



May 13th, 2019

Keep it simple...

It's been an ugly start to the week in the equity markets with there being no indications over the weekend that tensions between the U.S. and China on the trade file have simmered. If anything, given the headlines printed in the major news outlets from each side it appears both the U.S. and China are digging in their heels for what looks to be a protracted confrontation in the trade war that kicked off last year. As a result, risk assets around the globe are taking a big hit after what was the worst week for U.S. equities in 2019. Look, I'm not going to pontificate on the

specifics surrounding these negotiations, who has the advantage, and what each side may be thinking – there are far more knowledgeable minds on game theory, negotiating tactics, and geopolitics that readers should seek out for context on this issue.

What I am comfortable sharing my opinion on, and what I do think is just as relevant in light of this dispute between the two largest economies in the world, is the current backdrop in the economy and capital markets. What concerns me most is that this trade skirmish is occurring at a point of meaningful economic vulnerability across the globe. Have a look at the below table of the OECD's leading indicator, which declined again in the latest March reading to 98.98. This marked the 16th consecutive month of declines and the latest reading is the lowest level since September 2009. The NAFTA region (in

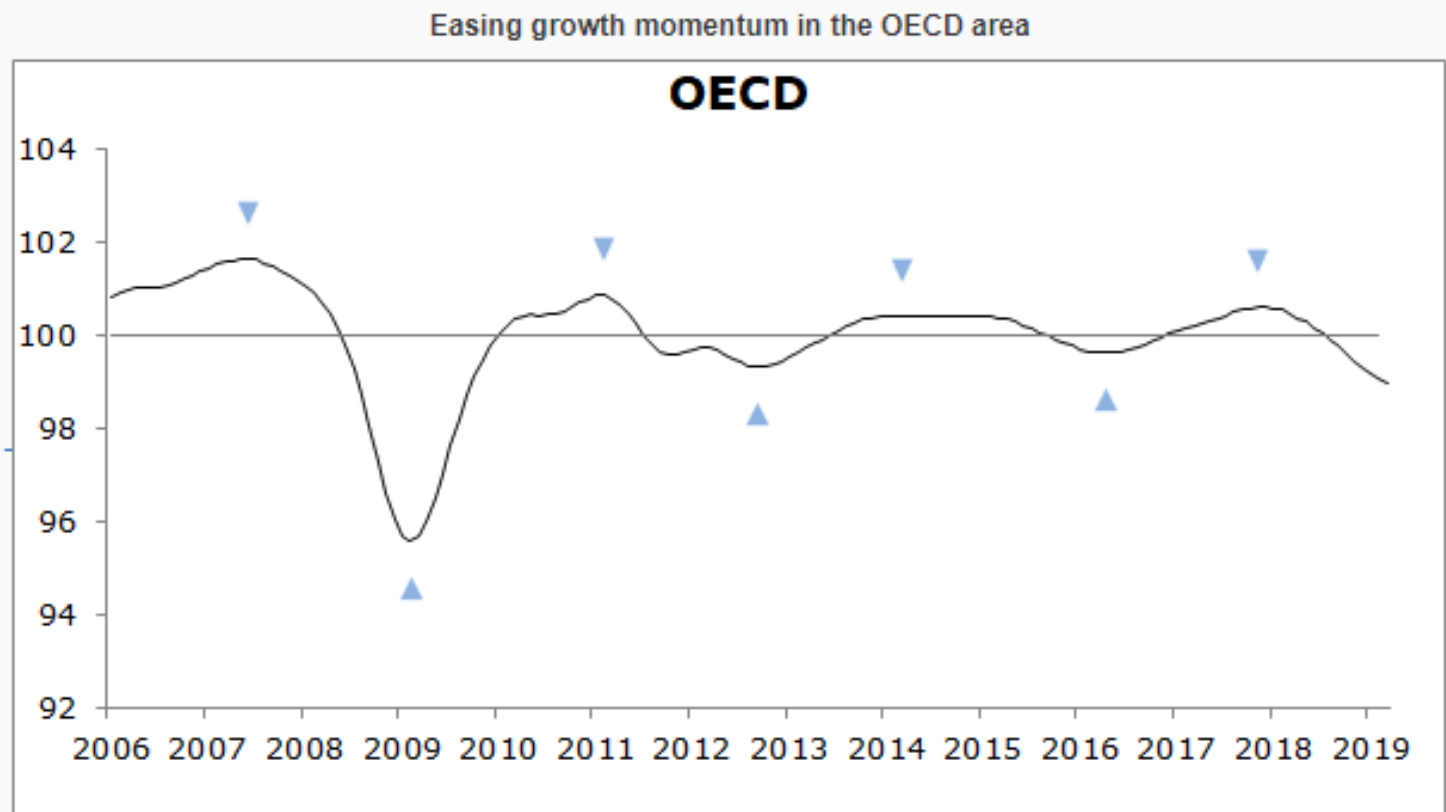
which the U.S is the dominant player) is at its lowest reading since November 2009 – back then no one was sure if we were truly out of the GFC, but at least it was moving in the right direction (up), which is in stark contrast to today with the U.S. in retreat.



