November 5th, 2018

The Good, the Bad, and the Ugly…

Last week brought about a relief rally for equity market bulls with global stock markets staging an impressive rise following what was an unrelenting steep decline throughout the month of October. The Dow Jones Industrial Average, Nasdaq Composite, and S&P 500 all notched weekly gains of roughly 2.5%, but it was the Russell 2000 Small Cap Index which led the pack as it rallied more than 4%. Global equity markets fared even better with the All Cap World Index Ex-US gaining 3.4% and the Emerging Markets Index surged by 5.4%. As impressive as these weekly gains are, it remains to be seen whether or not this is just a bounce off of very oversold levels or the potential for something more. After all, at the lows in the U.S. equity market sell-off last week nearly $3.0 trillion of total market cap had vanished into thin air, and a lot of this paper wealth was at the hands of popular index funds which have become this cycle's paint by numbers investment of choice.

The bottom line is that markets were poised for a bounce, especially when you consider that 93% of the markets in the All Country MSCI were trading below their 50 and 200-day moving averages. There's no telling whether this bounce is nearing its expiration before resuming a downtrend or if another leg higher awaits once we get past Tuesday's elections. But I will say this, and my confidence in this view grows by the day, and that is that the U.S. equity market remains in the midst of a topping process with the fundamental peak taking place on January 26th, which has been followed by a higher price peak on September 20th – in that the volume, volatility, breadth, and technical make-up of the September high failed to confirm the earlier cycle high. What's more is that the pattern we've seen take shape this year has a lot in common with the market tops in 2007, 2000, 1990, and 1979. Some are quick to dismiss the past and / or history to draw inferences about the present, but I consider it as the best source of information we have to guide our expectation of the future, not predict it, to which it's important to distinguish the difference in this interpretation.

According to our work, it appears fairly clear that we are in a topping process – and yes, tops are processes that play out over an extended period of time, whereas bottoms play out much quicker. So far in 2018 we have experienced two separate 10% or more intra-day corrections in the Dow, S&P, and Nasdaq, which also happened in 2008, 2002, 2001, 2000, 1987, 1974, and 1973. What all of these years have in common (with the exception of 1987) is that they occurred during or within a close proximity to a recession. The fall from grace of this cycle's market darlings (Apple missing estimates, Amazon lowering guidance, Netflix share price flopping after analysts had time to digest their quarter, and Google doing its best to stay under the radar from potential anti-trust actions) is another bad omen. The message here isn't to suggest that a recession is imminent or to attempt making a bombastic market call – it's more to acknowledge history, evaluate its relevance, and apply it to our present day thinking and analysis. To be ignorant of these facts or deliberately choose to ignore them would be a grave injustice to objective analysis.

The most important events of the upcoming week will be the U.S. mid-term elections and Fed meeting. Based upon the number of statements out of the executive branch last week about constructive progress on the U.S. / China trade file, it's a reasonable conclusion to think that President Trump was willing to pull out all the stops to boost the stock market coming into Tuesday's vote. I mean, Friday alone was just laughable with a statement being released in the wee hours of the morning that a trade deal was likely (which boosted equity futures) to then only see the air come out of the balloon after NEC Director Larry Kudlow claimed on CNBC that China has been unresponsive in any communication for months (which sent stocks lower), and then later that afternoon President Trump went back to the well while talking with the press corps before boarding Marine One that he thought a deal would get done (providing a modest lift to stock prices). China President Xi Jinping didn't come off nearly as conciliatory in his speech today, and even took the opportunity to take some shots at the U.S.

Nevertheless, it is what it is and this administration has not shied away from the stock market being a benchmark on the success or failure of its policies. Why they would want to tie their fate to such a complex ecosystem with so many uncontrollable variables is beyond me, but they have had the benefit of having some early success on this front. As for the mid-terms, the latest poll numbers from CBS, FiveThirtyEight, and Washington Post-ABC News show the House flipping to a Democratic majority while the GOP retains control of the Senate. Take the poll numbers for what they are (and that is an educated guess) and if we learned anything from Brexit or the 2016 U.S. election, it is that they are far from a certainty. The way I look at it is that the betting markets have the probabilities at 60-65% that we end up with Democrats controlling the house and the GOP controlling the Senate – therefore the odds of a surprise are 30-35%. So, the bigger pricing adjustment in the capital markets will occur on an outcome outside of what is already expected.

