January 29th, 2018

Check your blind spots…

The action in the U.S. equity market has moved into a parabolic state with the S&P 500 ending last week with a gain of 7.5% so far this year – and we haven't even completed the month of January yet. Please don't extrapolate this rate of appreciation going forward as it would imply that the S&P 500 is on pace for gains of 155% through the balance of the year which would handsomely take out the 45% ascent in 1954 as the best calendar year ever. So far this month the S&P 500 has registered 14 record closes and in the 18 trading days that make up 2018, on only 4 of those occasions has this index finished in the red. What's more is that 3 of the 4 down days have been declines of -3 points, -5 points, and -2 points (the one double digit decline was -10 points on January 16th) and this is on an index that trades at 2,870. We have now reached a point where the S&P 500 has gone 399 days without so much as a -5% pullback – folks this type of one-way action is not normal and hence why what investors are experiencing today is without precedent.

However, none of this is deterring retail investors from getting in on the action as the fund flow data shows money pouring into equity-based ETF's and mutual funds at a jaw dropping clip. Not to mention the accelerating signs of leverage and speculation visible in the increase in margin debt and positioning in the futures and options pits. Then to top it all off the discount brokerage shops (TD Ameritrade, Charles Schwab…) are posting record new account openings as well as reporting a wave of buying activity in the most speculative areas of the capital markets like cryptocurrencies and pot stocks.

Ladies and gentlemen, these are not signs you see when investors are executing diligence, prudence, awareness, and proper care in relation to their investment decision making. This is what you see when markets transition to froth and speculation – none if it indicative or telling of how or when it ends, but collectively it sends a loud and clear warning signal that excess and exuberance are at hand.

But, but Corey…the economy is strong and corporate earnings are going through a re-rating higher on the back of corporate tax cuts, not to mention how positive the deregulation push has been for the business climate. On the surface I don't disagree with these assertions, but where I think investors need a reality check is in terms of how much of a premium investors are willing to assign to asset prices as a result of these policies. The back of the envelope math I've come up with suggests that the corporate tax cut is worth about $100 billion in additional corporate profits this year, yet since this tax cut bill was passed in December the stock market has added over $1.5 trillion in market cap. A 15:1 ratio of valuation enhancement on top of what was already a richly priced market multiple – it's a little steep for my valuation-conscious mind. Not to mention that a similar comparison to the 1986 timeframe (when Reagan got his tax reform package through), the ratio was closer to 3:1 versus today's 15:1, and that was on a stock market that was trading at a much cheaper valuation relative to today.

This brings to mind a point Howard Marks of Oaktree Capital Management brought up in his recent investor memo:

> *"Most valuation parameters are either the richest ever or among the highest in history. In the past, levels like these were followed by downturns. Thus, a decision to invest today has to rely on the belief that 'it's different this time'."*

For those who don't know Mr. Marks, he has one of the best investing track records in history and has proven this through both good and bad markets. However, there have been several other highly successful and prominent money managers making headlines over the last several weeks that ascribe to a different philosophy for the current environment, namely Ray Dalio of Bridgewater Associates and Jeremy Grantham of GMO who believe markets are in the midst of a "melt-up" that could send stocks much higher while setting the stage for the ultimate popping of what each describes as a bubble.

How anyone chooses to play the late stages of this market cycle is entirely up to them and there are no shortage of narratives investors can grab hold of to justify their rationale. What I consider to be most important for investors is to recognize the risks that exist and act accordingly. Whether that is choosing to lean against the momentum and de-risk one's portfolio in what has become a frothy environment in anticipation of taking advantage of the opportunities on the other side, or double down and push your bets because there is a lot of money that can be made in the climax of a speculative bubble – either path has its own set of cost/benefit considerations.

One variable that all investors need to be mindful of in their prognostication of capital markets moving forward is the change that's afoot in the fixed income markets with yields globally finally looking like they have broken out to a new higher trading range. The yield on the 10-year Treasury bond hit 2.72% this morning, taking out the 2.64% level that had previously been resistance and making a move to the 3% level a distinct possibility. The German 10-year Bund is on the move as well as it rose to 67 basis points, while the 5-year German Bund broke above the zero-line for the first time since December 2015. Same goes for Japanese interest rates with the 10-year government bond moving up to 0.074% (handily above the BOJ target of 0.00%).

But herein lies the rub for this insane predicament we all find ourselves in today where global growth is the strongest it's been in this post-GFC period, yet central banks around the world continue to implement monetary policy as if we are in a recession – a view espoused by Barclay's CEO Jes Staley last week at Davos:

> *"…we've got a monetary policy that still seems like it is in the remnants of a Depression era."*

What this amounts to is a situation where we've fostered the backdrop for another 'boom-bust' cycle because the Fed has not learned from their predecessor's mistakes and once again have kept policy too loose for too long. There is no denying that the recent run of economic data has been firm, but even with learning last week that Q4 GDP came in at 2.6%, it still put full-year 2017 GDP growth at 2.3%. Yes, a bit stronger than prior years but not much more robust than what we have experienced throughout the entirety of this cycle. What's more is that while the internals of the report were actually stronger than the 2.6% headline would suggest, it also had the thumbprints of a late cycle report all over it. What I mean by this is that this report (like the Q3 GDP report) received a meaningful boost from the hurricane rebuild in the south (an event that is unlikely to repeat unless we get another unfortunate natural disaster) and a personal savings rate that collapsed from 3.3% in Q3 to 2.4% in Q4.

