Casilio Leitch Investments
A Private Wealth Management Company

Capital Market Musings & Commentary

January 8th, 2018

Broadening signs of excess, but nary a sign of anxiety…
Global equity markets carried over the upside momentum from 2017 into the start of 2018 with the Dow off to its strongest start in 14 years and the S&P 500 registering its best start since 2006. Each of the major averages rung in the New Year with four record closes in a row – a feat that doesn't happen very often. The equity market rally was even more pronounced outside the U.S. with European bourses, Emerging Markets, Japan, and Chinese averages all ripping ahead by more than +3% to kick-off 2018. The two major asset classes not catching the global growth optimism fever were the U.S. dollar and U.S. Treasury bonds, with both flat to modestly lower to kick off the year. Lower bond prices (a la higher yields) are not necessarily an inconsistent signal, and in some circles they are being interpreted as validation for a continuation of the synchronized global growth backdrop that took hold last year.

There is no denying that economic momentum both in the U.S. and across the globe gained steam as we moved through last year, but I found the price action in the U.S. equity markets somewhat interesting last Friday when the Dow finished off the week with a +220 point advance. It's obvious that there is a lot of momentum pushing stock prices to the upside, but what was surprising is that we were on the receiving end of four economic data points on Friday, all of which disappointed to the downside, and yet equity prices could have cared less.

- The jobs report showed the U.S. added +148k jobs in December, well below consensus expectations for a print of around +200k with the internals of the report showing a decline in full-time jobs, the diffusion index, the voluntary 'quit' rate, and manufacturing overtime hours. None of these metrics deteriorated at a rate that should be alarming to anyone, but they are consistent with what one should expect from a late cycle employment report. Just as it should be of little surprise to anyone when you see that 2017 was the softest year for employment growth for this cycle. After all, we are entering year nine of this expansion and with an unemployment rate sitting at 4.1% for three straight months, it's only reasonable to expect that there isn't a whole lot of meat left on this bone. Anyone needing further clarity on this view should look no further than the following chart that plots the unemployment rate (red line) versus the price of the S&P 500 (gray line) – a 4% level on the unemployment rate is about as good as it gets and it's when this metric starts to reverse on a sustained basis to the upside that it spells trouble for the stock market.

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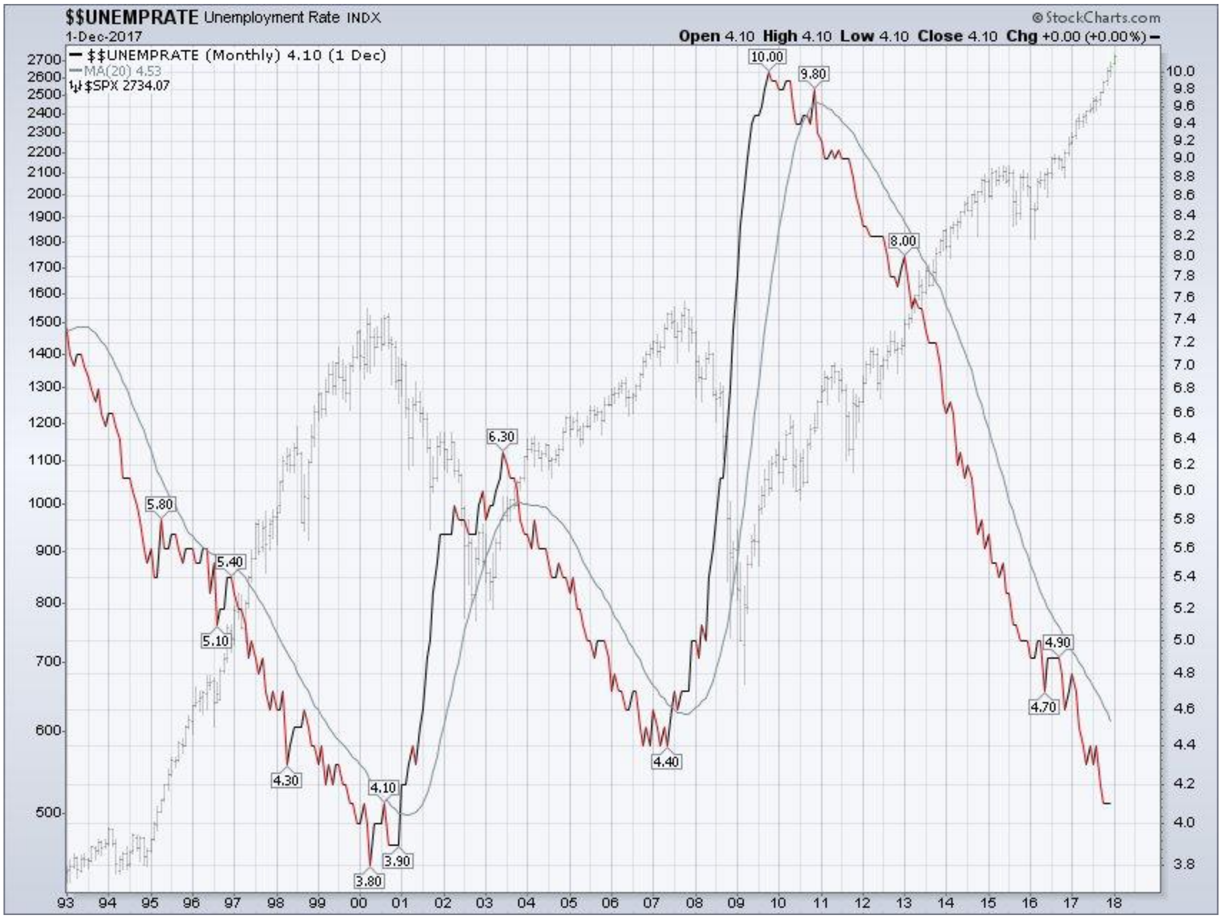

