October 1st, 2018

Five variables to watch…

Liquidity and Global Growth:

There are a number of factors that impact the short and long-term movement in asset prices: earnings, inflation, interest rates, currency movements, and sentiment, to name a few. While all of those variables are important and material, the one variable that, in my opinion, trumps all others is liquidity. Liquidity is the oxygen that helps to fuel the capital market engine, where times of ample liquidity create a tailwind to push asset prices higher, while during periods when liquidity is being siphoned from the financial system it acts as an anchor that creates a drag on upward price appreciation.

Over the next six months, this thesis on the importance of liquidity to asset prices is going to be put to the test as capital markets have to digest a meaningful shift in the liquidity tailwind that has helped propel asset prices over the last decade. Where starting in the month of October, the Federal Reserve's balance sheet normalization strategy reaches its monthly cap of $50 billion, up from $40 billion per month in Q3. While a $50 billion per month reduction in the Fed's balance sheet is below the $85 billion per month the Fed was implementing during QE 3, it still amounts to a $600 billion annual rate and is equivalent to the entire amount of asset purchases Bernanke executed for QE 2. According to Bernanke's own analysis, he equivocated $150 – $200 billion in asset purchases to a 25-basis point cut in interest rates. The reason the Fed had to take such a step back in 2011 is because interest rates were already at 0% and the only other way to supply additional monetary stimulus was through QE.

So here we are, with the Fed having raised the Federal Funds rate for the eighth time last week to the 2.0 – 2.25% range in addition to what has been almost $420 billion in balance sheet reductions over the last year. According to Bernanke's back of the envelope math this is equivalent to roughly a 3% increase in the Federal Funds rate since December of 2015. However, we don't have to solely rely on this simple model to contextualize the level of tightening experienced so far in this tightening cycle, as the Atlanta Federal Reserve Board publishes a 'shadow' funds rate model that incorporates these inputs. According to their model, they conclude that the level of monetary tightening in the past four years is the equivalent of 510 basis points (5.1%) of de facto rate increases. For perspective, the historical archives show that 500 basis points or more of Fed tightening has never failed to tip the U.S. economy into recession.

The first thought that logically comes to mind after reading such a statement is rightfully "well look at the economic data Corey, it's undeniable that the U.S. economy is ripping". To that I would concur, and outside of splitting hairs about pockets of weakness in the housing, autos, and consumer durables segments of the economy, I don't disagree with this reality. However, such an evaluation of the current backdrop has to be framed with the fact that the U.S. economy has been the beneficiary of one of the largest fiscal stimulus packages ever implemented without being in a recession. Moreover, starting from Q4 onward the tailwind from this fiscal stimulus will start to diminish – the key word being 'diminish'. There will continue to be some fiscal stimulus that will carry into next year and if additional legislation is passed to extend this stimulus, then it stands to reason that this economic expansion could extend even further.

But absent any further meaningful fiscal stimulus, the U.S. economy is about to start confronting some fairly stiff headwinds beginning here in Q4 with those headwinds picking up steam as we move into next year. It's hard to deny that the more than doubling in short-term interest rates over the last year is having a meaningful impact on the most interest rate sensitive segments of the U.S. economy. Homebuilding stocks down nearly -25% from their January highs and auto stocks down more than -20% are a case and point, not to mention the S&P Financials sector that is in negative territory for the year which is a material disconnect from an economy that on the surface looks so strong.

Based upon last week's Fed decision as well as what Chairman Powell had to say at his press conference, it seems likely that the FOMC is determined to continue to hike rates until something breaks. This is the point in the cycle we are at today – the point where we don't know what the equilibrium interest rate level is that balances both growth and inflation dynamics. What we are observing is an unemployment rate that is at multi-decade lows, an economy that looks more likely to overheat than materially decelerate, and inflation pressures are on the rise. This economic cocktail is forcing the Fed to continue tightening policy which is having minimal impact on a U.S. economy goosed by massive fiscal stimulus, but it is causing material angst in emerging markets.

