



July 2nd, 2018

Something's gotta give...

It's a holiday shortened trading week in the U.S. with the July 4th celebration on Wednesday, but that isn't going to interrupt a full slate of relevant economic data. Today we got updates on Construction Spending (headline numbers indicate results came in a bit lighter than expectations) & ISM manufacturing (came in at 60.2, solidly above expectations for a print of 58.1 with the internals supporting the strong headline print). On Tuesday investors will be watching Auto Sales for a read on the pulse of the consumer, Thursday is jam packed with initial jobless

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claims, ISM Non-Manufacturing, and minutes from the June FOMC meeting. Then on Friday we look forward to the jobs report for June with consensus expectations looking for a number around 200k new jobs, the unemployment rate holding steady at 3.8%, and wage growth of 0.3% MoM.

Of course, if this isn't enough to keep one busy on top of entertaining or visiting with friends and family over the holiday (hopefully we all have the luxury) then I'm sure there will be a fair share of news flow emanating from the White House on the trade front. Look, I'm the furthest thing from a geopolitical expert so please don't look to this missive to gain some clarity or valuable insight on this topic here. However, I am confident in my understanding of economics, capital markets, financial analysis, and the interplay of local and global government

policy in these spheres. With that said I don't think it's too much of a stretch to suggest that investors are getting more than a bit unnerved over a White House that is sending out incoherent and inconsistent messages when it comes to trade policy.

What is also likely starting to enter into investors' minds as more than just a passing afterthought is the realization that Q2 real GDP growth projections of 4% (plus or minus) are a bit deceptive. This isn't to suggest that the second quarter isn't setting up to be one of the strongest quarters in this expansion, but more so that it's likely to fade away just as abruptly as it unfolded. Reason being is that a significant amount of activity is being funded on the back of deficit spending by Uncle Sam which will be sure to exact a price on the economy down the road via a deficit hangover and a drag on future growth.

The latest illustration of a meaningful economic data point that is positively contributing to short-term economic growth but has no fundamental basis for being able to sustain itself over the long-term, was the personal income and spending data released last week. For the 29th consecutive month we saw personal spending outpace income (a record for the U.S. economy) and as such the savings rate continues to hover near record lows (leaving little cushion for households to fall back on should an unexpected financial event occur). How can anyone possibly look at this trend and expect it to persist as a possible positive contribution to the economy for the foreseeable future? Especially when you consider how dependent the U.S. economy has become on consumer spending: prior to the 1990 recession consumer spending accounted for 64% of the U.S. economy,

between 1990 and 2007 consumer spending accounted for 67%, and post the GFC consumer spending has risen to 69% of the U.S. economy.

So to summarize, we're looking at the profile of the U.S. consumer that is carrying one of its lowest savings rates (3.2%) on record, where spending has outpaced income since 2015, an unemployment rate running below 4% (hence simple math suggests that job growth is set to slow), and a Fed that is raising interest rates as inflation picks up.

Personal Income & Outlays (%)	May	Apr	Mar	May Y/Y	2017	2016	2015
Personal Income	0.4	0.2	0.3	4.0	3.1	2.4	5.0
Wages & Salaries	0.3	0.3	0.2	4.9	3.3	2.9	5.1
Disposable Personal Income	0.4	0.3	0.3	4.0	2.9	2.6	4.5
Personal Consumption Expenditures	0.2	0.5	0.6	4.6	4.5	4.0	3.9
Personal Saving Rate	3.2	3.0	3.2	3.8 (May'17)	3.4	4.9	6.1
PCE Chain Price Index	0.2	0.2	0.0	2.3	1.7	1.2	0.3
Less Food & Energy	0.2	0.2	0.2	2.0	1.5	1.8	1.3
Real Disposable Income	0.2	0.1	0.3	1.7	1.2	1.4	4.2
Real Personal Consumption Expenditures	-0.0	0.3	0.6	2.3	2.8	2.7	3.6