- Also on Friday we learned that the ISM non-manufacturing PMI gauge dropped 1.5 points to 55.9. While still a decent absolute level, this is notably below expectations for a print of 57.6 and the December level marked a four-month low. Deceleration was apparent across the board in this report with new orders falling to a 16-month low, business activity hitting its lowest level in 5 months, and 3 out of the 18 industries saw contraction in December versus just one such occurrence in November. Once again nothing alarming in this report, and to be fair the ISM manufacturing counterpart to this report was humming in December, but I find it interesting that with services representing more than 65% of the U.S. economy relative to manufacturing (now at less than 15%) that this deceleration in the services sector isn't garnering as much attention as the white-hot manufacturing side.

- One of the other two economic data points released on Friday was the Trade Balance, which saw the deficit widen in November by 3.2% to $50.5 billion to a nearly six-year high (in volume terms, the deficit widened to $66.7 billion from $65.6 billion – the highest it's been since March 2015). And finally, Factory Orders in November experienced some revisions with core capex shipments taken down to -0.1% from a previously reported number of +0.3%. In addition, core capex orders were ratcheted down to -0.2% from -0.1%.

When all is said and done, the hopes for a 3rd consecutive quarter of +3% GDP growth in Q4 have been dashed with several Wall St. economists cutting their Q4 real GDP estimates back down to under 2.5%. I know, I know…tax cuts are on the way and that is precisely what's been holding back this expansion over the last eight years – corporations' lack of access to capital with interest rates succumbing to 5,000 year lows, global central bank balance sheets reaching all-time highs, corporate profits at all-time highs, and liquidity having never been more prevalent (yes, that is a hint of sarcasm you may be picking up).

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The one thing that continues to surprise me among the consensus opinion regarding this tax bill is how convenient it has become to overlook the hoards of empirical research that exist showing the diminishing growth impacts of fiscal stimulus at ever higher levels of public debts and deficits. As it stands today, U.S. gross federal debt sits at 108% of GDP which is almost 3.5x higher than the 30% debt-to-GDP level that existed back in the early eighties when Reagan pushed through his tax reform package. Also keep in mind that the Reagan tax package was true tax reform that included bipartisan support and spending cuts to go along with a lowering of tax rates. Nevertheless, it is what it is and all we can do as analysts is evaluate the landscape in front of us.