Adding to the heap of what looks to be an increasingly fragile consumer profile is that commodity prices (which hit consumers directly in their pocket books) are moving decisively higher. Natural gas prices have risen to 13-month highs which are going to find their way into the home in terms of higher heating bills, and don't look now but gas at the pump has risen 24 cents in the last year to $2.54/gallon (and is expected to hit $3/gallon in the coming months). It's not hard to see where some, if not much of the 'relief' from the tax cuts is going to go.

Let me big picture this for you: we have an unemployment rate at 4.1% (the lowest level in almost two decades and a classic late cycle number) and a savings rate that is sub-2.5%. The last two times these two metrics were near these levels at the same time was December 2007 and before that December 2000 – if memory serves me correct, during neither of these time periods did a bell ring saying the good times were over, but on both occasions we learned with 20/20 hindsight that this was about as good as it gets.

Which brings me back to the Fed and their Holy Grail quest to keep monetary policy overly accommodative until they reach their fabled 2% inflation target. Well let me point something out to anyone not paying attention: the Fed has not hit its 2% inflation target since April 2012, and in fact it has missed its target 90% of the time over the past decade. How is that even possible, and to boot how is it even remotely responsible to be hitching monetary policy to an economic benchmark that has proven so elusive at being able to be achieved? In the last cycle, the Fed hiked rates 17 times from a 1.0% starting level in June of 2004 through June 2006 with each one of those hikes being of the 25-basis-point variety and that experience fueled the fire of what we look back at being a "housing and credit bubble".

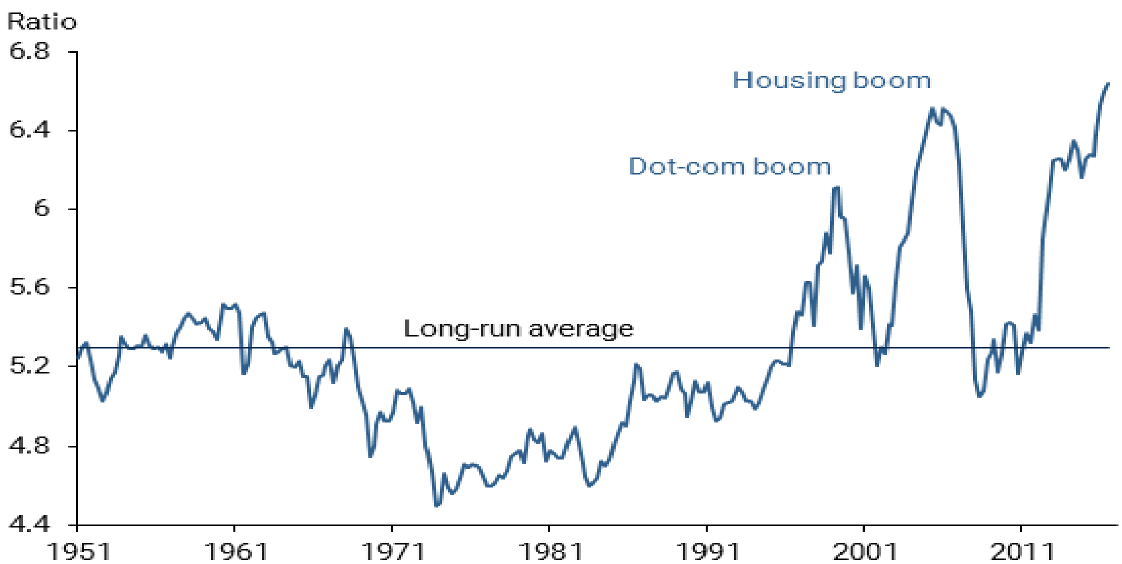
Contrast this with today where the Fed has hiked rates five times since December 2015 (each of the 25-basis-point variety) and we are only at 1.375% on the Fed funds rate. That is five hikes in over two years compared to 17 hikes over two years in the last cycle in which the Fed funds rate ultimately peaked at 5.25%. It's no wonder why risk asset prices continue to run into the stratosphere as there has been little credible evidence that indicates the Fed is willing to step in and exercise some restraint. No, instead we are in the process of blowing our third debt-fueled bubble in as many cycles. In the expansion from '92 – '00, total nonfinancial debt increased $7.5 trillion versus a corresponding $4.2 trillion increase in nominal GDP. In the '02 – '07 expansion, nonfinancial debt increased by $12.9 trillion vs. a $4 trillion increase in nominal GDP, and so far this cycle nonfinancial debt has increased $14.3 trillion since the peak in 2007 vs. a $4.8 trillion increase in nominal GDP.