Moving on from politics and back into the realm of capital markets and the economy, in this complex environment we find ourselves in today I think it's best to try and simplify things in the interest of attempting to gain a semblance of rationality to inform investing decisions.

The Good:

The U.S. economy is operating at full throttle and data we received last week affirmed this reality. Friday's employment report was everything anyone could have wanted out of a labor report, and this is coming from an analyst that tends to lean more in the direction of the bearish camp on the economy at this point. Job gains of +250k handily outstripped expectations for a print of +200k, and this strong showing out of the establishment survey was confirmed by the household data showing a +600k surge in job gains to boot. More than half of the +600k in job gains from the household survey (+318k) were of the full-time variety and the diffusion index came in at 65.7% (the best showing since May), indicating that the job gains were broad based. As for actual compensation, wages accelerated to +3.1% year-over-year versus +2.8% last month and this represents the fastest pace of wage growth since April 2009.

Hey, more jobs and more pay is definitely great news for the working class and seeing the unemployment rate remain steady at 3.7% in the face of the labor force increasing by +711k is no small feat. Had the participation rate not increased from 62.7% last month to 62.9% in October, then we'd be talking about an unemployment rate of roughly 3.3% – Wow. As a validation for just how strong this employment report was, we had average weekly earnings and aggregate hours worked increase 0.5% which is the biggest increase in work-based compensation since May.

No wonder the recent consumer confidence report from the Conference Board popped to an 18-year high of 137.9 in October from 135.3 in September. Not only was this an 18-year high, but the October reading marked the fourth consecutive month of growing confidence.

The only report that disappointed last week was the ISM manufacturing PMI which came in at a six-month low of 57.7 in October versus expectations for a print of 59.0. This is a rather steep decline from the 59.8 level it was at in September, but to be fair it's still at a healthy level nonetheless. However, it's looking increasingly likely that this metric has topped out for the cycle (on a historical context it rarely ever gets above 60, and when it does, it doesn't stay there…) and this is borne out in that 72% of industries that reported growth in October – down from 83% in September, 89% in August, and 94% in July to stand at the lowest level since January of 2017.

Jumping over from the economy to corporate earnings, we're seeing S&P 500 corporate profits coming in at +26% YoY for Q3 which is well beyond the consensus forecast for +20% growth. Perhaps the only fly in the milk on this story is that these strong EPS numbers are coming on revenue growth of +8% – solid but that's a historically large spread that isn't likely to sustain itself.

The Bad:

One of the counterintuitive aspects of investing is that when you get this deep into an economic cycle and the preponderance of data shows an economic and operating environment that has never looked better, then you know you're nearing the point where stress points start to give way. One of these stress points is inflation, and this is a far-reaching economic phenomenon that has tentacles stretching into all sorts of crevasses from the consumer, to businesses, input costs, interest rates and wages. Last week we received the latest inflationary measure (apart from the wage component of the jobs report) with the Employment Cost Index (ECI) firming to +0.8% in Q3, with the YoY rate coming in at a cycle high of +2.8%. The wages and salaries metric in this report was even firmer than the headline as it ticked up to a +3.7% annualized pace of growth. The last time we saw readings at these levels in some of the components of this report was in Q4 2006, and we all remember what began to evolve over the next several quarters going into late 2007.

At this point, with an unemployment rate holding below 4%, almost every business survey we read is indicating that one of their biggest problems is finding qualified workers to fill open jobs, and with inflation trending handily above the Fed's 2% target – it leaves the Fed with little to no wiggle room to back off its interest rate hiking path. What's more is the pressure on corporate profit margins increases as input costs rise and this becomes a reflexive circle which forces up interest rates and increases the cost of capital in both the debt and equity markets. Putting aside anyone's opinion on the matter, but setting off a trade war with the second largest economy in the world – an economy that has over the last several decades engrained itself in the supply chains of all forms of global production – only adds further fuel to already well-established inflationary pressures.

