July 30th, 2018

Tops are processes…

It was quite an interesting week in capital markets last week, one in which I cannot help but wonder whether a couple months or quarters down the road we'll reflect back upon this moment in time as an inflection point. This abstract inflection point I'm postulating is in reference not only to the equity market, but also to U.S. economic growth. After all, on Friday the highly anticipated Q2 GDP report was released, and given the lofty expectations going into the release, it didn't disappoint.

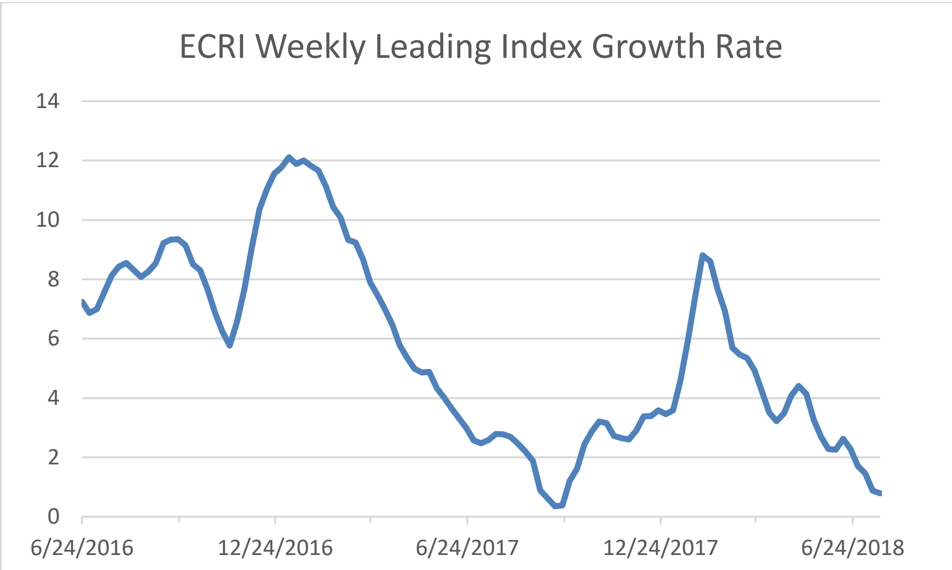
The U.S. economy expanded by 4.1% in the second quarter which was a bit below the hyped-up expectations for 4.3% growth, but no sense in splitting hairs on this front as any time the largest economy in the world puts up a 4% growth print it's an impressive accomplishment. There wasn't a whole lot in the report to snicker about and the underlying strength was as constructive as the headline print: real consumer spending came in at a strong 4% annual rate, nonresidential construction ripped at a 13.2% annualized pace in Q2, export volumes increased 9.3% (outpacing imports by a factor of 20), and inventories actually detracted from growth to the tune of almost 1%. There really isn't a whole lot not to like about this report and the strength that the U.S. economy experienced in the second quarter.

Keep in mind that some of the contributors to growth in Q2 will moderate going forward, exports in particular, which were goosed by a doubling (on an annualized basis) in soybean exports – a result of foreign importers stock piling in anticipation of tariffs on the part of this administration's trade policies – as well as a jubilant consumption figure of 4% that was assisted by a drop in the savings rate. Normalizing these inputs to a more sustainable run rate going forward suggests economic activity is closer to a 2.5% growth economy than the 4% print in Q2. Not bad by any means and indicative of an economy much closer to reaching its potential following a prolonged period of time operating below potential.

Arguably the best way to assess the organic fundamental operating capacity of the economy is to evaluate it on a four-quarter trailing basis, as this helps to smooth out the quarterly noise and gyrations. On this basis the year-over-year trend has been on a steady incline for the past eight quarters, reaching 2.8% in Q2 from 2.6% in Q1, and 2.5% in Q4 of 2017. Moreover, real domestic purchases rose at a 2.9% annual rate in Q2 (up from a 2.2% rate in Q1) and averaging the two together shows an economy growing at a not too shabby 2.5% clip in the first-half of 2018. This metric most closely represents where the underlying trend growth of the economy lies, which interestingly enough, is slightly below the average pace of 2.6% which the economy was tracking for all of 2017.

