August 13th, 2018

Last man standing…

The consensus view at the moment is that the U.S. equity market is an oasis of prosperity in a world mired in risk and uncertainty. Without question, this is an accurate observation – just look at the performance of the U.S. equity market relative to the rest of the world so far in 2018:

U.S. Indices

- S&P 500: +5.5%
- Dow Jones Industrial Average: +1.8%
- NYSE Composite: -0.5%

Foreign Markets

- Canada (EWC): -3.5%
- Japan Nikkei: -3.9%
- Germany (DAX): -4.3%
- United Kingdom (EWU): -5.7%
- Russia (RSX): -7.8%
- China Shanghai: -15.8%
- Brazil (EWZ): -17.2%
- Argentina (ARGT): -22.5%
- Turkey (TUR): -55.89%

The most recent bout of global anxiety is coming from Turkey where the lira is in freefall and the 10-year bond yield has shot up to 21.1%. The prevailing view over the weekend and even this morning is that the Turkish economy is only the 17th largest in the world and as such, it should have limited ripple effects on the rest of the world should it fall into recession. I can see how this argument could be made to assuage investor anxiety, but this is a rather simplistic view of the situation. It's not the size of the Turkish economy relative to the rest of the world that investors need to evaluate (although it is the fifth largest trade market in the EU), but rather Turkey's debt profile is the fulcrum point and evaluating the make-up and who is exposed to the debt that is important to watch. What makes the Turkey situation tricky is $220 billion of outstanding debt obligations is in the corporate sector which makes assistance from the likes of the IMF (an entity equipped to deal with sovereign government debt) more complicated.

But rather than getting embroiled in the nuances and technicalities of the Turkish situation, perhaps it's more insightful to view it as an example for the world at large. You see, the problem across the globe is that virtually every economy has used the last decade of overly accommodative monetary policy to pile on debt to the extent that world debt-to-GDP has reached an all-time high of 244%. What's more is that with the U.S. Fed being the ring leader of such policies and the U.S. dollar serving as the world's reserve currency, a lot of emerging markets have tapped this debt spigot by taking on U.S. dollar denominated debt. However, with the Fed now relentlessly moving down the path of hiking rates and shrinking its balance sheet (reducing liquidity), it's pressuring the dollar higher. So emerging markets carrying this debt are getting hit on two fronts as they service this debt – a rising dollar (or falling local currency relative to the dollar) and rising interest rates. This paradigm is the epicenter of the pain being felt by emerging markets and unless the Fed relents on its tightening path, then the pain being seen in the weakest of the emerging market constituents (Argentina, Turkey, Indonesia, and Brazil) is only the starting point.

I have no interest in sounding like an alarmist and/or overly sensationalizing contagion fears, but I don't think investors should treat this situation with too much complacency either. History is littered with examples of stresses percolating throughout the global economy once the Fed gets rolling down the path of tightening policy following a period of prolonged excessive monetary policy accommodation. The tipping point usually occurs once we get to a point where the liquidity noose gets tightened enough that it begins to cut off the oxygen to the weakest regions. Recall the Mexican Peso crisis in '94 (followed Fed easing from '90 -'93), Asian currency crisis that started in '97 (followed Fed easing in '96 which was the result of the

Peso crisis a couple years earlier), Russian Ruble crisis and LTCM bailout in '98 (a situation everyone thought was contained back in '97), the popping of the Tech bubble in 2001 (the result of Fed tightening), and let's not forget the credit crisis in '08 which was the result of the ultra-loose policy from '03 - '06.

The point I want to make is that these situations all start out contained, but with financial markets and global leverage as interconnected as it's ever been, these situations end up having ripple effects that flow through the entire system. If 2008 taught us anything it is that there is no such thing as "decoupling" and that extended periods of easy monetary policy incentivizes global market participants to behave recklessly. So why is it so difficult to ascertain or fathom that global capital markets may go through a bout of indigestion, with debt-to-GDP levels that have never been higher and geared towards an interest rate regime that saw 5,000-year lows just as recently as the summer of 2016, when the interest rate regime we have today and the one we expect going forward are not nearly as conducive to this much more indebted system?

For the moment, U.S. markets are a port in what is a rather dramatic global financial storm, but unless the fortunes of foreign markets take a turn for the better, I fear that this is nothing more than due to lagged impacts in this connected chain of dominoes. Consider that global GDP is roughly $80 trillion and U.S. GDP is roughly $20 trillion – so the U.S. is definitely the largest economy in the world constituting nearly 25% of global GDP, but this also means that over 75% of world GDP is outside of the U.S. If the rest of the world undergoes a discernable slowdown (which it is) then it's only a matter of time before it filters into the U.S. economy and U.S. corporate profit picture.

It's not lost in my analysis that U.S. corporate profits are coming off of their 2nd consecutive quarter where S&P 500 earnings are up nearly 25% YoY and that revenue growth is up nearly 10%. However, when you look under the hood you find that excluding the corporate tax cuts and the share buybacks, underlying earnings growth is much closer to 7% than the reported 25%. It is what it is, and this isn't to deny that what is being reported is reality, but as an investor (investor is the operative word, as opposed to speculator…) you should be willing to pay a higher multiple for sustained organic earnings growth rather than a one-time accounting adjustment, as is the case with the recent corporate tax cut. What's more is that it seems investors have completely forgotten that nearly 50% of S&P 500 revenues come from abroad, and with the U.S. dollar surging it's sure to have negative implications for the repatriation of those foreign sourced earnings.