	OECD Total	OECD + Major 6 Non Member Countries	Major Seven	Major Five Asia	Euro Area	NAFTA	Major Four Europe	OECD Europe	
Amplitude adjusted	long term average =100)								
April 2018	100.38	100.19	100.42	99.66	100.60	100.26	100.50	100.58	
May 2018	100.28	100.09	100.36	99.57	100.47	100.22	100.38	100.40	
June 2018	100.17	99.99	100.29	99.49	100.34	100.17	100.26	100.21	
July 2018	100.05	99.87	100.21	99.40	100.21	100.12	100.14	100.00	
August 2018	99.91	99.76	100.11	99.32	100.07	100.04	100.00	99.77	
September 2018	99.76	99.64	99.97	99.25	99.93	99.92	99.84	99.56	
October 2018	99.61	99.53	99.80	99.21	99.79	99.75	99.68	99.38	
November 2018	99.45	99.44	99.60	99.20	99.66	99.54	99.51	99.25	
December 2018	99.30	99.37	99.40	99.21	99.52	99.34	99.35	99.13	
January 2019	99.17	99.32	99.22	99.24	99.39	99.15	99.20	99.04	
February 2019	99.06	99.29	99.06	99.29	99.26	98.99	99.06	98.96	
March 2019	98.98	99.28	98.92	99.36	99.13	98.87	98.94	98.90	

The chart below plots the growth momentum in the OECD area going back to 2006, and what I think is attention worthy is that the latest readings are pushing below the levels

that marked the bottom back in early 2016 (the last time we had a global growth scare).



A large part of the rally in global risk assets following the steep decline late last year was predicated on two things: 1) the Fed and global central banks pivoting to a more accommodative monetary policy stance, and 2) expectations for global growth to pick-up, broaden out, and lead to a reacceleration in

