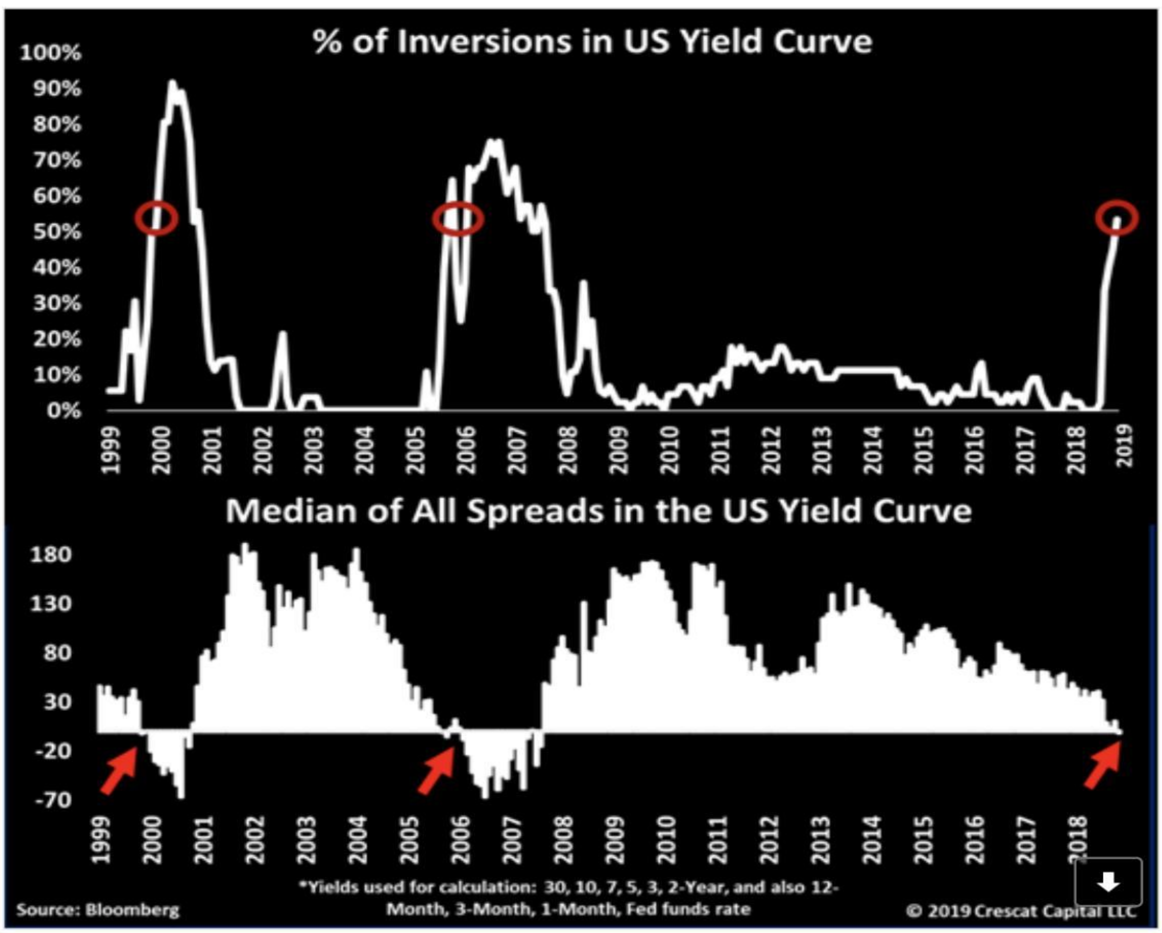
March 25th, 2019

Trapped…

When it comes to the capital markets, it's the stock market that everyone loves to talk about, but it's the bond market that leads the way. This isn't to say that the stock market doesn't provide important and valuable information, but at cyclical and structural turning points, it's the accurate interpretation of the message the bond market is conveying that matters most – and the message the bond markets around the globe have been conveying since Q4 2018 is that both growth and inflation were set to slow. What wasn't obvious was the degree to which both growth and inflation would be slowing, but given the recent steep slide in global interest rates as well as more than 50% of the U.S. yield curve inverting (see below chart created by Otavio Costa of Crescat Capital), it's becoming more apparent that the bond market is sending a clear signal that the global economy is weakening at an accelerating rate.



