April 9th, 2018

Don't fight the Fed…

Few market variables signal that a major transition is underway better than volatility, and that is precisely what investors are experiencing here in 2018. We are just a little over three months into the year and already the Dow Jones Industrial Average has experienced 22 days where the intra-day move has eclipsed 400 points. In all of 2017 there was but one occurrence of this level of intra-day volatility. Some pundits are quick to jump to the idea that what we are seeing this year is the norm for markets, but I would suggest it's anything but. The level of volatility this year is as abnormal as the virtual extinction of volatility was last year. Nevertheless, it is what it is and all investors have to come to terms with this current reality.

After all, there is no shortage of possible explanatory variables one could reference as to why markets are exhibiting such schizophrenic price action:

- Escalating trade tensions between the two largest economies on the planet…
- A new untested and less dovish Fed that thus far doesn't appear to be nearly as concerned about asset prices as its predecessors…
- Unorthodox fiscal policy – not in its construction, but rather in its timing. Here we are nearly 9 years into an economic expansion with the unemployment rate at 17-year lows, inflationary forces building in the system, and the output gap having been closed for nearly 8 months – yet this administration is embarking on one of the most aggressive fiscal stimulus plans in history. Admittedly this is one debate where I have strong feelings on both sides of the argument in that this economic recovery is the weakest on record in the post-WWII era, so I can understand the argument by those suggesting it has been a highly unequal recovery (benefitting the few to the detriment of the many), but resolving this imbalance is not as easy as blowing out the fiscal budget in an irresponsible fashion to prolong a recovery that has had way too much artificial support from the get-go…
- The broadening awareness that the "bloom is coming off the rose" on the synchronized global growth narrative – have a look at page B1 of this morning's Wall St. Journal, "Cracks Appear in Global Growth Story". The fact that this is on the front page of the business section suggests that the talking heads on bubblevision waxing poetic about the "great fundamentals" continue to look at the investment landscape through the review mirror when they should be focused on the picture that is not as bright when one is looking through the windshield. That view would show that the growth in the U.S. economy is back to stall-speed. The Atlanta Feds GDP model is forecasting Q1 real GDP growth of 2.3% (down from +5% at the start of the quarter) and the only reason this forecast is above 2% is because their model incorporates soft survey data as an input, whereas the hard data is indicative of an economy that is growing at a sub-2% clip in Q1 with the most recent estimate from Macroeconomic Advisors looking for a print closer to +1.5%.

Anyone who needs further validation that economic growth is decelerating should take a look at real retail sales which are down three months in a row (declining at a -4.4% annual rate from November to February), housing starts over the past three months that have collapsed at an 18% annualized pace, the Baltic Dry Index which has slumped 40% from its December peak to levels last seen in August 2017, and an Architectural Billings Index that slipped in February to a four month low of 52 from 54.7 in January.

It would be nice if I could highlight other parts of the world that are picking up steam at a time when it looks like the U.S. is running out of steam, but unfortunately that is just not the case. India, one of my favorite long-term investment and economic regions, is holding in just fine with growth near 7%, but even it is no longer accelerating. Japan is another region I like long-term and am interested in finding another window of opportunity to put some capital to work there given the constructive profile, but at present it looks like its economy is throttling back in a meaningful way on both the manufacturing and household spending front. China is in the midst of rebalancing its economy coming off last year's congressional elections, but overall its economy is showing no signs of accelerating. And then you have the good ol' U.S.A. as well as its cyclically sensitive neighbor to the north that both look as though they are stuck in a growth quagmire of roughly 1.5 – 2.0%.

Yet, even in the face of an S&P 500 that has seen its price swing up or down by 1% or more in nine of the past eleven sessions, investor complacency remains high – perhaps holding out for the notion that the price action from 2017 is set to return. Well, I got news for these investors – move along because that was a one-time deal and the sooner you accept this reality the better you'll be at navigating what's to come. Just to hit this point home, we are on pace for 100 sessions this year with at least a 1% move in the S&P 500. According to some fine data mining by Gluskin Sheff's David Rosenberg, in the past seven decades this level of volatility happened in 1974, 2001, 2002, 2008, and 2009. Recall for anyone with a foggy recollection of those years that none of them proved to be kind to investors carrying a high exposure to risk assets – with the exception of 2009 which was a year that itself lacked a high degree of clarity of whether or not we were out of the woods of the GFC. Forewarned is forearmed.