It's unrealistic to expect the robust activity level in Q2 will be sustained given the material deceleration we're seeing in the housing sector data over the past three months and waning momentum starting to show through in the manufacturing data – the latest AIA Architectural Billings Index slipped to a three-month low in June to 51.3 from 52.8 in May. Moreover, there were a couple of data points in the GDP report that were overlooked in the uber-excited weekend periodicals: business capex slowed sharply to a 3.9% annual pace from 8.5% in Q1 and the core of the U.S. economy (real personal disposable income) moderated to a 2.6% annual growth rate from 4.4% in Q1. Lastly, not in this report but related, is the concerning trend in the housing data that I referenced previously where the sector has contracted at a 1.1% annual rate in Q2 after a 3.4% decline in Q1, and you can't call this an isolated slowdown when you consider housing has declined in three of the last four quarters and four of the last six. So, it appears as though at best growth in Q3 will level off and likely begin to recede in Q4.

Beyond the material weakening we are seeing in the housing starts, permits, and resale activity over the last several months, why is it that I believe Q2 will mark the peak in economic growth for the duration of this cycle? Well, because the ECRI Leading Economic Indicators have taken a real turn for the worse with the Weekly Leading Index (WLI) growth rate sliding to 0.8% (its lowest level since September of last year). This index has slowed for four weeks in a row (was sitting at 2.6% in mid-June) and is down from a level just below 9% at the start of February.



The recent February peak is a data point to take note of and file away for future reflection because in the past five economic cycles, the peak in the ECRI Weekly Leading Index has foreshadowed every oncoming recession. However, this shouldn't be setting off alarm bells for anyone as the average lead time is roughly 10 months, but should the February peak prove to be prescient in lining up with the historical averages then it suggests that recessionary concerns should be on investors' radar screens for 2019 and not nearly as far out as current consensus thinking for some time in 2020 or 2021.

CEOs are also displaying less enthusiasm about the future with the recently published Business Roundtable's CEO Economic Outlook Survey declining in the second quarter to 111.1 from 118.6. To be fair, the pullback in the second quarter is from a record setting optimism level in the first quarter, but it's the rate of change that is noteworthy (not the level) in that this represented the first such decline in almost two years. The quarter-to-quarter decline was the biggest in three years and is eerily reminiscent of when this index cooled in the back half of 2015, correctly signaling the slowing to come in early 2016. Trade uncertainty had its thumbprints all over this report, but the internals of the report said it all with sales expectations, capital spending intentions, and employment all retreating for the quarter. Granted, they are all declining from lofty levels – so no need to run for the bunkers, but it's hard to look at this set of numbers and not at least consider that the Q2 GDP print may represent the high-water mark for the year.

So, I can see why the President proudly took a victory lap on Friday following the solid economic results, and to be fair he is right to attribute the strength in large part to his administration's pro-growth agenda. However, he may want to consider adjusting his strategy going forward to more of an 'under promise and over deliver' tactic (although given his personality that seems a bit out of character for him). One last thing in this regard, as it would behoove him and all others out there conducting even a modicum of analysis to acknowledge that this growth spurt is coming on the back of the biggest deficit-financed tax cut in the past 32 years. Not to mention the passing of an additional $300 billion in spending to what was already a bloated fiscal budget, and the majority of this spending hit in Q2 (with still some to spend in Q3, but less so).

That's a heck of a lot of fiscal stimulus injected into a U.S. economy that was already growing at a decent clip. So, there should be little surprise to see economic growth pick-up and reflect this influx of government spending, but beyond Q3, forecasters may want to exhibit a bit of restraint when attempting to extrapolate these numbers into the future. A cursory look at the price action in the capital markets following Friday's GDP report suggests that the markets weren't exactly ready to price in +3% growth for years to come: Russell 2000 Small Cap Index -1.9%, Nasdaq -1.5%, S&P 500 -0.7%, Commodities Index -0.4%, the U.S. Dollar Index -0.1%, and the yield on the 10-year T-Note fell 2 basis points. Who knows, maybe this was just a sell the news event?

