February 12th, 2018

Regime shift underway, and an overlooked opportunity with compelling potential…

They say records are made to be broken, so it seems only fitting after going through a record period of marked calm that markets pay back the gesture with record price swings the other way. The Dow Jones Industrial Average underwent a 1,022-point swing on Friday (intra-day high to low) and over the course of the past five trading sessions the Dow has averaged a daily price range of just over 1,000 points. The last time investors experienced such erratic short-term volatility was October 2008 – shortly following the bankruptcy of Lehman Brothers, the forced acquisition of Merrill Lynch by Bank of America, and the government taking over AIG. Not that past is prologue, but following those events the stock market still had another 25% of downside before the ultimate bottom was turned in.

Admittedly the circumstances are much different at the current time than they were back then with the economic data having already rolled over, the Fed having already finished its rate hiking cycle two years earlier and in the throes of cutting interest rates, and fiscal policy was some ways off, as opposed to the present where government spending is about to balloon. However, there are many parallels shared between now and then with the most important one on my list being a liquidity backdrop that is transitioning from a tailwind to a headwind. Many of the headlines canvassing the weekend papers highlighted inflation or too strong of economic fundamentals which are bringing about wage pressures as catalysts for the recent bout of heightened volatility (both of which are deserving of attention), but both are subordinate to what I consider to be the main culprit – liquidity.

I remain of the view that the fundamental backdrop underlying the economy is not nearly as strong as the consensus perceives, whereby perhaps the biggest distinction is between one's perception of the data. Take for instance a 4.1% unemployment rate: one is correct to view this as a very constructive reference point for overall economic health, but one is also correct in seeing this as an extremely late cycle reading where unemployment levels are nearing the nadir of perhaps as good as it gets. The savings rate declined to 2.4% in December which is the lowest level of this cycle and second lowest level ever recorded in this post-WWII era (just above the 1.9% reading in July 2005) – all of which suggests that the consumer has very little to fall back on outside of wages to satisfy additional consumption going forward. Likewise, Global PMI readings in the high 50's are a confirmation that economic activity is humming along, but rarely are these levels maintained and historically these are as good as they get. Lastly, take the wage figures from January's payroll report which many market prognosticators point to as the catalyst that marked the beginning of this heightened volatility period.

When you dig into the numbers of what on the surface showed wage growth accelerate to 2.9% YoY (its highest level since 2009), you see that the big culprit for this rise was the result of pay increases for the 20% of the workforce in management capacities. The 80% of the workforce known as nonsupervisory and production workers saw a grand total of a 0.1% month-over-month uptick and the year-over-year trend at +2.4% is actually below the +2.6% nearby peak reached last September. Add to this a 0.5% contraction in aggregate hours worked and you come away with a January labor report where work-based incomes actually declined by 0.2%. As you can see, there is more to this story than just what looks like a one-off wage print that requires a couple more data points to corroborate that a trend is underway.

This isn't to suggest that there isn't the potential for upward wage pressure in a system that is already at full employment and an output gap that has been closed for well over six months, but it comes back to my main point in that this regime shift playing out in the price action of financial assets is complicated by many moving pieces, with liquidity (or the diminishing thereof) at the center of this tug-of-war. This is the box the Federal Reserve (and most central banks, for that matter) have painted themselves into where economic activity is throttling ahead at full capacity, yet monetary policy is still operating as though we are in the depths of a recession with a fed funds rate that is in negative territory on an inflation adjusted basis. This has created an environment of severe financial imbalances that will be difficult to rectify without causing a recession – the 3rd such boom-bust cycle in the last 20 years.

After all, here we are moving into the ninth year of an economic expansion and the Federal Reserve has managed to hike interest rates a total of five times in the last two years (from 0% up to 1.375%). In the last interest rate hiking cycle the Fed hiked rates 17 times over the course of two years (from 1% in June 2004 to 5.25% by Juned 2006) and even that wasn't enough to restrain the imbalances and mal-investment that built up in the system that created what in hindsight we call the "Credit Crisis". Is it that illogical to think that this hasn't happened again? Just take a look around: corporate indebtedness is at all-time highs, household and government debt are also at all-time highs, NYSE margin debt is at all-time highs and, as a matter of fact, total global debt has grown from $57 trillion in 2007 to $233 trillion as of the end of 2017. Servicing this debt when the global economy is growing, liquidity is flowing, and financial conditions are loose is not a concern. It's when one or all of these variables turn that this avalanche of debt becomes a risk to the overall financial system.