Moody's articulated the potential squeeze average households are facing far better than I could have:

Implicit to such a very low average for the personal savings rate is the likelihood that 33% to 40% of U.S. households save an imperceptible, if any, amount of their after-tax income. When a financially stronger middle class provided a hospitable breeding ground for the persistently rapid consumer price inflation of 1972-1981, the personal savings rate averaged a much higher 11.4%. Yes, consumer price inflation may spurt higher every now and then, but today's average American consumer may lack the financial wherewithal necessary for the establishment of stubbornly rapid price inflation. (Moody's)

As for capital markets, I think last week's price action epitomizes the cloudy outlook that awaits the second half of this year. Take last Wednesday's epic market reversal as a case in point where at the high of the day the Dow was up 286 points to then end up finishing the day down -0.7% (a massive 451-point intraday swing). Same story for the S&P 500 which was up 0.9% at the highs of the day but ended up closing down -0.6%. If this year has taught investors anything, it is that markets are undergoing a transition and the first six months have offered enough data points to elevate one's conviction in this view.

Many casual market observers may look at the major averages and conclude that all is well with the S&P 500 closing out the books for the first half of 2018 with a gain of 1.5%. But this conclusion drastically misses the forest for the trees: if not for the six largest

companies in the index, the S&P 500 would be in the red for the first half. Take the NYSE composite index which is a much broader stock market index (including nearly 1,900 listed stocks) which finished the first half down -2.4%. What this is telling investors is that market leadership is very narrow with investors herding into a few select companies that have rightly earned the perception of being infallible to the whims of global growth or fundamental valuation, but history is pretty clear on this front in that the laws of economic gravity and competitive dynamics are undefeated when it comes to investing.

According to data from Bespoke Investments, the five FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) added \$523 billion to their market caps in the first half of 2018, while the rest of the stocks in the Russell 1,000 index added a total of \$183 billion.

Given it's a holiday shortened week, I'm going to keep this week's missive short and sweet as well, but before signing off I do want to call attention to the one variable that I believe is continuing to dominate everything else – Quantitative Tightening. Yes, the potential for a trade war is real and should it come to pass, it will be impactful. Likewise, the possibility of the Democrats flipping the House in November is likely to be a material event as it will likely bring the legislative process to a stalemate until the 2020 elections. Depending on one's views, stalling out any further fiscal momentum by this administration for the next two years may be interpreted as a good thing or a bad thing – as for me I don't think it's that simple.

But make no mistake – the 800lb gorilla in the room weighing on asset prices at the moment