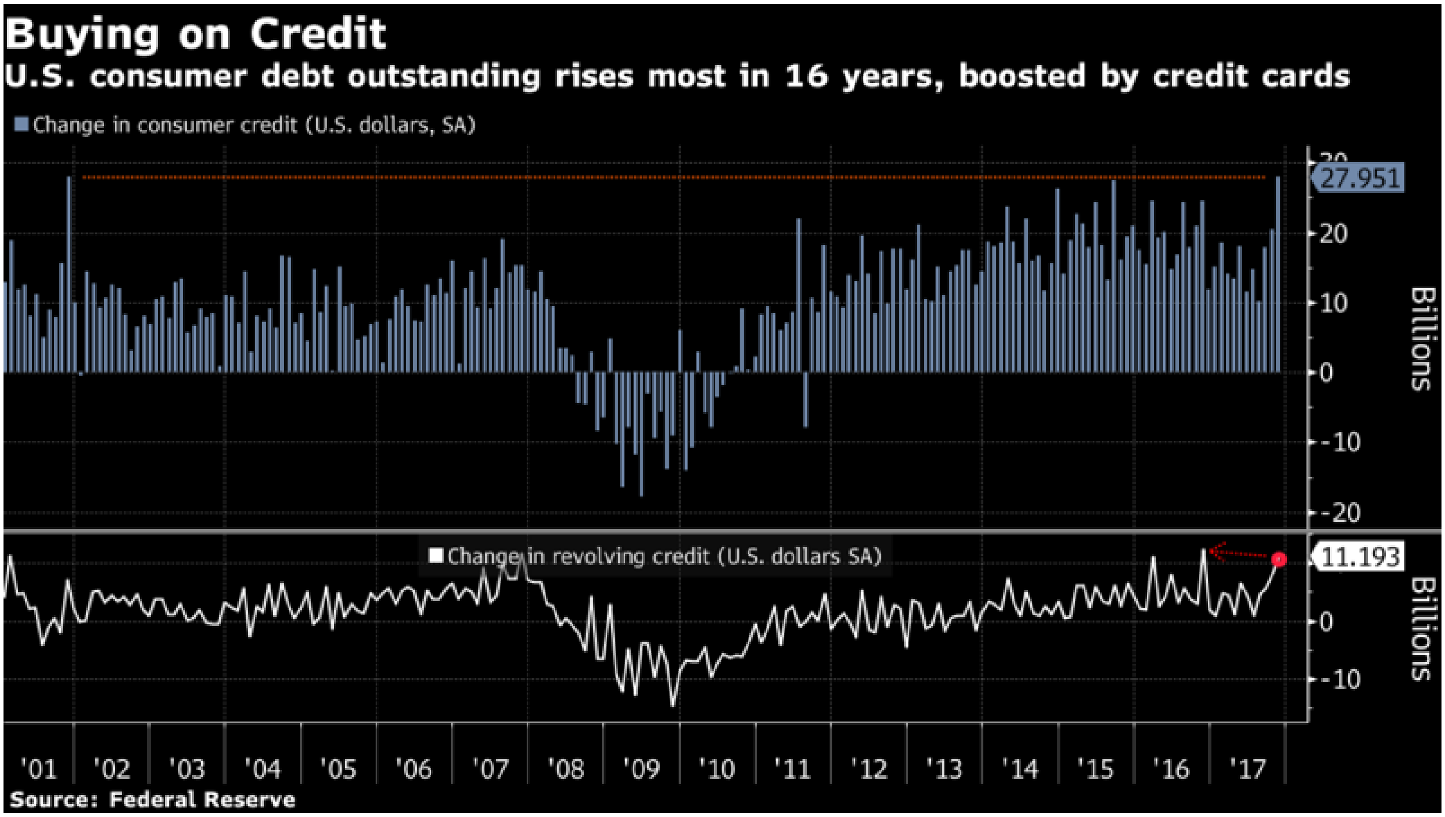
But we can reflect on the history of the last several cycles as a reference point for the present day in terms of finding a connection between debt and the economy. What I'm getting at is that this expansion looks a lot like the last two in terms of these two metrics. Let's start in the here and now and work our way back. From the peak in U.S. debt in 2007 to the most recent reading, total debt (including government, corporate, and household liabilities) has climbed by $14.3 trillion. What we have to show for this debt deluge is a $4.8 trillion increase in nominal GDP. This compares to the 2002 – 2007 economic expansion where debt across all levels of society increased by $12.9 trillion which corresponded with a $4 trillion increase in nominal GDP. Harkening back to the 1992-2000 expansion we can do the math where U.S. debt expanded by $7.5 trillion versus an increase in nominal GDP of $4.2 trillion.

Ladies and gentlemen, it's not rocket science to conclude that each of the last three expansions have been carried along on the backs of massive increases in credit. It's beyond ironic to me that here we are not even ten years removed from what in hindsight we commonly refer to as a Credit Crisis perpetuated by debt in 2007 – 2008, and yet we're so quick today to conclude that this time is different and that the highest level of global debt ever is not a risk to financial stability this time. True, mortgage debt and the widespread proliferation of easy underwriting standards have been reigned in this cycle, so it's unlikely that the housing market represents as great a risk as it was leading up to the GFC, but I would argue that the current debt bubble is much broader in that it entails subprime auto loans, student loans, credit cards, corporations increasing leverage to buy back stock, commercial mortgages, and C&I loans. The cherry on top just may be a tax package that is estimated to add another $1.5 trillion to outstanding Federal debt over the next ten years, and none of these estimates include an assumption for a potential economic recession.

