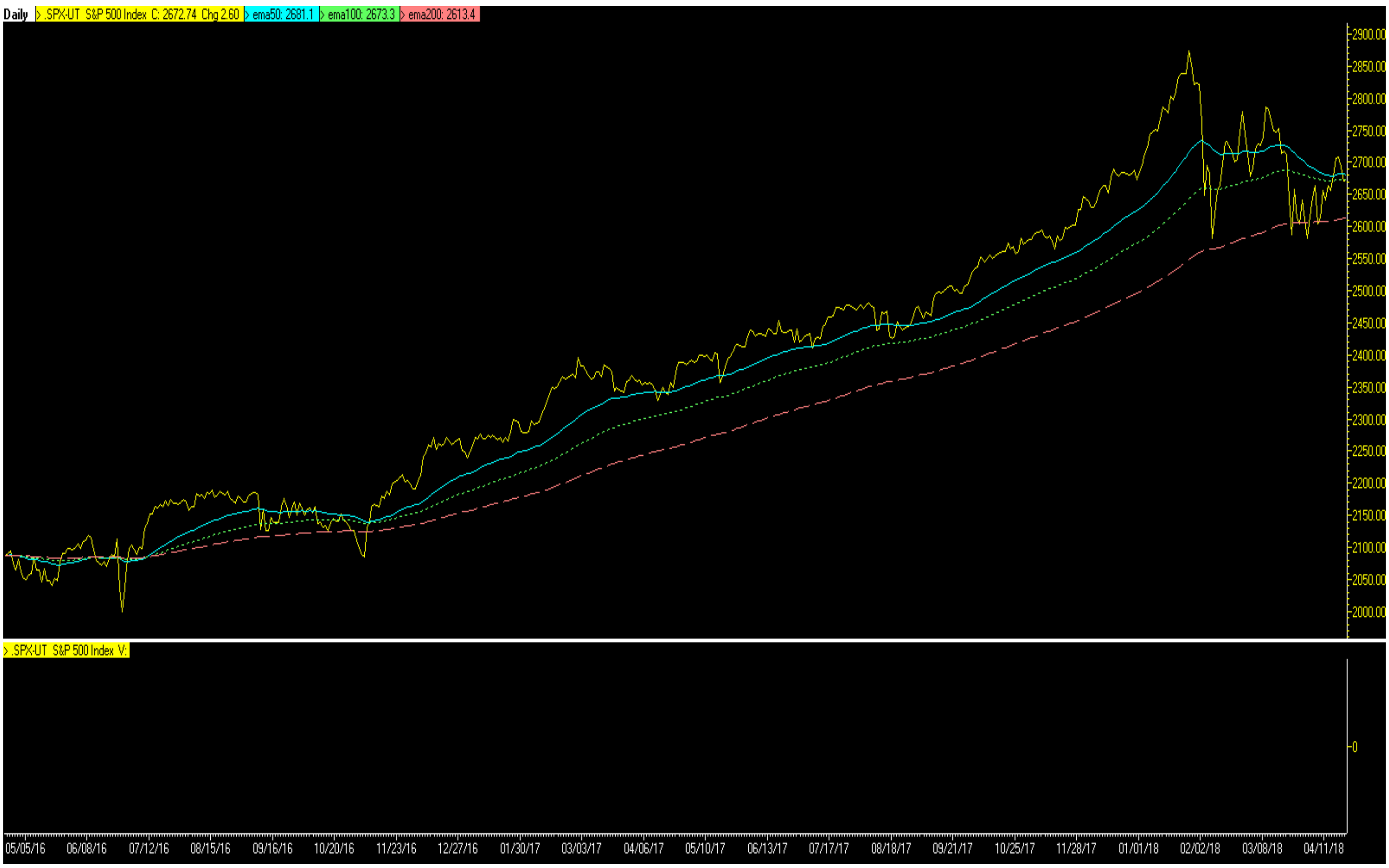
April 23rd, 2018

Quick takes on markets and economic data…

Equity markets:

Looking at the S&P 500 and using this index as a proxy for the overall equity market backdrop, it's pretty clear to see from the chart below that we remain stuck in a pretty tight trading range. As you can see, the S&P 500 has been bouncing between its 50- and 200-day moving averages since early February with failed breakouts having occurred numerous times. The biggest debate among the bulls and bears is in which direction this trading range finally gets broken in a sustained manner. A break higher sets up the possibility that the S&P 500 could revisit the highs it reached in late January but should this trading range break to the downside, then the probability increases that this bull market has passed its expiration date.