This is why this transition point we're at is important for investors to monitor. In particular, when this shift in monetary policy (the Fed attempting to raise interest rates and reduce the size of its balance sheet) is occurring at the same time that a radical pivot in fiscal policy is underway. It's economically counterproductive to implement large scale fiscal stimulus (a $1.5 trillion tax cut with an additional $300 billion spending package, which will take the fiscal deficit to $1.2 trillion or over 5% of GDP in 2019) while the Fed is moving down the path of monetary tightening. Here we are, with a gross Federal debt-to-GDP ratio of over 100% (and on its way much higher over the next decade) and most of the projections don't even account for a recession occurring along the way. It's not unrealistic to expect $2 trillion deficits at some point in the not too distant future. I don't want to come off as hyperbolic or an alarmist, but this is ruinous to the fiscal position of the U.S. With all due respect to President Trump and his comfort level with using debt, not to mention he has plenty of help from Pelosi, Schumer, and the death of the Tea Party in getting to this point, but the fundamental economic backdrop isn't even close to being strong enough to offset the devastation this will have on the sanctity of the national balance sheet.

But here is where things become challenging for investors and markets in that the new Fed, as headed by Jerome Powell, is not going to accommodate the fiscal largesse as it raises rates and shrinks its balance sheet, rendering the question of who will be the buyers of this bloated bond issuance that is about to come down the pike? And at what interest rate level will they be willing to buy this avalanche of newly minted Treasuries?

One thing that stood out to me during last week's wild swings in the stock market is that after more than 2,000 points were knocked off the Dow inside of a two-week window, how resistant central bankers were to hit the airwaves to sooth market anxiety. Case in point was NY Fed President Bill Dudley's comments last week about markets "*having a bump like this has virtually no consequence, in my view, to the economic outlook.*" This is a change of character for the Fed who during previous volatile periods during this expansion were quick to hit the speaking circuit with soothing words to calm market stress that they were at the ready to take action should things deteriorate further. To me this is an indication that the fabled "Fed Put" resides at price levels lower than the lows we experienced last week (perhaps much lower).

There is an old adage that the time to start picking away at the market is when the Fed begins to panic, yet there is no indication of that point being reached yet in this sell-off. Therefore, anyone still operating on the premise that the Fed will step in to bailout markets may want to adjust the lower bound of their pain threshold a bit.

Whether or not this correction in the stock market has run its course – who knows? On a technical basis the S&P 500 traded down to its 200-day moving average at Friday's low, which during this cycle has been a level that enticed buyers to come in. Given the amount of hubris and excess that has been built up over the last year and trickled over into January it would be reasonable to expect a little more froth to be unwound before all is said and done, but the 'buy the dip' strategy has been handsomely rewarded this cycle.

Valuation multiples have definitely cheapened up a bit in the midst of this drawdown, but they have hardly declined to a level that any value conscience investor would consider attractive. The forward P/E on the S&P 500 has compressed to 17x from 18.4x which is less than half the typical 3 ½ point contraction we see in corrections like these. However, should the earnings backdrop continue to improve with earnings estimates out of the analyst community continuing to track higher, then that could also act as a positive to reign in valuation levels a bit further. A decline in the forward P/E multiple to below 15x would bring this metric back in line with the long-term averages, and as a result would get the overall market to be a bit more intriguing to my eye. It surprised me to see how little impact this dramatic correction has had on bullish sentiment with the latest Market Vane reading modestly dipping from 72% bulls to 70%. A similar development played out in the net speculative long position in last week's CFTC data where investors continued to carry a net positive exposure to the S&P 500 which contrasts with typically seeing this exposure flip to net short before a market bottom has occurred.

