May 14th, 2018

Some thoughts on the economy and markets…
Equity markets put in a very strong week of gains last week with the Dow Jones Industrial Average rallying 2.3%, the S&P 500 up 2.4%, and the Nasdaq Composite bumping up by 2.7%. This was the best week in the last nine for the major averages, a run that has the Dow up for seven straight days (a winning streak the likes of which it hasn't experienced since November of last year). This recent rally has brought about some technical relief with all the major averages now trading back above their 50 day moving averages. The next important technical resistance levels sit at 2,800 for the S&P 500 (a level where the rally failed in March) and 7,500 for the Nasdaq, so we soon will find out if this leg up has enough energy to test or even take out those January highs, or if this will mark the fourth failed attempt to rally off of the 200-day moving average. Should it be the latter, then investors should really start to consider the possibility that the January highs just may mark the peak for this cycle and investment strategies need to be retrofitted for what historically comes next – a bear market.

Let's not get too carried away on that point just yet, because while there are plenty of signs indicating that a cautionary investment disposition is warranted, enough constructive signals remain suggesting that there is still a little more runway left in this bull market. Let's run through the pluses and minuses of some of the important variables that I believe will shape the next big move in the markets throughout the balance of the year:

> **Inflation:** This one metric takes top billing when assessing the major macro-economic variables going forward. My rationale for this view is multi-fold, but it starts and stops with the Federal Reserve and the fact that 'price stability' is one of the main objectives under their "dual mandate" (full employment being the other). You see, inflation has been running under the Fed's 2% target for almost a decade now, and it is for this reason that the Fed always had the flexibility to step in and add additional monetary policy support whenever the economic backdrop softened during what is now the second longest expansion on record. Hence, they've been able to keep the Fed Funds rate nailed to the floor at 0% from December 2008 to December 2015 and have only subtly nudged interest rates higher through five 25 basis point hikes over the last 2 ½ years. However, after seven years of 0% interest rates and with rates still extremely low today, the Fed has become more concerned about the imbalances and mal-investment that has been built up in the system. It was in the summer of 2017 that their tone began to change with more heightened attention paid to financial stability concerns (code for 'asset prices' and 'valuation levels') and the risks that a severe decline in asset prices could pose to the economy.
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> The U.S. economy (and the global economy for that matter) is finally reaching a point where inflationary pressures are threatening to push above the Fed's 2% target level. Yeah, I know,

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investors have been breathing a sigh of relief over the recent PPI, CPI, and wage growth data coming in below expectations, but I fear this is only a brief respite in these data series where the rising trends reassert themselves throughout the balance of the year. Why do I feel this way, you ask? For one, almost every earnings call or transcript I've reviewed this earnings season has made mention of the rising cost pressures from commodities, labor, and transportation with corresponding commentary detailing how managers intend to raise prices to counteract this margin pressure. In addition to what corporate executives are saying, these rising price pressures are showing through in a broader array of economic data reports. This weekend's Barron's pointed out that of the 46 countries that are represented in the world PMI data, 80% are showing signs of accelerating cost pressures while 74% of global purchasing managers are saying growth is decelerating. Sounds a lot like a stagflationary back drop to me.

It's also worth noting that other inflation readings outside of the CPI index and BLS wage data are not corroborating the soft readings to these reports. The Cleveland Fed's median CPI measure is running at a cycle high 2.6% year-over-year rate and this is what their own research department has to say on this series: "*the Median CPI provides a better signal of the inflation trend than either the all-items CPI or the CPI excluding food and energy…and is even better at forecasting PCE inflation in the near and longer term than the core PCE*." I know that's a lot of acronyms to digest for the casual follower of the economy, but what this implies in layman's terms is that we should be expecting higher inflation prints in the months ahead. This is the same message that the New York Fed's underlying inflation gauge (UIG) is suggesting with its most recent reading ticking up to 3.2%, the highest reading in 11 ½ years. Something that 'Bond King' Jeff Gundlach recently pointed out is that the UIG typically leads core CPI by about 16 months.

Why I'm making such a concerted effort to flag the inflation data as a key data point to watch going forward is that should it remain on its rising path, then it neutralizes the Fed from being able to step in with additional monetary policy support should the economic growth profile soften as we move into the second half of the year. Throughout this extended bull market cycle investors have been conditioned (and handsomely rewarded, I might add) to expect the Fed to step in and bail out investors at times of even modest stress. I don't think this investment strategy is as fool proof going forward given the Fed is now operating in an environment where it has achieved both sides of its dual mandate.