What's most unnerving for asset allocators so far this year is that diversification within one's portfolio is not providing any offset for the major asset classes investors typically have their highest exposures to. Have a look below at the 2018 performance of various asset classes through Friday's close:

- Oil: +4.2%
- Gold: +2.2%
- Agriculture: +1%
- Nasdaq 100: +0.5%
- Russell 2000: -1.3%
- High Yield Bonds: -2.2%
- S&P 500: -2.6%
- Investment Grade Bonds: -2.6%
- Treasuries: -3.4%

Within each one of these broad categories there are places that performed better or worse than the averages, but to be frank, you almost have to be surgical with your precision this year to overweight those exposures and even then, the overall performance to offset declines in other areas is rather anemic.

I'm not one for short-term market calls but should equity prices bounce from the levels they closed at on Friday (as looks to be the case as I'm penning this commentary) then the technicals suggest a nice rally awaits which could take the S&P 500 up into the 2,700 – 2,750 level. If and/or when we get there we'll have to reassess, but this could portend that should the S&P 500 be able to overcome the resistance levels in this price range then a more meaningful rally potentially awaits that could threaten the January 26th highs. However, should we get to these levels and reverse lower then there is rising probability that the market has topped for this cycle at the January highs and investors need to recalibrate their investment strategy for the challenges that come with managing capital through a declining asset price environment.

This week kicks off the start of Q1 earnings season which is expected to be one of the best quarters (in terms of growth rates) in recent memory, but what I think will be more interesting to monitor is how stock prices react to the high bar that has already been set. Carnival Cruises recent results are a perfect example of what I'm talking about. Carnival reported last week and they blew away expectations on virtually every metric – earnings came in above the high end of the range, revenues did the same, and the company raised guidance to-boot. On these stellar results the stock popped more than 3% only to end up closing the day down more than 1%. Whether this is a canary in the coal mine will be determined soon enough, but this illustrates a couple of things to me: 1) this is a potential sign of a market that is fully priced, 2) this is the type of price action you see in the very mature stages of a market cycle, and 3) a market/stock that doesn't respond bullishly to bullish news…isn't bullish.

Even given the 10% correction the broad market has experienced over the last six weeks the S&P 500 still trades at a 16x forward P/E multiple and this is a full point above the historical average. To be fair, not all of the bump we are seeing in corporate profits is attributable to the corporate tax cut so analysts will be keying in on organic growth metrics to assess what is the potential for earnings growth down the road (2019 and beyond) once we move past the one-time bump in corporate earnings as a result of the corporate tax cut this year.

Two other variables that have changed this year relative to prior years by going from a tailwind to a headwind is higher interest rates and rising inflation. First on interest rates, for anyone who hasn't been paying attention they are in a definitive uptrend. Using the yield on the 10-year T-note as a proxy for interest rates, its yield has doubled from the 1.36% historic low it touched a short two years ago in July 2016. Even despite the sell-off in the stock market over the last several weeks, the apparent softening in global economic data, and heightened geopolitical uncertainty, the best the yield on the 10-year Treasury could do was dip a total of about 20 basis points from the 2.95% high it hit earlier this year. This is having repercussions across the spectrum of credit instruments tied to interest rates and given that corporations are sitting on their highest level of indebtedness in history, it portends higher financing costs going forward into what is setting up to be the largest refinancing calendar over the next four years in the history of credit markets. Even accounting for the cash on company balance sheets, business leverage ratios are at elevated heights and this was one of the main arguments of why Guggenheims Scott Minerd, during a CNBC interview, believes that equity markets could potentially decline 40% in 2019 or 2020 when he expects the next economic contraction to commence.