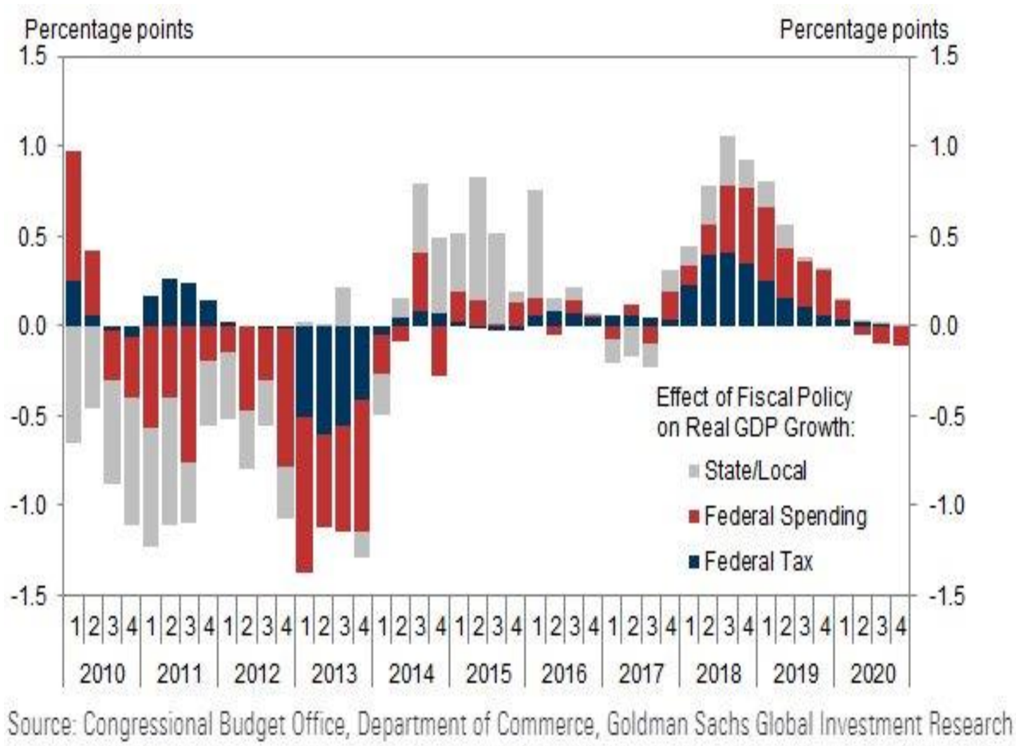
An article today in the WSJ referenced how many times trade or tariff issues has come up in Q3 S&P 500 corporate earnings calls and that number added up to 130. This followed a rather lengthy article in the Wall St. Journal last week, "That Big Mac and Coke Now Comes With a Side Order of Inflation", where it was a who's who of fortune 500 companies cited for announcing upcoming price hikes: Clorox, Coca Cola, Kellogg, Mondelez, Arconic, Apple, Delta, American Airlines, Sherwin Williams, PPG Industries, and McDonald's. Hershey Co. was cited as taking a different tack in a strategy known as "light weighting" where they are going to repackage their products in smaller sizes but maintain prices in an effort to target higher prices per ounce.

The analyst community, whose job it is to know these companies inside and out, don't seem to be missing the writing on the wall in this regard with them moving briskly to trim their first half 2019 profit forecast by a full percent over the last month to just +6%. This is a rather steep decline from the +20% growth levels we've seen this year, but when all is said and done, what has this growth really accomplished for stock prices with the major averages hovering around the flat line for the year? For a value conscious investor like myself, I welcome the fact that it's brought valuation levels back into closer alignment with historical norms, but there's been a lot of energy spent (buybacks on pace for record levels in 2018, corporate debt levels at the highest levels on record, corporate tax rates cut by almost 50%, and economic growth running white hot) with very little to show for it.