As for the stock market, and you'd be hard-pressed to see it in the major indices, but it's become increasingly obvious (at least to my eyes) that the entire investment landscape is in transition. Yes, over the past several months some of the major averages have made new all-time highs and others like the S&P & Dow are within a whisker of their all-time highs, but I view this strength as more deceptive than meets the eye. Why, you might ask? How could I fathom to question the health of the market with the indices at/near their all-time highs?

For starters, almost half the constituents in the S&P 500 are down 10% or more from their 52-week highs and the median S&P 500 stock is roughly unchanged on the year. Moreover, when you see cyclically sensitive groups like the Global Auto Index still down more than 15% from its January high or Homebuilders down almost 18% from their January high, Emerging Markets down 14%, China down almost 20%, volatility up nearly 50% from the average level of 2017, and Treasury yields out to the 3-year part of the curve are two-to-three times higher than they were this time last year... given these changes, you have to at least consider that the entire complexion of the marketplace may be in transition.

What has kept the markets near record highs is the leadership of a select collection of six stocks – Alphabet (Google), Microsoft, Amazon, Netflix, Facebook, and Apple. These companies collectively have amassed a market cap of over $4 trillion dollars (larger than the GDP of Germany) and now represent 17% of the market cap of the entire S&P 500. Six stocks comprise almost 20% of the market cap of the largest index in the world. If a professional money manager were to allocate that much of a client's portfolio in such a concentrated manner, it would be a layup for the regulators to find malfeasance and imprudence if something went wrong. But when it occurs in an index, then no one gives it a second thought as herd mentality takes over and investment professionals can always rely on the "well no one could have predicted that" defense.

While I'm on my soapbox, I wonder how many investors realize that the Powershares Nasdaq 100 ETF (QQQ) has an almost 48% weighting to these six companies. What could go wrong?
We haven't seen this level of concentration in the equity market since the Tech Bubble craze of the late 90's and before that the Nifty Fifty bubble in the late 60's.

Perhaps last week will serve as a wakeup call to overly complacent investors about the vulnerability of these companies. What I mean by 'vulnerability' is in no way an indictment on the companies themselves as operating entities (all have proven their acumen and innovation in moving the world forward into the next Tech revolution), but rather I'm referring to investor's recklessly pouring money into them with little to no regard for what the intrinsic value of these entities may actually be. Bloomberg published an article on July 20th, prior to any of these Tech behemoths reporting earnings, where they included the following chart showing that the Price-to-Sales ratio for the FANG stocks has reached almost 9x – up from 4x just as recently as the start of 2017.

Folks, when you're willing to pay 9x sales for a company you're in a sense willing to concede that if the company didn't pay its employees, didn't have any operating expenses, didn't invest anymore capital into R&D or any investments for future growth, and was able to maintain the same level of sales as it has today – then in nine years you would recoup all of your money from this investment. That is a lofty valuation premium that usually is only afforded (rarely I might add) to early stage high growth companies, but none of these companies are even in the vicinity of this stage. If anything, it's more likely they are reaching the more mature stage of their business cycle, where growth is going to slow down just organically because they dominate such a large chunk of their industries already.

The recent earnings reports suggest just that:

- Neflix (NFLX) dropped -10% following its earnings after issuing disappointing subscriber growth, and this was despite the fact that its net income grew 600%.
- Facebook (FB) plunged -20% after delivering lower user and revenue numbers even though its revenue grew 42%.
- Amazon (AMZN) was flat following its earnings report on mixed results where earnings were way above analysts' estimates but revenue for the quarter and guidance for Q3 were lower.
- Google / Alphabet (GOOGL) was the standout in this crowd with its stock rising 3% after beating on both the top and bottom line.

