August 20th, 2018

A rare long-term investment opportunity in a 'barbarous relic'…

After all of the choppiness of last week's price action, U.S. equity markets managed to register some modest gains as the S&P 500 moved back up to within 1% of the all-time high it reached back on January 26th. It's really a matter of perspective as to how one chooses to contextualize the current capital market setup in relation to where we are and where we've come from. The bulls can rightfully point to the resilience the equity market has exhibited in the face of heightened trade uncertainty, weakening economic activity around the globe, strong economic activity in the states, and stellar corporate earnings. Add to this a 10% correction that is now in the rearview mirror with nothing but open road ahead. The bears could counter with the fact that we are now looking at a U.S. stock market that has made no upward progress in almost seven months and this has coincided with U.S. economic activity registering its strongest results since the first half of 2015 and two consecutive quarters of +25% EPS growth for the S&P 500.

Reminds me of the optimist exclaiming that "things couldn't possibly get any better" to which the pessimist responds "I agree".

Admittedly our crystal ball is no clearer than anyone else's when it comes to predicting what may materialize in the capital markets over the next week, month, quarter, or year, but that doesn't stop us from analyzing, assessing, and observing the data to glean any insight it can provide. With that said, we remain of the view that the U.S. equity market is working its way through a prolonged topping process, one reminiscent and paralleling fairly closely with what transpired back in 2000. Keep in mind that while market cycles have many similarities, each have their own characteristics and idiosyncrasies – this one is no different.

The price action in the equity market over the last 13 weeks is rather telling in that it has taken on a late cycle feel with capital rotating from cyclical sectors to defensives.

Percent Change Over The Last 13 weeks:

Defensive Sectors:

- REIT's +11.29%
- Utilities +10.7%
- Consumer Staples +9.53%
- Telecom +7.3%

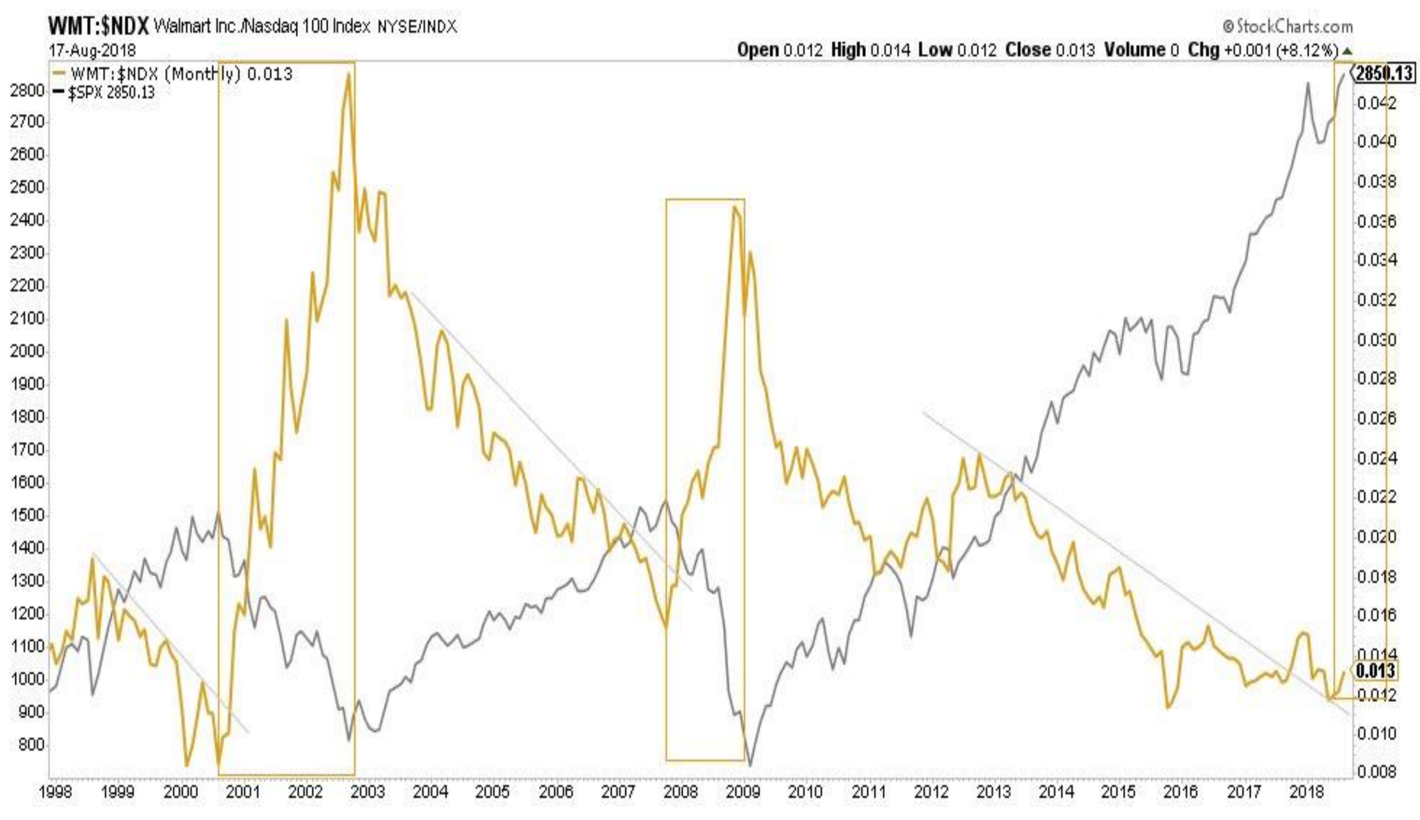
Cyclical Sectors:

- Energy -7.99%
- Materials -2.97%

- Financials -0.25%
- Industrials +1.24%
- Consumer Discretionary +7.05%

Last week was yet another great illustration of this expanding trend that's been underway since spring. On Wednesday the Fed implemented Quantitative Tightening (QT), as both Treasury bonds and mortgage bonds were maturing on its balance sheet and a little more than $20 billion were allowed to roll-off. At the lows the S&P 500 traded down 37 points and the Dow was down more than 300, but both rallied by the end of the day to close down 21 and 137 respectively. As one would expect on a risk off day like Wednesday, where the S&P 500 lost -0.8%, it was the defensive sectors that performed the best: Real Estate (+0.8%), Utilities (+0.8%), Telecom (+0.7%), and Consumer Staples (+0.4%) were all positive, while cyclicals were the laggards: Energy (-3.5%), Materials (-1.6%), and Consumer Discretionary (-1.2%). On Thursday the market recovered almost all of what it lost on Wednesday with the Dow rallying 396 points and the S&P 500 up 22, but once again it was the defensive sectors leading the charge: Consumer Staples (+1.5%) outperformed Consumer Discretionary by 1%, Telecom (+2.0%) more than doubling the gain in the S&P 500, and Utilities rallied +1.1% which was 30 basis points better than the Industrials. All told, Materials, Energy, Tech, Industrials, and Discretionary all lagged in what was a very defensive rally.

Now to be fair, it's worth noting the standout performance put up by Walmart on what were stellar earnings which perhaps exacerbated the rally in the Staples sector, but it's also worth noting that Walmart is the type of discount retailer that an investor would want to own during tough times. The below chart plots Walmart's stock performance relative to the Nasdaq 100 index (gold line) with the price of the S&P 500 (gray line), the two boxed in areas encompass the last two bear markets and economic recessions, 2000-2002 and 2007-2009, respectively. Time will be the ultimate arbiter as to whether or not this small sample size of only two has any validity for the future, but recent results from the likes of Walmart definitely hint towards at least the U.S. consumer acting with a bit more frugality.



Also confirming the defensive price action in the equity market of late is the lack of any upward movement in long-term interest rates. Even with the stock market rallying to within a whisker of its all-time high, the yield on the 10-year T-Note has traded down to 2.82% and the yield on the 30-year Treasury bond just broke back below 3.0% today. As for the 10-year, the current level says nothing other than the yield is at the low end of the 2.8% – 3.05% trading range that it's been pinned between for several months now, but should it break to the downside, it would be sending a rather large signal that the fiscally induced sugar high in economic growth in Q2 is set to moderate in the second half of the year.

This shouldn't be a surprise to anyone paying attention to the economic data so far in August as only 4 of the 14 economic releases have come in better than expectations and 9 of the 14 came in below (1 met expectations). The latest on Friday was the University of Michigan Consumer Sentiment reading slipping to a 13-month low of 95.3 from 97.9 in July. One has to execute some caution with reading too much into the headline decline which looks to be impacted by the wildfires in California (confidence out West fell pretty hard), but that doesn't explain away the drastic decline in spending intentions. Buying conditions for big-ticket items fell hard to 149 from 164 in July and this marked the weakest level since October 2014. Auto purchase plans have dropped to 121 in August from 140 as recently as June. Homebuying intentions experienced a similar trend as they fell to 129 in August from 144 in April, 140 in May, and 137 in both June and July – for reference this is the lowest reading in homebuying since October 2008.

