support of central banks.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215