I'll get back to some thoughts on the U.S. yield curve inversion in a moment, but I think it's important to note that interest rates around the world are melting down:

- Australia's 10-year yield is at an all-time low of 1.78%
- New Zealand's 10-year yield is down to 1.89% (also an all-time low)
- 10-year Japanese Government bond yields are trading at fresh three-year lows of -0.09%
- German 10-year Bund yields have slipped to -0.01% (the first negative print in three years)
- Only compared to ultra-low yields in other developed economies could the 2.46% yield on the 10-year U.S. Treasury bond look lucrative. But it's the rate of decline in this yield that is eye popping with the yield falling 15 basis points just last week, 30 basis points since March 1st (down from 2.76%), and off 77 basis points from their November 7th peak at 3.23%.

Perhaps the one global economic data point that best encapsulates the slowing global growth story that the bond market is confirming is global trade falling off a cliff. It's never prudent to rely or point to just one indicator, but we already know global growth is decelerating from the global PMI data, industrial production, and central banks lowering their GDP estimates, so it's not a stretch to take this data point at face value. One could look at the following chart and point out that it looks like nothing more than a mean reversion of the sharp uptick in global trade between late 2017 into early 2018. I'll agree with that, but I'd counter with pointing out a similar (albeit less intense) pickup and then rollover in mid-2014 into 2016, however the current slowdown in the 3-month trend in global trade growth has pushed meaningfully below the levels it bottomed at back in 2016 and has yet to show any signs of finding a bottom.

Highs and Lows

Global trade growth has seen a sharp downturn in recent months

Source: CPB World Trade Monitor

Which brings me to the Fed and their announcement last week that they don't expect to hike rates at all in 2019, they will begin tapering their balance sheet roll-off in May, and they plan to completely end the shrinking of their balance sheet in September. What is becoming more evident is that the Fed is trapped. Over the course of the last 18 months they've attempted to remove some of the ultra-loose monetary policy they implemented in the post-GFC expansion, but what is clear is that the highly leveraged global economy can't handle any further tightening in Fed policy. It's a bit unsettling to think that the Fed's balance sheet (which expanded from $800 billion prior to the GFC to $4.5 trillion at its peak) can't be reduced much below $3.7 trillion and the Fed Funds rate can't be raised above 2.50%. The maelstrom in capital markets in Q4 and continued weakness in economic data have definitely unnerved the Fed. Consider the irony, where back in 2010 then Fed Chair Bernanke did an interview on 60-Minutes where he openly exclaimed that the objective of expanding the Fed's balance sheet via QE2 was to raise asset prices, yet as the Fed was shrinking the balance sheet since October 2017, they contended that it would be insignificant to asset prices. Well, it looks as though the Fed got the message in December that unless there are willing to subject the capital markets and economy to a significant level of downside pain, they are stuck and are unable to unwind anymore of the accommodation they've provided since 2008.

The stock market chopped around in the 24 hours following the announcement, but a steep sell-off ensued on Friday with the Russell 2000 down -3.6%, the Nasdaq sliding -2.5%, the S&P slipping -1.9%, and the Dow dropping -1.8%, indicating that investors wanted more from the Fed. In a nutshell, there really wasn't much action taken with this announcement other than a continuation of the about-face that began shortly after the rate hike in mid-December. They didn't cut interest rates and the roll-off of the balance sheet will continue into September. So, while the bond market is reacting (lower yields) to where the Fed is ultimately going (rate cuts before year end), monetary policy is still tightening on net.