That my friends epitomizes the laws of diminishing marginal return – an exponential rise in debt relative to a more modest move in GDP. So here we are with a global financial system that has never been more indebted and the consensus view is that nothing will change so long as job creation continues to grow, asset prices continue to rise, and interest rates remain modestly low. What is fostering the present-day complacency among investors is that the financial system to this point has shown few signs of not being able to service the payments on this outstanding debt pile. But therein lies the rub – none of us know where that cross-over interest rate level starts to bite in terms of making the servicing cost unmanageable. According to the Fed's own forecast, they see the terminal Federal funds rate at 2.75% – this is the rate that should otherwise coincide with an economy at full employment and price stability – yet we have a Federal funds rate that is currently at 1.375%.

What I'm getting at is that it's looking more and more like the Fed is drastically behind the curve, and what this means for investors is that they run the risk of the Fed needing to hike rates and tighten policy faster than what markets are currently expecting. Hence, interest rates breaking to the upside of a trading range that has been in place for the better part of the last several years is something worth paying attention to, in particular when we are pushing the lower limits of what is considered full employment and inflation readings are starting to march higher.

This could potentially be a toxic cocktail and one that has been elusive throughout the entirety of this expansion, and the main reason why the Fed has remained so deliberate and gradual in their rate hiking path. But should these current trends continue (let alone pick up speed) then the market will inevitably force the Fed's hand in tightening policy much faster than they were anticipating. The signs of a tight labor market are spreading whether one looks at the Fed's Beige Book, NFIB Small Business Survey, or company conference calls and the likelihood of inflation readings picking up throughout the balance of this year is increasing.

So I'm sorry, I'm not in the Janet Yellen camp where she had the audacity to say back on December 13th of last year: "*I think when we look at other indicators of financial stability risks, there is nothing flashing red or possibly even orange."* Not even orange! Household net worth to disposable income – perhaps one of the more thorough measurements to gauge valuations across the spectrum of household assets – is at a new all-time high of 673%. For context this metric peaked at 521% in the bull market cycle of the late '80's, peaked at 612% in the early 2000's cycle, and peaked at 652% in 2006 at the height of the Housing Bubble.



With all due respect to Ms. Yellen, as she is one of the most intelligent minds to ever sit at the helm of the Fed, but this to me is a rather irresponsible statement to make when equity market valuations are flirting with the richest levels in history, global interest rates are moving up from what were 3,000-year lows reached back in the summer of 2016, and in the midst of an economic expansion that is about to turn nine years old. Perhaps a bit of humility, awareness, and objective reflection is in order.

I know, I know – all I keep hearing out of the talking heads on bubblevision is that 'yes, valuations are stretched, but valuation is a terrible timing indicator' to which I completely agree, but valuation is the most important variable for long-term returns. What I want to stress is that now is not the time to be complacent as the foundation that has underpinned the stable, calm, and tranquil movements in asset prices over the last 18 months are in the midst of a decisive shift: the fiscal and current account deficits are widening, the U.S. dollar is falling, trade frictions are intensifying, the Fed is adamantly tightening, the economy is at full employment, and bond yields are rising. All of this screams to me: REBALANCE your portfolio.

This doesn't mean move everything to cash or abandon a prudently diversified investment strategy, but within the equity market you want to shift your exposure to value and quality factors, take a look at some beaten up sectors that have lagged this most recent burst higher (there are some good quality high dividend paying utility companies that have traded down 15-20% since last November), and evaluate adding some long/short type equity strategies into the fold. In the fixed income markets, the same principals apply as it relates to a focus on quality and lowering the overall duration of your holdings. Spreads in the investment grade and junk bond market are back to the tightest levels they've experienced since the summer of 2007 (92 bps and 323 bps respectively), so there isn't much meat left on this bone for additional gains through spread compression. For the first time in quite a while you can actually receive some yield out of the short-end of the Treasury curve with 1-year Treasuries yielding 1.78% and the 2-year T-note yielding 2.14%.

Another area where investors might want to consider allocating some capital is in the commodities market. A move higher in inflation is a typical late-cycle phenomenon, and any reflection on history will tell you that trade wars are inflationary which makes commodity exposure a reasonable hedge. Gold and precious metals, while volatile, look to have broken out in December 2015 of what was a 5-year bear market dating back to 2011 and the recent move higher in gold broke some key technical levels that argue for more upward progress moving forward. Oil is a segment of the commodities market that I like, but admittedly my enthusiasm has waned as the price of crude and the equities that track oil prices have moved quite a bit higher over the past year and a lot of speculative money has pushed positioning to extremes.

Also, several foreign equity markets continue to trade at cheaper relative valuations to the U.S. and are much earlier in their economic and business cycles. Emerging Markets, India, Japan and the Asia Pacific region in general are areas that screen constructively over both a short and long-term holding period. Keep in mind that global financial markets have become highly interconnected in the present day financialized economy, so should a material hiccup occur in any one of these meaningful geographic regions it's sure to send ripples throughout all markets. So it would be an unrealistic expectation to think that any one equity market region around the world will be immune to this risk.

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