Regarding China, it's no secret they are a focal point of U.S. policy as it pertains to fair trade, but I'm a bit surprised about how little attention has been paid to the downright weak economic data we've been seeing out of this region of late. After all, this is the second largest economy in the world and with it this economy can set off a butterfly effect that ripples through other economies. Over the weekend we received disappointing data on both of China's PMI readings for September – the official index fell to 50.8 from 51.3 in August (estimates were for a reading of 51.2) and the Caixin version slipped to a 16-month low of 50 from 50.6. These two data points are only the latest in a slew of economic disappointments over the last several months with some diligent PBOC watchers saying that things have weakened so much that we could be on the precipice of cuts to rates, banking sector reserve requirements, or even both.

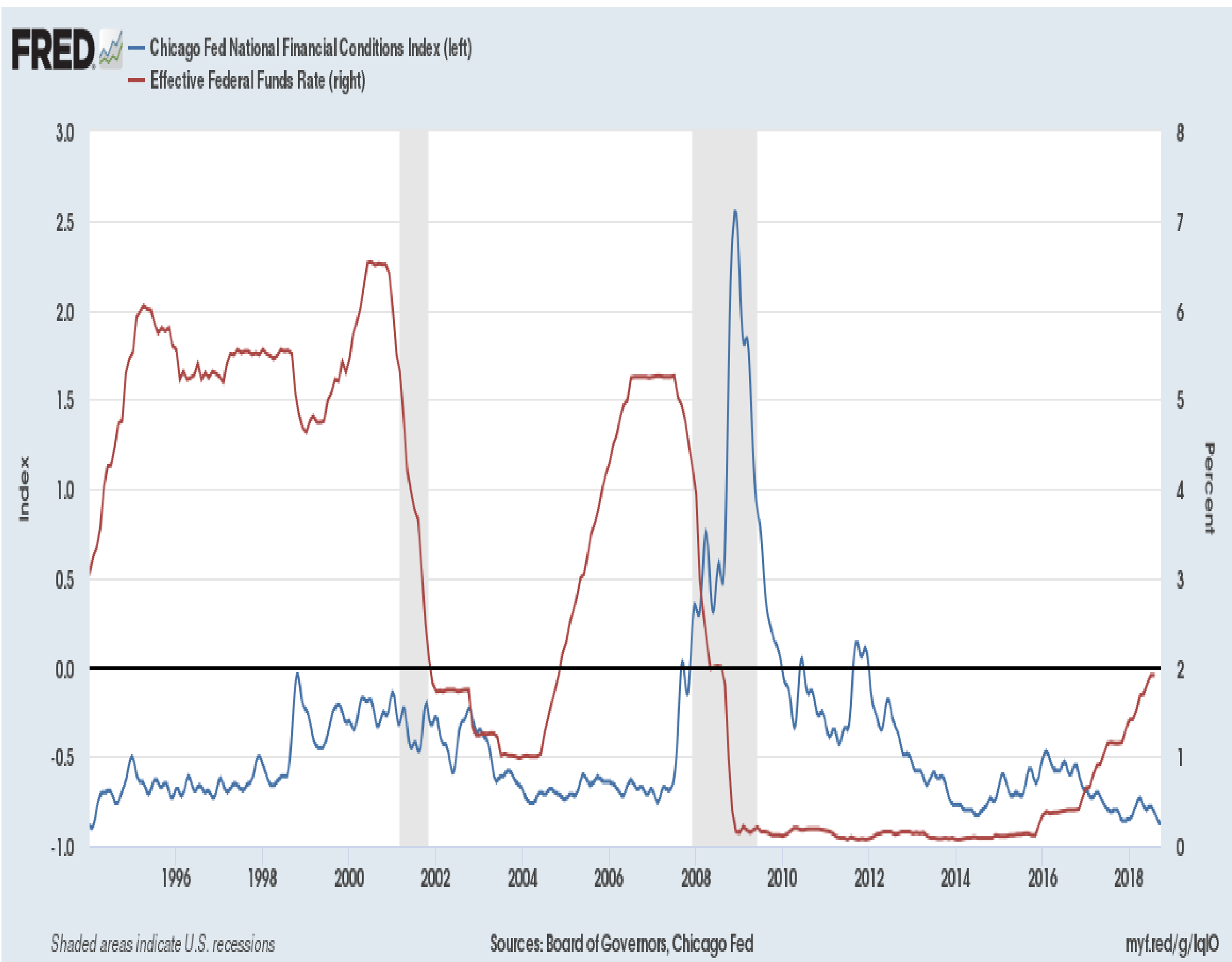
This is just one example of weakening trends in emerging market economies which is why I found it of little surprise to see comments by IMF Managing Director Christine Lagarde make headlines by saying international growth may have plateaued. "For most countries, it has become more difficult to deliver on the promise of greater prosperity, because the global economic weather is beginning to change," and she goes on to say that factors that were merely risks earlier in the year have begun to materialize into reality.

