November 12th, 2018

It's all about the U.S. dollar and interest rates…

So much for the post-election bounce that had markets in an ebullient mood following an outcome that was widely expected going into last Tuesday night. As I type this missive, the S&P 500 is now back to below the levels it closed at on Tuesday (2,755) before we learned that 30 House seats would swing to the Dems (also a net gain in governorships) and the GOP would maintain control of the Senate. Sure, the equity market rallied by more than 500 points the day after the election and, because pundits feel as though the move required an explanation, it was convenient to use the election outcome as justification. On the surface I can see the allure, just having this event behind us removes an element of uncertainty, but also the grandiose idea that a large infrastructure bill is a virtual certainty given the alignment between the two parties on a much-needed face lift to America's degrading airports, bridges, and roads was a tailwind.

The easy part is identifying the need for such policy, but as with most things, the details are not nearly as simple, like where will all the workers come from given the extremely tight nature of the labor market at the present time? Also, how will such a large expense be funded given the federal deficit is already on pace to eclipse $1 trillion this fiscal year? Not that these obstacles can't be overcome, as the positive economic contributions on the eventual payback for infrastructure spending is much more favorable than for unpaid tax cuts, but the math will be clouded given the precarious fiscal position we find ourselves in today. After all, interest payments on U.S. federal debt now amount to $523 billion at an annual rate – up from $360 billion in 2012, and $315 billion back in 2004 when we were recovering from the fallout of the popping of the Tech bubble. The CBO estimates that interest payments will rise to $915 billion by 2028 – equivalent to 13% of all outlays and 3.1% of GDP. The entire fiscal deficit of $779 billion in 2018 was 3.9% of GDP and in 2028 we're talking about interest alone accounting for 3.1% – really?

Nevertheless, the equity market action on Friday and again today suggests that investors are coming to the realization that this isn't 2016 all over again – an event that was unexpected and required a drastic repricing of most capital market assets with Donald Trump winning the Presidency and the GOP sweeping Congress. Nope, what the last couple days are suggesting is that there is an increasing probability that the momentum driving the deregulation and tax cut caravan is set to slow, if not outright stall. And this isn't about being partisan one way or the other just because the GOP has lost full control of the legislative branch, it's just a reassertion of checks-and-balances back into the federal government. The GOP forced through as much of their policies as they could in the two years that they had the unconstrained ability to do so. So now we're looking at an environment where the fiscal low hanging fruit has been picked and the only way forward requires compromise and the ability to reach across the aisle to get something of substance passed.

The likelihood of this happening is depressingly low given the low approval rating of the President among Democrats, and already a laundry list of investigations that are being cued up against key figures in the executive branch. It just goes to show how the swamp never did (and likely never will) get drained within the Washington beltway – if anything, it just got bigger. One other area to watch, where there appears to be some common ground among both Republicans and Democrats, is China. Both sides are motivated to tighten the noose around Beijing's unbalanced trade policies. Investors expecting and hoping for a simmering in the trade tensions at the upcoming G20 meeting between President's Trump and Xi should temper their enthusiasm as it looks as though this dispute is going to become a long, drawn out affair – comments on Friday from Peter Navarro, Director of the White House National Trade Council, pretty much affirmed this as a base case outcome.

In my opinion, the rally in the stock market to kick off November is nothing more than a normal retracement from what was a deep decline in the global equity market that experienced a $4.5 trillion erosion of value in October. Two other sources of support materialized since the end of October with the buyback blackout period for most companies ending following Q3 earnings results, and the overall stock market is moving into the most constructive part of its seasonality calendar which typically runs through January. At this juncture, using the S&P 500 as a proxy for the U.S. equity market, the broad market is trading in a highly technical fashion with the 2,815 high representing a pivotal retracement level that was rejected. As I've pointed out several times in these missives this year, this price action is highly reminiscent of the classic topping patterns we've seen at the tail end of prior bull markets. Should the S&P 500 not be able to push beyond this 2,815 level in the next several weeks and then go on to make new highs by the end of January, then it's highly probable that the bull market that began back in March 2009 has come to an end and for those that haven't already – it would be in your best interest to shift your investing strategy towards a focus on capital preservation in what is likely to be an oncoming bear market.

