



April 16th, 2018

Too much to ignore...

The parallels I'm seeing in the economic and capital market backdrop between today and the opening months of 2008 are becoming too numerous to ignore. This isn't at all to suggest that I expect a Global Financial Crisis Part Deux is lurking right around the corner, as many astute market observers have been correct in pointing out that banks are much better positioned today compared to then, but it is the non-bank financial intermediaries where the skeletons are hiding this cycle. After all, the U.S. economy (and the global economy for that matter) is more indebted

today than was the case only a decade ago with government, corporate, and household debt all at their highest levels in history. The U.S. government is leading by example on this front as the latest budget data shows that we are just five months into the fiscal year and already the budget deficit has ballooned (literally) to \$600 billion. There are still seven months to go in the year and we've already nearly taken out last year's deficit. What has kept these record high debt levels from meaningfully interrupting what is now the second longest economic expansion in U.S. history has been a gradually declining interest rate backdrop coupled with an insatiable investor appetite for yield paying investments.

Well, as I have been harping about for the last three months now, the winds of change are afoot with both liquidity and the cost of capital (a.k.a. the price of money – a la,

interest rates) reaching a point where they are both having the impact of restraining economic activity and hindering asset prices from moving to new all-time highs. Let's play out an example of what I'm getting at through the prism of corporate profits – a fitting exercise given we're moving into the heart of Q1 earnings reporting season. You'd be hard-pressed to glance through the business section of any major periodical today that wouldn't be describing the expectations for Q1 and full year 2018 earnings results as the strongest investors have seen in many years. And this narrative of 15 to 18% EPS growth for 2018 is realistic given the economic momentum coming into the year combined with steep corporate tax cuts.

But, in my opinion, this view is extremely lacking in context and of a deeper dive into variables that will have a meaningful impact

in the not-too-distant-future. First for context, you have to account for the fact that this current expansion is already 46 months beyond the length of the average expansion over the last eight decades. Admittedly this expansion has been unusual in many ways, but nevertheless it is highly likely that it will fall subject to the same late-cycle forces that all prior business expansions fall prey to at some point. These forces that negatively impact profitability and eat away at record profit margins are increasing costs via capacity constraints, raw material cost increases, rising labor costs, tightening liquidity conditions, and rising interest expenses.

What is becoming more evident in every inflation metric over the last several months is that inflation pressures are building and the only way for companies to offset these pressures is through increasing prices, given

that most companies have already spent the majority of this expansion in cost cutting mode, leaving very little room for improvement on this front. However, there is little evidence that the 70% of the economy that we call the consumer can digest even modest price hikes in their consumption baskets. The evidence so far on the household front as it relates to the recent tax cuts is that the freed-up cash-flows are not going into the real economy, but rather being used to rebuild savings, siphoned into the gas tank through higher gasoline prices, dumped into higher health insurance premiums, or paying down debt from last year's credit binge.

So far this year we've seen the personal savings rate move back up to 3.4% from the decade low reading of 2.4% in December of last year – just imagine what the consumption numbers will look like in the months ahead

should this figure mean revert to its historical average of around 5%. As for the historic debt binge households went on in the second half of last year, consider that in 2017 aggregate wage and salary income rose \$430 billion while consumer debt levels surged \$580 billion. Why anyone would think this trend is anything close to sustainable needs a reality check, and soon. This year just may be the start of that piper starting to get paid and this speaks volumes to the awful results we've been seeing in the retail sales figures in the three months that ended February.

So late cycle cost-push inflationary forces are starting to bite, but this is only part of the story that the chorus of bulls (who are still crowing about this recent 10% dip being a great buying opportunity...) are missing. For sure, valuations on the S&P 500 look much better trading at roughly 16.5x next year's

earnings, but this multiple is at risk of being grossly overstated in the face of a much different fiscal and monetary policy backdrop in 2019. On the fiscal front it's a virtual certainty that there isn't going to be another tax cut next year to lift earnings numbers 10% just by the stroke of a pen. Moreover, almost everything happening this year as it relates to fiscal policy is nothing more than a deficit-financed sugar high that will have a diminishing marginal return through time with much of the stimulus not lasting beyond 2018.