Coming full circle on where I started this missive, and that is on the liquidity backdrop that only looks to become more restrained going forward. Not only does the Fed's balance sheet reduction increase from $40 billion per month to $50 billion in October, but the ECB's asset purchase program takes an additional leg down to $15 billion per month in purchases from $30 billion in September (they ended last year at $60 billion per month in asset purchases. Then we have the BOJ (Bank of Japan) who made it abundantly clear last week that they are going to be reducing their asset purchases of bonds with maturities of 25 years or more to a band of ¥10 billion to ¥100 billion per operation from last month's range of ¥50 billion to ¥150 billion. The pace of QE support from the BOJ was already sliced in half last month and the tapering is set to gain momentum in the coming months.

One last thought on this point, and it's specific to the U.S. where not only will the Fed be withdrawing $50 billion per month in liquidity, but as a result of the fiscal stimulus and fiscal negligence by prior administrations in blowing out the Federal debt, the U.S. Treasury is on pace to issue $100 billion per month in Treasury bonds. If Uncle Sam is issuing $100 billion in Treasuries, that means someone has to buy them and that implies that there is $100 billion that has to come from someplace to buy these bonds. So, between the two we're talking about $150 billion per month of actual money that needs to flow into Treasuries to fund the government and that's money that will no longer be flowing into other places/uses such as the stock market or capital investment.

Financial Conditions and Oil Prices:

It's really hard to imagine that here we are nearly three years into a monetary tightening cycle and yet financial conditions are easier today than when the Fed embarked upon its tightening campaign back in late 2015.



For capital markets this is the key variable to monitor as the Fed continues to press forward on its tightening cycle. With the stock market near all-time highs, credit spreads near/at cycle lows, and real interest rates still negative, there really aren't any market pricing signals showing much signs of stress. However, when/if these stresses start to percolate – whether it be the U.S. dollar continuing to strengthen, credit spreads starting to widen, or the stock market experiencing a meaningful downdraft – then we'll start to see financial conditions tighten. The degree to which they do and whether or not the Fed chooses to react will be a material tell as to whether this late cycle stability in the economy and capital markets has more room to run or if investors should be preparing for an upcoming recession.

Oil prices as measured by the price of WTI crude moved up to four-year highs today, and this is not sitting well with the Trump administration who over the last several months hasn't been bashful about trying to talk prices down. U.S. retail gas prices are up more than 20% from last summer and this increase along with higher interest rates are doing a number at diminishing the incremental benefits of the tax cuts.

Earnings:

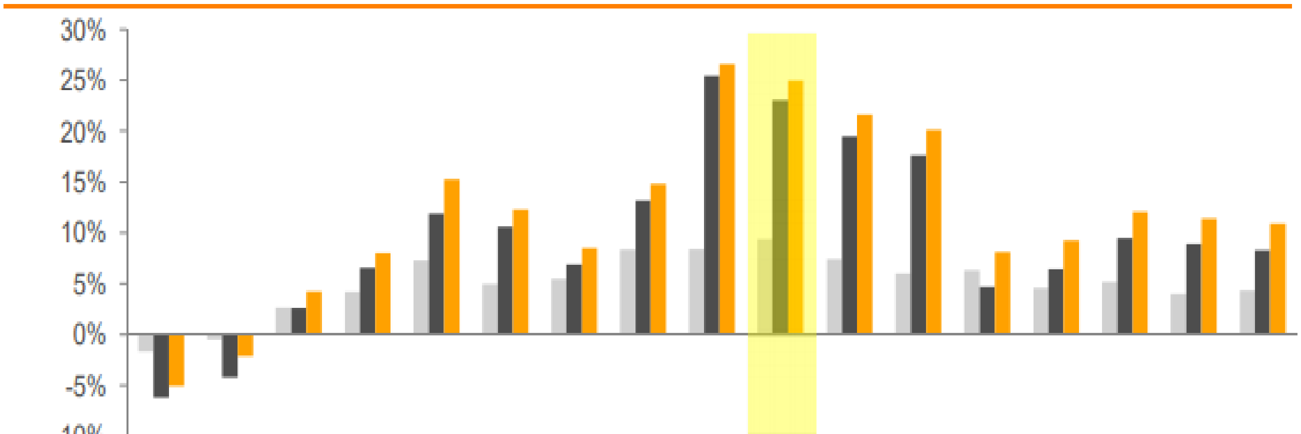
The following table is from Thomson Reuters' most recent earnings scorecard (updated as of September 30th) which indicates the superb earnings backdrop of the S&P 500 so far in 2018. Highlighted in green in the table below is the earnings growth numbers we've already experienced in Q1 and Q2 and the +20% growth expectations for the last two quarters of this year.