Interest Rates: There has been no shortage of ink spilled in the investment research community about the potential end to what has been an almost four-decade long bull market in bonds stretching back to 1981 when the 10-year Treasury Bond yielded north of 15.5%. The thing is, in looking back over the 37+ year bond bull market run, whenever the 10-year T-note yield touched the high end of the long-run channel, something either in the financial system or the economy ended up buckling and this inevitably spilled over into problems for the equity market: the crash in 1987, a recession in '90 - '91, an ugly bond and stock market sell-off in '94, the popping of the Tech bubble in '00, and the Global Financial Crisis in '08.

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That's the funny thing about rising interest rates in an over indebted system: the increasing cost of servicing outstanding debt is manageable as long as economic growth is higher than the corresponding level of interest rates. Once you cross the Rubicon to where the cost of capital exceeds the return on capital, then problems arise. This is a dilemma that I'm afraid the 'goldilocks' crowd cheerleading the recent stock market advance along just isn't grasping yet, in that the trend in inflation is rising, cost pressures are mounting (both negatives for record high operating margins), and bond yields are on an upward path, even if they are in the midst of a brief pause. Even if yields are range bound, they are doing so at the high end of their range, and here's where it really gets interesting in that should the economy accelerate (and there is little evidence suggesting this is the case) then this will just fuel the next leg up in interest rates.

Ultimately, it's looking like this cycle will end in the same manner as 10 of the last 13 Fed tightening cycles and that is with the Fed hiking rates until something breaks, which ends up pushing the economy into a recession. What none of us know is at what level are interest rates too high where they create a risk for the economy. Given the Fed seems to be on autopilot in its tightening campaign, my guess is we won't know until after the fact, but we'll all be sure with 20/20 hindsight to point out the obvious in the Fed's wake.

Economic Growth: Looking at the latest data on core capital goods orders, productivity, housing, auto sales, and employment, there is little indication that the U.S. economy is reaccelerating. This isn't to say that it is turning down in a meaningful way, but rather we're holding steady around the 2% level (plus or minus) that prevailed throughout this entire expansion. Sure, we've had quarters where GDP growth has come in with a three handle, but this administration will find out, just as the Obama administration did, that these periods never end up being sustained. The recent readings on the employment front are a perfect example, with the majority of the pundits raving about solid job growth with muted wage pressures. Yeah, I see their point but that analysis runs about as deep as the

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depth of a puddle and is missing the bigger story. The unemployment rate succumbing to a 3.9% level is great at highlighting to investors how solid job growth has been, but the message it conveys about job growth going forward is more than disconcerting in that it implies the economy is running out of bodies to fill current job openings. Take the jobless rate in the transport services sector, for example, which was near 12% at its cycle high and as of last check sits at a 17-year low of 3%. It just doesn't get much better than this level, and likely why companies are crying uncle about spiking freight costs, supply chain constraints, and delayed delivery schedules. This is what a late cycle expansion looks like and it brings both good and bad qualities.

Not to mention we are now reaching a point where any further increase in oil prices is a negative, not a positive for global growth. I know this is a hard thing for even me to acknowledge given my favorable investment view on the energy and natural resource sector, but gasoline prices at the pump are approaching $3 per gallon nationwide (20% above year ago levels) which isn't helping a consumer that is looking increasingly tapped out. Given the rise in gas prices and higher interest rates, it's of little surprise to see why the tax cuts are not having the economic impact on the household side of the economy that a lot of economists were expecting.

Corporate Earnings: Q1 earnings season has not disappointed by any stretch of the imagination with YoY profits rising more than 25% with nearly 90% of S&P 500 companies having already reported. What's more is that 62% of companies beat analyst's expectations on both the top and bottom line. A piece put out by Goldman Sachs over the weekend showed what companies have decided to do with this profit windfall, and that's buyback their own stock to the tune of an estimated $650 billion in 2018. Should this level of buybacks come to fruition, it would take out the prior record high of $589 billion set in 2007 – time will tell if this yet another ominous sign that lines up with peak cycle activity. One thing companies aren't doing with their money is pouring it back into capital investment or worker wages which are ticking along at 2.6% at the current time. A 26% rise in year-over-year corporate profit growth versus a 2.6% gain in wages is a rather wide gap that just doesn't seem sustainable to me. Another thing to keep in mind is that wage pressures accelerate late in the business cycle and this should put pressure on S&P 500 margins which are running at 12% – handily above the peak level of 9% reached in 2006 during the last cycle.

