September 24th, 2018

Watch the price of money…

Global equity markets are starting off the week in the red following the news over the weekend that China withdrew from the trade talks that were scheduled to take place in the coming days. It's looking more and more as if this situation is going to be a long, drawn out affair with the two biggest economies in the world digging in their heels. Should this be the case, investors can expect to see more companies join the ranks of Walmart, FedEx, and Micron – three companies that have all warned in the last week that tariffs are negatively impacting their businesses and will force them to offset these rising costs with price increases that will filter down to their customers. As for the upcoming earnings season, I must admit that even given my skeptical lean I was a bit surprised to see in the latest FactSet note that of the 98 companies that have issued EPS guidance heading into Q3 reporting season, 74 have guided below expectations. This equates to a 76% negative guidance ratio (74 out of 98), which is above the five-year average of 71%, and this marks the highest percentage of negative guides since Q1 of 2016.

I don't care to split hairs about the merits of this tit-for-tat trade "skirmish" (as Jamie Dimon would label it), but I do think it is important for all investors to acknowledge its existence and incorporate into their analysis a broad array of potential impacts this could have on the global economy, inflation, interest rates, and asset prices.

As of today, another $200 billion in Chinese imports will incur an additional 10% tariff with China responding by putting a similar tariff on $60 billion of U.S. imports into their country. These moves will have an impact, and keep in mind that should there be no resolution by the start of the year then the 10% tariff the U.S. imposed will increase to 25% in 2019, and still hanging out there is the administration's threat for an additional $267 billion in Chinese imports that could be tariffed. What I didn't see get a lot of media attention last week, but something I viewed as providing some juice for the rally we saw in Emerging Market equities was the announcement out of Beijing for fresh fiscal stimulus measures. This also came with commitment by China that they would not willfully devalue their currency to combat the U.S. tariffs. Whether this actually comes to fruition or even works is yet to be determined, but markets react to nuances and these were of the constructive variety.

It truly is impressive how undeterred U.S. equity markets have been over the last five months in the face of what has been some rather significant headwinds: the intensifying trade war between the U.S. and China, what is looking like irreconcilable differences between the E.U. and the U.K. on the soon approaching Brexit deadline in March, U.S. mid-term election uncertainty where polls suggest the House flips back to the left (although Brexit and the Trump victory should serve as a good reminder of how much stock to put behind polls nowadays), and an unrelenting weakness in Emerging Markets with India becoming the latest region to join this party which is a situation definitely worth watching given the darling of Wall St. they have been for capital.

Yet here we are with the Dow having risen in 8 of the last 10 trading days and in the process capping off its best two-week stretch since February. Technically speaking, the fact that the Transports have confirmed the move in the Industrials definitely helps with the validity of this move. Perhaps we're seeing a bit of algorithms driving the market action of late with the Nasdaq trading off 0.3% over the last week which has typically been the case when the dollar is weak and enthusiasm about the U.S. economy is rising. When the dollar has rallied, economic growth fears increase and trade-war anxieties intensify, and investors have typically flocked to the secular growth narrative proffered by the Tech darlings. Which brings me to another sector of the market that has been a bit perplexing this year, and that is the Financials.

Coming into the year this was one of the consensus picks for sector leadership, yet Financials have underperformed the market by nearly 7% as of today. After all, we have the strongest economic backdrop since 2014, valuations aren't expensive, balance sheets are strong, and interest rates are rising, so why is the sector up less than 2% for the year? I wish I had the answer, but I don't. My best guess is the flatness of the yield curve is one of the biggest headwinds, given that banks make their money from borrowing at the short-term end of the yield curve and lending at the long end. With a 10s/2s spread that has hovered around 25 basis points for most of the year, it doesn't really provide a whole lot of margin to be made off of such a small spread.