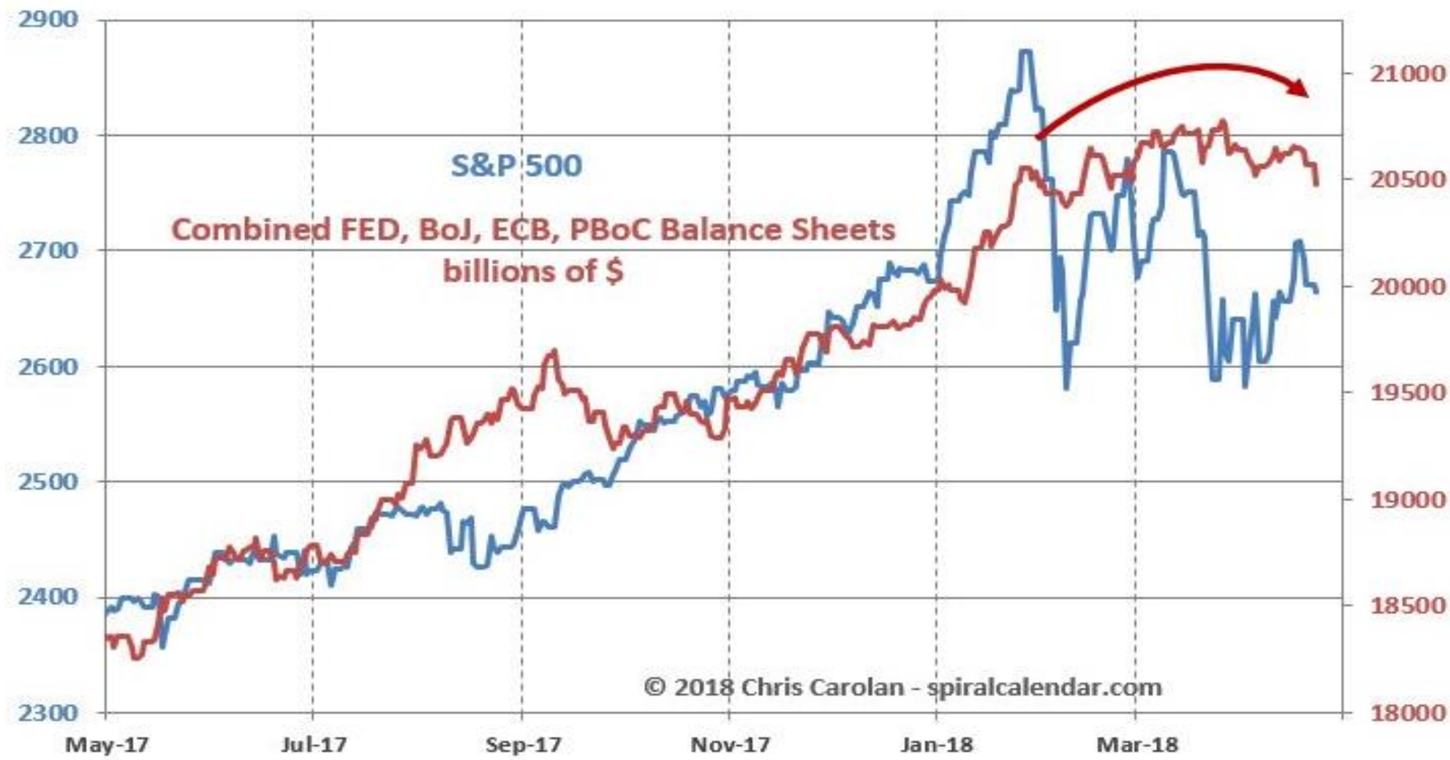
A couple things working against the bulls is that the 50dma (blue line) is on the cusp of slicing below the 100dma (green line), and this is a bearish omen. The real 'death cross' comes once the 50dma crosses below the 200dma (red line), but there remains leeway in this technical setup in both time and price. Thus far the 200dma has acted as solid support to the market, so calls for an imminent collapse are perhaps a bit dramatic, but don't let that foster a false sense of security because the market at this juncture looks as vulnerable as it's been in some time. What is also disheartening of late is that the recent rallies have been occurring on lighter and lighter volume while the sell-offs have been on higher volume.

