



July 16th, 2018

Late month fades...

The U.S. stock market has been enjoying a nice little rally over the last two weeks, during which the S&P 500 has risen from just under 2,700 to push above 2,800 last Friday for the first time since March 13th. How one chooses to look at the price action so far this year could understandably vary depending on their interpretation of the fundamental, technical, and sentiment data. Admittedly, I don't have much of a strong opinion at the moment in terms of what the price action over the last several months indicates for the rest of the year. For sure, stocks continue to climb a wall of worry and momentum (be it 3 steps forwards / 2 steps backwards) has pushed the major averages above some key levels but given the number of non-confirming signals in an array of areas, I'm finding it hard to get more optimistic.

Here we are, approaching nearly six months since the S&P 500 made its all-time high on January 26th with Friday's close just 3% below that high. The current count is 116 days since the S&P 500 made a new high, portending that the longer we go without making a new high, the more likely it is that this bull market cycle has ended. Furthermore, price action in other segments of the capital markets don't paint a very rosy picture with copper down -16% from its recent highs, and base metals in general off close to -10%. Oil prices have started to roll over with the WTI contract off more than \$8 (almost -11%) from its high around \$75 per barrel. The bond market is also standing out as a glaring non-confirmation versus the recent ebullience in the stock market with the 10-year T-Note yielding 2.83% – down almost 30 basis points from its highs. One would think (and historical data would back up such a notion) that yields would be rising and the yield curve would be steepening if the optimism surrounding the economy and the stock market was right. However, as it stands the 2s/10s spread just hit a new cycle low of 25 basis points and is the tightest it's been since the summer of 2007.

Perhaps there are other forces at work that support the growing chorus of arguments being made suggesting the yield curve is not as strong of a leading indicator as it has been in the past due to unprecedented monetary policy continuing to be implemented in some parts of the world (ECB & BOJ). I don't share this view, but I am willing to keep an open mind and listen to the thesis. Rather, I tend to lean more in the direction of Jeffrey Gundlach's view (eloquently laid out in a Barron's interview over the weekend [Barron's: Jeffrey Gundlach Says We're Getting Closer to a Recession](#)) in that it's signaling recessionary forces are building in the economy.

The corporate bond market is also showing some signs of late that things may be starting to weaken at the margin. The Vanguard Total Bond Market Index is down -1.33% on the year, and understandably this is in large part due to the broad-based increase in interest rates, but what's interesting is that it's the Investment Grade Corporate segment that is experiencing the most weakness. The iShares iBoxx Investment Grade Corporate Bond ETF has generated a net loss of -4.4%, with investors perhaps finally waking up to the

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insatiable debt binge in this space of \$6 trillion of net new issuance over the past five years (more than 50% above the Credit Bubble era of '02-'07). As if that isn't shocking enough, this mountain of corporate debt in aggregate is carrying the lowest average credit rating in history, with 50% of the investment grade bond market rated BBB (one downgrade away from being re-categorized as junk debt) – and this is nearly double the 27% level it was at just prior to the financial crisis.

It was interesting to peruse the most recent report from the Institute of International Finance (IIF) released last week where their accounting shows global debt has climbed to \$247 trillion as of the end of the first quarter. In and of itself these numbers are just mind numbing to try and comprehend, and as such very little actionable insight can be garnered from it. Yes, they are huge and yes at some point we all surmise that they will matter, but it hasn't done investors any good to fret over them while the global economy is growing. It's when growth slows that it becomes problematic for those segments that are too far out over their skis and it's when growth contracts that it becomes a problem for everyone. What stood out most to me in the report was the rate of debt growth over the past year where the world economy has tacked on an extra \$25 trillion in debt in just the last twelve months. In the first quarter alone, global debt increased by \$8 trillion which puts total world debt to GDP at an unfathomable 318%.

Let me try and put this \$25 trillion debt build over the last twelve months into context. The Gross Domestic Product (GDP) of the U.S. for all of 2017 was \$19.39 trillion, and the GDP of the U.S. represents 18% of the world economy. So, in twelve months the world economy added more debt than the entire annual output of the largest economy in the world. Looked at another way, world GDP in U.S. dollars was approximately \$75.5 trillion at the end of 2016 and just shy of \$80 trillion at the end of 2017 – so if we subtract the \$8 trillion in debt growth in Q1 from the \$25 trillion in debt growth over the twelve months ended Q1 2018, we're talking about a world economy that added \$17 trillion in debt in 2017 versus an increase of \$4.4 trillion in GDP (an almost 4:1 ratio of debt to growth).

Once again this doesn't matter until it does, but it's a clear illustration of the unsustainable nature of debt induced growth. You can only rack up so much of a balance on the credit card before the servicing of that debt begins to crowd out money that could have been used for more productive uses. This is a dilemma that may surface sooner than most expect and we'll have to wait and see just how many more rate hikes Chairman Powell and the Fed can implement before the increased interest expense starts to exact a toll on this imbalance.

What will be on investors' radars this week (and the next several weeks) will be corporate earnings with consensus expecting EPS growth of around 20%. This would be the second consecutive quarter of 20% growth and sales growth is expected to come in at an extremely strong 8.8%, so it would be unfair to suggest that strong bottom line results are all about tax cuts, buybacks, and accounting gimmicks. But what remains to be seen is whether stock prices will react positively to these upbeat expectations or has this news already been priced in – as was the case in Q1. What will be of most interest to me is listening to what managers have to say on the outlook going into the second half of the year, in particular, their comments on future capital spending, building cost pressures from wages and inputs, and what (if any) impact trade tensions are having on their forward planning.