I've said it before, and I remain of the view that the Fed has already overtightened this cycle, and with the 10-year/3-month part of the yield curve inverting (10-year yield of 2.40% below the 3-month T-bill yield of 2.45%) and with the upper end of the Fed funds range sitting at 2.50%, the unfortunate reality is that the Fed has very little ammunition to combat an economic recession. This is what risk assets are starting to figure out in that they are no longer responding positively to dovish talk. Look back at the last three interest rate cutting cycles by the Fed: In the Spring of 1989 the Fed began cutting rates from 9.80% all the way down to 3.0% in September 1992 to combat the recession in 1990/91; in January 2001 the Fed Funds rate was cut from 6.50% to 1.0% by June 2003; in September 2007 the Fed began cutting the Fed Funds rate from 5.25% to 0% by December 2008. On average the Fed has cut rates by 5% to counteract an economic downturn, but how do you do this if the peak in the Fed Funds rate this cycle is 2.50%? The short answer is that QE and other unconventional monetary policy tools (negative interest rates, inflation or nominal GDP targeting, the Treasury capping long-term interest rates…) will be enacted and this is likely what gold has been sniffing out and why it won't be long before it breaks out of the upper end of its 5-year trading range around $1,370/oz.

As for the inversion of the yield curve – yes, it is important and it is not a market signal that should be readily dismissed. I'm already seeing puff pieces like the one in today's Wall St. Journal, titled *"Inverted Yield Curve Is Telling Investors What They Already Know"* where they point out in the article that the 'yield gap isn't a recession guarantee', and while I agree it's not a guarantee, it does have a solid track record in terms of accurately predicting a recession 85% of the time. So, if you're inclined to play for the 15% of the time that this has been a false signal, have at it, but the key to long-term investing success is investing with the odds at your back, not slamming you in the face. The other consistent retort is the time lag you have when the yield curve inverts, because the average lag before a recession begins is twelve months or longer. This assertion puts way too much faith in the 'average' and does not provide enough context for the dispersion within the average. I overheard David Rosenberg of Gluskin Sheff being interviewed on CNBC about the 'average' time span between a yield curve inversion and the start of a recession in which his response was (and I'm paraphrasing here): "if you stood in a bucket of ice water and then lit your head on fire the average temperature of your body might suggest everything is well, but I doubt you'd feel this way".

All kidding aside, the important take away is that this is just another checkmark on a long list of items that confirms that a cautious and prudent investment approach is warranted at the moment. There is no sure thing in terms of markets and anyone acting or investing as if there were should be ignored. The incoming economic data, the Fed pivot to an ultra-dovish bias, inversion of the yield curve, the increasing risk of a multi-quarter earnings recession, and heightened global geopolitical risk (Brexit is a mess, the U.S. / China trade spat remains unclear, and while the Mueller investigation looks to be a big nothing-burger – it doesn't change the divisiveness that exists between the Republicans and Democrats when it comes to policy…) highlight the vulnerability and fragility of the investing backdrop today. Don't ignore it.

I wouldn't be surprised if even before the end of summer that the Fed is cutting interest rates – the Fed Funds futures market is already priced 60% of the way for one rate cut this year and 20% for two rate cuts – but it's important to remember that as this policy shift unfolds, the time to get ultra-aggressive and back up the truck to load up on equities is on the Fed's last rate cut, not the first one. The steep slide in yields over the last several months is the bond market's way of looking the equity market square in the eyes and calling BS on the prevailing view that 'this current soft patch is just a one-quarter anomaly that will be long behind us as we get into the second half of the year'. Parts of the stock market are in agreement with the bond market as the Financials, Transports, and Small-Cap stocks have all rolled over in a meaningful way and these were the parts of the stock market that were leading the way up coming out of the deeply oversold levels in late December.