Which brings me to the one variable in the capital markets that has my utmost attention at the current time: interest rates. At the end of the day, interest rates are the price at which money exchanges hands from a lender to a borrower. Treasury yields are the most influential interest rates in the world, and for good reason given that the U.S. dollar is the world's reserve currency and Treasury bonds are the world's reserve asset. I'll acknowledge that the reserve status of the U.S. dollar and Treasuries are under threat, but as of now there is no alternative to this reality and this isn't a philosophical construct I want to hash out in this missive. Getting back on point, as the U.S. Treasury market is closing in on some key inflection points with the 10-year T-note yield sitting at 3.08% and the 30-year T-bond at 3.22%. The interest rate on both of these maturity issues are within a whisker of multi-year highs, and should the

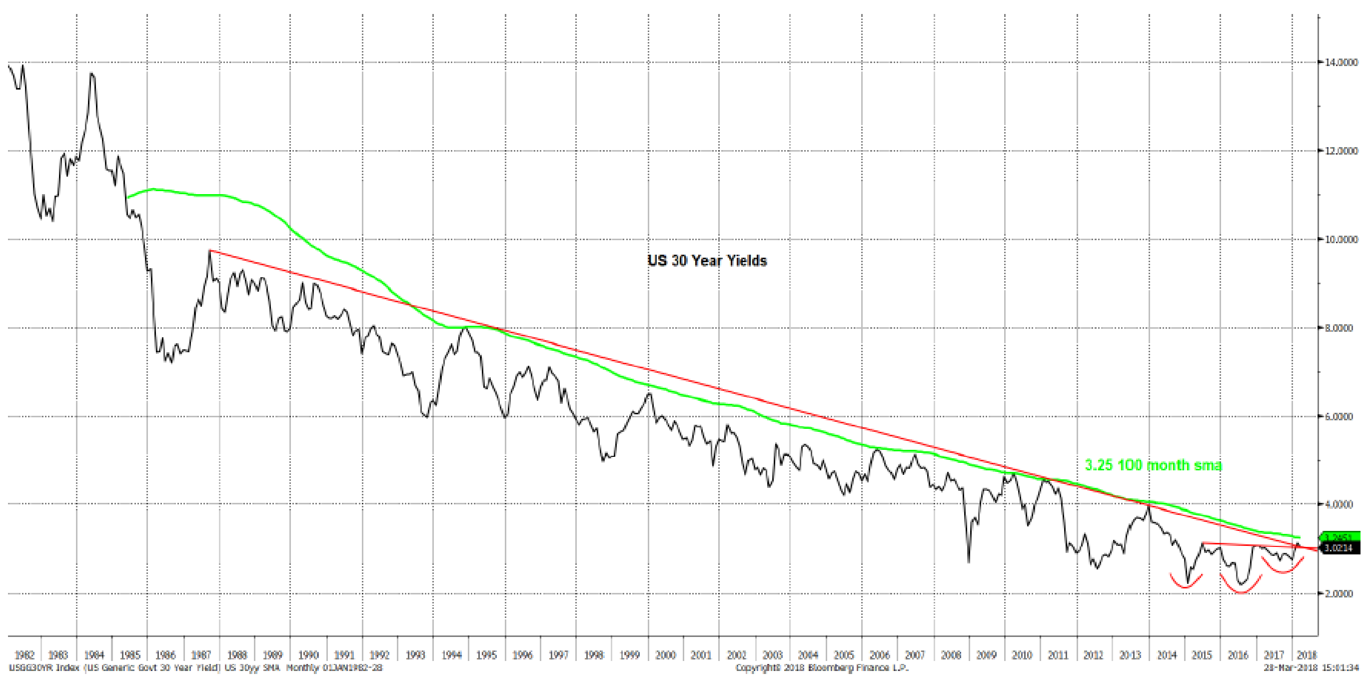
10-year sustain a move above 3.11 and more importantly the 30-year above 3.25%, then investors are looking at yields breaking above a downtrend channel in long-term interest rates that has been in place for almost 33 years.