All of this reinforces the view I've had since the S&P 500 made its highs at the end of January, and that is that U.S. equity markets are going through a prolonged topping process. Yes, tops are processes and not just points in times or prices. But, also keep in mind that equity markets top on good news, not bad news. And at this point, how much better can things get? We're coming off an eight-quarter run-rate where GDP growth was accelerating, the unemployment rate is at/near cycle lows, initial jobless claims are at four-decade lows, inflation is at the Fed's target, ISM is at/near cycle highs, and S&P 500 profits are about to register their second consecutive quarter of 20% EPS growth. Not to mention the largest fiscal stimulus package via tax cuts and government spending since the early 80's – yet as I look at my terminal I see the S&P 500 trading at 2,800, the same level it was at in the second week of January. Look back at the market tops from the last several cycles in 2007, 2000, and 1990 – they all tell a similar tale where the optimism and data couldn't get much better.

Which brings me to the Fed and the corner they've painted themselves into, which to me represents the biggest risk and challenge facing investors. How is it that an economy (on paper anyways) can look so strong, yet the Fed Funds rate still is at 1.875% – a negative real rate versus core inflation at 2.3%? Never in the history of the Fed, which dates back to 1913, has this governing body had themselves in the predicament they are in today where they've pinned risk asset prices to the ceiling while nailing interest rates to the floor. This is sure to be a very difficult needle to thread as they move forward with hiking rates while reducing the size of their balance sheet and expect that it will have minimal impacts on asset prices. After all, it was only a short eight years ago that former Chair Bernanke openly lamented in a Washington Post Op-ed about what the intent of QE was:

"Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. ***And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending****. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."*

— November 4, 2010

Then not even six months later he was testifying in front of the Senate Banking Committee about the math behind QE 2:

March 2011,

HIGHLIGHTS-Bernanke's testimony to Senate Banking Committee

BERNANKE ON HOW FED DECIDED ON $600 BILLION FOR QE2:

“We have tried through a number of methods to establish a correspondence between these purchases and what our normal interest rate policies would be.

“And a rule of thumb is that $150 to $200 billion in purchases seems to be roughly equivalent to a 25 basis point cut in the federal funds rate in terms of the stimulative power for the economy.

“So $600 billion is roughly a 75 basis point cut in the policy rate in terms of its broad impact.

“Seventy-five basis points in normal times would be considered a very strong statement, a very powerful move, but not one outside the range of historical experience.

“It would be one taken, that would be at a period of concern, and then we would observe the effect. So that was roughly the analysis that we did.”

For those keeping track at home, QT (or the Fed’s current balance sheet reduction plan) is up to $40 billion per month here in July and is expected to increase to $50 billion per month starting in October. So, if back in 2011, $150 – $200 billion in asset purchases was equivalent to a 25-basis point cut, then are we not to believe that once we get to the $50 billion / month tapering pace in October ($600 billion on an annual run rate) that this won’t be equivalent to an additional 75 – 100 basis points a year in Fed tightening?

However, there is a now a new Chair heading the Fed, and below are a couple interesting excerpts from comments he’s made about QE during FOMC meetings.

	Oct. 2012	Apr. 2015	Today
Trailing P/E	14.5x	18.8x	21.9x
Forward P/E	12.7x	16.9x	17.0x
High Yield Spreads	554 bps	459 bps	365 bps

*“**I think we are actually at a point of encouraging risk-taking, and that should give us pause**. Investors really do understand now that we will be there to prevent serious losses. It is not that it is easy for them to make money but that they have every incentive to take more risk, and they are doing so.”*

-October 24, 2012

*“Overly accommodative monetary policy also poses risks. First, the economy could overheat, and rising inflation could require the Committee to raise rates faster, which--if overdone--could produce a damaging recession. **For now, I would be more concerned with a second risk, which is that more-accommodative policy could lead to frothy financial conditions and eventually undermine financial stability**. While I do not see a troubling buildup of these risks today, tighter monetary policy might eventually be necessary if such risks do appear.”*

-April 8, 2015

Notes:

Source: Meeting of the FOMC (October 23-24, 2012). Speech at the C. Peter McColough Series (April 8, 2015)

