May 21st, 2018

Let’s not overthink this…
It’s safe to say that the synchronized global growth backdrop that understandably had investors excited coming into this year has cooled off meaningfully over the last several months. Sure, the U.S. economy looks to be doing a bit better in the second quarter following what was a solid, but disappointing Q1. However, as I’m digging through my work throughout the day I find myself scratching my head more often than not when overhearing the talking heads on the television rave about the strength in the economy. Seriously, what data sets are they looking at that I’m not privy to? Job growth in the last two payroll reports have both disappointed expectations and substantiated that a decelerating trend is underway. On the latter point, this should be of no surprise given we have an unemployment rate that has fallen to an 18 year low of 3.9%. But the lack of a breakout in wage growth – which has everyone all excited because it implies a Fed that won’t accelerate the pace of its interest rate hiking cycle – is hardly constructive given that real work-based weekly earnings dipped 0.1% in April, and they are actually slightly lower now than where they closed out 2017.

Dig a little deeper into the math and what you find is a household consumer profile that is getting squeezed from all directions. Oil prices are at their highest levels in over two years which has pushed gas prices 28% above year ago levels, cornerstone agriculture crops that feed into food prices such as corn, soy, and wheat are up between 5 – 16% over the last twelve months, and mortgage rates have risen to nearly 5%. Add to this interest rates on credit card debt which have moved to an eight year high of 13.6%, and it is no wonder we’re seeing the delinquency rate on credit card loan balances at commercial banks (other than the largest 100 – representing the 4,788 smaller banks in the U.S.) spike to 5.9%, exceeding the peak during the Global Financial Crisis. Just so none of you think I’m cherry picking the data here by excluding the 100 largest banks, where the delinquency rate is much lower (2.48%) and not flagging a major concern, but the big banks (because of their scale) have focused their efforts on providing credit to those consumers with higher credit scores. These smaller banks can’t compete with the terms being offered, hence this is just another example of the growing inequality in the system today and why it’s become necessary for analysts to not just assume that the aggregated data in a given data set tells the whole story of what is going on in the economy.

This crimping of the consumer’s pocketbook would be less concerning if the household savings rate was running close to its historical average of 6%, but instead it’s hovering near cycle lows of just 3% (down from 10% back in 2012). This drastically impairs the ability for these consumers to absorb the increasing cost of their standard of living and throws a real wrench into the sustainable 3-4% GDP growth projections promoted by the Pollyanna’s out there, given nearly 2/3rds of the economy is driven by consumption. Ahh, but don’t worry – households can just borrow more, which is exactly what they’ve been doing as we learned from the recently released data out of the NY Fed that showed household debt in Q1 set another all-time high at just over $13.2 trillion.

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Alright, I'll dial back the sarcasm a bit, but it's not hard to comprehend the strain being created in the system when wage growth is running below 3% yet the cost for essentials such as food proteins (+3.5%), gas (+28%), shelter (+3.4%), and healthcare (+3.5%) are all increasing at a much more rapid clip. Let's not over think this – this can and has gone on for some time, but common sense tells you that this can't be sustained indefinitely.

So not only is the consumer in a tough spot from escalating everyday costs, but the most recent quarterly Fed loan officer survey showed an across the board contraction in the household demand for residential mortgages, credit cards, and auto loans. Perhaps the consumer sees the writing on the wall and has said enough is enough in terms of losing interest in adding further to the heap of debt they already have on the books.

Back to the rolling over of the synchronized global growth narrative, where we learned last week that real GDP in Japan contracted 0.6% QoQ (annualized) in Q1 whereas the consensus was looking for a much smaller 0.1% setback. The disappointment wasn't just with the Q1 results as both of the previous two quarters were revised down as well (Q4 was lowered to +0.6% from +1.6% and Q3 fell to +2.0% from +2.4%). There really was no other way to interpret the results other than being poor across the board with private housing, consumer spending, and private capex all declining on the quarter. The latest data out of the Eurozone suggests growth has stalled to roughly a 1% annualized growth rate – half the level it was running at last year.

Add to this the signs of slowing in the recent slate of Chinese data and you can see why I'm calling into question the health of the global growth view. China reported retail sales below consensus expectations in April, property sales dropped 4.1%, and fixed asset investment softened to a 7% pace through the first four months of 2018 – the most sluggish start to any year since 1999. Industrial production data did pick up a bit to 7% YoY, but this was coming off of a seven-month low of 6%. For most other economies these are enviable results, but for how dependent global growth has become on the Chinese economy moving the global growth needle, these won't do.