An interesting analog to consider for investors and perhaps some practitioners who are acting upon this very view (given the intractable debt situation in the U.S. that only gets worse in the future with $100 trillion in entitlement costs yet to be tapped) is the extent to which the U.S. economy begins to resemble an emerging market economy. Two extremes are what's going on in Venezuela and Zimbabwe where their respective equity markets were the strongest in the world last year on a price appreciation basis, but when you take into account the decline in their respective currencies on a purchasing power parity basis, the picture equals 'not good'.

This is a rather complicated scenario to work through with a lot of moving parts, but when you account for the U.S. dollar's global reserve currency status coming under threat, the U.S. debt profile, and U.S. Treasury bonds (considered the world's reserve asset) offering near the lowest yields in their history – you have to be open minded to the idea that perhaps foreign investors may be considering that U.S. companies (a.k.a. U.S. equity securities) offer a better store of value proposition and return on capital proposition than Treasury bonds. Hence this unrelenting and perpetual bid higher in U.S. stocks over the last 20 months. This isn't a base case scenario, but something to think about.

As for the capital markets and the stock market in particular, it's hard not to think that things are getting stretched and excesses are becoming more prevalent. This isn't to say that the current backdrop from an economic standpoint doesn’t (at least on paper) look as strong as it’s been in some time or that stock prices can’t continue to move higher, but the bigger question all investors should be asking themselves is whether or not the current level of excitement and exuberance is sustainable? One example on the economic front of what I’m getting at here is the fact that more than 100% of the growth in retail sales over the last four months has been funded by credit card usage. Let me put this another way: in the three months through November, total retail sales increased by $15.5 billion, which I’ll tell you is a very strong retail sales backdrop. However, over this same time period credit card balances have increased by $25 billion ($11.2 billion alone in the month of November). Couple this trend with the household savings rate falling to a 10 year low at 2.9% and you have all the makings of a consumer back drop that looks tapped out. All this tells me is that there is no problem showing activity occurring in the economy, but it is disingenuous to not look under the hood and evaluate whether this activity is derived from organic and sustainable sources, or (as it looks to be the case) a short-term sugar rush that will at some point wear off.



Buying on Credit

U.S. consumer debt outstanding rises most in 16 years, boosted by credit cards

Source: Federal Reserve

Another example is how dependent it appears the U.S. economy has become on rising asset prices. At last count the ratio of ‘household net worth to disposable income’ has surged to a record 673%, surpassing the peak level it reached in ’06 -’07 at 652% as well as the 612% this ratio hit at the peak of the Dotcom Bubble in 2000. U.S. households’ exposure to equities as a share of U.S. financial assets now stands at its second highest level ever of 40%, only surpassed by the 47.5% it reached at the height of 2000 Tech Bubble.