Right now, the U.S. dollar is acting as a global wrecking ball for the rest of the world, and it's not until the rest of the world's problems find their way into the U.S. that the current state of tranquility will come under assault. I found the conclusion of today's WSJ editorial as a rather astute assessment of the current situation:

> *"But Mr. Trump has a larger interest in avoiding financial contagion to other countries from the Turkish crisis. The U.S. isn't an economic island and needs the world to prosper if the U.S. wants to maintain the 4% U.S. growth of the second*

quarter. The world is awash in dollar debt after a decade of quantitative easing that has kept interest rate differentials artificially low, and a currency crisis could quickly become America's problem."

Keep in mind that in the first two quarters of 2018 the U.S. economy has been the beneficiary of one of the largest fiscal stimulus packages in decades and the peak of that stimulus hit in Q2. Anyone fact checking the "tax cuts will pay for themselves" mantra proclaimed from this administration when selling it to the public should have a look at the recently released deficit showing Uncle Sam is tracking an $800 billion annual shortfall – up nearly 30% on a calendar year basis. Perhaps we just need to give the tax cuts more time to work (what a joke, to put such a burden on future generations). The irony is that it's not the revenues that are the big problem (although they're down 3% so far this year), it's that government spending has ballooned by 10%.

From this point going forward the impulse from the fiscal stimulus will begin to moderate, and by this time next year it will be completely gone. Which brings me to the data we've seen so far to kick off Q3 in which according to my tally over 90% of the economic data reports so far in August have come in below expectations. To be fair, many of these indicators are rolling over from some fairly lofty levels, but it is the rate of change that matters most and it couldn't be more clear in signaling that growth in the second half of the year is slowing. The problem seems to be that we have so many market prognosticators doing reporting rather than actual analysis.

However, it looks as though the capital markets have begun to sniff out the trend in slowing economic growth:

- WTI oil prices have slid back into the $66/bbl area and are down 12% from their early July high above $75/bbl
- Copper is off nearly 20% from its February high
- Lumber prices, after being up nearly 45% for the year at their high in May, have proceeded to decline nearly 35% in the last three months
- Gold prices remain flat on their back, hitting seventeen-month lows today in the face of a strong U.S. dollar and a falling Chinese Yuan. Sentiment and investor positioning are at some of their most extreme levels in decades in the precious metals space (a good set-up for contrarians), but it's not until the Fed

begins to walk back on its tightening campaign or there is a break in the U.S/China trade spat that precious metals will experience relief. Like in the uranium space, both gold and silver are reaching price levels that are below the actual cost of production, so when this market turns, it's likely to be decisive.

Then there are the credit markets which tend to lead stocks, where the iShares Investment Grade Corporate Bond Index has generated a negative 2.4% total return year-to-date. I don't know about you, but when I see a world where the MSCI All-Cap World Equity Index (ex. U.S.) is down 6% year-to-date, Emerging Markets down 9.6%, Commodity markets in decline, same for Investment Grade and High Yield bonds, and the lonely S&P 500 as the only major index immune from the duress, it doesn't give me a warm and fuzzy feeling.

And even the strength in the S&P 500 is a bit misleading when it's been six large-cap growth stocks that have accounted for 2/3rds of the gain in this 10% rally off of the February lows. Given sentiment, investor positioning (both back near their highest levels of the year) and the fundamental backdrop, I'm a bit disheartened by the market's failure to take out the January highs last week. Perhaps we're still in a consolidation pattern that has persisted since those highs, and for all intents and purposes the S&P 500 remains little changed from where it was on January 16th when it first touched 2,800, but last week's failure to take out the highs occurred on weaker market internals. This is a classic sign of a late-cycle topping process, the same as was experienced in 2007, 2000, and 1989.

Looking ahead I think it's imperative to pay attention to the U.S. dollar. If it continues to rally then it's realistic to expect most other asset classes outside of the large-cap tech safety trade to be under duress. Beyond the dollar, it's all about the Fed and unfortunately, unless something breaks in the next several weeks, we won't hear much from them until

September at their next scheduled FOMC meeting, but they too will be a catalyst one way or the other. Should they continue to push forward on their path for tightening, then investors should be working off of the thesis that they are going to tighten until something breaks – that will be bad for all asset classes, including U.S. equities eventually as they are typically the last to get the message. Should they begin to float trial balloons into the market about backing off the tightening already being priced in, then it could give some new-found life to risk assets. But keep in mind they played this card back in 2016 to rescue the world from a global recession, so they need to strike a delicate balance without completely losing their credibility. One last thing to consider, and that is that global central bank liquidity (balance sheet expansion) inflects into contraction sometime in Q4 2018 / Q1 2019. This is a major shift from what has been nearly a decade of uninterrupted balance sheet expansion.

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