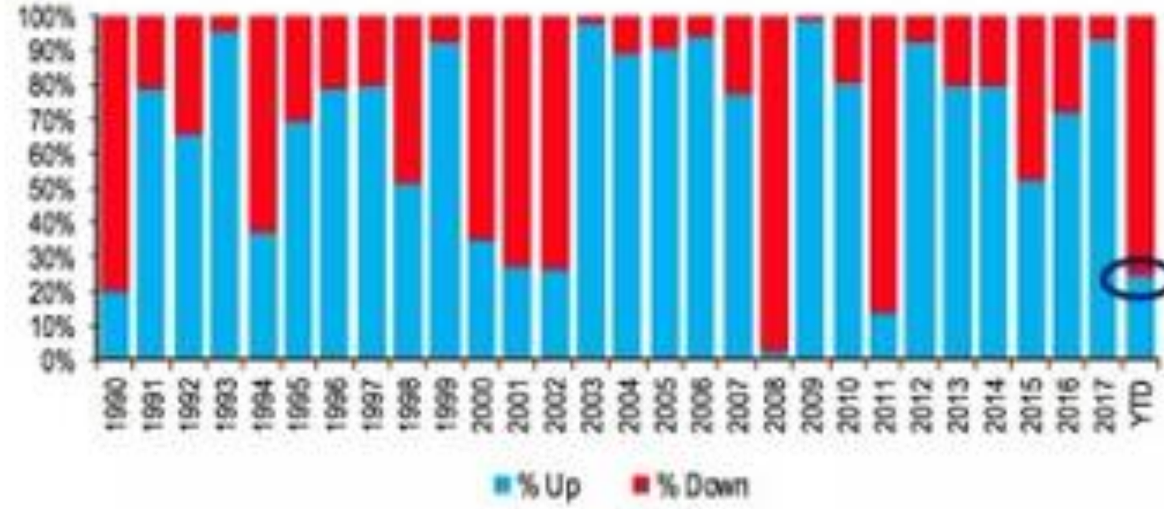
For all intents-and-purposes, it's rather difficult for either the bulls or the bears to make much of a claim at anything this year. What 2018 really embodies is frustration across a wide swath of asset classes as the two tables below (from the research departments of Morgan Stanley and BofA Merrill Lynch, respectively) highlight just how challenging it's been this year to find investments that have generated a positive return through the first 10+ months of the year.

Ranked Asset Class Return by Year. Green Means You're Beating Inflation

Ranking	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1	US 10Yr	MSCI EM	REITS	US 10Yr	MSCI China	Russell 2000	REITS	MSCI Japan	Commodities	MSCI China	S&P 500
2	US 2Yr	MSCI China	Russell 2000	Inflation Bonds	MSCI Europe	S&P 500	S&P 500	REITS	Russell 2000	MSCI EM	US HY
3	US Agg. Bond	Global HY	Commodities	EM $ Sov Credit	Global HY	MSCI Japan	US 10Yr	US 10Yr	US HY	MSCI Europe	US 2Yr
4	EM Local Debt	US HY	MSCI EM	US IG	REITS	MSCI Europe	MSCI China	EM $ Sov Credit	Global HY	MSCI Japan	Russell 2000
5	US IG	Commodities	MSCI Japan	US Agg. Bond	MSCI EM	US HY	US IG	S&P 500	S&P 500	S&P 500	REITS
6	Inflation Bonds	MSCI Europe	US HY	REITS	EM $ Sov Credit	Global HY	EM $ Sov Credit	US 2Yr	MSCI EM	Russell 2000	US Agg. Bond
7	EM $ Sov Credit	EM $ Sov Credit	S&P 500	US HY	Russell 2000	MSCI China	US Agg. Bond	US Agg. Bond	EM $ Sov Credit	EM Local Debt	Global HY
8	US HY	REITS	Global HY	Global HY	S&P 500	REITS	Russell 2000	US IG	REITS	Global HY	US 10Yr
9	Global HY	Russell 2000	EM Local Debt	S&P 500	US HY	US 2Yr	Inflation Bonds	MSCI Europe	US IG	EM $ Sov Credit	Commodities
10	Commodities	S&P 500	EM $ Sov Credit	US 2Yr	EM Local Debt	US IG	US HY	Global HY	EM Local Debt	REITS	US IG
11	MSCI Japan	US IG	US 10Yr	EM Local Debt	US IG	US Agg. Bond	US 2Yr	Russell 2000	Inflation Bonds	Inflation Bonds	Inflation Bonds
12	Russell 2000	EM Local Debt	US IG	Russell 2000	Inflation Bonds	MSCI EM	Global HY	US HY	MSCI Japan	Commodities	EM $ Sov Credit
13	S&P 500	Inflation Bonds	US Agg. Bond	Commodities	MSCI Japan	Inflation Bonds	MSCI EM	Inflation Bonds	US Agg. Bond	US HY	MSCI Japan
14	REITS	MSCI Japan	MSCI China	MSCI Europe	US Agg. Bond	EM Local Debt	EM Local Debt	MSCI China	MSCI China	US IG	EM Local Debt
15	MSCI Europe	US Agg. Bond	MSCI Europe	MSCI Japan	US 10Yr	EM $ Sov Credit	MSCI Japan	EM Local Debt	US 10Yr	US Agg. Bond	MSCI Europe
16	MSCI China	US 2Yr	Inflation Bonds	MSCI EM	Commodities	US 10Yr	MSCI Europe	MSCI EM	US 2Yr	US 10Yr	MSCI EM
17	MSCI EM	US 10Yr	US 2Yr	MSCI China	US 2Yr	Commodities	Commodities	Commodities	MSCI Europe	US 2Yr	MSCI China

Source: Bloomberg, Morgan Stanley Research;
Note We compute annual returns minus US headline inflation. Green means returns (in USD) beat inflation, and red means returns trailed inflation. 2018 shows YTD returns.