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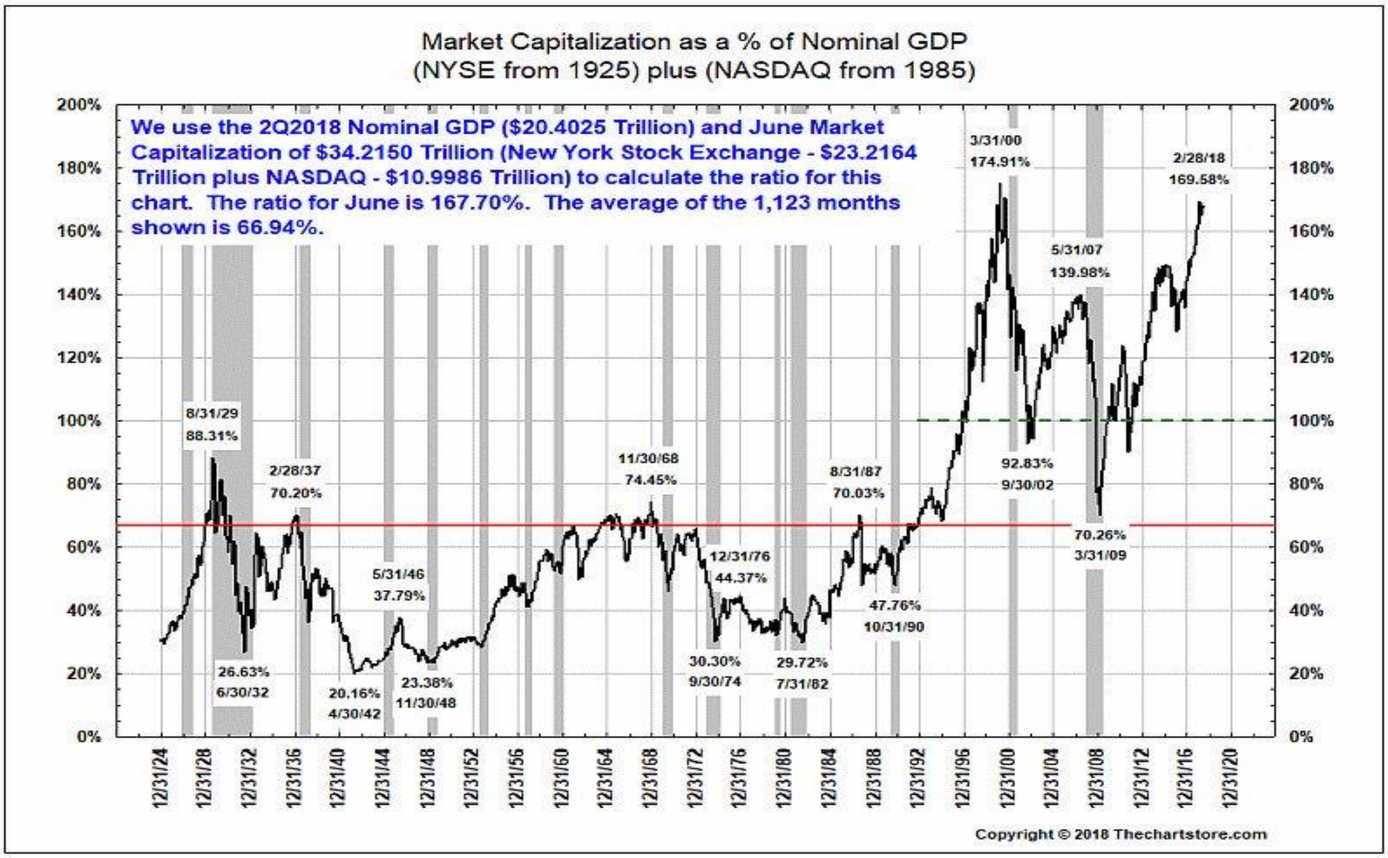
Ladies and gentlemen, it's often opined in this industry that the four most dangerous words in investing are "this time is different". It's stated rhetorically because history is littered with human behavior that commits the same mistakes over and over again. But given that we as an investment community have never experienced the degree to which central banks have inserted themselves into the capital markets and in some ways distorted asset prices, I'm inclined to consider – more than I ever have – that this time truly is different. Please don't take this as alarmist, sensationalizing or even dramatizing the situation, but rather just an open minded and objective observation as I see it. I'm not sure myself how best to analyze it or frame probabilistic outcomes through scenario analysis other than to elevate the risk factor in all risk-based models. With that said, it makes sense that the valuation premium this market has been afforded for years should be on the decline, but the rate and magnitude of this devaluation is rather unclear. What is clear is that relative to history the current broad market valuation premium as gauged by Warren Buffet's favorite valuation metric – Stock Market Cap / GDP – is 50% higher than its average and has only ever been higher during the late 90's Dotcom Bubble.