Now, there is no need to get all up in arms about a global recession because many of these economies (including the U.S.) are slowing from what were some pretty healthy levels. So, should this deceleration persist, and absent an exogenous shock, then there remains another couple of quarters (assuming a steady pace of decline) before we succumb to levels that should put investors on heightened recession watch. I lifted the following chart from Denis Ouellet's "Edge and Odds" blog – where on a daily basis he puts together a solid and thorough compilation of news and research – providing the most recent update from Ned Davis Research on their Global Recession Probability Model which reached 57.54 as of the end of May.

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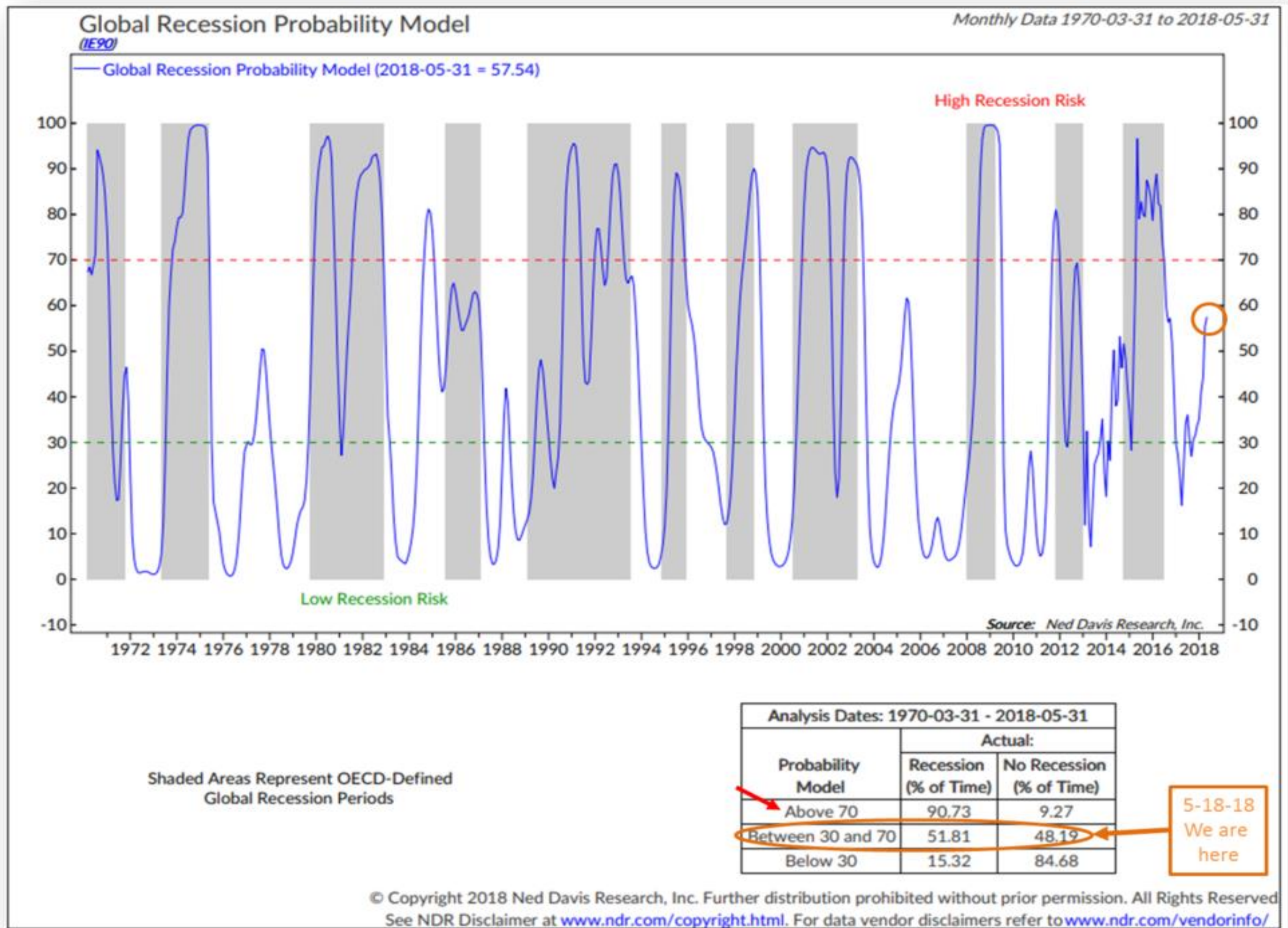

Analysis Dates: 1970-03-31 - 2018-05-31		
	Actual:	
Probability Model	Recession (% of Time)	No Recession (% of Time)
Above 70	90.73	9.27
Between 30 and 70	51.81	48.19
Below 30	15.32	84.68

Below are notes from Denis on how to interpret this chart:

