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An unusual investment environment…

Equity markets capped off another week of chop with the Dow Jones Industrial Average and the S&P 500 experiencing some violent moves (both up and down), but when all was said and done the major averages ended little changed on the week. That has been the story since the January 26th high of 2,873 on the S&P 500 and the February 9th low of 2,533 – a range bound market that has shown little interest in breaking out in either direction. However, if there was a gun to my head and I had to choose, I'd side with the price action leaning a bit more in the direction of the bears than the bulls at the current juncture.

Irrespective of the cautious view I continue to retain on the global macroeconomic environment, the weakening rebounds in the S&P 500 off its 200-day moving average are quite telling in my opinion. Just prior to the election in November 2016, the S&P 500 flirted with its 200dma and subsequently rallied 38% off this key technical level. Its next encounter with the 200dma was a few months ago in February where it then went on to bounce by 10%. Again, in April the S&P 500 hit its 200dma which was followed by a recovery of 7%, and then last week the 200-day was touched yet again which has led to an almost a 4% pop as of this morning's price action. Should this pattern remain intact then it would be reasonable to presume that this rally doesn't have much more upside to it and if so, investors should be taking the opportunity to lighten up on their risk exposure.

One additional note on the technical backdrop – the 50dma and 200dma are in the midst of converging, so it won't be long before this market is forced into a position of breaking out in one direction or the other. Another sign that the stock market has lost its upside momentum is the reality that the Dow Jones Industrial Average has now gone 68 sessions without making a new high, which is the longest stretch since the summer of 2015. In case you don't remember, back at that time global equities were making their highs for the cycle but the global economic data had begun to roll over and that lead into a Chinese currency devaluation in the fall which then cascaded into the global economy flirting with a recession by February 2016, before global central banks came to the rescue with a tsunami of monetary accommodation.

When looking across the various asset classes in the capital markets I find myself rather uneasy with the increasing number of metrics that are approaching or have already moved through key inflection price levels. The DXY U.S. dollar index has become the focus of my attention these days and is the first thing I check when I wake up and the last thing I look at before I turn in the for the night. It recently broke through all of its major trendlines and is making a run at the 92.75 level which is its highest print for the year. Should this move have a little more momentum behind it then we could see it push up into the 94 area which is where it started its decline back in November and continuing into this year. Why the U.S. dollar is so important at this juncture is because of the amount of dollar denominated debt that has been taken on by Emerging Markets in this cycle.

A rising dollar index coupled with higher interest rates hits Emerging Market debtors on both fronts and this will have a dramatic impact on the synchronized global growth narrative that the consensus is still trying desperately to hold onto. Have a look at what's been happening with the Turkish Lira and the Argentine Peso over the last several weeks. Argentina's central bank had to raise interest rates three times last week by a cumulative 1,275 basis points to 40%, and even that wasn't enough to keep the Peso from plunging. It pays to take note of what's going on in the Emerging Market sphere as this area is the weakest link in the global capital market chain. When liquidity is flowing and money is cheap it's a great place to allocate capital, but when the tide turns (as I believe is the case at present) then it's these areas where the cracks first emerge.

So, if the dollar keeps rising, the Fed keeps tightening, interest rates climb higher, and global growth continues to decelerate, the issues challenging the investment thesis for the EM space become extremely problematic. The sage words of legendary investor Don Coxe seem quite prescient at the current time:

"*Emerging markets are markets you can't emerge from in an emergency"*.

Not to mention, a stronger dollar is going to put a dent into the 44% of S&P 500 revenues that are generated abroad – this is yet another tailwind turned headwind that markets are in the midst of repricing in 2018 versus 2017. Speaking of earnings, Q2 reporting season is winding down, and so far 78% of companies that have reported are beating EPS estimates (according to Factset data). All told, earnings growth is coming in 24% above year ago numbers and revenues are equally strong with YoY growth of 8.5%. It really is fascinating to observe the debate between the bulls and bears on the earnings and valuation fronts. Both sides can make a compelling case based upon the available data at hand, so at the end of the day it comes down to how you interpret the data, what that suggests to you about the future, and the context in which you are evaluating it.