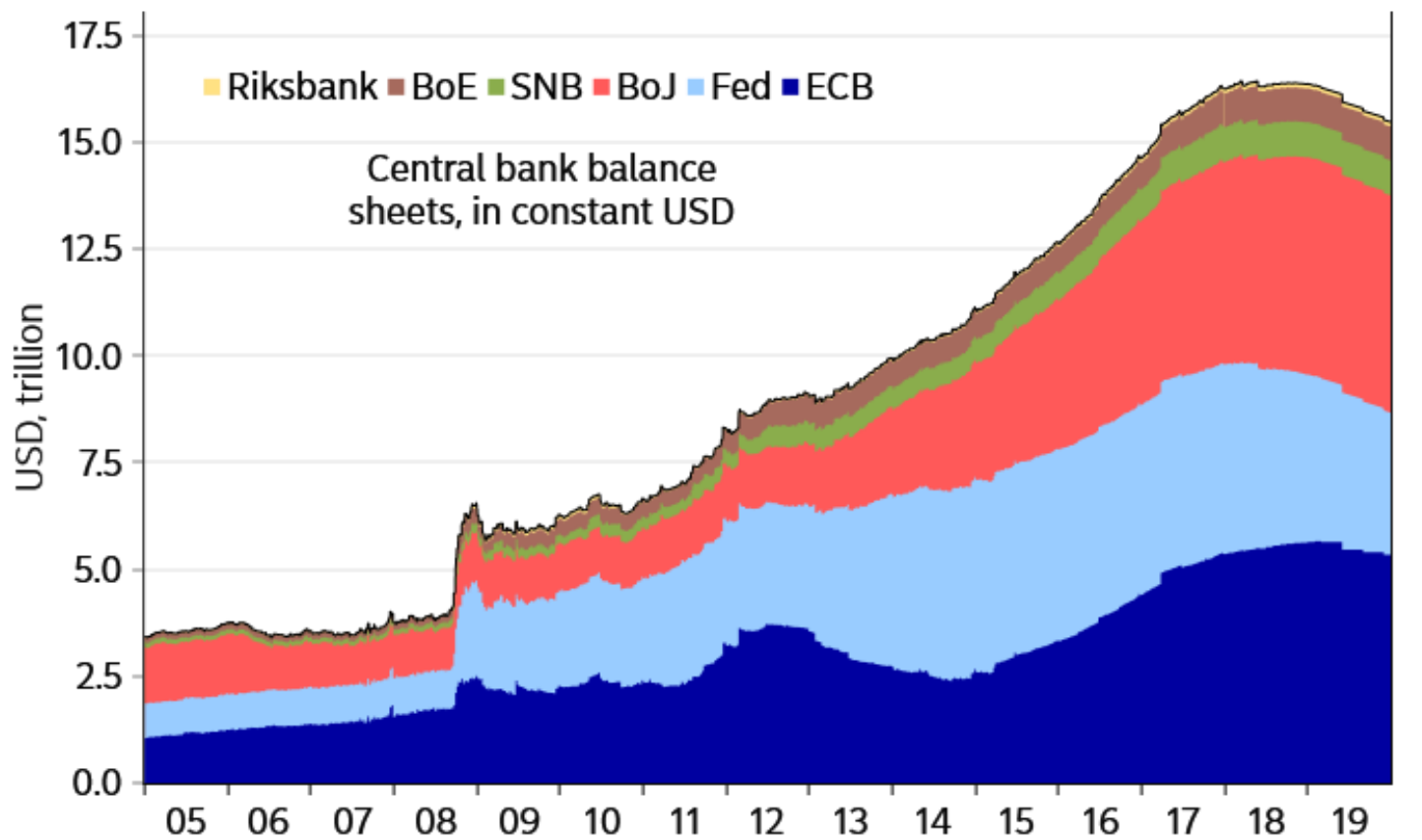
is the Fed and soon to be other global central banks joining the fray in draining liquidity from the financial system. For the first time since the Fed started hiking rates in December 2015, they are finally having the impact of tightening financial conditions and hence the U.S. dollar has appreciated nearly 9% from its January 25th low (just a day prior to the January 26th high in the S&P 500). U.S. interest rates (while off their highs) have also moved higher, but their big move started in September of last year. Keep in mind the impact from rising interest rates, which eventually increase the cost of capital, work with a lag, so it makes sense that the effect of higher rates are starting to be felt throughout the economy.

An appreciating U.S. dollar relative to other global currencies in tandem with higher rates is inflicting a lot of pain in emerging markets,

and this is typically where this tightening is felt first. We've seen the likes of Argentina go cap in hand to the IMF for a bailout, the Turkish Lira recently traded at its lowest cross rate to the dollar in history, and the synchronized global growth story ended earlier this year. These are just a couple examples of the pain being felt around the world: Emerging Market equities are down almost 20% from their January highs, China's Shanghai Composite just entered bear market territory (a more than 20% decline), Frontier Markets also recently dipped into bear market territory, and Latin America is off by almost 30%. These are the markets that are the weakest links in the global capital market chain and the ones most dependent on low global interest rates and high liquidity – two variables that at the margin have changed in a disruptive direction.