The following chart from MI2 Partners President Julian Brigden provides a visual of just how engrained this downtrend channel has been for asset markets since 1985.

The same is true at the long end

On the monthly chart there are lots of levels around 3.15-3.25%

There's a neckline on an inverse head and shoulders, a 30yr trendline but most importantly is the 100 month SMA, which comes in at 3.2577% and has held us since 1985



Folks, it isn't the absolute level of interest rates that are important here, and anyone reading this while telling themselves under their breath that I am crazy because 3.22% on a 30-year bond is still ridiculously low, you're 100% correct. But consider that it is these ridiculously low interest rates that has allowed the system to function normally while heaping on an ever-increasing amount of debt. McKinsey Global Institute recently released an updated report on the global debt picture where since the Global Financial Crisis in 2008, total global debt (household, nonfinancial corporate, and government debt) has increased by 75% from $97 trillion to $169 trillion in the first half of 2017. To be fair, China is the biggest culprit when it comes to this debt bulge, but this is a double-edged sword. What I mean by this is that the financial industry was complicit in overlooking and excusing this excessive use of debt when China's GDP growth was humming along at 8 – 10% from 2000 – 2011 and the rest of the world was the beneficiary. Now here we are with China attempting to manage a deleveraging cycle with GDP growth hovering around 7% for the last four years and global growth is decelerating, outside of a fiscal stimulus abated U.S. growth spike.

Two weeks ago, the Wall St. Journal printed an op-ed article titled "*Get Ready for the Next Financial Crisis*", in which some of the data from this 36-page report was highlighted. I understand the title is a little dramatic and perhaps over the top, but nevertheless the data is the data and denying its existence because of a clickbait headline isn't a very objective way of thinking.

“This is what zero interest rates and quantitative easing have wrought—more debt and lower credit quality. Yield-starved investors were happy to look the other way and refinance dubious credits so long as rates were low and they had no better alternative. Small wonder central banks are glacially unwinding their balance sheets and raising rates. But higher rates are coming, possibly heralding a tsunami of credit defaults…

The U.S. owes $21.5 trillion of Treasury debt, the majority of which is scheduled to be refinanced in the next eight years, disregarding the additional $1 trillion required by the 2017 tax reform and an estimated $100 trillion of unfunded entitlement spending ahead. The Fed still owns $2.324 trillion it bought from banks as part of quantitative easing, which *will need to be refinanced at maturity. Foreign sovereigns own $6.5 trillion, 40% of which is in the hands of China, Japan and Saudi Arabia.*

China and Japan are increasingly refinancing their own debt. As China continues its transition from exports to domestic consumption and buys its oil in its "petro yuan" straight from Saudi Arabia, while the U.S. buys less Saudi oil, Riyadh and Beijing have less appetite for U.S. Treasuries. Finally, the European Central Bank's anticipated policy normalization suggests Europe too will be competing with the Fed for buyers in sovereign refinancing markets….

Cautious as the Fed may be about raising short-term interest rates, and even should economic growth naturally slow as the *one-time spike of fiscal easing subsides, supply-demand dynamics suggest the "belly" of the U.S. Treasury curve is headed higher…*

When credit turns, stocks have never been far behind. The longest-ever bull market may be closer to ending than we think—and that could be the least of our problems."

While the $21 trillion (and growing) national debt level is truly astounding, I'm of the view that the USA will never classically default on its obligations, given we have the world's reserve currency and we have a printing press. One thing we learned for sure from the last cycle is that there is ample willingness to use it if necessary. That's not to say that such actions won't have consequences, one of which would be crowding out private sector funding and pressuring interest rates higher (a bit of what we are seeing right now), but let's save that topic for another day. Outside of sovereign debt, the excess leverage in this system isn't in mortgage debt or the banking system, so it's unlikely that we see a replay of the GFC if/when this credit cycle turns.

