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Are we back to 'good news' being 'bad news' for asset prices?

One of the features that stands out most to me when I reflect back upon this current expansion (now into its 111th month and the second longest in history) was the mantra of bad news being good for asset prices because it meant that the Federal Reserve would keep monetary policy accommodative via low interest rates and asset purchases. Earlier in this cycle during periods of economic weakness – outside of 2011 when there were legitimate fears of a European debt crisis potentially spreading to the U.S. and causing a double dip recession – risk assets never really sold off much as investors held firm to the view that the Federal Reserve had their backs. Likewise, as we transitioned into the muddle through stage of this expansion where double dip recession risks were no longer a concern, during the sporadic bouts of strong economic activity risk asset price gains were restrained because of the fear that the Fed would begin to remove the punchbowl. It took an exceeding amount of forward guidance and jawboning by the Fed over the last several years – Bernanke during the 2013 'Taper Tantrum' and Yellen in late 2015 / early 2016 when the probability of global recession was rising – to appease investors during periods of both economic strength and weakness.

But here we are today, where for the first time this cycle it appears as though the Federal Reserve is no longer in sole control of global economic variables. This isn't to say that they are not playing a major role in what is transpiring, but the fiscal stimulus implemented by this administration first via deregulation which ignited animal spirits following the election, then came the passage of tax cuts and an additional $300 billion in government spending on what was already a bloated budget, which all together adds up to an additional impulse of 1% of GDP in 2018 and 2019. So, it should come as little surprise that the U.S. economy is experiencing such a meaningful surge in economic activity so far this year. Consider that the budget bill was passed in March and the government's fiscal year ends in September, so we're talking about a couple hundred billion dollars having to be spent in the matter of about six months. What would be surprising is if the economic activity didn't get a boost to reflect this fiscal injection.

But therein lies the rub and the dilemma facing market observers and practitioners in 2018, where the Fed no longer has the liberty to pull back, pause, or reverse its tightening policies in the face of an economy that is firing on all cylinders. Take last week's employment report as the latest illustration of what a 'hot economy' looks like according to the Fed's terminology. The U.S. economy added 201k jobs in August which bested consensus estimates for 190k, the unemployment rate held steady at 3.9%, and finally we experienced a breakout in wage gains to 2.9% year-over-year after months of stagnation around the 2.7% level.

For all those analyzing the labor market, according to the headline statistics we're looking at an employment backdrop that is drum tight with the broad U-6 rate falling to

7.4% from 7.5% to stand at the lowest level in seventeen years. There were definitely some warts in this report that I didn't see receive much attention in the weekend periodicals: -50k in downward revisions to the prior two months, education added +53k to the headline number (customary with school starting back up), factory payrolls dipped -3k (a big shortfall from the +23k consensus expectation), no change in the manufacturing workweek, and the diffusion index fell to 52.6% from 61.2%.   One other non-confirmation of the headline strength of this report was the household survey showing a -423k decline in employment, and all of this was in full-time jobs. Not to mention the employment-to-population ratio falling to 60.3% from 60.5% - tied for a seven-month low.

All told this employment report has a distinct stagflationary signal to it: accelerating wage growth, weak establishment survey internals, and outright declines in household employment. This isn't the best news for financial assets, but perhaps this is what stocks have been figuring out throughout the balance of this year with the S&P 500 closing last week below the highs it reached in late January.

Which brings me back to the Fed and the corner it's backed itself into with the unemployment rate at 3.9%, sitting handily below the Fed's own estimate of the natural rate at 4.5% for 17 months running, and now every inflationary metric one can pull up exceeds the Fed's 2% target. The Fed finds itself in a similar pickle as has been the case in the last three economic cycles where they have waited too long to tighten and now that we have fiscal policy goosing what was already a mature economic cycle, not to mention the material risk of a trade war between the two largest economies in the world (which ultimately will feed already broadening inflationary pressures) and now the Fed will have to tighten more aggressively (or continue to tighten) to catch up. There isn't a market trading today that is priced for a Fed that according to its own metrics is still 100 basis points away from what they deem as a "neutral" policy rate.