I'm going to sign off this week's missive not with my own words or opinions, but with the Op-ed penned by Martin Feldstein in last week's Wall St. Journal. This is an economist with a long tenure and keen understanding of capital markets, as such whenever he has something to say I listen, and I think you should too: [Save Low Interest for a Rainy Day]

> *President Trump told a national television audience last week that he disapproves of the Federal Reserve's decision to continue raising short-term interest rates. He later repeated his concern in a series of tweets. In complaining publicly about the Fed, Mr. Trump is breaking decades of presidential precedent, and he is wrong on the substance. The Fed actually is behind the curve in*

normalizing short-term interest rates, and it should now raise the federal-funds rate at least four times a year.

The president isn't alone in his opposition to the Fed's interest-rate policy. Narayana Kocherlakota, a former president of the Minneapolis Fed, recently published an article criticizing the interest-rate hikes. Critics of the Fed's policy point out that the inflation rate is neither high nor rising rapidly. The consumer-price index in June was only 2.9% higher than the previous year, pushed up by the recent jump in energy prices. The price index the Fed uses to calculate inflation, the personal-consumption expenditures index, was up only 2.3%.

But controlling inflation isn't the primary reason for the Fed to keep raising the short-term interest rate. Rather, raising the rate when the economy is strong will give the Fed room to respond to the next economic downturn with a significant reduction.

That downturn is almost surely on its way. The likeliest cause would be a collapse in the high asset prices that have been created by the exceptionally relaxed monetary policy of the past decade.

It's too late to avoid an asset bubble: Equity prices already have risen far above the historical trend. The price/earnings ratio of the S&P 500 is now more than 50% higher than the all-time average, sitting at a level reached only three times in the past century. Commercial real-estate prices also are extremely high by historical standards.

The inevitable return of these asset prices to their historical norms is likely to cause a sharp decline in household wealth and in the rate of investment in commercial real estate. If the P/E ratio returns to its historical average, the fall in share prices will amount to a $9 trillion loss across all U.S. households.

Large drops in household wealth are usually accompanied by declines in consumer spending equal to about 4% of the wealth drop. That rule of thumb implies that a $9 trillion drop in the value of equities would reduce consumer spending by about 2% of gross domestic product—enough to push the economy into recession. The fall in the value of commercial real estate would add to the decline of demand. And with consumer spending down sharply, businesses would cut back on their investment and hiring.

Recent recessions have generally been short and shallow, as a result of a rapid response of offsetting monetary and fiscal policy. The Fed typically cuts its short-term interest rate by several percentage points, and tax cuts and increased government spending help spur demand.

But significant monetary stimulus would be impossible to achieve if the short-term interest rate remains at the current 1.75%. And there is less room than ever for fiscal stimulus, as annual deficits will exceed $1 trillion by 2020 and federal debt will be greater than 100% of GDP by the end of the decade.

That's why it's important for the Fed to raise the federal-funds rate to 4% over the next two years, which would allow it to cut the rate by at least three points when the next recession begins. Such a rate reduction might not be enough to prevent a recession within the next two years, but it would maximize the Fed's positive influence on the economy.

Raising rates does increase the risk of bursting the asset bubble sooner than investors and consumers might hope. But the Fed has let the economy grow fragile by keeping short-term rates too low for too long. Now it must respond by raising rates enough to deal with the bubble burst when it inevitably comes.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of the Journal's board of contributors.

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