February 5th, 2018

Live by the sword, die by the sword…

The price action in capital markets last week was a perfect illustration of what has become my biggest fear for investors coming into this year: the scenario where everything declines together. U.S. domestic stock indices registered meaningful declines (the Dow Jones Industrial Average gave back 1,097 points during the week, the S&P 500 plunged -3.86%, the Nasdaq Composite fell -3.38%, and the Russell 2000 Small Cap Index slipped by -3.64%), International Equity Markets experienced a similar fate (the German DAX lost -4.16%, China sold off more than -6%, India was down almost -7% on the week, Japan was down more than -3.5%, and Emerging Markets as a whole lost nearly -6%), and even the safe-haven defensive sectors within the equity market saw declines (Utilities -2%, Healthcare -5%, and Telecom -2.7%).

What is most upsetting to me is seeing this large of a setback occurring just after global retail investors plowed more than $100 billion into equity funds in the month of January, adding $25 billion more last week, so apparently there remains a healthy appetite for "buying the dip", reminiscent of Bob Farrell's rule #5: "the public buys the most at the top and the least at the bottom".

During times of equity market anxiety, diversified investors typically take solace in their fixed income exposure, but even that didn't provide much of an offset last week with Treasury Bonds carrying a maturity beyond the next 2 years declining anywhere from roughly 75bps (3-7 Year Treasury Bonds) to almost 4% at the very longest end of the T-Bond maturity spectrum. Corporate Bonds, be it investment grade or junk rated, fell between -1 to -2% on the week. Heck, even gold was off last week to the tune of -1.3% which was a strong showing in that it declined less than most other asset classes, but it still wasn't able to act as a positive offset to broad based declines in all other asset classes.

Consider the irony that these declines occurred on the back of what on the surface was some more strong global economic data: global PMI's continued to hover near cycle highs, this morning's release of China's services PMI showed business activity expanding at the fastest pace in over seven years, and we learned last week that the U.S. labor market added another 200k jobs in January which was accentuated by the strongest growth in wages since 2009.

So what gives? Two words: Interest Rates, and in particular the pace at which they have increased over the last two months. The 10-year Treasury yield (as a proxy for interest rates) was 2.35% as recently as mid-December, just prior to when the tax cut bill was signed into law. As of this morning the yield on the 10-year Treasury bond reached 2.86%, which relative to history doesn’t seem like much, but given the backdrop today and the ultra-low interest rate environment that has defined this economic expansion, this swift move higher is causing asset prices broadly to reprice. You see, everyone was excited to price in the roughly 10% bump to corporate profits on the back of lower corporate tax rates, and this bump came on top of analyst's expectations that corporate profits were already slated to increase by roughly 9% this year. A stock market that raced ahead by double digits in the second half of last year (and then fired out of the gates this year to the tune of a 7% gain in the S&P 500, which pushed the forward P/E multiple to north of 18x) had fully priced in these lofty earnings expectations.

What wasn't in the math of these earnings estimates was a 10-year T-Note yield responding by rising to four-year highs. This dose of fiscal stimulus, coming in the ninth year of an economic expansion, with an unemployment rate at 4.1%, an output gap that has been closed for more than six months now, late-cycle inflationary forces starting to show through in the data, and fiscal deficits as a percentage of GDP having increased for two consecutive years, all put's the Federal Reserve in a challenging spot where they may have to tighten policy (via more rate hikes) faster than markets were pricing in at the start of the year. Markets are now priced 70% of the way for three rate hikes this year, and this is a meaningful move from only being priced 30% of the way as of mid-December.

Let me give you an example of why higher interest rates matter, even though they remain historically low. In the International Monetary Fund's most recent annual *Global Financial Stability* report, they conveyed a stark warning about the health of the U.S. economy in that they concluded that **22% of U.S. corporations are at risk of default if interest rates rise**. In their report they cited the rapid decline in the average coverage ratio over the past two years – the ability of current earnings to cover interest payments – as its primary evidence. In a separate study by the Bank of International Settlements (BIS) that was released last year they concluded that the number of companies they defined as "zombies" doubled between 2007 and 2015, reaching roughly 9 – 10% of all public firms. The BIS defines a "zombie" company as any listed firm which is more than 10 years old and has a ratio of EBIT-to-interest expense below one. Eoin Murray, Head of investments at Hermes Investment Management made the following comment that I thought was quite astute after the report was released:

> *"Like animals in captivity, companies incubated on the milk of QE and low rates may no longer exhibit the natural behaviours needed for success in the wild of a stimulus-free market. Ultra-low rates and excessive borrowing may have allowed corporate financial alchemists to present*

ailing patients in rude health. Unfortunately for bondholders, the elasticity of unreality has a snapping point. ***QE and ultra-low rates have insulated many companies, and unwary investors, from the dangers that normally lurk;*** *they are now treading a dangerous path…Central bankers have inadvertently managed to stem natural attrition, something which is paramount for healthy capital markets, with a knock-on effect on the flow of money into new enterprises. Eventually, the natural order must prevail."*

What is unknown is at what level do higher interest rates become a problem? In the last cycle the Fed hiked rates from 1% to 5.25% over the course of two years and this ultimately ended up being the threshold that caused the cycle to tip over. In the late 90's expansion the Fed hiked rates up to 6.5% before things began to wobble and ultimately the expansion rolled over. It's important to acknowledge that while all cycles have a similar rhythm to them, they each have unique characteristics that define and make them different. A couple of important contrasts between this cycle and the last two is that the system is much more indebted today than at the height of those prior expansions and economic growth is much weaker. Hence why interest rates this cycle reached all-time lows and have remained low for an extended period of time.