However, what will have a lasting impact on corporate profits from this point going forward are higher interest expenses. It's amusing to me how cavalierly it gets thrown around that corporate balance sheets are in such great shape when the aggregate credit rating in the corporate credit world is BBB. This is only one notch above junk status and

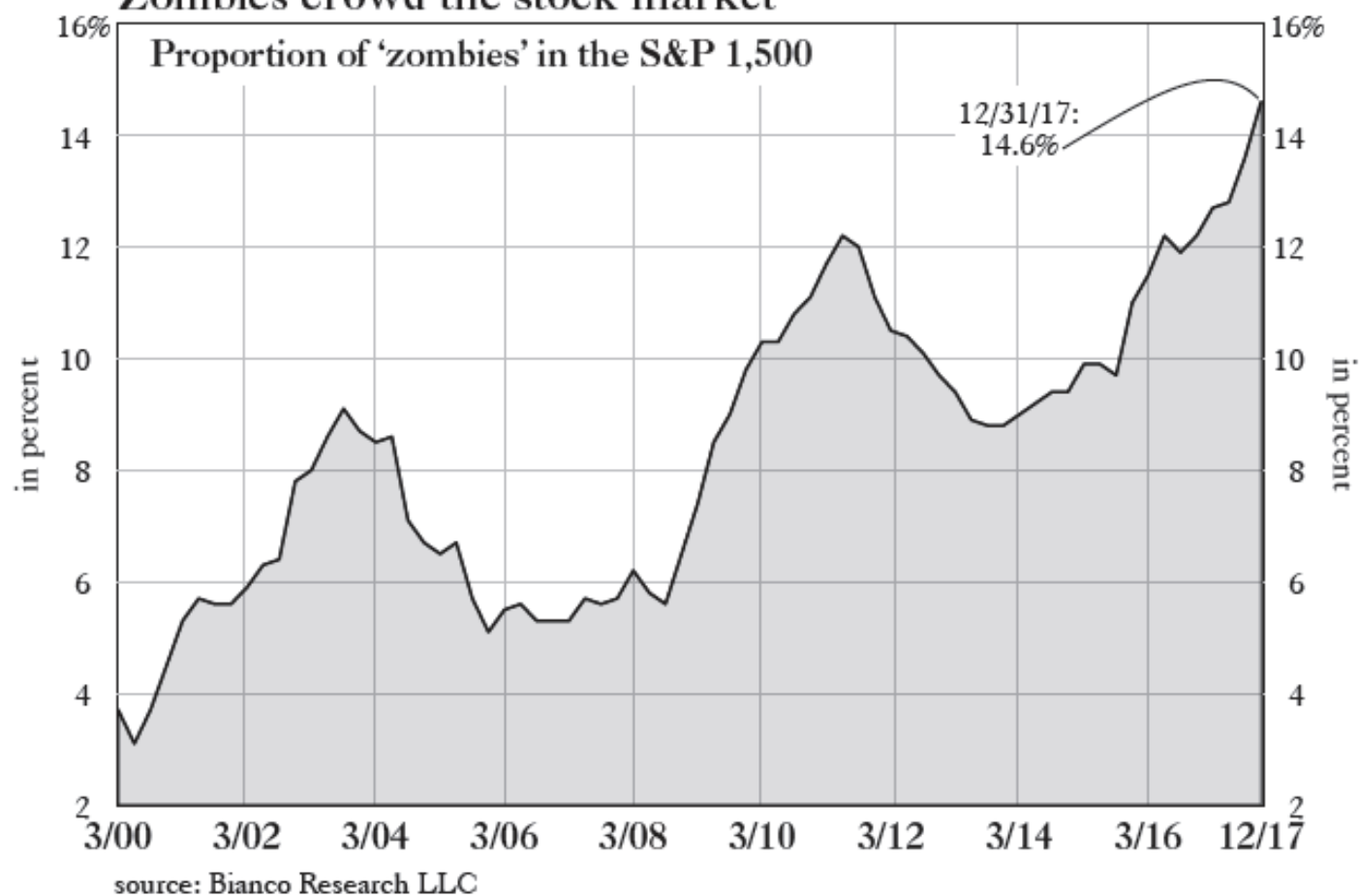
we're talking about close to 50% of corporate debt outstanding carrying a rating of BBB or lower. Look beyond the rating and you'll see that the nonfinancial business sector has nearly \$5 trillion of debt outstanding with a final maturity inside of 6 years. Do you see the dilemma yet? Over the next five years we will have the largest refinancing calendar in the history of credit markets and this will be occurring in the face of higher interest rates. Now you could point out that interest rates are still low, but this misses the point that all things in economics and markets price off of what happens at the margin – it's the marginal change that moves prices and, on this front, we're looking at an interest rate backdrop that saw global rates hit their lowest level in 5,000 years back in July 2016.

Odds are that anyone rolling over debt in the coming years will be doing so at a higher

interest rate level than was the case at any point since late 2015 / early 2016.