One other item I want to hit on before signing off on this week's missive, and it relates to the fiscal situation of the USA. Keep in mind anytime you broach the subject of the debt situation in the U.S., it's a dark and ugly conversation, but it's important to realize that as ugly as it appears here in the U.S., it is even worse in most other regions of the world. It is for this reason that I continue to think the U.S. dollar will remain the world's reserve currency for some time to come until a viable alternative comes to bear. However, at this juncture a strong U.S. dollar relative to other global currencies is a curse as it relates to S&P 500 earnings in that roughly 40% of sales are derived from outside U.S. borders – weak global growth coupled with a strong U.S. dollar is a material headwind to EPS growth. Getting back to the U.S. deficit situation, where we learned last week that the budget deficit for the month of February hit a record $234 billion – up 9% from a year ago. February's shortfall helped push the deficit for the first five months of the fiscal year to $544.2 billion, up almost 40% from the same period the previous year.

These numbers are becoming mind-boggling in that the U.S. economy had one of its strongest calendar years of growth for this cycle in 2018, and yet we're looking at a budget deficit that is on pace to reach $1 trillion. Just to offer some perspective on this file, in 2007 (which was the peak year of growth in the last cycle) the annual deficit was $167 billion – February's deficit alone was 40% above that full year tally. I don't care to get into whether it's tax cuts (that will 'pay for themselves', cough, cough…) or increased spending – you can have that debate with someone else. What I think is important for investors to be aware of is the reality that $1 trillion deficits for years to come is a very possible reality. To me, this is another large variable that almost guarantees that the Fed has to restart QE by year's end to monetize the growing fiscal deficits. We already know that the rest of world (on net) is no longer buying the increased supply of U.S. Treasuries, and while pensions, investment funds, and individual investors have increased their ownership, it is starting to crowd out private investment. This will have investment implications, and as counterintuitive as it sounds, this is one of the most significant variables that argues for investors to overweight their portfolios to equities.

No, no, no…this is not a 'buy everything' endorsement, but such a backdrop could for the first time in several decades set-off a sustained period of elevated inflation. If the Fed has to revert back to QE to take up a larger stake of oncoming Treasury supply (whether it's labeled Modern Monetary Theory (MMT) which is gaining more prominence on Wall St. and around Washington D.C., or Quantitative Easing 4, is irrelevant), then the money supply will increase and such a backdrop will favor stocks over bonds. As we're researching and analyzing such a possibility, it suggests that a portfolio should tilt towards real assets (precious metals, select commodities, real estate), corporations with quality balance sheets (low leverage, ability to increase leverage, pricing power, and above average return on assets), and short-duration variable rate debt.

It's important for me to point out that this potential setup remains on the horizon – it is not a present-day reality. Looking out ahead, I see three scenarios to which I ascribe the highest probabilities:

- We experience a soft landing. The Fed steps in and is successful at resuscitating and extending this business cycle. The economy does not revert back to the robust pace of growth that we saw in 2018, but we are able to achieve the roughly 2% GDP growth pace that the U.S. economy has averaged throughout this expansion. Profit growth ticks along at 4-6% and a dividend yield of 2% gives you a roughly 5-7% return out of the equity market, and bond returns are in the low single digits.

- We go into a recession. The Fed steps in with aggressive stimulus, but is unsuccessful at reflating activity. Both growth and inflation fall considerably. Deflation risks drive down both interest rates and profits. On average the S&P 500 has declined a little over 40% (peak to trough), corporate bonds fall as credit spreads expand, and high quality long-duration fixed income is one of the only asset classes to generate a positive return until the recession runs its course.

- We enter a period of stagnation. The Fed steps in, but all they are able to reflate is inflationary pressures while growth remains stagnant. This is likely the worst backdrop for investments as both stocks and bonds have a difficult time generating positive returns. The best assets to own are select real assets that preserve real returns: gold, and short-term bonds / cash alternatives.

At this moment, it's unclear as to which one of these scenarios plays out (if any), but I think one of the three is the most realistic over the next 12 – 18 months. The incoming data and policy responses over the next six months will set the table for how investors should be adjusting and shifting their positioning, in my opinion. However, at this time I remain of the view that the most prudent course of action is to stay cautious and patient as I believe that the next 2 – 3 months will provide useful information to bring one of these scenarios into light.

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