So, it appears the overall complacency during this market sell-off and in the face of elevated volatility remains high which in and of itself is surreal. Let me be clear when I say we are entering into a new paradigm as it pertains to capital markets, the economic cycle, Central Bank and Fiscal policy, as well as inflation dynamics. This isn't the same set-up as the last eight years where many of the dynamics that moved asset prices on a steady push higher are now shifting, such as algorithms programmed with certain historical correlation relationships triggering their buy and sell decisions as these correlations are in the midst of breaking down. One example is the inverse correlation relationship between stocks and bonds, which has worked for the last two decades but may be in the process of reversing. Over the last two weeks it hasn't just been stocks declining, but so were bond prices as interest rates moved higher. Larry McDonald elaborated on this point with some great data on his Bear Traps Report blog where he dove into the historical archives to measure how many occurrences he could find where stocks and bonds sold off together for two weeks or more:

- 1970's: 11 times
- 1980's: 10 times
- 1990's: 3 times
- 2000's: 0
- 2010 – 2017: 0
- 2018: 1 time (the last two weeks)

Below are some additional thoughts on where his research is leading him:

> *"In the 70s and 80s this was very common – over 21 instances where stocks and bonds sold off together two weeks + (clearly inflation-driven). In the 90s only a few (3) instances, from 2000-2018 there had been nearly zero 2-3 periods where stocks and bonds moved lower together – **UNTIL NOW.***

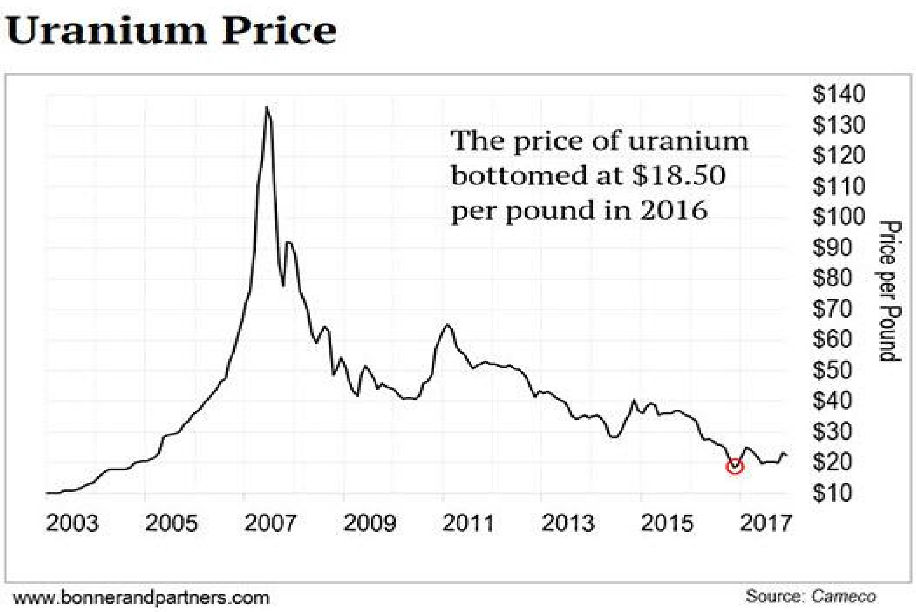
As you can see above. In the 2010, 2011, 2014, 2015 and 2016 equity market drawdowns – bonds rallied in a substantial fashion. In every "risk off" regime, it has been stocks DOWN – bonds UP for as far as the eye can see. This month, for the first time in nearly two decades, the negative correlation between stocks and bonds turned positive. This is a MAJOR game changer for the wealth management industry."

"We believe inflation is set to finally pick up in 2018. Much of the passive and quant-side (a $1.5T shift in asset management) has become heavily invested in the "risk parity" model which involves being long equities and bonds on a risk-adjusted basis. One of the fundamental problems with this strategy is you're effectively really long disinflation. Sure, it's worked very well in the post great financial crisis period, but it's a grossly crowded trade and has all the makings of a gruesome slaughterhouse.   In this case, the risk tail is a period where equities and bonds fall together, which is not that uncommon in a late cycle inflationary environment (see 1980s and 1990s). Other than out of the money puts in rates (bonds) a big way for this crowd to hedge inflation is to increase commodity exposure."

