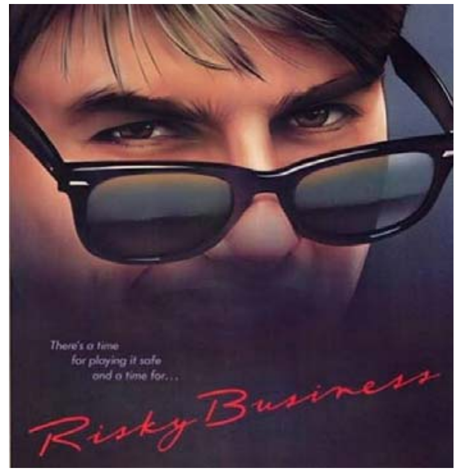
Risky Business

September 2016

In the 1983 movie classic, Joel (Tom Cruise) takes advantage of his parents being away for the weekend to step outside his usual, staid suburban life, and with the active goading of his friend Miles, gets in well over his head. Despite ample flashing warning lights, a series of dubious decisions are made, and unintended consequences begin a cascade of bad outcomes that spin far out of his control. It's only through creative thinking, solid planning and some "unusual" solutions that Joel engineers a successful outcome.

As the movie tagline says: "*There's a time for playing it safe and a time for Risky Business*"**.** It's tough to ignore the goading of market prognosticators and stay conservative as markets have continued to move marginally higher in recent weeks.



However, current risk levels appear to be heightened, and we remain cautious in our exposure to the more volatile, extended areas of the markets.

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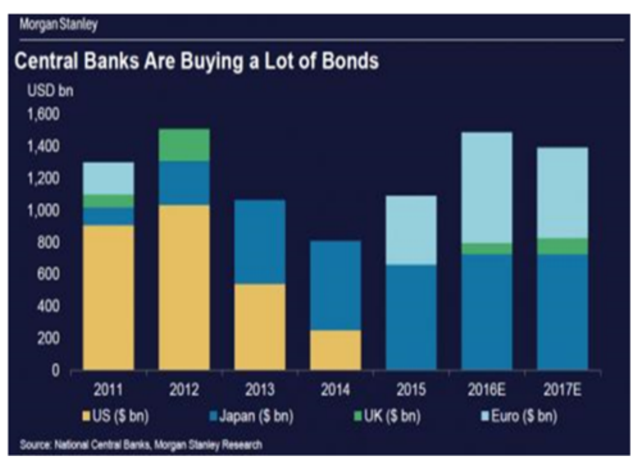
Weakness Abroad

The most glaring warning signals that all is not right with the global economy are the recent GDP misses in both China and Japan**.** Neither country has been shy about applying any and all fiscal and monetary tools available to them for the last several years, and yet they just can't seem to generate sufficient spark to crank their economic engines. In fact, Japan's disappointing 0.2% GDP report would have been negative if not for $276Bn in stimulus spending, which saved them from having to report that growth in 5 of the last 10 quarters has been negative, alternating between growth and contraction for the last four. Estimates for full year 2016 GDP are barely positive at this point for Japan.

Despite introducing NIRP policies (negative interest rates), and doubling the amount of ETF's their central bank is buying in Japan's stock market, the Yen continues to strengthen, which makes their exports more expensive on the world stage. A new QE program in the U.K. (post-BREXIT vote) is putting the desired downward pressure on it's currency and interest rates, although any meaningful follow-on impact on foreign trade may be delayed as the actual BREXIT may not occur until 2019.

Central Bank (CB) QE-related bond purchases have, by design, the effect of weakening the home currency, ostensibly to strengthen export trade. But by definition everyone can't weaken their currencies at once, so the globe has devolved into a game of musical chairs with most of the major players trying to weaken their currencies against everyone else. Clearly there have to be some "losers".

With trillions of dollars in CB purchases manipulating the bond markets many feel the yield curve can no longer efficiently serve as an early warning system of developing economic weakness.