- *The orange circle shows the current level and is signaling a* ***57.54% probability of recession****.*
- *Note the dotted red line. It marks the "High Recession Risk" zone. Not there yet.*
- *The box in the lower right of the chart shows the time since 1970, based on the level of the probability model, that the global economy was in recession. When the reading is above 70, recession has occurred 90.73% of the time. Thus, high risk.*
- *When between 30 and 70, recession has occurred 51.81% of the time so we are not currently out of the woods.*
- *Note too that the line is increasing and* ***the rate of ascent can be fast****.*
- *The gray areas mark recessions (note that these periods are according to the OECD's defined criteria).*

To me the main culprit behind the cracks that are starting to spread throughout the economy and financial system has to do with the steady (but unrelenting) rise in interest rates. There were notable achievements notched last week across the U.S. Treasury yield curve which I think are worthy of some attention. First, the 10-year broke to a new high for the year (the highest level in four years, I might add) as it hit 3.11% at its peak last week. It has since backed off a bit, but the push above 3.05% was notable in that this level represented a key resistance level and as such it's reasonable to consider that when all is said and done, after a bit of back and fill in the market, that this becomes a new floor level in the 2nd half of the year. Second, the

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long bond (30-year Treasury maturity) closed above 3.25% on Thursday which represented a break above a 30-year trendline that has held since 1985. Since then the long bond has fallen back below this level, but suffice it to say this remains a key level to watch going forward and should it sustain a move above this level, then I'm of the opinion that it will create some collateral damage – not immediately, but with a lag as is often the case with tightening financial conditions.

Lastly, we have the move in the short-end of the Treasury yield curve where in December 2017 the 2-year T-note broke above the dividend yield on the S&P 500 for the first time since 2008. Last week it was the 3-month T-bill's turn when it too broke above the dividend yield on the S&P 500. This is actually a very interesting development in that no longer can the case be so easily made in support of 'TINA' (there is no alternative…) when it comes to the stocks vs. bonds debate. Whether it's a 1.90% annualized rate on 90-day paper or 2.57% on the 2-year T-bill – it may not seem like much, but those are returns with very little risk of loss outside of inflation versus a stock market that (even though valuations have become cheaper following a stellar earnings season) is still rich versus historical averages and is in the ninth year of its bull market run.

Furthermore, the rise in interest rates has put a charge under the U.S. dollar which has risen nearly 7% since the end of January. This combination has done quite a number in terms of tightening financial conditions which is first showing its ill-effects in the Emerging Market currency complex (Argentina and Turkey being the two most prevalent examples). Once again, it's too early to know whether this is just a hiccup or something we'll look back upon with hindsight as a canary in the coal mine. However, anyone with a sense of history knows what this means (Mexican Peso Crisis in '94, Asian Contagion in '97, and European Peripheral regions last cycle) which begs the question as to why investor complacency has returned to equity markets in such a quick fashion. The latest investor's intelligence readings show the number of bulls at three times the level of bears – it just goes to show you how old habits are tough to break.

Meanwhile we have a stock market where the price action is syncing up quite logically with what is happening in the U.S. economy. For instance, the homebuilders and auto stocks are down nearly 20% from their respective peaks which makes perfect sense given their sensitivity to the credit cycle and interest rates. The airline and media sectors are two very cyclical segments with both down around 15% from their highs. The energy sector, while highly cyclical, is now up over 9% on the year (the best performing sector, to boot) and doing what one would expect when you get into the very late innings of an economic cycle.

Nevertheless, this all remains well and good until it doesn't – let that be the most worthless statement you'll read this week. I look back at what has transpired over the last several weeks – interest rates flirting with (and on some maturities breaking above) well entrenched multi-year trendlines, oil prices moving to their highest level in several years, and the overall tenor of the economic data remaining strong enough to keep the Fed on track for further tightening but not weak enough to force them to pause – none of this makes me feel better about the investment climate 3-6 months down the road. The below chart from Bianco Research suggests that when taking into account the tightening in the shadow rate (i.e. unconventional monetary policy – Quantitative Easing transitioning to Quantitative Tightening) along with the normal hiking of the Fed Funds rate, the Federal Reserve has already implemented the most aggressive tightening cycle in four decades.