Speaking of debt, have a read of the op-ed piece penned in today's Washington Post, "A debt crisis is coming. But don't blame entitlements". Look, I'm trying to do my best to steer clear of politics and partisanship as it has become nothing more than a lightning rod for retort and questioning one's objectivity. But I can't find any way to get around it after reading this piece given it was penned by five former chairs of the White House Council of Economic Affairs including Jason Furman and former Fed Chair Janet Yellen. It's an interesting article and filled with data, facts, and sound reasoning, I guess where I get derailed is in its irony and hypocrisy. They argue that a debt crisis occurring sometime in the future will be accelerated as a result of the recent tax cuts and budget bill. Neither of which I disagree with, but keep in mind that Furman and Yellen we're center stage, sitting in two of the most powerful financial positions in the world over the last decade when U.S. Federal debt doubled from roughly $10 trillion to over $20 trillion. And now that both of them are out of their powerful posts they feel the need to be more vocal, genuine, and sincere about the dilemma this mountain of debt presents to the U.S. Come on, give me a break – what were you looking at when you were in a position where you could have actually done something about it, rather than being the enablers that assisted in us getting to this point?

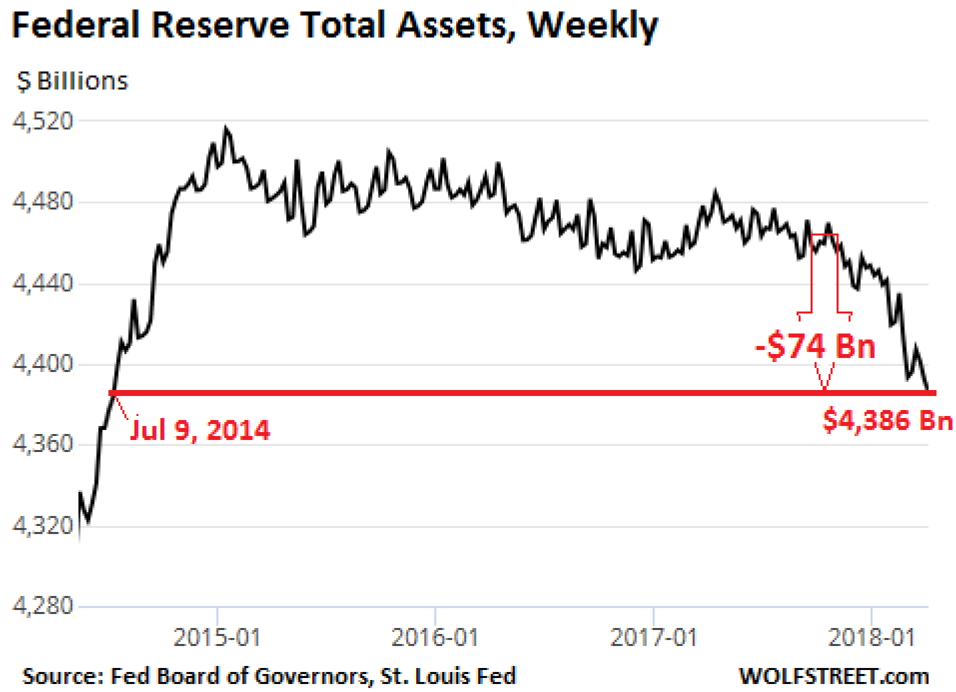
It is a bit reminiscent of the GOP gaining sole control of all branches of government following the last election and this party of fiscal conservatism forgetting all about that principle as soon as they came into power.

Stepping off my soap box, and back to the other variable that presents a challenge to corporate earnings going forward, and that is inflation. What I'm talking about here is the steady, gradual rise in wage inflation (the biggest expense for most companies) as well as other metrics signaling tightening capacity in the supply chain that could crimp profit margins. Nearly all the survey data over the last several months, be it NFIB Small Business Sentiment, ISM, and CEO conference calls, are highlighting rising cost pressures. The three-month trend in the core PCE deflator (the tamest of all the inflation measures and the Fed's preferred inflation gauge) is now running at a 2.8% annual rate over the three months to February. In an eerie case of foreshadowing, the last time we saw a reading like this was in November 2007 just before the peak of the last business cycle.

Add to this the threat of a trade war between the U.S. and China and you have yourself even more gasoline to fuel the inflationary fire that is already in the system. A couple points on this trade war spat in that those pointing out that the direct economic costs should a full-blown trade war break out are quite small are correct in that the hit to U.S. real GDP growth would be roughly 0.2%. China, while reducing its export dependency over time, is far more exposed on this front and estimates indicate approximately a 1% impact to their GDP growth rate. The important point is that contrary to President Trump's view, there are no winners in a trade war, just varying degrees of losers. What is unknown and can't be measured is the tertiary impacts that a trade war would have on other parts of the economy and capital markets, i.e. confidence, credit markets, and sovereign debt markets.