The other economic data point that caught my eye last week was the large drop in the Philly Fed Index to 11.9 from 25.7 in July (well below consensus expectations for 22.0). Just another survey data point revisiting lower levels from several years ago, this one being the lowest since November 2016. Net-net this was a pretty weak report with orders plunging to 9.9 from 31.4, employment slowed to an 11-month low of 14.3 from 16.8 in July (was 30.4 in June), and backlogs receded to 5.6 from 11.0. Had it not been for a rise in inventories to a five-month high of 15.4 from 14.4 in July then this index would have come in even weaker. But keep in mind a build in inventories is only good if those items turn into sales and then that sets off another restocking cycle.

The housing starts data reported last week for July was another weak data point coming in at 1.168 million units which was up 0.9% at an annual rate, but that's about as good a spin as you can put on this number. On an absolute basis, expectations were for a print of 1.264 million units, so this was a huge miss and rather than getting caught up in the month-to-month housing data (which can be noisy) all one really needs to do is look at the annualized pace in housing starts over the last six months to see what is really going on, with that figure down -23.3%. That is not a constructive trend and really makes you wonder whether the housing market has already slipped into its own recession. You'd never know it by the results out of the companies appealing to the refurbishing theme like Home Depot and Lowes, but the homebuilders industry – which is down 20% from its January high – are singing a different tune.

Which brings me to last week's comments from the National Economic Council Director, Larry Kudlow, who I really have built up a lot of admiration and respect for over the years, but I can't help but wonder why he is focusing so much on touting the economic results that are in the rearview mirror rather than looking through the windshield. He's always been an optimistic spirit and I understand how when you are rewarded with a seat at such a high post within public service that you have to put on the cheerleading uniform and pick up the pom-poms, but to speak as aggressively as he does about the underlying and unwavering strength in the economy is pushing the envelope of being irresponsible and doing a disservice to the public.

Second quarter growth was great, no question about it, but all the data we've seen so far for Q3 suggests the U.S. economy is undergoing a meaningful slowdown from Q2. This isn't to suggest that we're falling off a cliff, but the ECRI leading economic index (which has a pretty good track record at forecasting the economy) continues to slide and hit +0.6381% last week. Keep in mind this index was at +8.8% in February and accurately foreshadowed the upcoming strength the economy experienced in Q2. With this indicator slipping to its lowest level in the last eleven months, what do you think it is saying about growth in the coming 3 – 6 months?

As an aside, and not to be too critical as I have zero interest in wanting to offend anyone who interprets this as a political view, but hitting the news headlines as I type are comments from President Trump criticizing the Fed for hiking interest rates. If the National Economic Council Director is touting the current economy as the strongest in recent decades, "explosive" in his words, then why shouldn't it be able to handle a 25-basis point increase in interest rates each quarter? You can't have it both ways: either the sustainable growth potential of the economy isn't that strong and it should be treated as such, or it is the greatest economy in decades and modest interest rate hikes should have little impact, if any. I find myself in the President's camp on this one, in that even modest hikes jeopardize what sustainable strength can be mustered in this economy and anything that could negatively impact financial stability (high asset prices) poses a big risk to economic growth.

The IMF Global Financial Stability Report (GFSR) released in April, which I encourage everyone to read, gets at just this point (emphasis is mine):

> *"…short-term risks to financial stability have increased somewhat since the previous GFSR. <u>Medium-term risks are still elevated as financial vulnerabilities, which have built up during the years of accommodative policies, could mean a bumpy road ahead and put growth at risk</u>. Higher inflation may lead central banks to respond more aggressively than currently expected, which could lead to a sharp tightening of financial conditions. <u>Valuations of risky assets are still stretched, and liquidity mismatches, leverage, and other factors could amplify asset price moves and their impact on the financial system</u>".*
>
> *Policymakers and investors must remain attuned to the risks of rising interest rates and higher market volatility…this GFSR also examines the short- and medium-term implications for downside risks to growth and <u>financial stability</u> of the riskiness of corporate credit allocation. <u>It documents the cyclical nature of the riskiness of corporate credit allocation at the global and country levels and its sensitivity to financial conditions, lending standards, and policy institutional settings</u>".*

For me this all harkens back to the Fed, who has already raised rates seven times since December 2015, and its latest forward guidance indicates that it has four more hikes until they reach their estimate of 'neutral' (whatever that means). However, the yield curve as measured by the 10s/2s spread is down to below 24 basis points which suggests the Fed is one, maybe two, hikes away from inverting the curve. Now I know that everyone and their sister on bubblevision has come out to educate investors that they still have upwards of 12 months before a recession commences after the yield curve inverts and stocks historically have rallied during this period. History is history and there is no refuting these findings, however what you hear very little about in this era of extremely low interest rates is that both Europe and Japan experienced recessions in the last decade without yield curve inversions. Just food for thought and it makes one ponder that when everyone is aware and looking for the same thing, is anyone really doing any thinking?