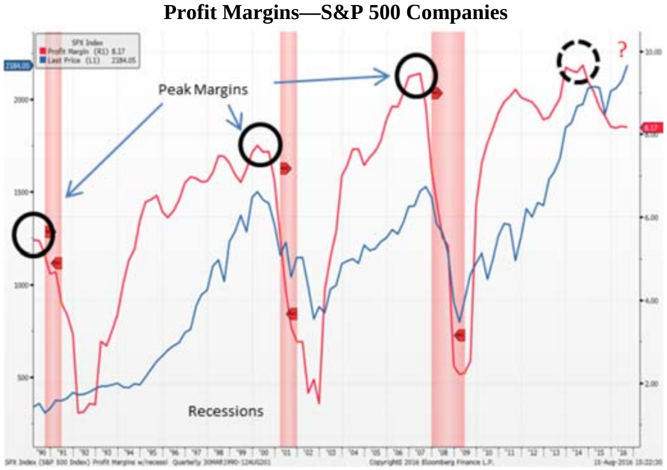
Source: Morgan Stanley

Weakness at Home

While markets remain excited over the recent employment and hiring data, a number of other indicators have continued to lag. Factory orders have declined 5.6% y/y. Manufacturing indices are at the lowest levels in a year, with 7 out of 12 ISM factors still growing, but now at a slower rate than earlier this year, despite expectations for a mid-year re-acceleration. Second quarter earnings now look to be down about 3.5% from last year, and are projected to be down 1.7% in Q3. According to Factset Data Services, earnings are now forecast to decline -0.3% for the full year. This is the second time the S&P has reported two consecutive years of earnings declines since 2008 and 2009.

As seen below, profits and margins peaked in 2014, in a manner similar to previous economic peaks, which preceded the recessions of 1990, 2000 and 2007.

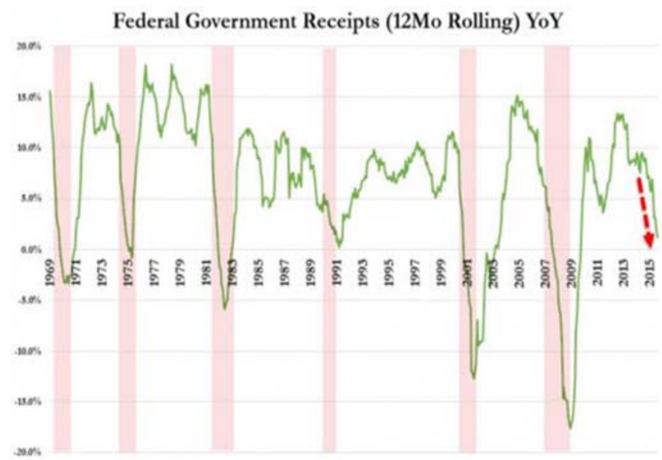
Profit Margins—S&P 500 Companies



http://www.zerohedge.com/news/2016-08-09/why-gaap-matters-real-profit-margins-tumble-10-year-lows

While companies may play with their numbers to meet certain earnings targets, no one wants to pay more taxes than they owe, so Federal tax receipts are a pretty good indicator of the health of the economy, and whether or not it is continuing to grow. A look at the following chart indicates that the 12-month rolling average of year-over-year growth in tax receipts peaked in late 2012, and has been declining sharply ever since.

The dramatic slowdown in the growth rate of tax receipts confirms the slowdown we've seen in the macro level GDP numbers. If we examine similar periods of decline going back to the late 1960's, another worrisome pattern emerges. Each time tax receipts have fallen at both a similar rate, and by a similar magnitude (less than 3% y/y growth) we have been either approaching, or have already entered a recession.



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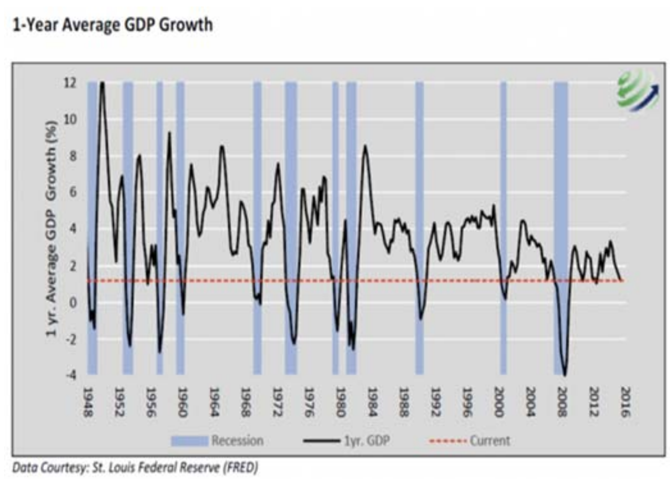
The graph below plots average 1-year GDP growth rate on a quarterly basis going back to 1948. The blue shaded areas represent recessionary periods, and the red dotted line indicates the current GDP rate of 1.2%. As we can see, every recession since 1948 has begun when GDP was growing faster than the recent 1.2%. That said, there are only three times the economy grew less than today's 1.2% rate and a recession didn't occur; with the most recent two occurrences being the 2011-2012 period when QE programs likely kept us from sliding into recession. We are sitting on the knife's edge, making fiscal and monetary policy crucial.