I can't say I carry the same level of conviction as Mr. McDonald on the inflationary view, although I've gravitated over to the camp that late cycle inflationary dynamics are at play that could give a lift to the inflation data throughout the balance of the year. Furthermore, I do think portfolio's having some exposure to the commodities market at the present time is prudent – while one must understand that this is a volatile space that requires a bit more patience and intestinal fortitude to stomach the price swings.

One commodity in particular (and I like more than just this one) that I have warmed to since Q3 last year is Uranium. I know, I know – don't run for the hills as the investment thesis has nothing to do with Uranium for the purposes of nuclear weapons, but rather the energy generating capacity of this element.

Let me try to summarize it in as clear and concise a portrayal as possible, but understand that the constructive investment case stems from both favorable dynamics on both the supply and demand side of the equation. First let's start with a little history. The price of raw Yellowcake (U308) Uranium peaked back in 2007 at around $140/lb and having dealt with a rush of miners bringing supply online to take advantage of that price, as well as the unfortunate Fukushima nuclear reactor blow-up back in 2011 (which put a stigma around the entire nuclear energy space), the price of Uranium has declined roughly 85% over the last decade.



So, we're talking about a bombed-out market that has been left for dead, but the question is are we at a potential turning point?

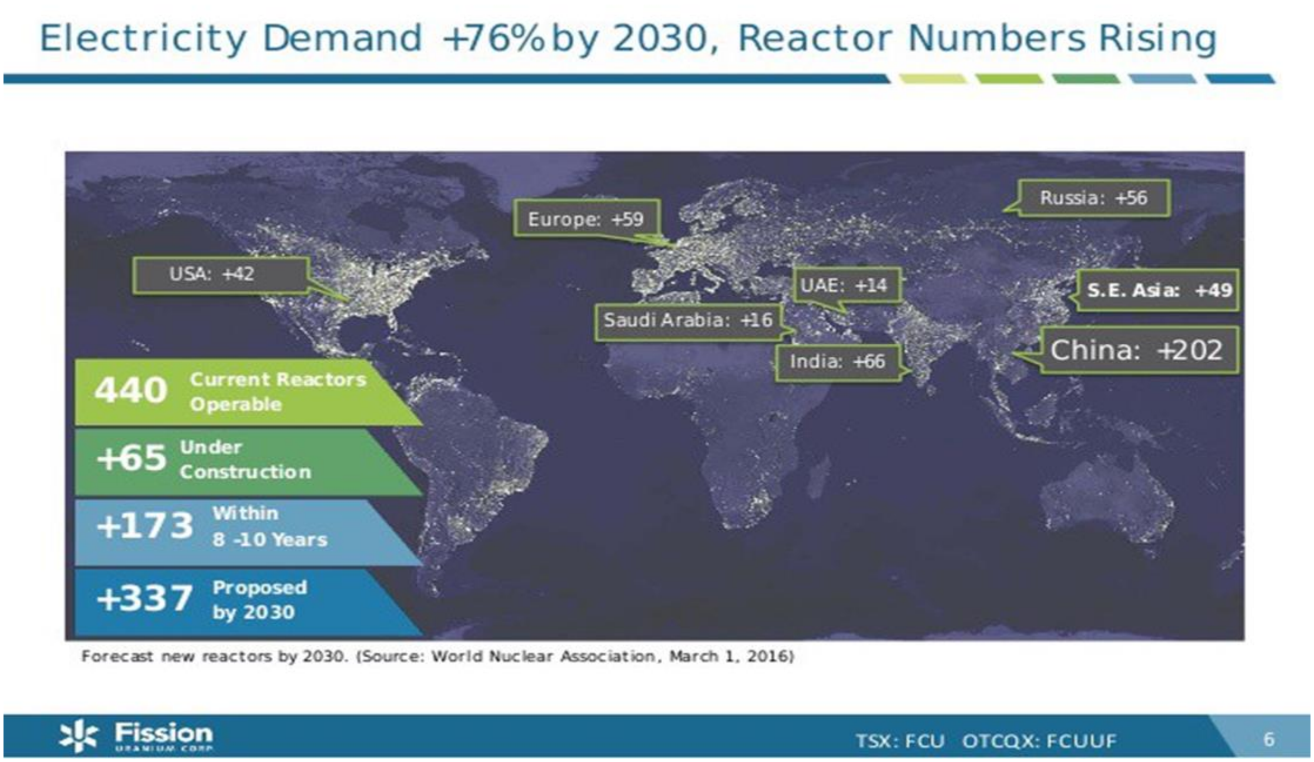
Many people may not be aware that nuclear power remains a key component of many country's base load power supply – including accounting for nearly 20% of the United States base load power.