I can't help but wake up each morning worrying about how higher interest rates and a stronger U.S. dollar will impact the most indebted global economy we have ever seen. For the time being the problems in Argentina and Turkey have been put on the back burner, but they are far from yesterday's concern. Consider that Argentina's currency has depreciated by over 40% in the last year and this country owes $250 billion to foreign creditors. The Turkish Lira began the year at 3.8 to the U.S. dollar and last week tipped above 7.0 and this is an economy that owes $429 billion to foreigners ($224 billion which is held by international banks). In particular, European banks in Spain, France, and Italy are the largest lenders to Turkey, and two of these three European regions have sketchy financial profiles to begin with. As an aside on Italy, watch out for an upcoming show down between their newly elected governing body and the EU over fiscal profligacy in the coming months to become front page news, as this is sure to raise anxiety about potential further EU disintegration.

The Brazilian Real is down nearly 20% with external debt of $545 billion, the Russian Ruble is down roughly 17% with external debt of $483 billion, and the South African Rand is down 14% with external debt of $144 billion (numbers compliment of Myrmikan Research). These debts coupled with a currency crisis won't resolve themselves and only worsen as the credit cycle turns more aggressively on the back of a tightening Fed policy. Ladies and gentlemen, what we're seeing in emerging markets is only the end of the beginning for what lies ahead for economies and capital markets to contend with in the months and quarters ahead. These economies were the biggest beneficiaries and took full advantage of the near decade long period of zero interest rate policy, so it's only logical to expect that with the over $11.4 trillion in U.S. dollar denominated debt that's been built up since 2007 that these will be the regions that are most negatively impacted by the removal of excessively accommodative monetary policy.

U.S. equity and debt markets have been the beneficiary of the rest of the world's pain up to this point, and a fundamentally constructive argument can be made that this could be sustained for some time to come, but ultimately the longer and deeper this pain extends in these regions the bigger risk it poses to U.S. capital market resilience. Yes, the recent performance of the U.S. economy has been strong, but that's in the past now and investing is all about the future. Emerging markets are flagging global economic weakness and, by themselves, perhaps it would be appropriate for investors to shrug it off as an isolated issue that will resolve itself in time. But when I see the likes of global cyclical commodities getting torched then it makes me think that something more is going on: Oil prices down 15% from their recent highs, Zinc down nearly 30% in two months, Copper off nearly 20%, Aluminum prices down over 20% since June, and Nickel down 17%. As for the oil story, it's no longer just about increased supply out of Russia, Libya, and Saudi Arabia that is putting pressure on the price as the EIA just recently trimmed its demand forecast for 2018 from 1.5 million bpd to 1.4 million bpd.

A good gauge of how the Fed is viewing these developments will come on Friday morning at 10:00am EST when Chairman Powell speaks at the annual Jackson Hole symposium (the theme of the entire symposium is "Monetary Policy in a Changing Economy"). Should Chairman Powell reiterate his steadfast approach to tightening policy via reducing the balance sheet and hiking interest rates, then all investors should continue to expect the global liquidity backdrop to tighten and these initial emerging market cracks and tremors to eventually morph into craters and earthquakes.

Historically, that's just the way these tightening policies eventually play out with the weakest links buckling first which then creates a domino effect that eventually topples over the next piece. Which is why investors who haven't been paying attention to gold may want to spend some time getting their arms around the history of this "barbarous relic". It's been a challenging year so far for gold with the precious metal down nearly 9%. This doesn't come as much of a surprise given its negative correlation to the U.S. dollar, which at the end of last week was hitting its highest level since May 2017. However, with gold flirting with 19-month lows at just under $1,180 per ounce and the S&P 500 back to trading near its all-time high, the ratio of the gold price to the S&P 500 is just over 41. For those that study history, you're aware that the historical average for this ratio is 80 and the recent reading of 41 is the lowest reading since January 2006. While past performance is not indicative of future results, gold went on to rally 12% over the ensuing three months from that January 2006 trough in this ratio (its gain was nearly 20% over the next six months).

Moreover, the latest CFTC data shows that the noncommercial accounts on the COMEX have shifted to a net short position in gold for the first time in seventeen years. Said another way, it has been a long time since gold has been this detested and anyone with a time horizon that extends beyond their nose may want to consider adding a little bit of this insurance policy that has actually outperformed the S&P 500 so far this century (imagine that).

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