One last thing of note with the above chart is how each of the rallies since the January 26th peak have made lower highs, and none of the moves have been able to establish a new uptrend. This pattern is eerily similar to what equity investors experienced at the end of the equity bull markets in 1980, 1990, 2000, and then in 2007 – a hallmark of late cycle market behavior. Hence, why it's important for investors to be objective in their thinking that we likely have entered into the 'sell the rip' and 'do not buy the dip' part of this market cycle.

As for the earnings backdrop, it's been nothing short of what's been advertised – over 20% of companies have reported results thus far with over 80% beating earnings estimates by an average of more than 6% – but there-in lies the rub as these earnings results were bought and paid for several times over in the last 12 months. What's more is that a good chunk of the elevated results are coming at the hands of corporate tax cuts which, for future growth prospects, will start to fade out of the results as soon as next year. Another important contributor to the strong corporate profits results is the weaker dollar which benefits 50% of the sales from S&P 500 companies that come from overseas, but don't look now as it appears as though the U.S. dollar has put in a short-term bottom.

This rightfully begs the question about what multiple should investors be willing to pay in an environment where global growth looks to have peaked and margin pressures are rising from increased input costs and higher interest expense? Sure, the forward P/E multiple has come down a full 2 points from its lofty levels in late January, but it still remains above historical averages and a strong argument could be made that the cheapening in this valuation metric is primarily the result of an accounting adjustment due to the corporate tax cut. I'm not saying it's not real, but as an investor I'm more willing to pay a higher multiple on sustainable organic earnings growth rather than for a one-time accounting adjustment.

Then there is the reality in the following chart that really shouldn't need any further explanation as it plots the level of the S&P 500 (in blue) versus the cumulative size of the balance sheets of the big four central banks – The Fed, ECB, BoJ, and PBOC. What's clear is that since the end of January when the cumulative growth in these central bank balance sheets started to flat-line, the S&P 500 has not been able to make any further progress upwards.



Let this serve as reminder that this is a time to be very selective on what you own in your portfolio and, if anything, investors should be even more discerning and vigilant in their security selection – if not outright circumspect. All cycles eventually end and this one will be no different. What is important to understand at this point is that we are one month away from this becoming the second longest expansion since the Civil War, and while none of us know exactly what the expiration date is, the signs are broadening that it's getting closer. Most forecasters are highlighting 2020 or 2021 as to when investors should worry about a recession hitting. I'm not so sure we'll have that long and peg the odds of the U.S. being in a recession within the next 12 – 18 months. Given that the stock market historically peaks around 8 – 10 months before the onset of a recession, should the January 26th high prove to be the peak then we're looking at a recession to start sometime late this year or early next year.

Interest rates…

Treasury yields have been pressured higher over the last week with short-term yields out to the 3-year maturity at their highest levels since '08 -'09 and the 10-year yield reaching its highest level (2.99%) since 2014. It'd be nice to be able to point to one or two key variables that explain the move higher in rates, but I'm afraid it's a bit more of a complicated analysis than that. First and foremost is the Fed and the fact that they are so far behind the curve in getting rates back to a normalized level earlier in this cycle that the new crop of Fed officials (led by Chairman Powell) are being forced to make up for lost time. You see, the Fed is playing with fire at this point where for the last five years they have worshiped at the altar of getting core PCE inflation above 2% (a target that it has been below since April 2012) that it has flooded the financial system with liquidity, with most of that liquidity finding its way into capital markets – thereby creating asset price inflation, but little in the way of reported inflation metrics.