Top Nuclear Power Generating Nations

Country	% of energy from nuclear
France	72.3%
Slovakia	54.1%
Ukraine	52.3%
Belgium	51.7%
Hungary	51.3%
Sweden	40.0%
Slovenia	35.2%
Bulgaria	35.0%
Switzerland	34.4%
Finland	33.7%
Armenia	31.4%
Korea	30.3%
Czech Republic	29.4%
Spain	21.4%
United Kingdom	20.4%
United States	19.7%
Russia	17.1%
Romania	17.1%
Canada	15.6%
Taiwan	13.7%

Source: International Energy Agency report "Key World Energy Statistic", 2016 edition.

So there is a base of use that will remain in place to underpin Nuclear Power as a meaningful source of power and electricity supply. Let's walk through a high-level overview of the demand side of the equation. There are approximately 440 Nuclear Reactors currently in operation with approximately 65 reactors under construction. The latest estimates from the World Nuclear Association indicate that the total number of Nuclear reactors in use could double over the next 15 years, with the bulk of this increased demand coming from China.



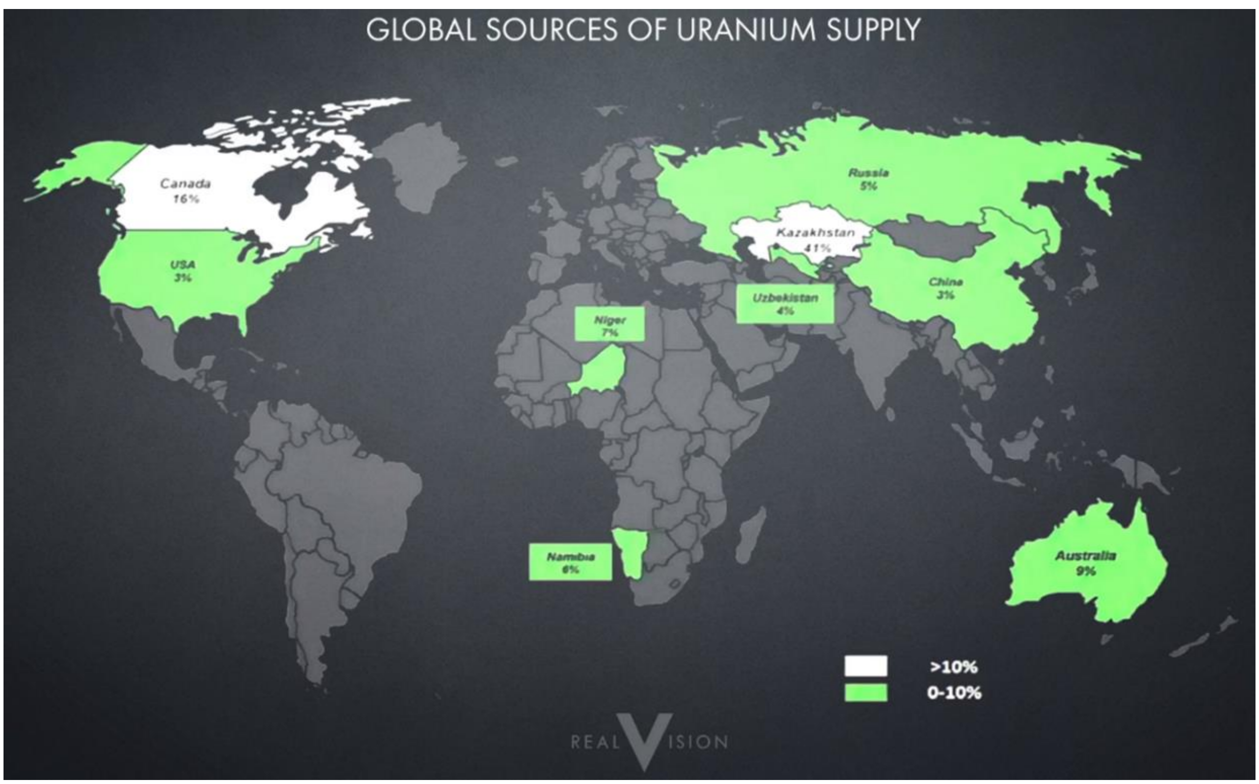
China and the Asia Pacific region in particular are key drivers for future demand growth going forward. In China's latest five-year plan, they detailed ambitions to bring online 8 nuclear reactors per year for the next five years. India is another key source of demand going forward with 3% of their current base load power coming from nuclear with a goal of getting this to 20% over the next two decades. In both of these regions, pollution and air quality is of key concern which is why nuclear energy is considered to be one of the key sources they will leverage to meet the energy demands they will need in an environmentally friendly fashion. This doesn't at all mean that either of these regions are intending to rely solely on nuclear energy as the only source of electricity generation, as they are also investing heavily into alternative energy sources – but nuclear is a key part of their energy strategies.