Another thing to think through on the earnings file is that several key variables have shifted from what were tailwinds last year to headwinds this year: 1) the U.S. dollar was in a steady decline throughout 2017 and at least in the interim this no longer seems to be the case, 2) the corporate tax cut, while permanent, has the effect of a one-time delta in terms of computing year over year earnings growth – once we get into 2019 earnings the tax rates will be the same as 2018, and 3) earnings growth in the energy sector, which are set to double this year, will start to decelerate later this year and won't have as big of a positive attribution beyond that point.

None of this is outright bearish or setting off alarm bells, but it does indicate that at the margin the outlook going forward will be more challenging for earnings growth than what existed coming into the year. I've lost track of the number of times I've heard a talking head on one of the business networks rave in dismay about how he/she couldn't understand why the stock market wasn't roaring, given how strong the earnings season has been – to this I'd reply that markets started pricing in these results in the second half of last year as the probability of corporate tax cuts increased. The reality is that at the end of last year the S&P 500 was trading north of a 20x P/E multiple on trailing earnings which is pretty rich and difficult to maintain in the face of rising interest rates, a slowing economy, and rising cost pressures. It's just that simple, and thankfully the earnings season has been as strong as it's been to take some of the excess valuation out of what was a very expensively valued market on almost any historical valuation metric.

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So where do we go from here? To my eyes this cycle is playing out in a very similar manner to the end of the cycles in 1989, 2000, and 2007. The Fed is on a tightening path, unemployment is at cycle lows, interest rates and inflation are on the rise, debt levels are at all-time highs, and valuations (while they have cheapened) are stretched across most asset classes. The flattening in the Treasury yield curve and rise in commodity prices are both classic late cycle events. In this environment investors should be considering rotating their portfolio allocations into a more defensive posture – one that favors 'return of capital' over 'return on capital'. That doesn't mean abandoning everything, but rather rebalance while you can rather than being forced into the decision when things are much more uncertain.

Within the equity market, investors should focus on quality balance sheets, sustainable earnings, and companies with pricing power. Also, a tilt towards defensive sectors (Consumer Staples – this sector has been beaten and battered over the last 12 months, so a lot of the froth that once existed is much less so at present – Healthcare, and Utilities). This defensive sector positioning can be complimented with exposure to the Energy and Materials sectors which will provide some cyclicality as well as the typical late cycle move higher in commodity prices.

Speaking of commodities, gold deserves a look and while it has been frustrating to hold this year given its inability to break-out of what has been a tight trading range, it historically acts as a good portfolio diversifier late in the cycle and into an economic contraction. Gold also has some other compelling arguments for owning it with the heightened geopolitical tensions around the world and growing signs that the U.S. dollar's time as the world's reserve currency may be approaching its expiration date. Also, in the commodity market I remain extremely fascinated with the favorable asymmetric return profile in the Uranium market given the growth prospects for Nuclear energy adoption over the next several decades. The more time I spend researching this industry, the more my confidence grows that this will be one of several winners in meeting the future energy needs of the world going forward.

Lastly on the fixed income side, you want to shorten up your duration, step up in quality, and fight the urge to reach for yield in what remains a low interest rate environment. It remains to be seen whether we are in a secular rise in interest rates or just a late cycle spike that then reverts lower during the next recession. But should we be in a new era where the 37+ year bull market in bonds officially ends, then there are a whole lot of investors that have never managed a bond portfolio in this environment. Moreover, there are a lot of financial instruments that have been created over the last several decades and have never seen a sustained rising rate environment. One that comes to mind is the high yield market (a.k.a., junk bonds) which were created in the mid- to late-1980's when interest rates were just starting to come off their all-time highs. The investment became widely used by individual investors in the late 90's early 2000's, so we have no idea how these instruments will perform in an environment that has long been forgotten by some and never experienced by many.

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