
**January 16th, 2018**

# A growing divide…

The melt-up in equity markets to start out 2018 is full steam ahead with the Dow Jones Industrial Average and S&P 500 having closed higher in 8 of the 9 trading days so far this year. It's as if daily price gains have become a preordained decree, so if you're an investor, why bother worrying about paying some of the most expansive valuation multiples in history when it appears as though any downside risk has been outlawed? Yes, that is a hint of sarcasm you may detect, but with the Dow logging 500-point gains per week after coming off a calendar year that will

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go down in history as the least volatile one-way march higher in stock prices ever, a bit of humor is a much-preferred emotion to the reality check that ultimately awaits.  When that reality check occurs is anyone's guess as there are very little signs that suggest a pullback is near – market breadth remains strong, divergences are few and far between, and volumes are rising.

Enjoy it while it lasts as we've seen this movie play out before where markets take on a life of their own, casting aside the widening gap between prices and fundamentals.  If one wants to use the overall stock market to illustrate this growing divide then they could reference the strength of the overall economy at the current time, but how do you square the fact that the S&P 500 has soared at a 12% annual rate since QE2 was implemented back in 2010 relative to EPS growth that has been

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less than half that pace? Both observations are factually accurate, but the latter brings to attention the increasing risk embedded into share prices today relative to a static observation that the current economic backdrop is stronger than it's been at any point in what has been the weakest recovery in the post-WWII era.

Anyone looking for a single company that epitomizes the levitation we are experiencing in stock prices today need look no further than Boeing. It is the largest component in the price weighted Dow Jones Industrial Average and while it is one of the highest quality companies the U.S. has to offer, its share price has risen almost 175% in the last year and a half alone. Undoubtedly its business has improved over this time period, but on an Enterprise Value / Revenue valuation metric its share prices are trading today at double the

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levels they have rarely achieved in the last 30 years of the company’s history.


As I said, enjoy it while it lasts, but don’t ignore the signs of exuberance that are becoming more pronounced. According to some technical work by @SentimentTrader, the last time the S&P 500 rallied more than

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2% to a 52-week high during a little over a week, and the VIX was also up 10% (all of which occurred last week) was March 24, 2000 – the peak of the Tech Bubble.

The DXY U.S. Dollar Index is in freefall after declining more than 10% last year, and has carried this trend over into 2018 having declined for four days in a row to 90.3 – the lowest level it has reached since 2015. The Dollar's pain is the Euro's gain as it has strengthened to $1.22, the highest it has been since December 2014. Gold is basking in the sun of U.S. dollar weakness as it pushed above $1,340 per ounce, but it will be interesting to see if the precious metal has enough in it to move above some very serious technical resistance levels it is nearing.

Commodities in general perform well in a weak dollar environment and that goes for oil

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prices as well with U.S. crude futures closing at $64.30 per barrel last week – their highest level since late 2014. Oil prices haven't needed a slide in the dollar to justify a constructive investment thesis. This is a segment of the market that I've liked for some time now and that thesis was predicated on an improving supply/demand equilibrium, a massive cut in capex investment and production that began in 2015, growing coordination on the part of OPEC to bring stability to the market, and a rise in the price of cyclical commodities (a la oil prices) as is typically the case in the late/mature stages of an economic expansion.

The fact that global supply/demand dynamics have improved dramatically over the past year-and-a-half has gone a long way in putting a floor under prices as well as propelling them back up to levels which many thought just two