The Ugly:

The U.S. does not operate in a vacuum, no matter how much the price action in the U.S. stock market has tried to convince investors otherwise this year. Global equity markets are down double digits this year and many emerging markets are down more than 20%. This is the same global economy that had everyone cheerleading the synchronized global recovery coming into this year, but how quickly we've moved on from emerging markets driving 2/3rds of the growth in the entire globe to them not mattering and the U.S. operating on an island all by itself. This is no indictment on the U.S. – we are the largest, most dynamic, and strongest economy in the world, but over the last several decades the financialization of the global economy has broken down borders. To the extent we attempt to resurrect those borders and the degree to which we take it is a separate issue for some time down the road, but the road from here to there is sure to be a bumpy one.

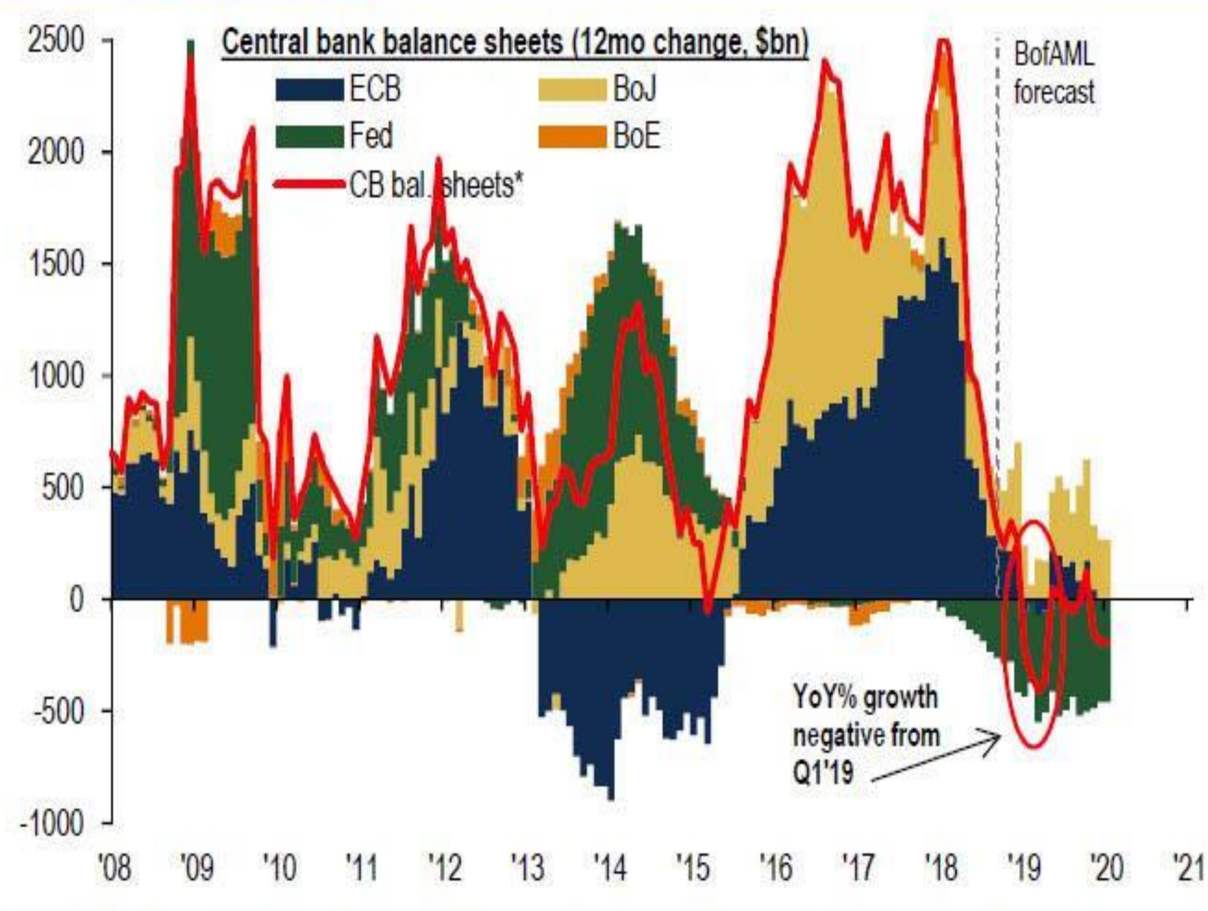
All that aside, what I'm trying to get at is that the OECD leading indicator has retreated for nine consecutive months, where international markets that didn't have the benefit of a massive fiscal stimulus package but had to deal with the consequences of tighter monetary policy (less liquidity and higher interest rates) have already experienced a high degree of pain. Should the trend in global growth continue to decline then a similar reality awaits the U.S., with the positive impacts of fiscal stimulus already set to wane from this point going forward (see chart below).