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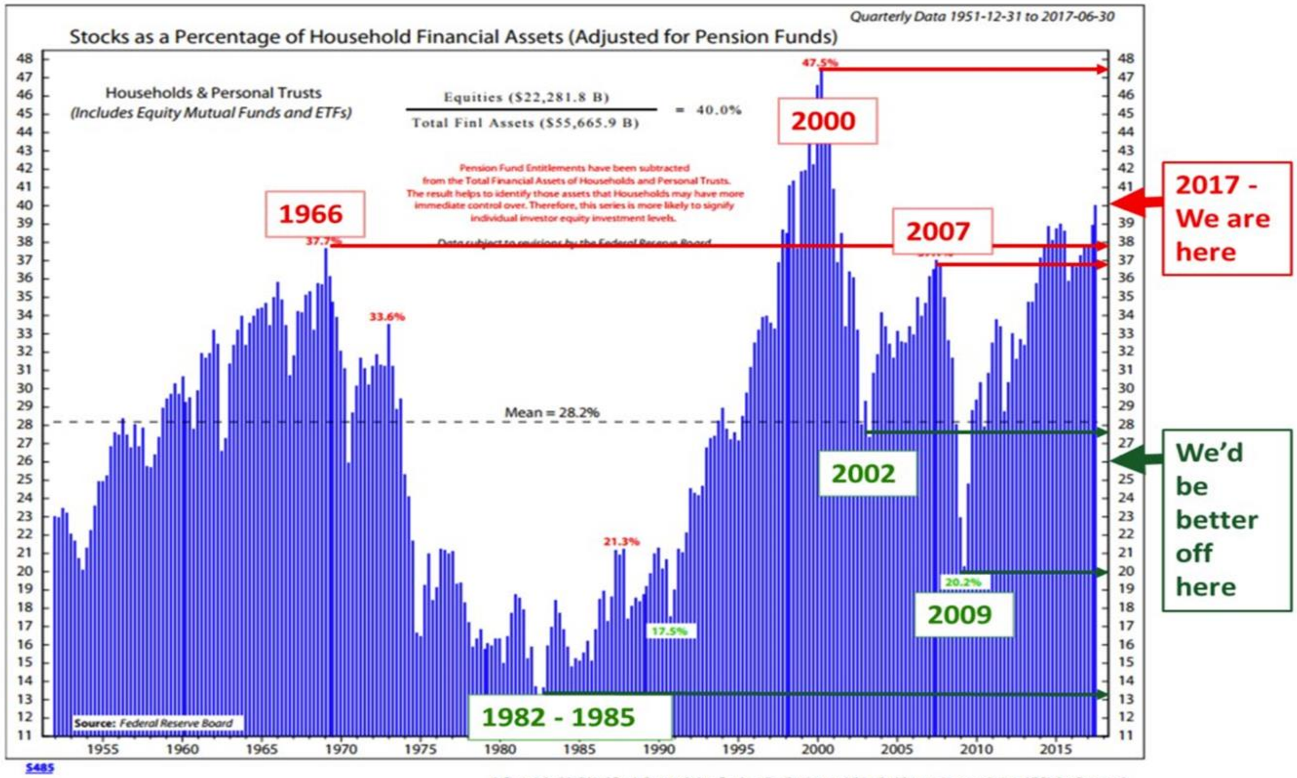

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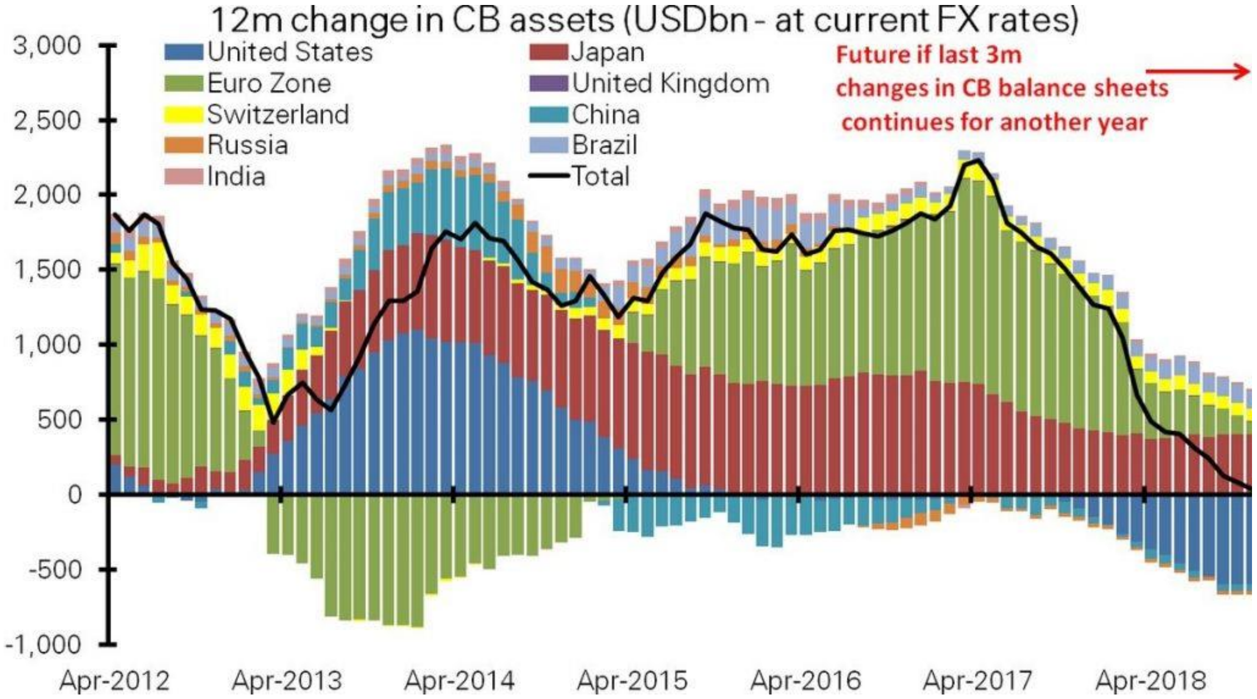
Equity market sentiment measures are singing a similar tune with the latest AAII investor poll showing those with a bearish view have plunged to 15.6% from 34.2% only a month ago, while those with a bullish view of the equity market have soared to 59.8% from 36.9% last month. Another similar survey conducted by Investors Intelligence recently reported that their poll averaged 77% bullish for all of calendar year 2017 and that represented the second highest level ever recorded. Let me reiterate, none of this is indicative of an imminent decline in the stock market, but rather a confirmation that a lot of good news is priced in at this time.