From my perspective, the 7% pullback from the January high in the S&P 500 and the corresponding 15% jump in trailing four quarter earnings has done wonders for restoring P/E valuation multiples from over-valued territory to fairly valued. But it's what investors envision and model in for future assumptions that will determine how you should position your portfolio going forward. At this point I'm less interested in what the corporate profit picture did over the last four quarters, and now that we've seen a quarter of results with the new corporate tax rates, analysts have already put pen to paper regarding what this implies on this front going forward. That leaves the less certain assumptions of where one thinks we are in the current business cycle, how much longer they estimate it will last, and what this suggests for profit margins.

Regarding these unknowns, I'm of the view that we are late cycle with less than 18 months (max) left in this expansion, and sprouts of stagflationary forces are in the process of blooming into full grown flowers. You have to go back to the 1970's to derive some context for the last time the U.S. experienced a meaningful bout of stagflation. Don't get me wrong – it's not appropriate yet to think that what we're seeing now is nearly as dramatic at what took shape back then, but one thing is for sure and that is that this is not a friendly backdrop for valuation multiples. A 16x forward P/E multiple on peak earnings, peak margins, a Fed that is raising rates, central bank balance sheet reduction, rising input cost pressures, and a fully employed economy doesn't exactly seem like it's a bargain relative to the average historical forward multiple of 14.5x.

So, let's peel back the onion on this stagflationary theme a bit more. Starting with last week's jobs report, which revealed that the U.S. economy added a not too shabby +164k jobs in April – a bit below consensus expectations for a print of +193k, but there were +30k in positive revisions for prior months, so all in all not that big of a headline miss. The unemployment rate falling to a 17-year low of 3.9% had everyone in a celebratory mood (and why not, the more people employed, the better…), but this statistic really has become quite flawed in its information content. The only reason it fell from 4.1% in March to 3.9% in April was because the labor force contracted by 236k. Yes, you got that right: the unemployment rate went down because 236k people decided they no longer were interested in looking for work. Further undermining the decline in the unemployment rate to 3.9% is that it coincided not only with a decline in the labor force, but also a decline in the employment-to-population ratio and a decline in the diffusion job indicators.

That doesn't make this a bad report, but it does cement (in my mind) the number of metrics that are confirming the economic and stock market cycles are in their very late stages. The time to get bullish and load up your portfolio with risk is when the unemployment rate is at 10% (as was the case at the end of '08), not 3.9% and when corporate profits are crashing into negative year-over-year territory (as was the case in Q1 and Q2 of 2009) not surging +25% nine years into a business cycle expansion on the back of a one-time corporate tax cut adjustment.

Don't believe me? Just pull out a history book. The last time the unemployment rate was this low was back in 2000 (a recession started in 2001). Before that was early 1969 – granted you still had a couple years here before things got really ugly, but a recession was just around the corner, and before that was 1957 which coincided with a recession in that very same year. All I'm getting at is don't lose sight of the forest for the trees here. Nothing in this report was alarming for better or worse, but rather just further confirmation that there is little to no slack left in the labor force. What this means is that either employment growth starts to slow down in a more meaningful way from what is already a decelerating trend (not a positive for economic growth) and/or labor expenses start gaining more steam which is a problem for corporate profit margins.

The markets were relieved by the mild increase in the wage components of this report, as the feedback loop currently being traded in markets today is that wage pressures beget a more aggressive Fed, and that begets higher interest rates which inevitability tightens financial conditions, and that ultimately hastens the pace at which this expansion meets its expiration. But me thinks investors are acting in much too sanguine and complacent a fashion on the wage growth front, as I'm seeing wage pressures in a growing number of other venues (ISM surveys, NFIB Small Business Survey, Corporate Conference Calls, Personal Income and Spending report…). Moreover, economists remain puzzled by the lack of wage pressures with hourly earnings increasing a meager 0.1% MoM in April and March having been revised lower from +0.3% to +0.2%, thus keeping the YoY growth rate at 2.6% for the 3rd consecutive month.