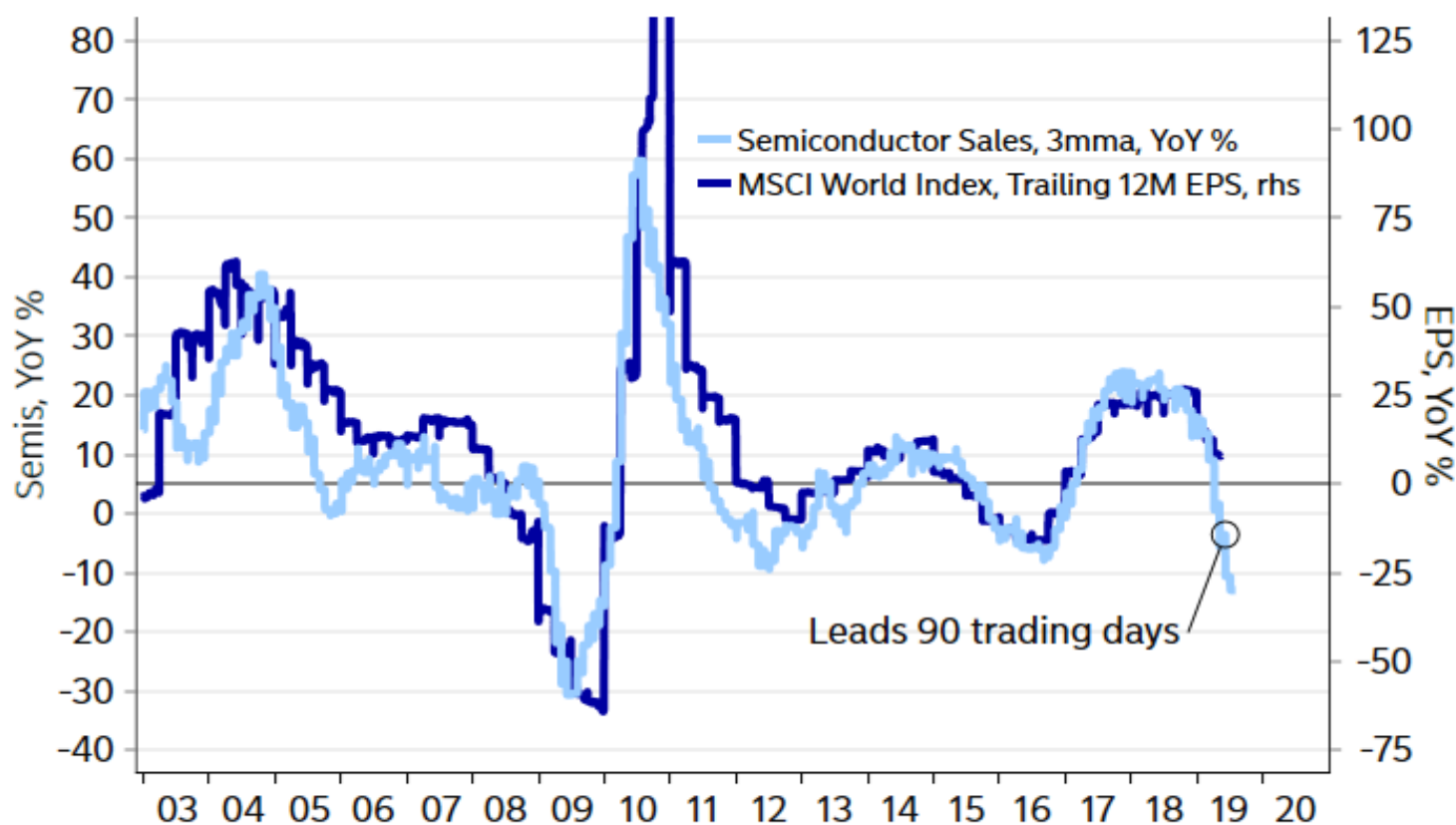
global growth in the second half of the year.

Well, with 32 out of the 36 member countries in this OECD index seeing their growth momentum deteriorate, it becomes really difficult to defend the ‘second half recovery on global green shoots’ investment thesis.

I’ve made mention of the semiconductor sector in previous missives because of its close approximation with the overall strength and health of the global economy. This technology touches so many areas at this point with its use in autos, phones, machinery, etc...which is why it’s such a closely followed leading indicator. However, like so many other indicators over the last several months, the cognitive dissonance between hope/belief and reality continues to widen. Nordea published the following chart recently that

plots semiconductor sales versus the trailing 12-month earnings per share for the MSCI World Index, where historically semiconductor sales has lead EPS by three months. If the relationship in this chart remains consistent (which by looking at the chart going back more than 15 years suggests there is little reason to question its tight correlation) with semiconductor sales down nearly -30% year-over-year in the latest 3-month moving average, then it's reasonable to consider that earnings per share for the MSCI World Index are set to contract by some 20 – 25%. The latest guidance by Intel (one of the largest semiconductor manufacturers in the world, which took down its estimates for the next three years) is the most recent confirmation that the organic growth drivers

in this market are weakening. I have been and remain of the view that the possibility of a multi-quarter earnings recession is quite feasible, which will come as quite a surprise to many investors who seem pretty convinced that earnings are set to trough in Q1 or Q2.



Source: Macrobond and Nordea

I don't want to drown out the message I'm trying to convey in this week's missive by hitting on an array of topics or areas of the

capital markets. Net-net, my big picture view remains pretty consistent with where it's been for the last year and a half – the U.S. economy is in the very late stages of this expansion and the U.S. equity market is still in a topping process. I hear and partake in some of the debates on whether we're in a bull or bear market, but quite frankly I think this misses the point. If one were to be truly agnostic and objective, they'd conclude that such a debate has been a colossal waste of time given that the stock market is no higher or lower today than it was back in January 2018. So, we have nearly 17 months of triumph, failure, or frustration during that period depending on the actions one has taken with their capital over that time. But I digress.