At this point, U.S. based investors look at the world through a unique lens given their experience is nothing like what has been playing out in the rest of the world over the last five months. But this is also par for the course in the late cycle playbook where global capital seeks safety in the U.S. which reflexively exasperates the conditions that are bringing pain upon foreign capital markets (pushing up the dollar and elevating already increasing local interest rates). However, should the Fed continue on its intended course with two more rate hikes this year (perhaps three more next year) in addition to the acceleration of its balance sheet reduction, then it's my opinion that the U.S. equity markets will in time experience the same price weakness that we've already seen in other higher risk equity markets around the world.

The below chart from Nordea Markets and Macrobond captures the inflection point we're reaching with global central bank balance sheets about to turn down for the first time in over a decade. Last year (2017) global central bank balance sheets expanded by \$2 trillion and global equity markets ripped higher. This year is a transition year with global central bank balance sheet expansion moderating to less than \$300 billion on an annualized basis by December. Then in 2019 (Q1), should central banks stick to the plans they've laid out to markets, global central bank balance sheets will be contracting.

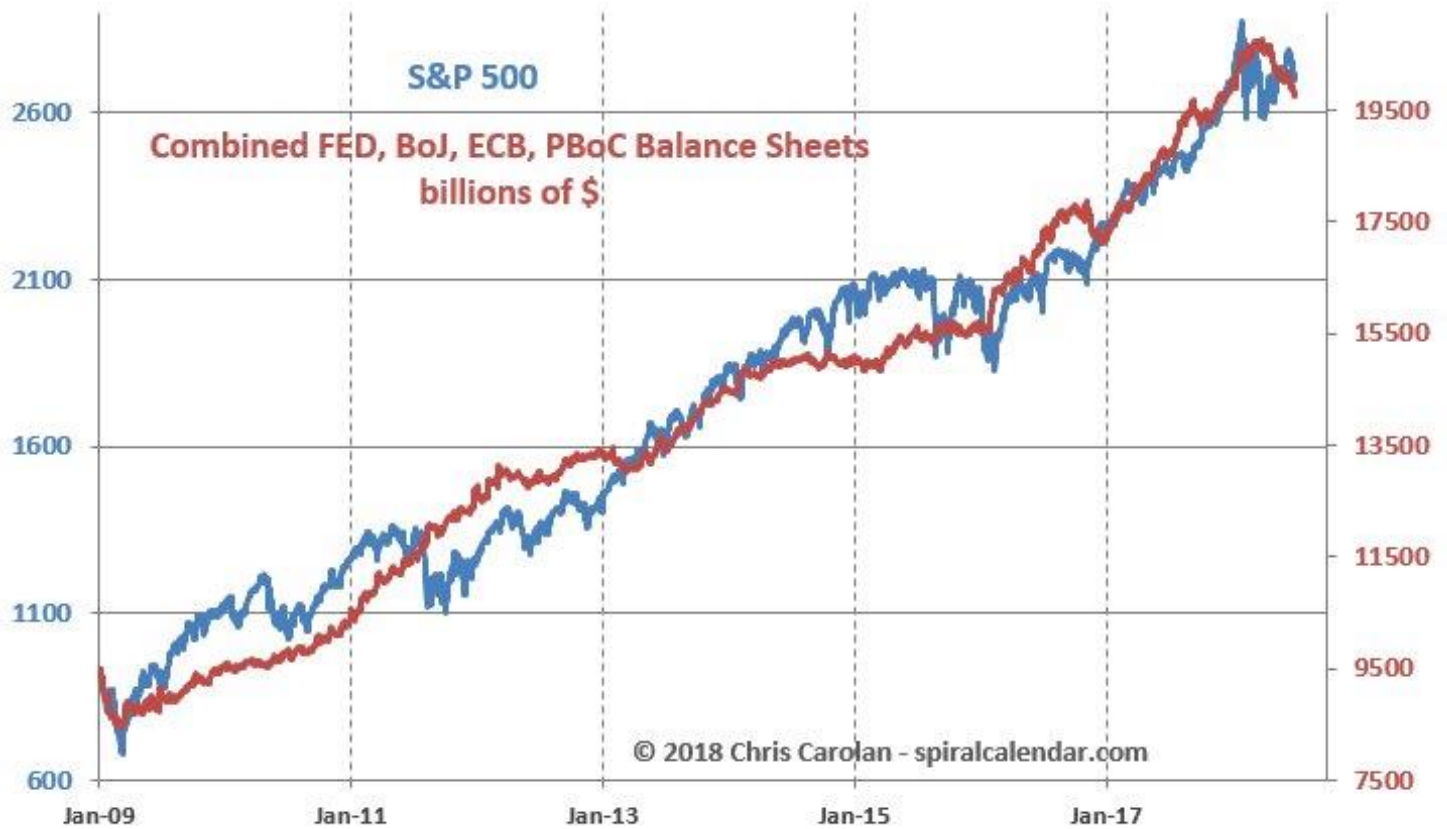


Source: Nordea Markets and Macrobond

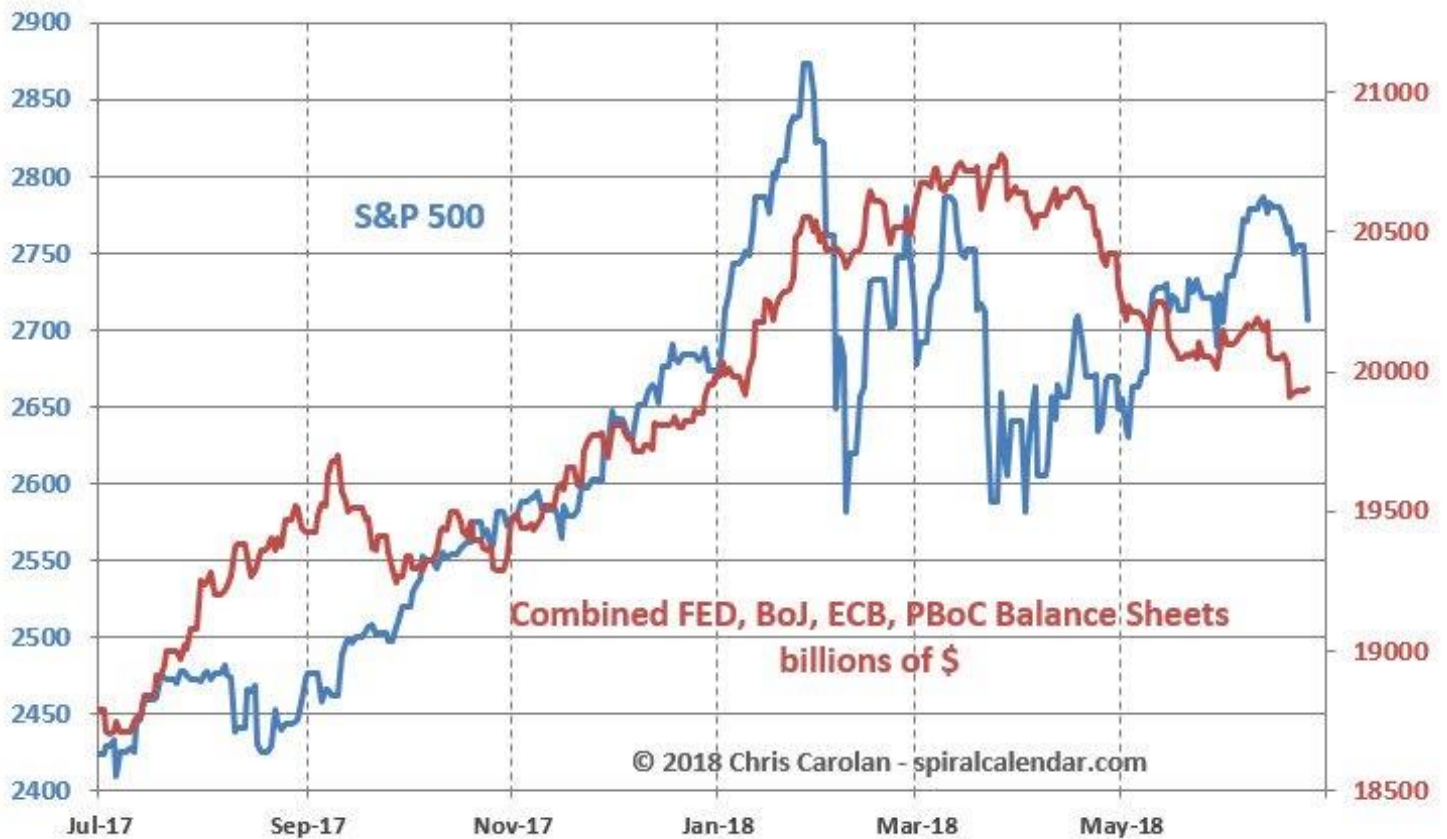
For those who may have forgotten or are unfamiliar with the theory underpinning this unorthodox monetary policy tool, let me refresh your memory: the central bank buys bonds (typically the safest bonds, such as government bonds) from other market participants in which it pays for them with newly created electronic money, called bank reserves. The acquisition of these safe assets removes them from the market and thereby