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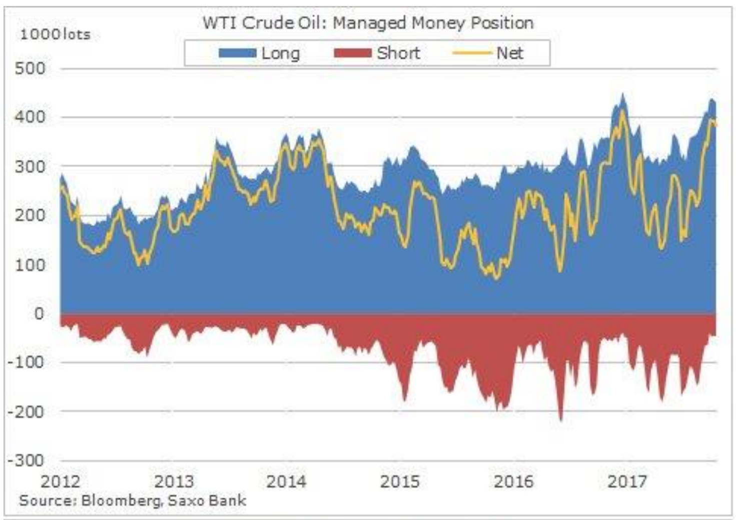
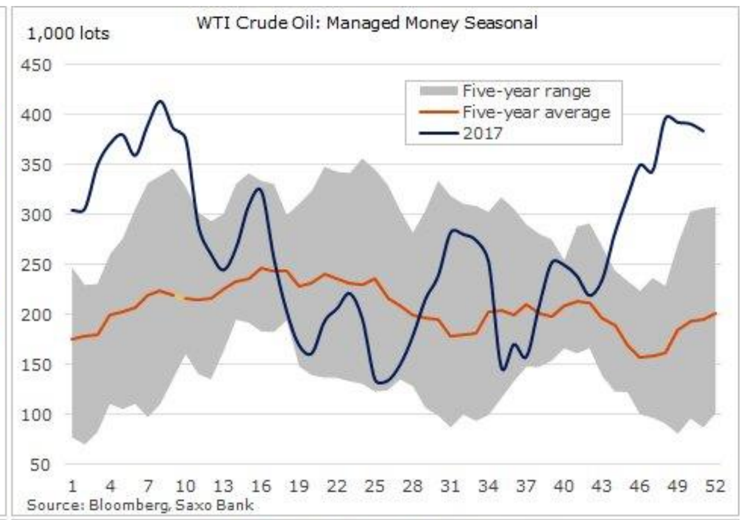
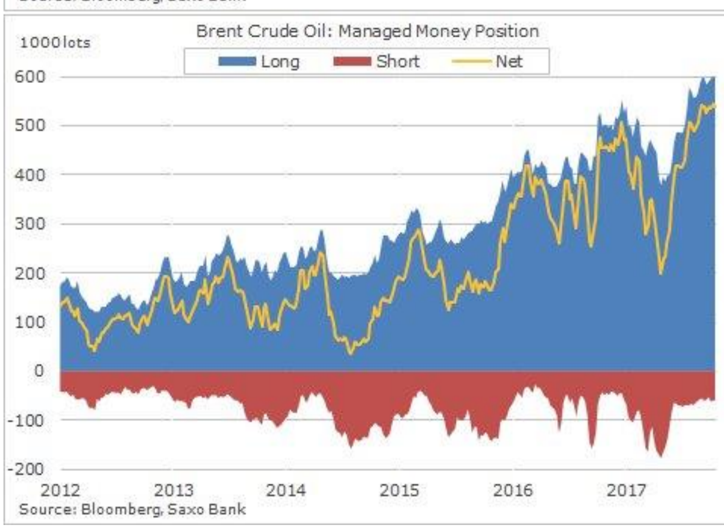
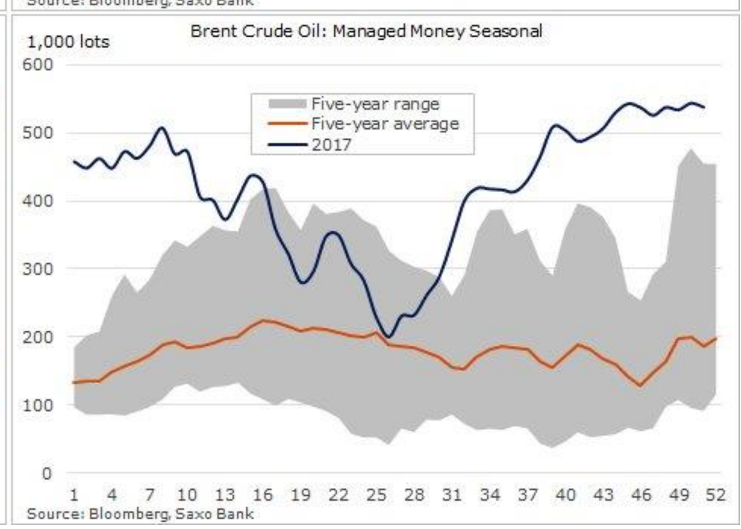
years ago we may never see again. And while I still think there is good reason to have exposure to the energy segment going forward, one has to acknowledge that this is no longer a contrarian view and judging by the latest data from the futures pits, a lot of money has moved over to the bullish side of this market.