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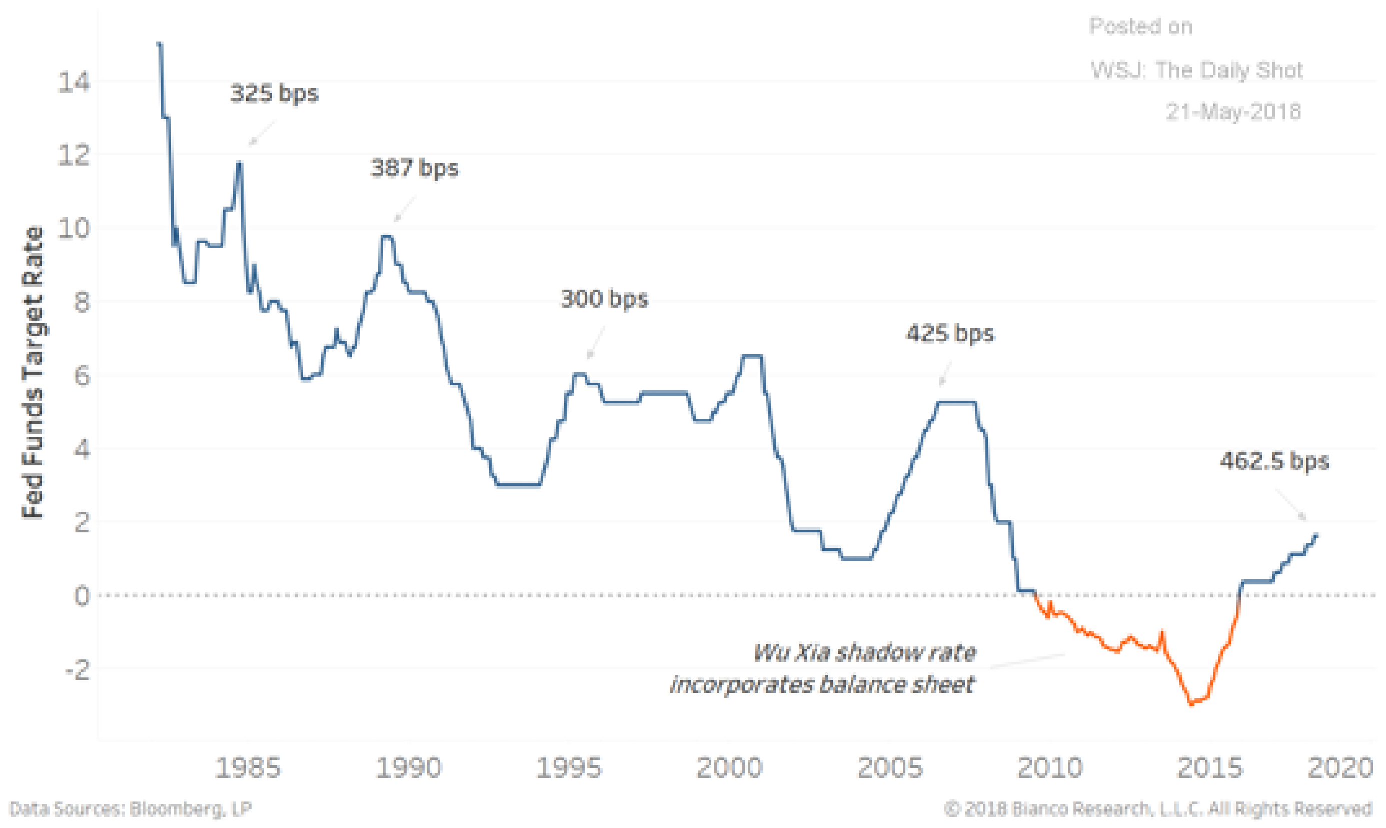

Source: Bianco Research

Sure, there may be a little more momentum behind this move that could extend this rally further, but I remain of the view that investors should be using this as an opportunity to de-risk and shore up their positioning for what I expect to be a much more challenging investment environment as we get deeper into this year and into 2019.

Patience is the one investment virtue that I believe will be the most valuable yet also the most frustrating for investors to maintain going forward. This is always the case at the end of the business cycle because that is when everything looks its best. The unemployment rate is at its lows, asset prices are at their highs, confidence across a bevy of survey data are at cycle highs, and all this is easy to extrapolate indefinitely into the future, as if it's never going to end. This is the time when investors are most vulnerable to repeating the same mistakes they swore they'd never make again after being negatively impacted at the end of the prior cycle.

It has become less difficult to recognize the risk, instability, and vulnerability of the economy and financial system at the current time. On these issues I'm becoming fairly confident of my view that they are quite significant, but what remains more than a little tricky is the timing as to when these imbalances will matter. I so often hear that you can't time the market and you can't predict in advance what the catalyst will be that ignites the unwind – to this I 100% agree. But I think this view completely misses the big picture in that it excuses inaction to the obvious risks staring investors in the face. It was Albert Einstein that acknowledged compound interest as the eighth wonder of the world. The key to that thesis is to 'compound', as in generating a return on a stable or growing pool of capital. The key to long-term investment success is mitigating or side stepping big losses or permanent impairments to one's capital base – which at times

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requires an investor to shift their investment objective to capital preservation from capital appreciation and vice versa given the investment backdrop. Such a shift is warranted at this time – in my opinion.

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