What I think is noteworthy with the recent heightened anxiety on the trade front between the U.S. and China is that it is coming at a

pretty fragile point for the global economy. In February and March there were some signs of stability in parts of the global economic data, but the recent data has thrown cold water on such optimism. As for the U.S., yeah we've had a couple solid employment reports and Q1 GDP came in much better than expected, but when you dig into the internals of these reports (as well as many other economic data points) the overall strength of the U.S. economy isn't nearly as solid as it was in the middle part of last year. So we have the Eurozone which is flirting with recession, the Asian region which is still trying to grapple with a material growth slowdown in China, and the U.S. where the economy is still growing but at a decelerating pace since Q2 2018.

This squishy fundamental backdrop heightens the significance of negative impacts brought

about by the recent escalation in the trade war between the two largest economies in the world. The risks of a global recession increased meaningfully given the recent developments on the trade front. Should cooler heads prevail and the recently implemented tariffs be pulled back in the not too distant future, then there is a shot that the recent slide in global equities represents yet another ‘buy the dip’ opportunity. The recent price action in U.S. interest rates (moving down), the U.S. dollar (holding near its highs for the year), gold (pushing back above \$1,300/oz.), and even Bitcoin (up almost 90% for the year) indicate that a flight to safety (perhaps a bit of capital flight out of Emerging Market regions in regards to Bitcoin) among investors is underway. Add to all of the above the fact that the toolkit for central banks is pretty sparse given their inability to raise interest rates throughout this expansion.

Perhaps the most eye-popping thing I read last week was the speech by Fed Governor Brainard titled, “How Does Monetary Policy Affect Your Community?” where she floated the notion that the Fed was evaluating the merits of capping longer dated interest rates as a policy tool in the future. They actually implemented such a policy back in the 1950’s coming out of WWII to combat the massive increase in federal debt.

Asset valuations remain high relative to their historical ranges in several major markets, suggesting that investor appetite for risk is elevated. Compared with the previous FSR, valuation pressures have eased slightly. Equity prices relative to forecast earnings remain above the median value over the past 30 years. Spreads on high-yield corporate bonds over benchmark rates are inversely related to

valuations and are low relative to their historical range. However, spreads on leveraged loans over benchmark rates have widened since the previous FSR and now are above the median value over the past 20 years. Prices have been growing faster than rents in commercial and residential real estate for the past several years, although price increases in residential real estate have recently slowed somewhat.

After growing faster than GDP through most of the current expansion, total business-sector debt relative to GDP stands at a historically high level. That said, in 2018, total business-sector debt grew a bit below its average pace since 2013 ([figure 2-3](#)). The sizable growth in business debt over the past seven years has been characterized by large increases in risky forms of debt extended to firms with

poorer credit profiles or that already had elevated levels of debt. While growth in these riskier forms of debt slowed to zero in late 2016, it has rebounded more recently, with leveraged loan net issuance more than offsetting a modest decline in issuance of high-yield and unrated bonds.

Although the increase in nonfinancial business debt has been broad based across most sectors of the economy, it has become increasingly concentrated among the riskiest firms. Detailed balance sheet information of publicly traded nonfinancial firms reveals that, over the past two years, the firms with the most rapid increases in their debt loads have higher leverage, higher interest expense ratios, and lower cash holdings... The largest components of the \$9.7 trillion nonfinancial corporate credit outstanding are corporate bonds

(about \$5.5 trillion), bank C&I loans (about \$1.2 trillion), and leveraged loans (about \$1.1 trillion).

On the domestic policy front, contacts viewed various aspects of U.S. monetary policy as potential sources of risk. During outreach at the start of the first quarter of 2019, contacts were focused on risks related to the potential for monetary policy to become overly restrictive; however, at the end of the quarter, some contacts noted the potential for excessive risk-taking, owing in part to a more accommodative monetary policy stance than had been previously anticipated. Many respondents raised concerns that the U.S. economic expansion was in its latter stages.

To be fair, this report has to be taken with a grain of salt as its objective is to evaluate the

risks to financial stability and as such, if taken at face value only highlights potential problems while not providing much color on the potential solutions and remedies to counterbalance the stated risks. However, it does a reasonably solid job at highlighting the delicate situation the global financial system finds itself in at the moment.

In times like these, it's important for investors to remind themselves to stay disciplined, don't panic, and be patient. Opportunities will assuredly present themselves, but if the last 18 months have illustrated anything, it's that algorithms, trend-following, and high frequency trading strategies can, will, and have driven market prices to extremes in both directions. Waiting and acting on these extremes is easier said than done, but one way to eliminate the all or nothing bet is to have a

plan, stick to it, and implement it along the way.



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