Let's just say my curiosity on the forward-looking views from the executives heading the most dynamic, successful, and insightful companies in the world perked up even more following last week's University of Michigan Consumer sentiment report. The early July reading of consumer sentiment was a bit on the soft side, moderating to 97.1 from 98.2, but what was most notable was the slide in various metrics within the survey. Business expectations for the coming year dropped from 107 last month to 98 (this is the lowest level since September 2015), and business conditions compared to a year ago fell to a 12-month low of 124 from 132. As an aside, this morning we got the NY Fed Empire Survey where the index tracking capital

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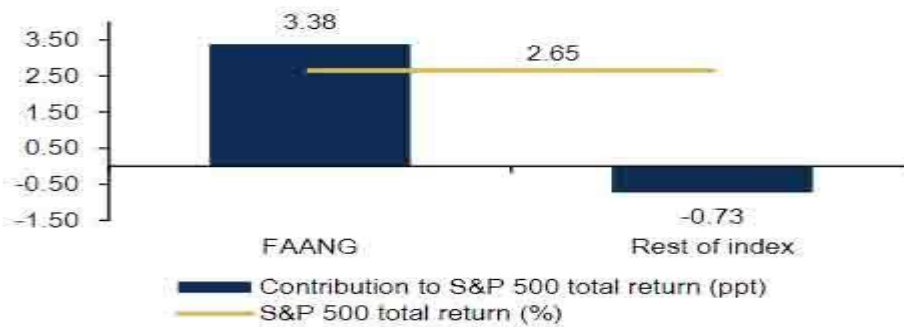
expenditures six months ahead fell ten points to 17.1 and the technology spending index slipped eight points to 9.4 – both are at their lowest levels in roughly a year. The consumer spending intentions in the Univ. of Mich. Survey took a turn for the worse – down to 162 from 166 in June, intentions to buy a car dropped meaningfully to 127 from 140 (the worst showing since 2013), and home buying plans dropped to 132 from 137 (hitting their lowest level since December 2008).

Both of the University of Michigan Consumer Sentiment Survey and the Empire Survey are July data points with both pointing to a moderation in economic momentum in the second half of the year from what looks to be perhaps the peak of the cycle in Q2. Hence the outlook in the earnings calls should likely prove to be more of a determinant in the reaction in the stock price rather than the likely strong results that seem to be already firmly priced in.

There are two other items I want to opine on before signing off, and the first has to do with a report put out by Bank of America Merrill Lynch’s research team highlighting just how challenging the stock market has been this year for the majority of companies. They tabulated that the S&P 500 would have generated a negative (-0.73%) return in the first six months of the year if you exclude the stellar returns in just five companies (Facebook, Apple, Amazon, Netflix, and Google/Alphabet). Time to dust off Bob Farrell’s Rule #7, “Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names”. There is no refuting the innovative edge, foresight, and technological prowess of the market leaders, but any investors still chasing these names today should tread cautiously. Not that these companies are at risk of being a charade or an illusion, but it gets harder and harder to justify the valuation multiple being paid for what no doubt is a solid forward growth profile, but the same was said about Microsoft, Qualcomm, Intel, and Cisco at the height of the Tech Bubble. All of these companies continue to exist today, but it wasn’t until just a few years ago that buyers at the height of that bubble finally got back to even on some of these names.

Chart 5: Excluding FAANG stocks, index returns would have been negative

FAANG stocks’ contribution to the S&P 500 1H18 total return



Note: FAANG = FB, AAPL, AMZN, NFLX, GOOG/GOOGL

Source: S&P, BofA Merrill Lynch US Equity & US Quant Strategy

The other item I have in mind is the pattern that has been playing out in the stock market over the last four months where early month strength reverses into late month weakness. Have a look at the four chart panes below starting with March and running through June where the S&P 500 grinds higher from the start of the month until roughly the 15th – 18th, and then it is choppy at best into month end. There are not enough data points yet to come to a conclusive determination for what is driving this repeated pattern, but the working theory I’m operating off of has to do with the growing fiscal deficits and the Fed unwinding its balance sheet. The Fed’s balance sheet normalization has been increasing by \$10 billion per quarter starting last October and beginning in July this pace reaches \$40 billion / month until October when it caps out at \$50 billion. In this normalization process the Fed is simply allowing the Treasury and MBS securities it holds on

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its balance sheet to mature. As it pertains to the Treasuries, they mature on the 15th or 30th of each month hence the entirety of each month's Quantitative Tightening takes place in the latter half of each month. Additionally, since the Treasury runs a reoccurring deficit it constantly has to refinance this debt in the open market, so its issuance levels have been increasing throughout the year to fund not only expanding deficits but also the increased supply from the Fed's maturing holdings.



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This increased supply of Treasuries needs to be funded from somewhere and this illustrates what is implied by the theory of government borrowing ‘crowding out’ private borrowing. Uncle Sam isn’t going to default, but investors (both domestic and foreign) likely will over time require higher interest rates for the increased borrowing – thus the 2-year T-Note is at its highest level in 10 years and nearly double the level it was this time last year.



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