No, the leverage excess that worries me is in the corporate debt markets this cycle. I hear it repeated over and over how great of shape the banks are in at the current time (to which I don't disagree), but that isn't where the analysis should end. It's as if after acknowledging that since the banks are fine in a higher leveraged financial state that the risk doesn't exist. To think in such a manner is to forget history in that there have been numerous financial calamities around the world that didn't originate from the banking system. A couple were right here in the U.S. with the popping of the Tech Bubble in 2000 as the most recent occurrence, and prior to that the LBO bubble in the late 1980's.

Corporate debt has doubled over the last decade from $3.3 trillion to $6.3 trillion, with nearly half of these outstanding corporate liabilities carrying a credit rating of BBB (the lowest investment grade rating) or lower. At the peak of the last cycle in 2007, only 27% of the investment grade bond market was rated BBB versus 55% today. As was the case with mortgages a decade ago, much of this leveraged loan craze (courtesy of M&A and Private Equity transactions) have been repackaged into Collateralized Loan Obligations (CLO's).

So here we are with roughly $4 trillion of corporate debt that is set to mature over the next five years and it will have to do so at interest rate levels that have been pushing higher for over two years now. Short-term Treasury yields out to the three-year maturity are the highest level they've been since 2008, the 10-year Treasury yield is the highest it's been since 2011, and the 30-year T-bond yield is the highest since 2015. Said differently, anyone looking or needing to refinance debt will be doing so at a higher interest rate than they've seen in at least three years, if not seven to ten years. Also, keep in mind the rapid pace at which short-term interest rates have moved in just the last twelve months. The 2-year T-bill yield has doubled from roughly 1.4% to 2.8%. In the past when we've seen this large of a relative move in the 2-year yield was from the Summer of '04 to the Spring of '06 (the housing market peaked and set the stage for the GFC dominoes falling starting in '07). Before that it was the Spring of ’99 to Summer of 2000 which coincided with the peak of the Dotcom Bubble. Prior to that it was February of ’94 to December ’94 when the 2-year yield doubled from roughly 4% to nearly 8%, but this set up a large disruption in both the debt and equity markets during that summer. We saw a similar rise in April of 1987 to October 1987 and we all recall how that ended with Black Monday.

The point is, it doesn’t matter what the absolute change in yield is, but rather the relative change and the speed at which it occurs. At this time, other than blowups in Emerging Markets (Turkey, Argentina, and South Africa) there is little evidence that this move in yields is having an impact in the U.S. And there is many a good reason for this to be the case: strong economic momentum, tax cuts (which really benefited the business community), and massive stock buybacks.

However, given the key technical interest levels several parts of the Treasury curve are pushing up against, I think it's important for investors to be aware of the pressures it could put on asset prices. Truth be told, I'm not entirely convinced this is as negative of a backdrop for the equity market as it could be for the debt market, but that's a much deeper and more intricate discussion.

When I think about what is the most important development in the past year, it would be this move higher in interest rates and in particular the 2-year Treasury yield. To me it is at least partially responsible for the weak global equity markets, U.S. equity market concentration, volatility in currency markets, and stress in the most interest rate sensitive parts of the U.S. economy (Autos and Housing). Only three other times in history have 2-year Treasury yields doubled over a twelve-month period, which has seen this part of the Treasury curve generate a -0.5% return, which is a 1 in 14 event.

To me the reason this is happening is rooted in shifting expectations about the Fed, and for the first time this cycle markets are finally realizing that the Jay Powell led Fed is much different than that of his predecessors. This Wednesday we hear from Mr. Powell following what is widely expected to be another 25-basis point interest rate hike. What will be telling for markets is the guidance he gives on future hikes going forward. At this time markets are already pricing in a 76% probability that the Fed hikes again in December and a 42% probability they go again in March of 2019. These hikes with these probabilities are what are currently priced into the yield curve, so what I'll be watching in the days following the

Wednesday announcement is how these probabilities shift. Should they increase, then I would expect interest rates to break above the key technical levels which they're sitting just below at the moment, and it will be interesting to watch how other asset prices react.

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