Consider that one of the biggest crutches to markets this cycle was the engineered push higher in asset prices by the Fed to create a "wealth effect" that they hoped would stimulate economic activity. So here we are today, staring down the backside of a decade long monetary policy experiment which has exceeded even the wildest of imaginations that global central banks would have collectively bought up nearly $20 trillion in global assets, ushered in a 5,000-year low in global interest rates, and re-leveraged the entire financial system well beyond where it stood at the doorstep of the Global Financial Crisis. I get asked all the time what period in history the current capital market setup reminds me of, and to that my response is a combination of the late 90's and mid 2000's.

As I've said before, all cycles are unique with their own characteristics, but cycles do have a consistent rhythm across history. In the current cycle we're at the juncture where the fundamental setup will continue to put pressure on the Fed to continue tightening policy until something breaks. Inflationary pressures are only continuing to build with wage inflation historically being the latest and most lagging of inflationary indicators. With an unemployment rate at multi-decade lows and underlying economic momentum in the U.S. continuing to maintain strength, it’s only reasonable to expect wage pressures to continue to build. In addition to wage pressures we’re looking at a system that has to deal with potential supply-chain disruptions from the mounting pressures on globalization, a strengthening U.S. dollar (don’t forget that nearly 45% of S&P 500 revenues are derived outside of U.S. borders), and the increasing cost of capital from higher interest rates.

Outside of short spurts of a quarter or two during this prolonged economic expansion has any one of these variables applied meaningful pressure on the financial system – we had the ‘Taper Tantrum’ in 2013 lift interest rates, but then they eventually backed off. We had an extended rally in the U.S. dollar from the middle of 2014 through the early part of 2015, but then in the fall of 2015 following a surprise Chinese Yuan devaluation that sent global stock prices into a tailspin, global central banks stepped up to stabilize the system. As for broad based inflationary metrics, that has been the one metric that has mystified economists throughout this entire cycle in that it has been non-existent – at least in the way it's measured.

But right here right now, all of these metrics have picked up simultaneously to act as headwinds. At this point the pain is being felt in almost every other market except for the U.S. with emerging markets down nearly 20% from their peak earlier this year, commodity markets are in deep declines, and even U.S. debt markets having generated negative returns year-to-date. Take oil prices as an example in the commodities space, where the Iran sanctions should have added a tremendous amount of support given its significance as an oil producing nation and with the outlets for it to sell its production virtually drying up come November. However, after moving above $71/bbl in early May, WTI has been having a difficult time staying in the high $60's during what is the strongest part of the calendar from a seasonality standpoint. For the most widely used and demanded commodity in the world to have such a muted response with one of the largest individual producers losing its ability to sell into the market, one would have expected a firmer pricing backdrop than what has transpired.

I'd be more open minded to the arguments that the world is changing and the demand for oil at the margin is in decline, and/or that the increased production in the U.S. has more than made up for any supply disruptions in

Venezuela, Iran, or Libya, if it weren't for the deep slide in many of the other highly cyclical commodity markets like copper, aluminum, zinc, and iron ore. The collective decline in all these commodities leads me to believe that global demand is under pressure and it's not solely the result of excess supply.

Which brings me full circle to the U.S. economy and the stock market acting as the lone outlier in a globalized world that is showing increasing signs of rolling over. We very well might be in the opening innings of a new world order where the four-decade evolution of globalization is starting to be unwound by growing nationalistic and populist movements. If so, so be it, but it would be naïve to think that this phase transition will unfold with little to no impact to U.S. equity markets. At the moment the U.S. stock market is carrying on with its customary flight to safety edict, where capital flows exiting markets with higher risk and less security are redirected here. But, this starves these foreign markets of much needed liquidity that they are dependent upon and have lived off of throughout this cycle. Should these markets (and I'm specifically talking about emerging markets) continue to come under pressure and not stabilize in the not so distant future, then investors should be preparing themselves for some of this pain to matriculate its way to the U.S.