Those who process information better through a visual prism can spend some time comprehending the below chart from Bianco Research (recently posted on Jesse Felder's blog "The Felder Report") which came to the conclusion that 14.6% of the companies in the S&P 1,500 Index should be considered "zombie companies". A "zombie" company according to Bianco is one whose interest expense is greater than their 3-year average EBIT (earnings before interest and taxes).

Zombies crowd the stock market



Stated simply, these companies don't generate enough in earnings to even cover the servicing cost of their outstanding debt load – so their only option is to take on more debt to pay the interest expense on their existing debt. In case you're wondering, NO – this is not a sustainable business model.

All of this comes full-circle to the Fed and their once again having made the same mistake that has haunted them at the end of most economic cycles – they over stay their welcome on the easing side which allows imbalances to build beyond what they otherwise would have grown to, and then these bubbles ultimately get popped at some point when the Fed tightens too much. Just how much is the \$64,000 question today because no one knows how much liquidity withdrawal or how many rate hikes is the perfect balance – not even the Fed knows where that is, but this won't stop them from trying and this means trouble for investors who have become addicted to measuring success with a daily scorecard. If investors would just take the opportunity to look beyond their own nose they'd realize that the Fed is going to keep raising rates until either

something breaks or the economic expansion becomes impaired.

I sympathize with the position Fed Chair Powell finds himself in and much of it is not of his own doing. That blame falls squarely on the shoulders of former Fed Chairs Bernanke and Yellen who waited too long to normalize policy, so now this current Fed board has to make-up for lost time and perhaps quicken the pace of normalizing a funds rate that in real-terms is still negative. Even under the Fed's own method for calculating a funds rate that is consistent with full employment and price stability, they have to hike at least another 100 basis points before getting to neutral. The trouble with this equation is that the yield curve has flattened to its lowest level since 2007 and it will only take perhaps two more hikes before it's inverted.

This is the cherry on top of the ice cream sundae that is the growing list of eerie similarities that exist today compared to 2008. The economic data from employment, to housing, to the industrial production data, to the high-but-falling ISM, and recent inflationary forces all line up with the late-cycle playbook. Even the paradigm shift we've seen in volatility from this year compared to last stands out as a cautionary yellow flag fluttering in the wind. So far this year the VIX has averaged 18x which puts it on the map with the following years that had a similar average: 1990, '91, '98, 2000, '01, '02, '08, and '09. Anyone not familiar with what happened in these years may want to rush over to the library and check out a history book because these periods weren't kind to investors who were over exposed to risk assets. Come to think of it, history books are

perhaps one of the most undervalued assets in the world today given the potential shifts afoot.

Please don't construe these comments as alarmist or sensational – I'm trying to be everything but. However, I'd be remiss and feel irresponsible for not shedding some light on the pile of risks that continue to grow by the day. Just because the market continues to hold its ground and ignore the escalating geopolitical risks from around the world doesn't mean they are irrelevant. It just implies that it's irrelevant at the moment, but it by no means suggests that trade tensions and policy uncertainty don't matter to what multiple an investor puts on an investment.

Here's my guess – this current rally we're in may have a little more steam left, but these next several months just may be the last best

opportunity for investors to de-risk and reposition themselves for what are likely to be some much choppier waters ahead. There is growing evidence indicating that the stock market is in the midst of a topping process. Yes, tops are processes and they usually play out over a much longer duration of time than bottoms which are typically much quicker. In the coming months, investors are likely to hear much more from technicians and market pundits like me about the ‘death cross’ which is when the 50 day-moving-average crosses below the 200dma. This is not a bullish set-up – it’s actually the opposite of the ‘golden cross’ which occurred back in early 2009 indicating that it was safe for investors to wade back into the risk pool.

So, unless the economy reaccelerates (and it’s getting hard to see how this happens), the case for extending this bull market even longer is

becoming more difficult to make. It's realistic to at least consider that the high for this bull market may have been put in place back on January 26th, and all we're experiencing right now is a newfound tug-of-war between the bulls and the bears with neither camp making much headway since early March. Sure, we could continue this rally a little further and maybe even flirt with the 2,800 level reached in the S&P 500 on March 13th, or we could revisit the 2,554 level reached on April 2nd. This is the new trading range the index has been in and it's not until we break out of this range in one direction or the other that investors will have their next capital market signal. Same story goes for the yield on the 10-year T-Note which is hovering around the 2.84% level, smack dab in the middle of its range of 2.95% on the high-end and 2.70% on the low. A break of either of these levels will be equally as important.

More than anything, what I'm trying to say is that we are at a juncture in capital markets where investors need to pay attention and fight the urge to try and predict every wiggle and twist. Let the market dictate to you what is going on, which at this time is flashing some critical (though classic) late cycle indications that are deserving of all of our attention and focus.



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