Now here we are today with inflation readings at or above the Fed's objective and the full employment objective having been achieved several quarters ago, so the Fed has run out of excuses for not pulling the punchbowl away. The two levers they are pulling to tighten financial conditions are reducing the balance sheet by over $400 billion this year ($600 billion at an annualized rate starting in Q4) and raising the Federal Funds rate, both of which serve to drain liquidity from the system and raise the cost of capital. This is what is most unnerving to a steward of others peoples' capital in that the Fed drastically overstayed its welcome this cycle and in so doing fostered an error of mal-investment that has raised the level of outstanding non-financial debt in the system from $27 trillion at the peak of the last cycle to more than $50 trillion today.

Up until this point it's been the right decision for investors and market prognosticators to ignore these imbalances that were in the system because interest rates were trending down to the 5,000-year lows they hit in the summer of 2016. Even after those lows were reached and as interest rates started to move higher, these imbalances still remained manageable because interest rates were still historically low and were only gradually moving higher. However, this dynamic has changed since September of last year with interest rates across the curve having moved meaningfully higher:

- 3-month Treasury Yield: 1.04% on September 15th versus 1.82% on April 20th

- 6-month Treasury Yield: 1.17% on September 15th versus 2.01% on April 20th

- 1-year Treasury Yield: 1.30% on September 15th versus 2.22% on April 20th

- 2-year Treasury Yield: 1.38% on September 15th versus 2.48% on April 20th

- 5-year Treasury Yield: 1.80% on September 15th versus 2.83% on April 20th

- 10-year Treasury Yield: 2.20% on September 15th versus 2.98% on April 20th

- 30-year Treasury Yield: 2.77% on September 15th versus 3.14% on April 20th

This rise in interest rates will at some point prove to be too much for a U.S. economy that has never been more indebted both on an absolute basis and relative to GDP in its history. Not only that, but one thing that I don't see getting much attention in the headlines (I imagine it won't be long) is that nearly 1/5th of outstanding corporate debt needs to be rolled over each year looking out over the next 5 years. Good thing for the tax cuts as they will help to alleviate what is going to be a $100 billion increase in incremental debt servicing cost over the next several years.

Which brings me to the yield curve and how readily it's being dismissed by some of the talking heads suggesting that it hasn't inverted yet and once it has inverted, investors still have another 12 – 24 months left to the bull market before you need to worry. Really? I'm as guilty as the next analyst at using history as a guide to what one might expect in the future, but there is no historical analog to the environment we've been investing through over the last several years. So history can only take you so far at this point and then you've got to roll up your sleeves and perform some deep level bottoms up analysis to try and comprehend the investment mosaic that we are working with today.

Inflation…

Anyone still in doubt that inflationary forces aren't present and building in the system should pull up the Fed's Beige Book for April that was released just last Wednesday. See for yourself from the comments below, but to me these scream margin pressures for companies and offer some credence to why bond yields are on the verge of breaking out:

Federal Reserve Bank of Boston:

Many respondents cited modest to moderate price increases; a few noted steeper jumps.

Federal Reserve Bank of New York:

Input prices have continued to rise briskly but have not accelerated further, according to contacts in most industry sectors. Still, businesses generally anticipated further increases in the months ahead. A growing proportion of service-sector contacts indicated that they were raising their selling prices--most notably, wholesalers--but manufacturers noted only modest hikes in their prices.

Federal Reserve Bank of Philadelphia:

Builders continued to note rising prices for construction materials as well as labor and noted concerns about a potential trade *war. Contacts cited double-digit price hikes for lumber and drywall and expressed concern for steel and reinforced concrete.*

Looking ahead six months, manufacturing firms continued to anticipate higher prices, with nearly two-thirds expecting increases in prices paid and over half expecting increases in prices received for their own goods.

Federal Reserve Bank of Cleveland:
Upward pressure on input prices remained strong, particularly for commodities used by goods producers. According to contacts, recently imposed tariffs have accelerated price appreciation of steel products, in some cases at double-digit rates.