What's more is the pressure building in the economy and financial system is set to get only more intense as we move forward. You can ignore or dismiss everything I've typed in this missive up to this point and only focus on the following three charts that are included below. To me these remain the most important and most instructive set of charts that will dictate how capital markets and the economy evolve going forward.

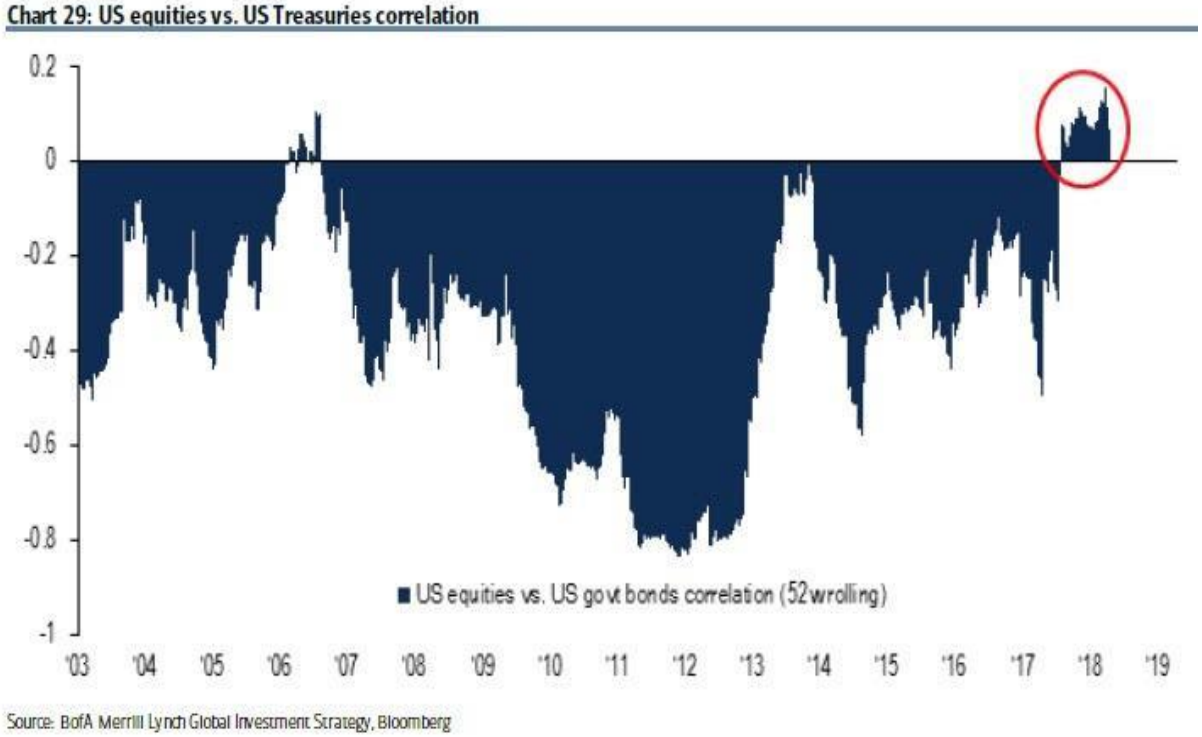
You've seen this first one before (it's just an updated version) but we are now at the point where over the next several months, global central bank balance sheets will move into a sustained period of contraction for the first time since the global financial crisis. If larger balance sheets and increased liquidity were a recipe for higher asset prices, then what should one infer about the withdrawal of this liquidity? Keep in mind this simple adage: "growth is doing what you did last year, plus some". To me it doesn't matter that global central bank balance sheets will remain at a high level, it's that the financial system has become reliant on them always expanding, and this trend is changing.