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The fundamental improvement story continues to play out in this space with EIA estimates still targeting an increase in global oil demand in 2018 after a 1.6% increase in 2017 and the over-supply situation progressing with a story in this week's Barron's publication indicating that the inventory decline over the past two months marked the biggest decline in history over such a short period of time.  Another support for oil prices is the increasing tensions and uncertainty surrounding geopolitics which on any given day could engender a meaningful disruption to the supply side.

All I want to get at here is while the underlying investment thesis in the energy segment remains intact, this is no longer an under-the-radar situation and a lot of momentum-chasing money has entered the equation.  In my opinion, this doesn't alter the overall investment thesis, but given the large

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sized move that has already occurred in oil prices and oil related stocks, as well as hot money rushing in, the risk / reward payoff has moved to a much more balanced level.

Make no mistake, a weak U.S. Dollar is very constructive for emerging market equities – an asset class that has managed to outperform even the record setting start to a year in U.S. equities – but the Chinese economy remains the number one catalyst for the fate of EM going forward. This is why it will be important to pay attention to the release of China's Q4 and full-year GDP data on January 18th, where these numbers are unlikely to disappoint, but these should be looked at as 'rearview mirror' data. What will be more relevant is what happens from this point going forward as there is little question that the latest Chinese money and credit numbers are indicating a discernible slowdown is afoot.

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We received another set of strong retail sales numbers on Friday which showed Q4 2017 went out with a bang. The month-over-month increase of 0.4% was a bit below the 0.5% consensus expectation, but focusing on this I think would be missing the bigger picture and that is that retail sales for the quarter ticked in at an annualized pace of more than +11%. To put this pace of sales growth into perspective you need only compare it to the +4.5% pace in Q3 or the +1.4% pace in Q2 to contextualize just how big a number that is. In fact, this was the second strongest quarter of this entire expansion and the third strongest quarter in nearly 15 years. As optimistic and exciting as this all seems, an objective analyst would be committing an injustice if they didn't point out a couple items that raise some doubts about the sustainability of this level of growth:

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1. The underlying components of spending growth raise some suspicion – Department Stores down 1.1%, Clothing Sales down 0.3%, Sporting Goods, Books, and Hobbies down 1.6%, and Electronics down 0.2%. Contrast this with a gain of 1.2% in Building Materials, Furniture up 0.6%, Grocery Stores 0.7%, and Pharmaceuticals up 0.4%. These components that make up the latter are more 'necessity' based consumption items or tightly linked with the rebuilding needs from last year's hurricanes. Whereas the former are more akin to discretionary items where a decline in this type of spending doesn't exactly jive with the widespread 'everything is awesome' view among the consensus.

2. The other thing that stands out – and it's not represented in this report, but they go hand-in-hand – is the massive increase in

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credit card borrowing that went on last quarter. The surge in credit card balances over this interval is almost unprecedented and now that the holiday season is over, the bill is coming due, so we'll have to wait and see how this plays out in the data over the next several months. Thankfully consumers have a tax cut coming their way, but perhaps this money was already spent last year in anticipation (and isn't this the American way – to charge everything and worry about the bill later?).

This brings me to an interesting battle playing out in the bond market at the current time, about whether or not the 35+ year bull market in bonds is reaching its expiration date. Two of the most successful fixed income investors on the planet, Bill Gross and Jeff Gundlach, have come out in the last week suggesting that this could very well be the case. When

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heavyweights like these are taking bold stances like this, it's best to pay attention to what they're saying and at least understand what is driving their view. Admittedly, I find myself leaning their way as I do think the U.S. economy (as well as the global economy) has some embedded inflationary pressures in it that we will likely see come through during 2018. This combined with a Federal Reserve that appears adamant about hiking rates another 3 to 4 times this year (heck, if the inflationary pressures end up being hotter than expected – which some of the models I follow suggest they could be – then the Fed is already well behind the curve) while also reducing the size of its balance sheet, and a U.S. Treasury that is set to flood the market with nearly $1 trillion in new Treasury bond issuance in 2018, it's pretty difficult to see how interest rates are not pressured higher this year.