As with most things, time has a way of healing most wounds. With the nearly seven years that have passed since Fukushima, the stigma that has hovered over nuclear power is slowly lifting. Furthermore, there has been increased focus on technological improvements around safety in the construction of nuclear reactors, the placement of said reactors, and even the size and energy output so as to lessen the overall upfront cost of construction.

Me thinks Ken Caldeira of Stanford University's Department of Global Ecology is on to something when he says:

> *"There's only one technology that we know of that supplies carbon-free power at the scale of modern civilization requires, and that is nuclear power."*

This brings us to the supply side of this equation which took a meaningful turn last year when the world's two largest producers took it upon themselves to step up and start the process of curtailing production. Kazatomprom of Kazakhstan is the world's largest uranium miner and Cameco from Canada is the world's second largest miner. Together they control over 50% of the world's uranium supply, so when you think about the perceived control OPEC has over the price of oil, that is nothing compared to the impact these two suppliers could inflict should they want to affect prices.

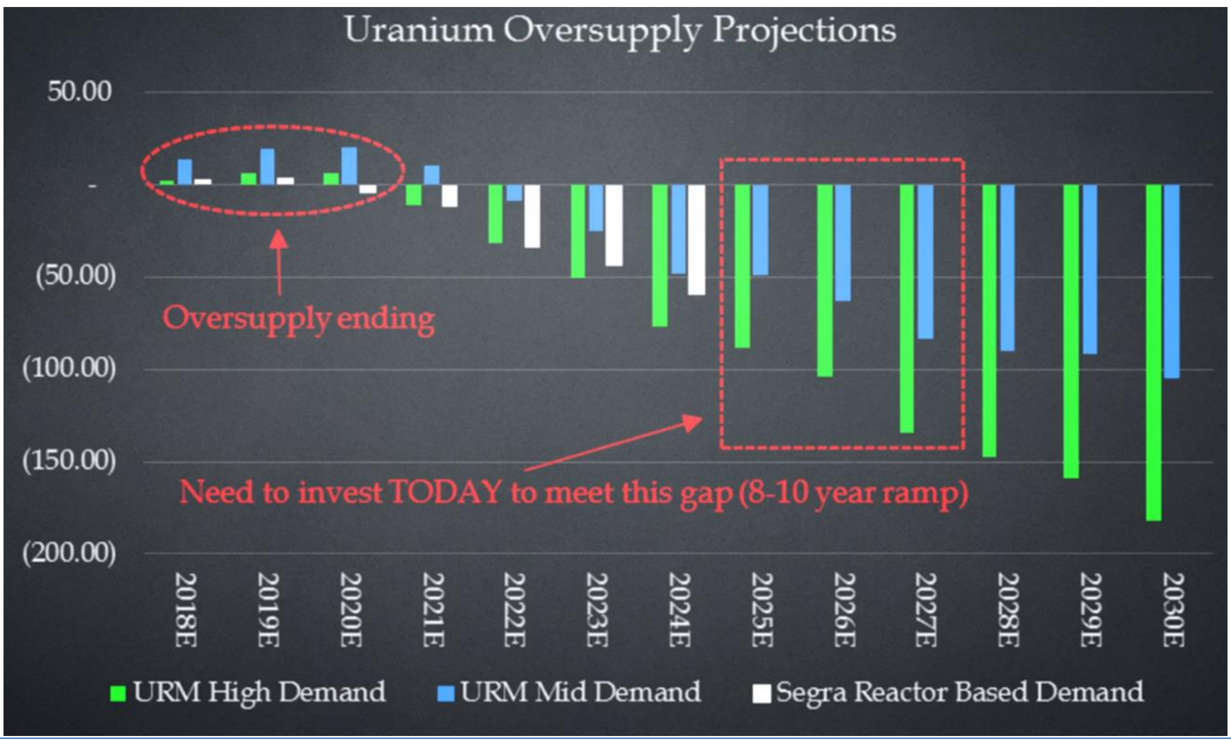


Well, last year both of these suppliers decided that enough was enough with Kazatomprom announcing in December that they would be cutting their uranium production by 20% starting in January of 2018 to better align output with demand. Shortly before that announcement in November, Cameco announced that due to continued uranium price weakness they were going to shut down their McArthor River mine starting at the end of January 2018. For reference, the McArthor River mine is the world's largest uranium mine and accounts for nearly 12% of annual uranium supply.

So here you have a situation where the two largest uranium producers in the world have taken it upon themselves to bring some semblance of reality to a market that has been saturated with supply over the last several years. Estimates suggest that the breakeven cost for uranium production is about $60/lb, so that is to say that uranium would need to nearly triple from its current spot price of $23/lb just to breakeven. It makes all the sense in the world for these miners to take these steps rather than continue to pull product out of the ground and lose over $35/lb on the open market.