This is why I continue to have my doubts about whether the tax cut bill that was passed will have any beneficial impact at all. Even when you consider the positive impacts on the total revenue stream through increased investment and/or spending, the numbers still come out to suggest that this law borders on irresponsible if not potentially dangerous. Here's to hoping for the best, but should these tax benefits just be squirreled away by corporations into more share buybacks and one-time dividend payments, or saved by consumers who have already pared down their savings rate to decade lows, then we can all kiss goodbye the hopes of 3 – 4% GDP growth.

Although what we'll be left with is an ever-growing pile of Federal debt, with the most recent estimates I've come across indicating that the government's borrowing needs are set to go from $519 billion last year to $915 billion this year to $1.083 trillion in the 2019 fiscal year and $1.128 trillion in 2020. This little tidbit is another variable that I don't think most investors are truly appreciating in that this money to fund Uncle Sam has to come from somewhere in the financial system and that is money that then cannot be used to make investments elsewhere – this is what is implied by the term ‘crowding out’. The double whammy is that this is occurring at a time when the Fed (one of the largest purchasers of U.S. Treasuries throughout this entire cycle) will be stepping away from the table in a more meaningful way.

This is what the new Fed Chair Jerome Powell had to say back in 2012 about the Fed’s unprecedented balance sheet expansion, and why investors may want to rethink Janet Yellen’s comments that the unwind of the balance sheet will be like “watching paint dry”:

> *“First, the question, why stop at $4 trillion? The market in most cases will cheer us for doing more. It will never be*

enough for the market. Our models will always tell us that we are helping the economy, and I will probably always feel that those benefits are overestimated."

"My concern is that for very modest benefits, we are piling up risks for the future and that it could become habit-forming."

"My third concern – and others have touched on it as well – is the problems of exiting from a near $4 trillion balance sheet. We've got a set of principles from June 2011 and have done some work since then, but it just seems to me that we seem to be way too confident that an exit can be managed smoothly. Markets can be much more dynamic than we appear to think. Take selling – we are talking about selling all of these mortgage-backed securities.

Right now, we are buying in the market, effectively, and private capital will begin to leave that activity and find something else to do. So when it is time for us to sell, or even to stop buying, the response could be quite strong; there is every reason to expect a strong response."

What I take away from these comments more than anything else is that we are all (including the Federal Reserve, who started us down this path…) working from a text book that hasn't been written yet. We all have our models, our theories, and beliefs, but we must objectively admit (at least in part) that there are "known unknowns' in this equation that won't be unearthed via any other mechanism than trial and error. As such it is important that all investors take this into account when assessing expectations for the future.

Back to the interest rate story for a moment: in fairness, one must acknowledge the prevailing consensus narrative that interest rates are rising for the right reasons and that is because the global synchronized growth story is alive and well. Couple this with a strong corporate profits backdrop and you have all the necessary ingredients to mix together a pretty bullish equity market cocktail. However, I'm not so sure that this prevailing view carries the same bite today as it did last year as I'm seeing broadening signs suggesting that the U.S. economy is cooling off. The Economic Cycle Research Institute (a group that has a fairly unblemished track record at forecasting the economy) has lately been pointing out the weakness it is detecting in its leading indicator.

The more that I look back on the Q4 real GDP data, the more holes I find. Mind you, I think there is a reasonable chance that the 2.6% print gets revised higher before all is said and done, but it's the sustainability of the drivers of that growth that don't look repeatable. When one removes the stimulative impact from the post-hurricane 'repair and rebuild' – an event that won't be repeated (outside of us experiencing another natural disaster) – and a consumer that went 'ass over tin cups' wild on a credit card binge and by drawing down their personal savings rate, there was very little growth in Q4. On top of this we saw productivity contract last quarter which is an ominous sign when you couple it with the fall in aggregate hours worked in January's employment report.

Something tells me it won't be too long before the Atlanta Fed takes a hatchet to its initial estimate of 5.4% GDP growth for Q1.

Look, there is nothing fun or comforting about a sell-off like the one we are currently in the throes of, full stop. The important thing is not to panic and, after all, what the stock market has done thus far is unwind the parabolic move we had to start out the year. What's more is there is no secret formula or crystal ball that will tell anyone when or where it ends. Sure, there are plenty of bright minds and great investors trying to ascertain that very question, but even they are subject to indecision and uncertainty. It's important to maintain composure and perspective as this market may very well have a lot of excess and exuberance to work off (speaking of, I didn't see any tweets from the President last week about record stock prices…). I applaud and celebrate a pro-business agenda and any policies targeted at having a positive impact on society (even if I may disagree with the results), but using the stock market as a benchmark for one's success (and this goes for the Fed as well as the administration) is widely astray of the mark on many fronts. Case and point is that it may entice those unfamiliar with, incapable of, or unable to afford the risk to take actions they shouldn't.

For investors and traders alike, it's important to not miss the forest for the trees, in that valuations in the equity market still remain near the most expensive levels in history. As such the margin of safety underpinning prices is much lower than the current bid. I don't pen this to be dramatic or an alarmist, but rather to encourage investors to look at what you own and why. Take this drawdown as an opportunity to do an autopsy on your portfolio and determine what (if any) adjustments are prudent for you going forward.

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