Chart 28: Central bank liquidity ($bn)



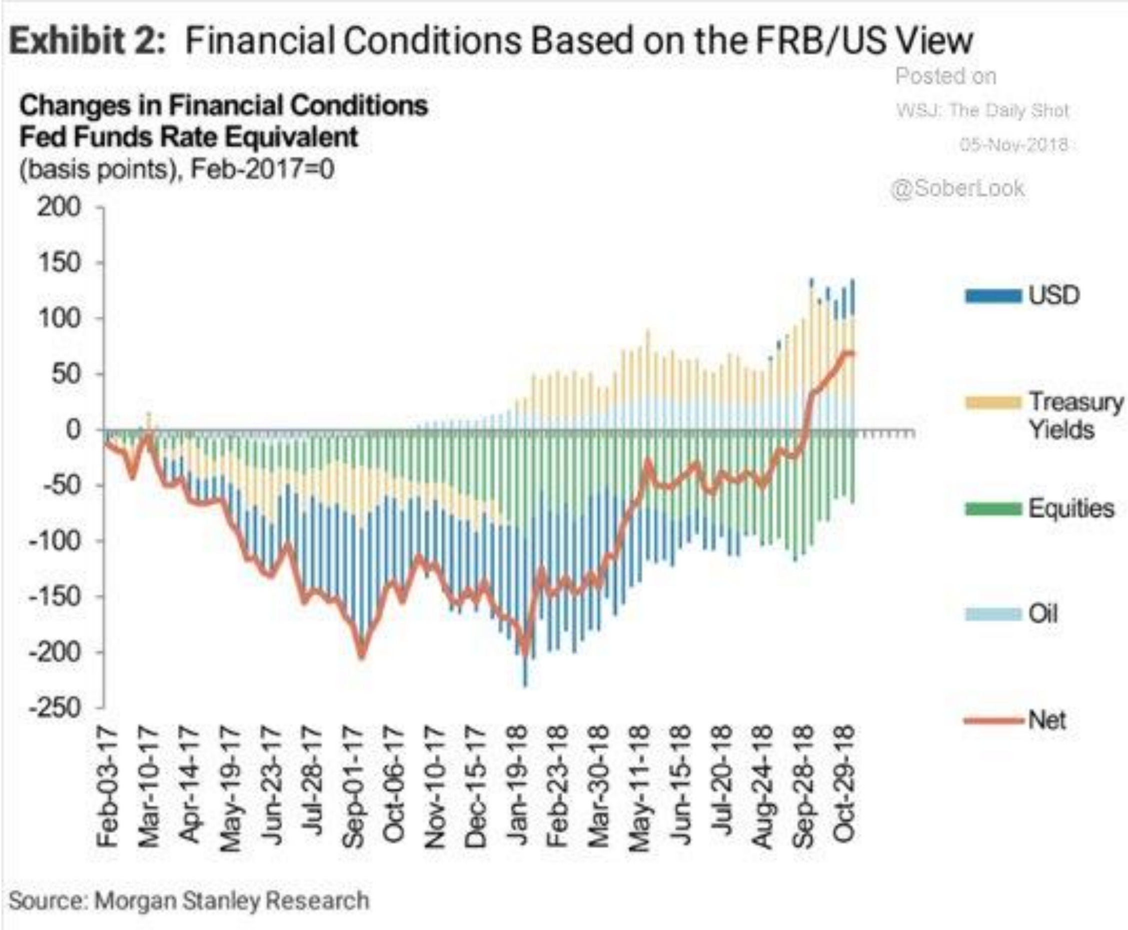
Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg; * assumes BoJ purchases continue at the current reduced pace vs stated level

The last time liquidity was being curtailed and interest rates were rising was back in 2006 when it set off a brief period where the historically negative correlation between stocks and bonds (stocks rise / bonds go down, or the inverse where stocks go down and bonds rise in value) flipped to a positive correlation, where both asset classes rose and fell together (see chart below).