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However, what I find interesting is that with all of this known – a global economy that looks stronger today than at any point over the last 10 years, a U.S. economy looking very much the same, unemployment at cycle lows, ISM manufacturing near cycle highs, a surging stock market… why hasn't the yield on the 10-year Treasury Note broken above the 2.6% level that has acted as a ceiling for nearly two years now? This is a question I find myself pondering daily and waffle back and forth on, admittedly non-committal yet to either the "higher rates" or "lower rates" camp. One view that I do have a raising level of conviction on is that higher interest rates pose a much bigger threat to the economy and risk assets than do lower rates. Consider that we're talking about a U.S. economy that is more indebted than it's ever been in history (on an absolute and relative basis) where unemployment is at multi-decade lows, the

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household savings rate (2.9%) is at 10-year lows, and wage growth has been unable to keep pace with the appreciation in asset prices (housing and the stock market) – all of this implies that there is very little wiggle room for increased cost pressure from the servicing of outstanding debt loads.

It's also important for stock market bulls to understand how the math of rising interest rates works as it pertains to valuation multiples.  As in, higher interest rates decrease the present value of future cash flows, or as Abby Joseph Cohen estimated in this weekend's Barron's Roundtable that every 100-basis point increase in bond yields tends to result in as much as a 3-point compression in the P/E multiple.  Over the past 18 months this relationship hasn't held steady with rates having already backed up more than 100 basis points yet P/E multiples have climbed to cycle

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highs on both trailing and forward earnings. No doubt optimism over the business-friendly fiscal agenda has something to do with this, but this 'carrot' can no longer be waved in front of the equity market going forward as was the case throughout 2017.

I remain of the view that the most important variable for asset prices going forward will be the Quantitative Tightening (QT) by global central banks and the likely impact this has on global interest rate levels as well. The pace of growth in central bank balance sheets on a rolling twelve-month basis as we ended last year was running at roughly $2 trillion and based upon the guidance from the Fed, ECB, and the BOJ that pace is expected to be wound down to $300 billion by the end of 2018. Chew on that for a moment: you're talking about a change in money creation of over $1.5 trillion dollars, or on a percentage change

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basis this equates to a 2% YoY growth rate from what was a 16% YoY pace. It seems overly naïve to assume that this unwind will be like "watching paint dry" as soon-to-be Former Fed Chair Janet Yellen suggested, when all along the way as they were implementing these policies their explicit intent was to raise asset prices. The following statement was made by soon-to-be Fed Chair Jerome Powell at the FOMC meeting back in October 2014:

*"I think we are actually at a point of encouraging risk-taking, and that should give us pause. Investors really do understand now that we will be there to prevent serious losses. It is not that it is easy for them to make money but that they have every incentive to take more risk, and they are doing so. Meanwhile, we look like we are blowing a fixed-income duration bubble right across the credit*

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*spectrum that will result in big losses when rates come up down the road. You can almost say that is our strategy."*

Say again Chairmen Powell! Is this what you mean when you say, "*it is not that it is easy for them to make money but that they have every incentive to take more risk, and they are doing so…*"?

- Mutual Fund managers are holding the lowest level of cash on record
- Stocks as a percentage of financial assets are at the second highest level in history, only exceeded by the peak of the Tech Bubble in 2000
- Individual Investors, as calculated by AAII, hold the least amount of cash since 2000
- U.S. stock market capitalization as a percentage of GDP is at its second highest

level in history, only exceeded by the 2000 Tech Bubble

- The NYSE reports that margin levels are at record heights on an absolute basis, and as a percentage of GDP have hit historic highs
- Last October, the University of Michigan Consumer Sentiment Survey found that nearly 65% of those polled expect the stock market will rise in the next 12 months – the highest reading on record
- The S&P 500 has gone more than 390 trading days without a drop of 5%, the second longest streak in history
- A recent Wall St. Journal article reported that "many investors have decided that spending cash to hedge against big declines is a waste of money"
- Or what about the observation that the advance in U.S. equities is now the singularly most one-sided move in stock market history with the S&P 500 having