What has helped prop up the United States and a big reason why global capital flows are flooding into our markets is because the U.S. has the world's reserve currency, the world's reserve asset in U.S. Treasuries, the perception and reality of the safest and most secure equity market in the world, and heightened respect for the rule of law. But in Q4 and beyond, the fiscal stimulus package that has goosed the U.S. economy will begin to wear off and should these foreign economies still be in a state of deceleration, then they will pull the U.S. down with them as well.

In conclusion, we are at a point where investors need to be keenly observant of what the market is telling us. This isn't to say it's easy to read or it's going to draw investors a map to follow, but what I mean is to listen and react accordingly. This isn't a time to be anticipatory and attempt to tell the market what it should be doing. It's bigger than all of us, but the collective judgement that goes into moving asset prices and creating trends continues to suggest that a defensive rotation is underway. It continues to baffle me how anyone can proclaim with unabashed confidence how healthy the stock market is when over 50% of the S&P 500's gain so far this year comes from just five stocks (Amazon, Apple, Google, Netflix, and Microsoft). These five stocks are up on average nearly 30% for the year while the other 492 (there are only 498 stocks in the S&P 500 at the current time) are up roughly 3%. So yes, go ahead and tell me that all anyone owns are these five stocks and none of the rest, nor do they have any exposure to Emerging Markets which are down -12% on the year (-20% from their highs), Europe is down more than -7%, Investment Grade bonds down over -2%, Gold down -8%, and Real Estate which is flat on the year.

It's a sad reality, but it's true – diversification has been an investor's worst enemy this year. This isn't an endorsement to abandon diversification and asset allocation as a prudent, time tested, and successful long-term strategy, but rather to highlight just how narrow the return profile of portfolio returns has become recently. Moreover, it argues for investors to exercise a little more thought and diligence in thinking about what the horizon looks like rather than continuing to relish in the past. The parabolic gains in the high-flying stocks of this year are in the books – is it reasonable to expect this to continue? I don't know, but let me lay this on you for context: the combined market cap of Apple and Amazon has increased by $675 billion so far this year which, if this was a separate company, would make it the fifth largest company in the U.S. (just behind Google and Microsoft). This separate company would be larger than Berkshire Hathaway, which for all of his brilliance and what Warren Buffett has built over his entire career doesn't stack up to what these two companies have been able to add to their combined market caps in fewer than 170 trading days.

Yes, in my mind there are excesses in the financial markets today, and any number of smart people I encounter are correct to point out and acknowledge the positives they see. I see them too, but I also see the burgeoning imbalances that can't be ignored. Imbalances that won't persist indefinitely in an environment where the cost of capital is increasing (interest rates), profit margins are pressured (rising wages, capacity constraints, and increasing input costs), and global growth is weakening (look at global monetary aggregates, foreign exchange volatility, and rising foreign interest rates). I remain of the view that the U.S. equity market is undergoing a prolonged topping process, one that is consistent with what transpired in 2000. This one won't playout exactly the same and just because we made a new all-time high last week, this has not altered my view.

We are at the point where good news is bad because good news keeps the Fed pushing forward on tightening financial conditions and strong economic data (goosed by an unsustainable fiscal impulse) is the conduit which forces the Fed's hand to continue tightening until something breaks. Emerging markets could end up being the canary in the coal mine suggesting that, just seven hikes into this tightening cycle, the financial system is being destabilized. This is how it played out in the late 90's with the Thai baht being devalued which led to a broader Asian currency crisis and it wasn't until fifteen months later that the Russian Ruble crisis forced the Fed to come in and bailout out Long-Term Capital Management (LCTM). Just because it takes time for these things to play out and the impacts to ripple their way through the system doesn't mean that they don't matter. It's the bus that you don't see that runs you over, so always be aware of your surroundings and don't allow yourself to be overconfident and complacent.

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