forces other market participants to purchase riskier assets. This in turn pushes the prices for most assets higher, boosting household wealth and improving corporate balance sheets as the discount rate falls. Economic activity expands as a result and inflation returns to normal. In a nutshell, that is the theory.

And as we see from the following chart from Chris Carolan which plots the S&P 500 against this decade long increase in global central bank balance sheets, it has worked very well at raising the price of risky assets. I don't care to get into the unintended consequences debate at this moment as it will digress from the main point I'm trying to convey in this missive. Notice in the chart though how the stagnation in the S&P 500 over the last six months coincides with the plateauing of global central bank QE.



The following chart hones in on this relationship between global central bank balance sheets and the S&P 500 over the last year which, given this short observation period, suggests an inflection point is at hand.



The point I'm trying to make is the same one everyone was right to make from the start of QE in 2009 until the start of this year – don't fight the Fed. Why is it then, that this is good advice when the Fed is providing stimulus, but this same advice is readily dismissed when the Fed is removing stimulus? Those of you screaming, "these policies work with a lag and the market does well during the early stages of a Fed tightening cycle" – you are correct and I

agree. But where we may differ is on the interpretation of where we are in this tightening cycle. On this debate I'll defer to the interpretation of Gluskin Sheff Economist David Rosenberg whose financial market experience and economic intelligence speaks for itself among informed market opinions.

“I said it once and I shall say it again: if the Fed remains on track for what it is pledging in aggregate, not just in a traditional sense but also the shrinkage of the balance sheet, the cumulative tightening through 2019 will have totaled 525 basis points. Rest assured – the U.S. economy has never, not once, failed to roll over into recession with such a scale of monetary restraint. Will it really be different this time?”

What's more is that the price action in the capital markets is starting to move in a way that suggests the Fed is already flirting with too much tightening. Over the last several months defensive sectors (Utilities, Consumer Staples, and REIT's) have started to outperform cyclical sectors (Industrials, Financials, and Materials). Emerging markets are on the brink of a bear market, credit spreads are starting to widen, the yield curve is at its lowest level since 2007 (10's vs. 2's spread at 31 bps), long-term Treasury yields are no longer rising, and the U.S. dollar is spiking. All of this suggests that the Fed may very well need to back off its tightening path in the next quarter or two, or risk assets (U.S. equities included) become quite vulnerable to the down side. Something's gotta give because what is materializing in the capital markets are a growing list of warning signs for the Fed to back off. Should they blink, then

risks should abate for the time being. Should they press ahead, then investors should expect a more severe replay of what they've experienced over the last six months.



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