One of the biggest questions that will impact the timing of when/if uranium prices start to turn up is when does the supply/demand pressure start to balance out the excess inventory that is currently on the market? The latest estimates I've come across from the industry indicate that uranium production was 162 million pounds in 2016, 151 million pounds in 2017, and estimates for 2018 suggest uranium production will fall to 140 million pounds. Contrast this with demand estimates for 189 million pounds and it's reasonable to conclude that it's only a matter of time before this market shifts from an oversupplied market to a market in deficit.

What is perhaps the most compelling aspect of this small portion of the commodity market is that there has been virtually zero new capital investment into uranium mining since 2013. And from what I understand about this market, it takes nearly 7 – 10 years to bring new supply online for any outside sources interested in rushing into the market should prices move higher. So, should we go from an oversupplied market to a deficit, there is a reasonable chance it will remain that way for several years before investors have to worry about new miners flooding the market with supply (as is usually the case in the resource complex). As they say, "high prices are the cure for high prices, and low prices are the cure for low prices".



Let me close by saying that while this looks like a compelling opportunity, it is by far a riskless endeavor. The demand side of the equation is highly dependent on the evolution of Chinese interest. There is always the risk of another nuclear reactor melt-down which will put the industry back on its heels. But in a world where financial assets are pricing at a premium, a little exposure to a bombed-out industry that has tangible economic value, and the potential for meaningful returns is worth the look. One last caveat, and I'll say it again: patience is required, as volatility in this space is high and the price swings can very easily scare away the faint of heart before the potential payoff arrives.

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