I read all kinds of explanations (none that are really conclusive) trying to explain how wage growth could be so tepid with an unemployment rate dawning a 3-handle. Perhaps the Payroll survey data on wages has not kept pace with demographic and industry shifts as well as compensation schemes favoring commissions, bonuses and other perks and benefits. Furthermore, there are a few realities the wage data from the BLS employment report just don't seem to be picking up:

- Most companies, large and small, are complaining of the scarcity of workers, skilled or not.
- Minimum wage rates have gone up across the U.S.
- Wages and salaries per Personal Income data are up 4.4% YoY in aggregate and +4.5% annualized in Q1, up from +3.3% in 2017 and +2.9% in 2016. Since employment is up 1.6% YoY, the same as in 2017 following being up +1.8% in 2016, wages and salaries per employee has accelerated from +1.1% in 2016 to +1.7% in 2017 and +2.8% in Q1'18.

- Total private industry compensation per the Employment Cost Index is +2.8% YoY in Q1’18 from +2.5% in 2017 and +2.1% in 2016.

The fact that the yield on the 2-year Treasury Bill has moved up to its highest level of the cycle indicates to me that the bond market is paying more attention to the cumulative evidence from other wage indicators that suggest wage pressures are mounting than it is to the BLS calculated metric. Corroborating the stagflationary backdrop was last week’s ISM manufacturing data which for anyone who took the time to read the comments from survey participants – or plotted the rise in order backlogs, cost increases, and supplier delivery delays – would see the obvious: an economy that has hit a wall from a spare capacity standpoint. Look, I’m far from a raving inflationist as I remain of the view that deflation is the more likely path over the long-term, but you have to acknowledge and accept the cyclical inflationary forces that are at play today.

Rising inflation on everyday consumption items, such as national gas prices moving up to $2.81/gallon from $2.31/gallon a year ago, will take their toll on consumer pocketbooks and what will make matters worse is if these same consumers don't experience a corresponding bump in their wages.

Another item feeding the stagflationary pressures is this administration's trade strategy which, should they prevail on getting it enacted, will likely lead to slower economic growth globally (at least in the near-term). The uncertainty alone is restraining activity with just the mere floating of trial balloons through the media of the potential shift in global trade patterns already having the impact of boosting the cost of material inputs and disrupting supply chains (NAFTA being the largest in the world). By itself, without even taking any other action, this is enough to stagnate whatever is left of this global economic expansion.

It won't be too long now before the fiscal stimulus this administration injected into the U.S. economy begins to fade going into 2019, and then what lever is left to pull to prolong this expansion even further? The Fed is done and any about face on their part from tightening back to easing is likely to have a diminishing marginal return given how much stimulus they provided for such an extended period of time. There isn't much fiscal stimulus left on the bone given the $21 trillion in government debt that already exists and the deficit-to-GDP set to move beyond 5% after already increasing in the prior two fiscal years.

All this leads to a precarious position that investors find themselves in at the current time. The volatility index as measured by the VIX trades today nearly 50% above last year's average, interest rates on the short-end of the yield curve are nearly double year ago levels, and global liquidity is retrenching – all this adds up to a distinctly different backdrop for investors relative to the last several years. This is a market in transition out of the secular bull phase and into an environment that is much more unforgiving. Yes, the Oracle of Omaha (Warren Buffett) has bestowed some soothing words over the last couple of days, and I do share his view that equities offer a superior risk/reward profile relative to most other asset classes over the long-term, but there are times when cash and cash alternatives should command a larger stake in an investor's portfolio – it's my opinion that we are in one of those times. I only wish Mr. Buffett would be a bit more forthcoming on this front as he currently holds over $100 billion in these so-called cash and cash alternatives.

In closing, let me try and summarize this transition that is underway: To combat the Global Financial Crisis, the Fed took it upon themselves to undertake unprecedented measures to rescue the financial system. Over the course of employing these tools over the last decade, they found it ever more difficult to remove these artificial supports (low interest rates and ample liquidity), and as a result, investors became conditioned to believe that asset prices would be supported at any level by the Fed. Hence for the last 18 months equity market valuations have been glued to the ceiling while interest rates have been nailed to the floor. However, since mid-2017 the tune at the Fed has been changing and references to financial stability (a.k.a. asset price bubbles) have become more prominent in Fed speeches (and not in a good way). In the Fed's naval gazing and reflection on the last decade, it's as if they are realizing in real-time that their policies may have played an important role in some of the social tensions arising in society today (inequality, poverty, a pivot to nationalism, and the undermining of the creative destruction elements of capitalism). This makes for a highly unusual investment environment for any of us to navigate in the months and years ahead.

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