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As we've previously noted, the consumer has largely kept the U.S. economy afloat as manufacturing and energy continue to slide. In fact, without the consumer strength our GDP numbers would already be negative. It is disconcerting that some recent Consumer Confidence measures have begun to slip, and recent revisions have revealed the purported wage gains of the last several years to have been illusory.

What, Me Worry?

From widespread fear earlier this year, investors have morphed to a position of widespread complacency, seemingly unconcerned with the imbalance between the underlying fundamentals in global economies and markets flirting daily with new highs. The *Investors Intelligence* ratio of "Bulls-to-Bears" has risen to a 12 month high, while investors "Looking for a Correction" have fallen to 2 year lows. Short interest, a market-sentiment indicator that tracks whether investors think stock prices are going lower, has fallen to three year lows after the recent, sharp, short-covering rally.

http://www.zerohedge.com/news/2016-08-05/investors-over-trim-their-hedges

Complacency, as measured by the Volatility Index (VIX), just dropped below 11, and is at the lowest levels since last August when the S&P was preparing for a three week plunge of 10%, after a series of lower market highs.

Finally, as we can see in the bottom panel of the chart above, the average volume in inverse ETFs, which are bets on a decline in equities, has fallen to levels previously associated with near term market tops or short-term corrections. Similar to market conditions in 2000 and 2008, there is apparently little fear of a large decline, despite a net out-flow of nearly $200 billion in equity mutual funds by retail investors year-to-date.

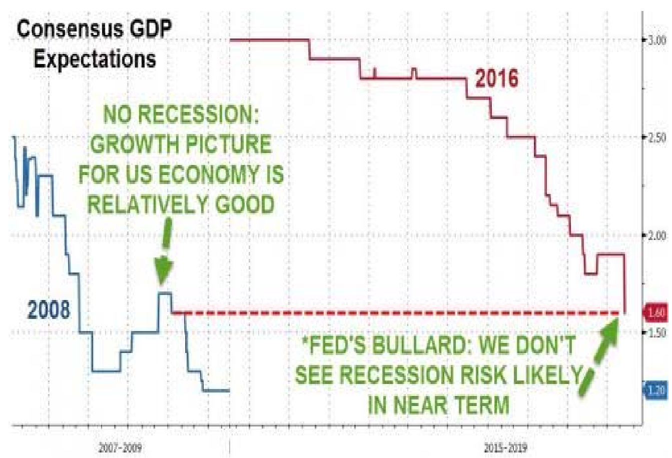
Our experience over the years is that it's always difficult to bet against the Fed, and the last 6 months have proved no exception. That said, when markets have been this complacent for this long, in the face of tepid to deteriorating fundamentals there is usually a price to be paid. By definition, tops form when things are "as good as it gets", astute investors start to perceive a developing disconnect between prices and value, and "smart money" anticipates a downward correction in prices. However, lately it's almost as if investors believe that the Fed won't let that happen.

Timing is Everything

St. Louis Federal Reserve president James Bullard recently opined that the Fed doesn't "*see recession risk likely in the near term"* and that he sees just one rate hike in the next few years. Normally one might take some solace from such comments. But one might be disappointed to discover that the Fed is no more infallible now than it was in back in 2008. During a presentation at the University of Arkansas in November 2013 Bullard offered the following retrospective analysis of how the Fed entirely missed the 2007 recession.