Transportation companies across the board were able to raise freight rates in response to strong demand relative to available capacity without pushback from customers. To a lesser extent, manufacturers have been steadily raising their prices since the beginning of the year to pass along their higher raw materials and transportation costs.

Federal Reserve Bank of Richmond:
Prices grew moderately, on balance, since our previous report. According to our most recent surveys, manufacturers' input costs grew at a moderate rate and continued to outpace growth in selling prices. Steel and aluminum prices rose sharply and were expected to rise further as a result of recently-imposed tariffs. Housing and construction material prices, such as those for appliances, cabinetry, carpet, drywall,

lumber, and concrete were also on the rise. Service sector prices grew at a modest rate, overall.

Federal Reserve Bank of Atlanta:
...some contacts noted rising prices for transportation, as well as steel as tariff rhetoric increased. The Atlanta Fed's Business Inflation Expectations survey showed year-over-year unit costs were up 1.9 percent in March. Looking ahead, survey respondents indicated that they expect unit costs to rise 2.1 percent over the next twelve months.

Federal Reserve Bank of Chicago:
Overall, prices rose modestly in late February and March, and contacts expected prices to continue to increase at that rate over the next 6 to 12 months.

Manufacturers facing higher steel and aluminum costs because of the new tariffs expected to pass on about half of the increased costs to their customers on average.

Federal Reserve Bank of St. Louis: *Price pressures have increased slightly since the previous report. Building materials prices rose. A contact in northwest Arkansas reported an increase in construction costs, and steel and scrap metal prices increased moderately throughout the District.*

Federal Reserve Bank of Minneapolis: *Price pressures were moderate overall since the last report, but wholesale prices increased more briskly. Multiple contacts reported dramatic increases in the prices* *for steel products, partly attributable to recently announced tariffs; a manufacturer of tractor trailers said they "can't raise prices as fast as material costs."*

Federal Reserve Bank of Kansas City:
Prices in the construction sector continued to rise moderately, with strong increases expected in the coming months. Manufacturers noted a modest increase in prices for finished goods, while raw material costs rose moderately. Manufacturers expected moderate growth in both finished goods and raw material prices over the next few months.