One of the interesting dynamics of today's environment is that here we are at the peak of an economic cycle with GDP expanding at a 3% clip, yet because of unfunded fiscal stimulus (tax cuts and government spending) the fiscal deficit is running at 4% of GDP and heading higher. Historically speaking, at the peak of an economic cycle Uncle Sam should be running surpluses or at least small fiscal deficits, yet here we are going into fiscal 2019 with budget projections that the U.S. will be running a $1 trillion deficit as far as the eye can see. It's no wonder why interest rates continue to have a floor under them and why during the two 10% corrections in the S&P 500 this year, bond yields actually went up and offered no diversification support to investment portfolios that retain fixed income for their historically offsetting characteristics. Yes, the laws of supply and demand even pertain to the U.S. government where if they have to issue more Treasuries to fund their burgeoning deficits, then it's going to take capital from other sources. And with the Japanese and Chinese (the two largest holders of U.S. Treasuries) no longer buyers on net of U.S. debt (meaning their share of the overall Treasury market is declining) Uncle Sam will have to attract capital from elsewhere and of late, in order to do so they've had to offer higher interest rates. This is a trend I don't expect to change until we see a more decisive change in the economy – the change I'm referring to is the onset of a recession where I expect (don't know for sure) Treasuries will reclaim their flight to safety bid.

The next chart is a measure of financial conditions, which as a result of a rising U.S. dollar, higher interest rates, and increasing oil prices, financial conditions are at their tightest level since early 2017. It's of little surprise to me that the stock market peak in late January coincided with the loosest financial conditions we've seen in several years. As long as this index remains elevated or rises further, it will pose a steep challenge to any further appreciation in asset prices.



To give you a real-life example of how this plays out, let's consider some typical household debt service items:

- Interest rates on credit cards are now as high today as they were back in 2008, while the rise in credit card debt has increased from $312 billion at the end of 2007 to $800 billion today. Since 2016 (recall interest rates bottomed in the summer of 2016) interest payments are up 17%, but total balances are up 21% since then. In 2016, card holders were paying $79 billion in interest versus $113 billion now – an increase in interest costs of 43%.
- Student debt has increased by 280% since 2007 with the interest payments on this debt having increased from $37 billion in '07 to $87.75 billion in 2018 – an increase of 137%. However, what is really striking is that since 2016 the increase in interest expense on this debt is more than 30%.
- The level of outstanding car loans has increased from $809 billion in 2007 to $1.25 trillion today (an increase of 43%). Since 2007, interest payments have increased by 30%, but since 2016 they have increased by 25%

My point is that the cost of money is changing and this increased cost of money ends up having real world impacts even on the average American household. One place we are seeing some relief over the last several months is in the oil market with oil prices down nearly 18% from their highs this summer, and this is coming on the back of inventory numbers moving back closer to historical averages and stepped up production from U.S. shale producers, Saudi Arabia, and Russia.

So, what does this all mean to me as a steward of other people's capital: to invest with a higher degree of skepticism and focus on quality across the board. It doesn't mean I think investors should pull up anchor and put all their money under the mattress, although that is an option. No, there remain some valid and fundamentally sound investment opportunities available in the markets, but it takes a little more effort, rigor, and patience today. The investing environment from 2012 – 2017 was very forgiving because investors had central banks providing a meaningful tailwind. The current environment is not nearly as forgiving as anyone who has invested capital this year would attest. I've deployed some capital into certain areas this year to only find out very quickly that it wasn't going to work. The point is that I/we are much more selective and tactical at the current time. There are certain investment themes we'll act upon that represent long-term time horizons where we'll allow for a lot more latitude on price fluctuations before being shaken out. There are other investment opportunities that will present themselves in the heat of a sharp, quick 10-12% correction.

The main point I would like to convey to anyone reading this missive is that you need to have a plan and evoke some discipline with where we are today. Yes, it's true that markets historically tend to go up and that there has never been a recession or correction that has stopped the stock market from making new all-time highs. But there also is the reality that it can take some time to get on the other side of a deep drawdown in a portfolio's value – just ask S&P 500 index investors who were fully loaded into the market in 2000 that didn't see positive returns until October 2007. Then it wasn't until 2014 that the S&P 500 reclaimed the level it first reached in 2000 and again in 2007. It's my opinion that the risks in the investing environment are as elevated today as they were in 2007 and 2000, hence I suggest to invest accordingly.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215