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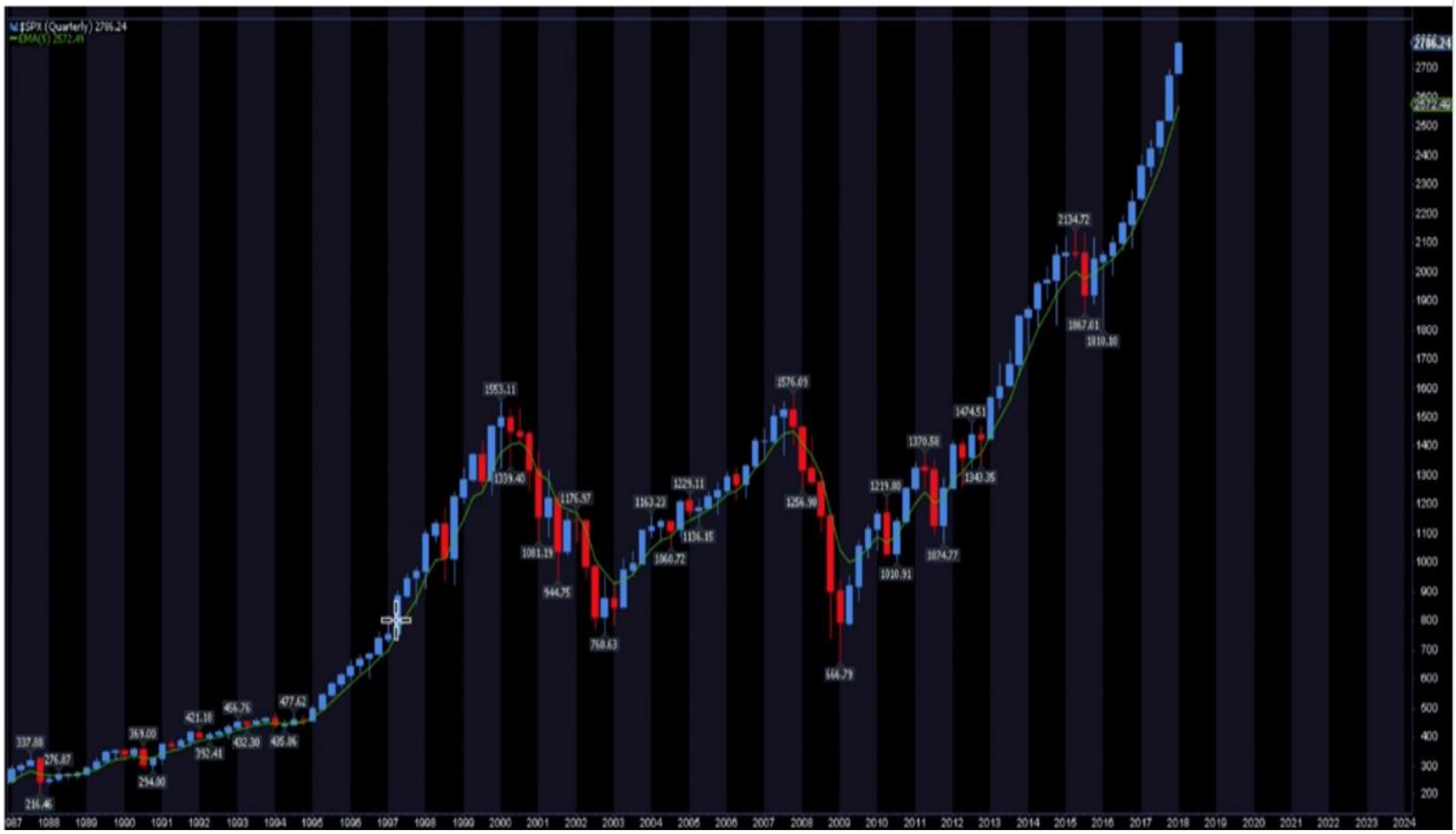
generated a positive monthly return in 21 of the last 22 months. The below chart from Sven Henrich of Northman Trader depicts the S&P 500 on a quarterly basis in which you see that one-way levitation and how the rate of ascent is going vertical:



Why everyone is so complacent in expecting that the unwind of the 9+ years of central bank policies that have brought about these

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excesses will not have at least some detrimental impact when they are being unwound remains puzzling to me.

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