"*As of July 10, 2008, forecasts for the second half of 2008 were for continued modest growth*" and "*as of early August 2008, the growth picture for the U.S. economy according to available real-time data was relatively good*." Finally, he noted that "*There was no recession according to the conventional definition of two consecutive quarters of negative GDP growth*".

"*According to today's data, real GDP growth in the first quarter of 2008 was steeply negative, but this information was* ***not available at that time*** *(emphasis added). There was a good case to be made that the "muddle through" scenario, which had apparently been correct for an entire year, would continue through the end of 2008."*



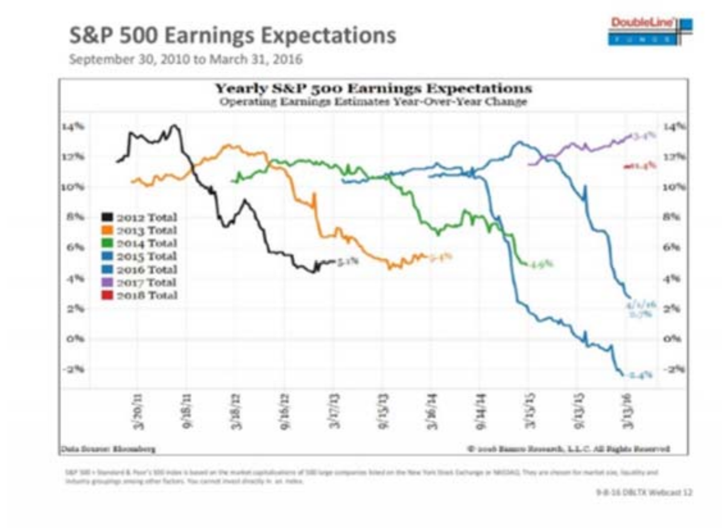
http://www.zerohedge.com/news/2016-08-12/feds-bullard-we-dont-see-recession-risk-likely-near-term-just-august-2008

In reality, as of August 2008 the US economy was already 8 months into the worst recession since the Great Depression, and a month later the S&P 500 would begin a meltdown of over 55% from the highs before it was over. And the Fed missed it completely.

A glance at the chart above does little to provide comfort to those of us who remain concerned about the underlying fundamentals of the U.S, and global economies. Deja vu, all over again?

Earnings Matter

Our May newsletter highlighted the risk to investors who focus solely on U.S-centric data, while acknowledging the growing importance of non-fundamental data in today's markets. We pledged to "take the 'old school' approach of examining what we feel will be the most important drivers of economies and markets for the balance of the year; global economic growth, earnings trends and market sentiment".



The graph to the right highlights a recurring pattern in annual estimated earnings for the S&P 500 over the last five years; hopes for the ever-elusive earnings recovery have evaporated each year. What are the odds that 2017 is the year it finally occurs?

Jeffrey Gundlach, The CIO of DoubleLine Capital, raised eyebrows recently by noting that he believes bond rates have bottomed, and that the Fed may raise rates in September. Such a move could roil traditional bond investors, as bond values would move lower as yields rose, increasing the risk of bond portfolio losses.

While it's possible the Fed could make a pre-emptive move, we have taken the position that both the economic and earnings outlook in the U.S. remain far too tenuous for the Fed to take that risk; especially two months before a tight presidential election.

Our list of flashing warning lights has grown, and yet politicians and global financial authorities continue to make, what appear (at least to us) increasingly dubious decisions. Pervasive global economic weakness, disappointing retail sales, collapsing energy and manufacturing earnings, post-peak corporate profit margins and U. S. tax receipts, record low global bond yields, with investor complacency and valuation levels at cycle highs, appear to be of little concern to investors or global central banks. Our concern is that an unexpected event with unintended consequences may one day soon begin a cascade of bad outcomes that spin far out of the Fed's control. Again.

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Now What?

We have remained mildly cautious on equities throughout the modest summer rally and have recommended maintaining slightly higher cash positions as our perceptions of market risks have increased. We continue to maintain our underweight positions in small caps, international and emerging market equities for the time being. We have also maintained our positions in high quality, medium duration bonds, and remained cautious on weightings to high yield bonds and interest rate sensitive securities.

But our stance could be changing shortly, as we stand ready to take advantage of any substantial selloff in either equities or fixed income as risk perceptions shift.

If you would like more information please contact us at 954 809-6363.

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