What is also accurate is that China is running out of room on the tariff file to counter what this administration may throw out there given the U.S. imports $506 billion from China while we only export $131 billion to China. One of the counter punches some are pointing out is that China could start dumping its Treasury holdings, but I think this is an unlikely outcome given it would cause them to take losses on their FX reserve holdings. But China could hold back from being a major participant in future Treasury auctions which could be problematic given the amount of debt the U.S. Treasury has to issue this year as the budget deficit is set to double the level from last year and continue its rise for the foreseeable future.

While I think everything that I've penned in this commentary prior to this point is important, interesting, and relevant (at least to me) – it all takes a backseat to the 800-pound gorilla in the room that I'm going to end this missive on, and that is liquidity being drained from the system. You see, the entire complexion of this market has changed since the start of 2018 as a result of the Fed stepping up the pace at which it reduces the size of its balance sheet. The biggest question I had coming into the year is whether it would matter as early as Q1 or would it start to bite in Q2 and beyond. Recall the schedule of the Fed's balance sheet reduction: $10 billion per month in Q4 2017, $20 billion per month in Q1 2018, stepping up to $30 billion per month in Q2, $40 billion in Q3, and peaking at $50 billion per month starting in Q4 of this year. The below chart from Wolf Richter of Wolf Street research details what this looks like over a short-term interval with total Federal Reserve Assets down almost $75 billion since Quantitative Tightening began in October of last year.



This next chart provides some context on a longer-term framework as it plots the rise in the S&P 500 since the start of this bull market in asset prices that really took off in earnest with the initiation of QE1 back in 2009.

A lot has happened over the past decade and it is not fair nor accurate to suggest that the rise in asset prices as well as ensuing economic expansion occurred solely because of QE. From 2010 through 2014 there were numerous organic and fundamental developments that supported both of those outcomes. However, there were also a fair amount of challenges that the added liquidity via QE implemented by the Fed helped both the markets and the economy to overcome:

- The European Debt Crisis in 2011, as well as fears of Greece defaulting on its debt…
- A downgrade of U.S. debt by one of the major ratings agencies in 2011…
- The taper tantrum in 2013…
- China devaluing its currency in 2015…
- A collapse in the price of crude oil starting in 2014 and lasting into early 2016 that brought on a depression in the energy sector…
- Last but not least, the broadening sprawl of nationalism/populism first in the U.K. with Brexit and then in the U.S. with the surprising election of Donald Trump. These are two nations known in the history books for their democratic liberties which have found themselves turning inward and away from decades of global integration…

At every one of these anxiety-ridden intervals there was the Federal Reserve who took decisive action to step on the liquidity accelerator, whether it was using forward guidance to announce another rendition of QE or appeasing capital markets that it wasn’t going to be pulling the punchbowl away. This created a conditioned response / investment mentality that investors became quite reliant on, gaining confidence that the Fed would always be there to infuse liquidity at times of heightened anxiety and establish a floor underneath risk assets.

It remains early days, but by the looks of the above chart we’re in a new regime with a new sheriff in town, and Chairman Powell has yet to even blink at the temper tantrum markets have exhibited since QT started to bite at the end of January. What’s more is that his lieutenants at the Fed (Brainard, Boskin, Mester, and recently announced NY Fed Chair Williams) are following his lead in distancing themselves from being attached to ever rising asset prices. So, keep in mind that we’re just getting started on this balance sheet reduction objective where Powell himself is on the record at suggesting a long-term target for the Fed’s balance sheet would be around $2.5 - $3.0 trillion dollars. With a starting point of just under $4.5 trillion, that would suggest that there is potentially $1.5 – $2.0 trillion in liquidity withdrawal coming down the pipe which is something for all investors to strongly evaluate given how markets have acted thus far with only $75 billion in QT implemented since Q3 of 2017.

Surly it’s not prudent to look at this variable solely in a vacuum as there are plenty of other factors currently at play adding to the elevated levels of uncertainty, but don’t lose sight of the ‘forest for the trees’. As the saying goes, “don’t fight the Fed” – why everyone assumes this advice only applies to when the Fed is providing accommodation and not when it is removing accommodation is beyond me.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215

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