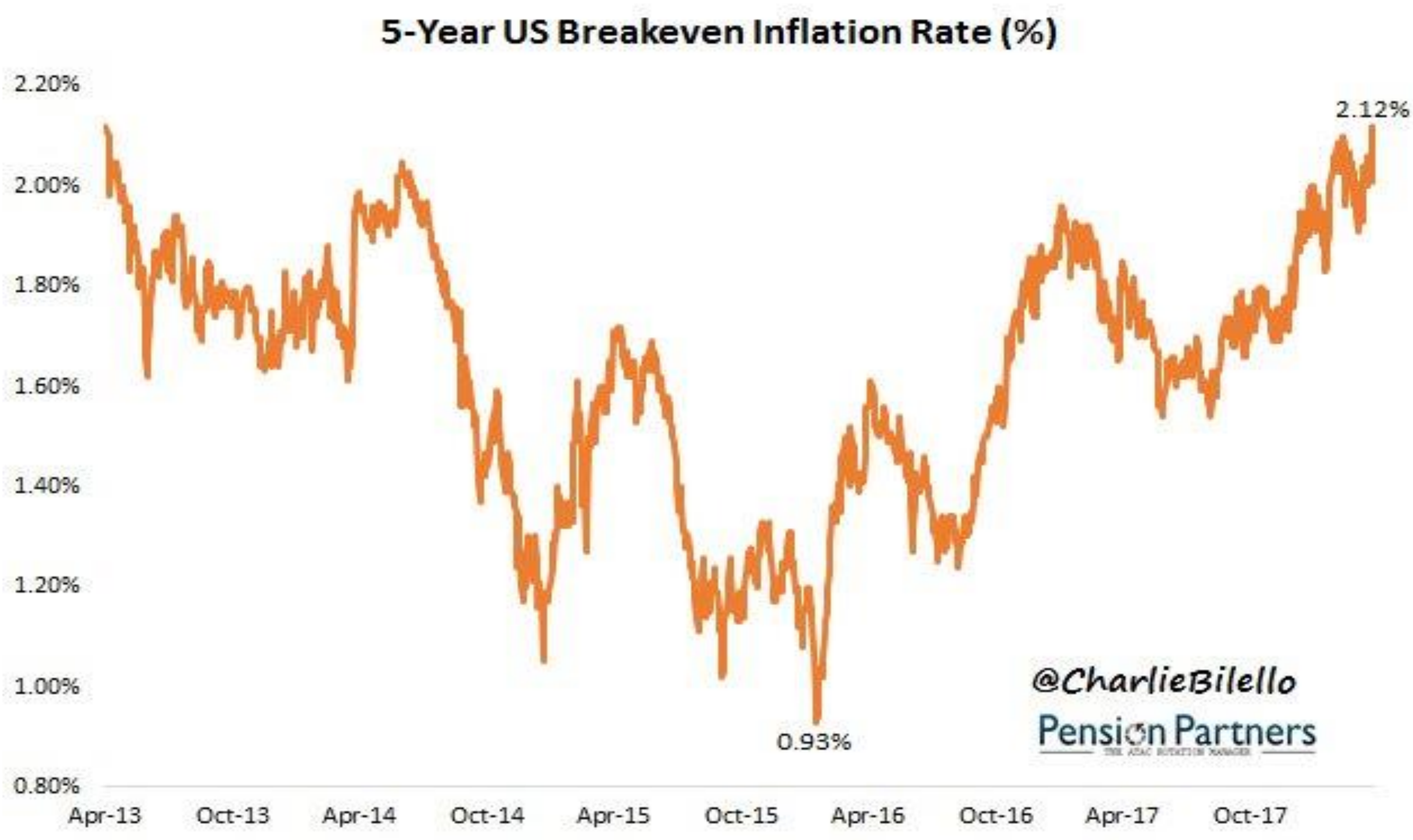
Federal Reserve Bank of Dallas:
Price pressures remained elevated over the past six weeks. Input cost pressures increased among energy, manufacturing, and construction firms, partly due to the

announced tariffs on steel and aluminum. Upstream energy firms said the steel tariffs represent a worry, although some contacts said there shouldn't be much of an impact on costs until 2019 when contracts roll over.

An architecture firm noted that the increase in steel costs will impact the ability of their clients to move forward with some construction projects.

Federal Reserve Bank of San Francisco: *Price inflation increased modestly over the reporting period. Strong construction activity drove further price inflation for a wide variety of building materials, including lumber and sheetrock. Contacts reported a jump in inflationary pressures for metals prices, partly due to the* *anticipation of tariffs and unrelated increases in raw material costs.*

Judging by the move in the 5-year Breakeven Inflation rate to its highest level since April 2013, it looks as though the bond market is pricing in some of the inflationary dynamics apparent in the Fed's Beige Book.



Add up the action in the equity market, what the Fed is doing, the pick-up of inflationary forces, and rising interest rates, and it's all consistent with what investors would see in a late-cycle investment playbook, which suggests that investors should position themselves in ways that benefit from inflationary forces (commodities, real assets, and companies with pricing power), rising short-term interest rates (laddering a high quality bond portfolio with maturities out as far as 2-3 years), and most importantly, reducing the overall beta and cyclicality of the holdings in your portfolio. This last point includes understanding what your risk exposure is in the fixed income side of your portfolio because one element that may prove to be different in this cycle relative to previous cycles is that the inverse correlation between stocks and bonds that has provided diversification benefits to investors during the worst of times over this 35-year bull market in bonds, just may not be as beneficial going forward.

On this last point, I’m by no means a raving bear on the bond market as I do believe that Treasuries will prove to be a port in the storm in the next economic downturn, but right here and right now it’s hard to deny the late-cycle inflationary forces that likely make it challenging to hold long-term Treasuries at the moment. In the final years of each of the last three cycles (’89, ’00, and ’07) long duration bonds took it on the chin, but once those cycles eventually tipped over into a recession, we saw Treasury yields come down considerably and those holding 10- to 30-year T-Notes were grateful they had them.

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