What other interpretation should an investor have with a wide swath of valuation metrics registering cycle highs and in some cases rivaling all-time high levels? I'm seeing a growing chorus of analysts suggesting that there is no euphoria like we saw at the height of the Tech Bubble in '99 - '00, or acknowledging that stocks may be rich relative to historical averages but they can still go higher before they take out the levels reached in 1999. I guess they're right if this is their reference point, but should that really give any rational, prudent investor peace of mind to use the most speculative environment in stock market history as a justification to throw caution to the wind? I think not! If you look at prior market peaks, very few of them came with obvious signposts of euphoria, but what they all have in common is widespread complacency and investor confidence – both are prevalent in today's market.

The one last thing I want to hit on in this missive before signing off is the Fed and global central banks in general. At the end of the day, monetary policy has been the dominant driver in asset prices during the last nine years and if they follow through on what their plans are in 2018, then the tailwind of liquidity that has been implemented via QE since '09 is going to change to a headwind sometime in late Q3. This is definitely a change that investors need to be mindful of throughout the first half of this year, where by May and June we should be able to ascertain whether the decline in central bank balance sheets is having an impact on asset prices.



So, while there is a lot of excitement around the potential boost to come via fiscal policy from deregulation, the recently passed tax cuts, and now discussion of an infrastructure package – these have to be weighed against a more restrictive monetary backdrop. The Fed alone is targeting a $420 billion withdrawal of monetary support via a decline in the size of their balance sheet. In addition to this the FOMC is projecting four rate hikes this year according to their latest dot plots (the futures market is only pricing in between 2-3 hikes thus far), but even if we are only to get 2 hikes this year it's estimated that this equates to an additional $100 billion drag on nominal GDP for 2018.

If there is one thing that I think investors are underestimating going into this year it is this change in central bank provided liquidity and its potential impact on asset prices. Keep in mind that monetary policy works with a lag so it's too early to determine at this point what impact (if any) this withdrawal is having on asset prices. But collectively this global central bank balance sheet reduction will amount to $1 trillion in liquidity coming out of the market in 2018 compared to over $2 trillion being injected in 2017. We were told back in 2010 by then Fed Chair Ben Bernanke that these policies were targeted at lifting asset prices, and at this time it's easy to conclude that these policies have achieved that objective.

However, I think it is naïve to think that the removal of these policies will not have the opposite impact when they are reversed. I mean, there are times of late where it's difficult to work through an objective analysis on an investment without considering how potentially distorted asset prices may be today because of all the liquidity that has been injected into the system. A case and point of what I'm talking about is Portugal and Italy being able to issue sovereign debt at interest rates lower than what the U.S. can issue similar maturity Treasury bonds. Keep in mind these two countries carry the highest sovereign debt to GDP ratios of any nations in the world outside of Japan, and they can issue debt at a cost that is less than the U.S. government.

Yeah, it doesn't make much sense, but it also 'is what it is'. It's the environment we're in, and as such it's what investors must keep in mind when evaluating what information can be objectively garnered from asset prices today.

The take away for investors looking out over the horizon for this year is to appreciate the momentum that is pushing equities higher, but don't get lulled into a state of complacency. Late cycle fingerprints are all over the current capital market setup: commodities rallying, yield curves are flattening (10s – 2s curve recently touched 50 bps), seeds of inflation appear to be blossoming, loan covenants are the weakest they've been in 10 years, credit spreads in both investment grade and high yield credit are razor thin, and the Fed is well into its tightening path. Not to mention, at the moment the economic and capital market environment leaves as little to be concerned about as it has at any point in this cycle – that in and of itself should give you pause and remind you to stay alert.

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