Exhibit 4. 2018Q2 Actual Earnings Growth

	S&P 500
Today	24.9%

Source: Thomson Reuters I/B/E/S

Exhibit 5. S&P 500 YoY Growth Rates



	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1
Revenue	-1.7%	-0.4%	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	9.4%	7.4%	6.0%	6.3%	4.6%	5.2%	4.0%	4.3%
Net Income	-6.2%	-4.2%	2.6%	6.6%	11.9%	10.6%	6.9%	13.1%	25.4%	22.9%	19.5%	17.6%	4.7%	6.4%	9.5%	8.9%	8.3%
Earnings	-5.0%	-2.1%	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	21.6%	20.1%	8.1%	9.2%	12.0%	11.4%	10.9%

Source: Thomson Reuters I/B/E/S

Highlighted in red are the earnings estimates for 2019 which won't have the benefit of a significant tax cut as was the case in 2018. It's not that 10% earnings growth for 2019 wouldn't be a solid encore to what was a stellar year in 2018, but what's important to recognize as an investor is that this is where the current base line is – meaning this is the expectation that is already priced into the equity market at present. Once we get into the Q3 earnings season over the next couple weeks, analysts and investors will begin shifting their attention to 2019 numbers and it is the guidance and color that executives provide on their conference calls that will cause these forward estimates to adjust.

Given the rise we've seen in interest rates, the doubling in corporate debt this cycle with a heavy refinancing schedule starting next year, increasing oil prices, rising labor costs, increased input costs, and a stronger dollar, it's hard to imagine these forward estimates improving in a material way. A possible canary in the coal mine highlighting these profit margin squeezes is the price action in the small cap index which has declined by almost 4% since August 27th. Perhaps this is just a bit of investor repositioning given the strong performance in the small cap space this year, but another item to consider that may be weighing on the group is the fact that 40% of small cap company debt is of a floating rate variety. Meaning that the interest expense increases as rates go up and this is on an index where nearly 30% of the companies in the index don't turn a profit.

The moral of the story on the earnings front isn't that things are not great, it's that they are great and that's the point. It's a similar story for the economy and that story is titled "Great Expectations". With the bar set so high with a President exclaiming on a daily basis that we "have the greatest economy ever", a stock market at all-time highs, credit spreads at cycle lows, and consumer and investor confidence metrics at multi-decade highs – it takes an awful lot to exceed those expectations. That's where we are: a stock market trading at valuation levels that on most measurement criteria have only been exceeded in one or two other bull market peaks, hyped up expectations that things only get better from here, and that mounting evidence of global growth slowing with material degradation in emerging markets will remain isolated to those regions.

Could everything in the U.S. continue to fire on all cylinders for a little while longer? Sure it could. But that expectation has to account for all of the following variables being accurately accounted for in current prices or having become less relevant: oil prices at four year highs, labor costs rising, inflation hitting seven year highs, a strengthening U.S. dollar crimping overseas earnings, interest rates at multi-year highs, fiscal policy starting to wane, global central bank liquidity going negative in Q1 2019 for the first-time in a decade, and global central banks on net raising interest rates.

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