Only 23% of assets have positive total returns in 2018 – a number usually seen in financial (2008) and debt crises (2011). Percentage of assets with positive vs. negative total returns (yearly).



Source: BofA Merrill Lynch. Yearly total returns. Using sample of over 300 assets across equities, commodities, FX and credit. COB 31-Oct.

For the first time in a while, investors can make the assertion that valuations are no longer offensive with the S&P 500 trading at a P/E multiple of 16x on forward earnings, which have come down a full two points from 18x at the start of the year. I do, however, find it somewhat amusing that these same investors that were quick to dismiss the lofty valuations at the start of the year were the same ones making that argument based on low interest rates. Now here we are with a Federal Reserve that is likely to push through four hikes this year (a feat few thought would be probable) and bond yields having moved into a new higher range, and yet most valuation arguments fail to acknowledge how big of an impact this variable has had on compressing valuations. Anyone looking for confirmation of this impact need look no further than the FANG stocks which, broadly speaking, trade at high valuation multiples with no dividends (hence they carry a higher equity duration and therefore are sensitive to changes in interest rates) where Facebook (FB) has plunged by 35% since late July, Amazon (AMZN) is off by 20% since early September, Netflix (NFLX) has declined by 30% since late June, and Google is off by 18% since late July.

Exacerbating the pressure on all risk assets is the stubborn upward increase in the U.S. dollar index which reached an 18-month high today at 97.47. Most of the recent move has come against the British Pound which has been undercut by the challenging Brexit negotiations, and the Euro which is being weighed down by a very contentious Italian budget showdown. Putting aside these issues, which are important and will have cascading impacts on the global macroeconomic environment, I want to simplify what this move in the U.S. dollar implies for corporate profits of multinational corporations domiciled in the U.S.

Should the U.S. dollar index maintain this level going into and throughout the first quarter of next year, and there is little evidence to suggest that it won't, then we're talking about multinational corporations that are staring down a 10% hit to their earnings simply from the currency translation adjustment. For sure, this is starting to be reflected in analyst estimates as they have been busy cutting estimates going into next year, but from what I'm seeing thus far, the cuts are not nearly deep enough to reflect this reality. What's more is that global growth is continuing to slow (we'll get Japan and German GDP data later this week which I expect to further cement this reality) and a broadening number of U.S. economic variables are beginning to catch down to the rest of the world. I'm not talking about lagging economic data points like the unemployment rate, consumer sentiment surveys, or GDP, but rather leading indicators like the ones the ECRI puts out or the most cyclically sensitive parts of the stock market like housing, semiconductor, and automotive stocks which are all down more than 20% from their 2018 highs.

Oil is the latest victim of major asset classes falling into a bear market with WTI prices falling to a nine-month low of under $60 per barrel today (off more than 21% from its highs). As if that wasn't bad enough, but oil prices have now declined for 11 consecutive days and this is a stretch of losses that haven't been seen since 1984. It's been an array of catalysts setting off the recent decline with OPEC production surging (reaching 32.76 million-barrels-day in September, or more than 1mbd above demand forecasts for the first half of 2019), U.S. production reaching record highs, and crude inventories have moved back up to five-month highs. What's more is that it doesn't seem as though Russia is interested in curbing production with it now running a budget surplus and estimates pegged that its fiscal break-even price is $53 per barrel (perhaps a good reference point for a potential floor).

When things get complicated, as is the case when you get deep into an economic and bull market cycle, it's best to attempt to simplify the complexity when you are getting conflicting data points. The lagging indicators are telling you things are great and could hardly be better while the leading indicators and parts of the stock market (as well as volatility) are screaming at you that the environment has changed. It remains my view (and this will continue to advocate for a defensive investing posture going forward) that the Federal Reserve is going to continue to hike interest rates and tighten monetary policy until something breaks. And no matter how much the cheerleaders on bubblevision plead to the Fed to stop – and they aren't off base in doing so, as these policies will bring an end to this cycle – the unfortunate reality is that the Fed can't stop given its success in prevailing on its dual mandate of full employment and price stability.

They've reached their objective, and while the policies used to procure this victory artificially inflated asset prices, it's the responsibility of investors to recognize this and act accordingly, and not to kowtow and beg for mercy at the feet of central bankers. The punchbowl is being removed and this is igniting an unrelenting rise in the U.S. dollar as well as interest rates. Without a doubt, there are other policy drivers from around the world, but the U.S. from an economic and financial market standpoint is the center of the universe. As it tightens, it forces the hands of the rest of the world to act accordingly or deal with the consequences.

So, from an investment standpoint, take your cues from the dollar and interest rates. When each of these stop going up, then that will be the moment that the collective view of the major players in the capital markets indicate that the Fed has gone too far. This will only be the starting point of the unknown that lies ahead, but it will be a marker for which those with a plan, process, and strategy will adjust course to plot their next move with portfolio exposures and allocations.

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