Mixed Signals

Volume III, 2017

The disconnect continues between the “soft” survey data and the underlying “hard” data, which have sharply diverged since the end of last year. The market has obviously been reacting to the soft data and expectations-based indices, which is consistent with historical market behavior. The issue remains whether the data catches up with the expectations over the next several months, or whether the new-found business and consumer optimism alone are driving the markets, rather than any actual near-term improvement in business investment, hiring, production and income.

As the new administration settles in, we look at some of the more obvious disconnects between expectations and current economic conditions as we continue to develop our 2017 forecast.

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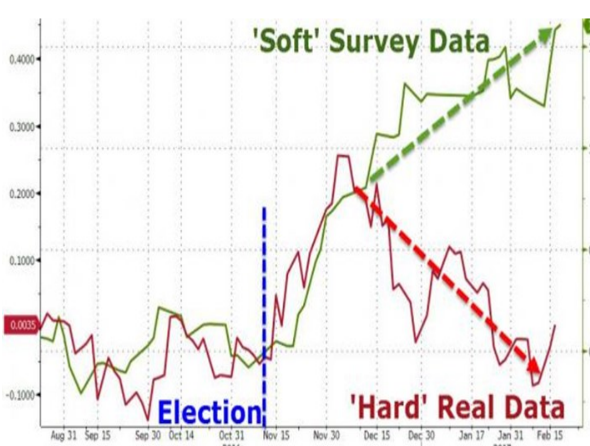
Hard or Soft?

A review of recent “soft” indicators, such as the Consumer Confidence index, NFIB small business surveys, Purchasing Managers (PMI) and Institute for Supply Management (ISM) indices, have revealed a pattern of significant strength in the post-election period, with some hitting multi-year highs.

These are called “soft” indicators because they survey respondents about how they perceive the economic or business environment outlook to be over a given timeframe, and their *intentions* to spend, invest or hire. They do not measure actual activity.



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On the business side, while the National Federation of Independent Business (NFIB) Confidence Index is at the highest in 12 years, and the measure of *Optimism* among small businesses has spiked post-election, so has the level of *Uncertainty*, which has exceeded all historical levels seen in the last 40 years. The good news is that a peak in the *Uncertainty* index has never been in close proximity to an economic recession. However, neither has the peak in NFIB *Optimism*, so neither measure is particularly good for forecasting an economic peak, a growth slowdown or a recession, and are much more of a coincident indicator.

Similar to the explosion in business optimism, there has been a corresponding spike in the Consumer Confidence indices post-election to the highest level seen in 15 years, with consumer spending *intentions* gaining significant strength.

In order to justify current market valuation levels, we must now see a transition from confidence and hope to actual consumer and business spending, hiring and capital investment, and a re-convergence in the two lines on the chart to the left. In our experience, they both can’t be correct.

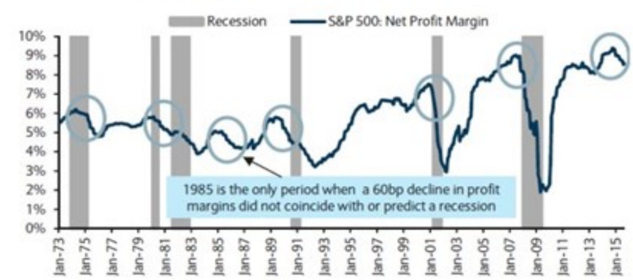
Late in the Cycle

While enthusiasm and confidence is nice, actual strength must follow in the form of sales, earnings and profits. An examination of several key hard data indices, such as durable goods and factory orders, capacity utilization levels, inventories and supplier delivery indices, profit margins and recent GDP data all reveal a pattern of sluggish, waning strength or decline.

We have noted for quite a while that corporate profit margins peaked in 2015 and have since rolled over, as shown in the graphic below published by Barclays last August. The pattern is particularly concerning because it is typically associated with late-cycle behavior.

A decline of this magnitude is rare when not entering, or in a recession, and in the last 40 years it has only happened once without a recession occurring.

FIGURE 2
A large decline in profit margins usually leads to or coincides with a recession

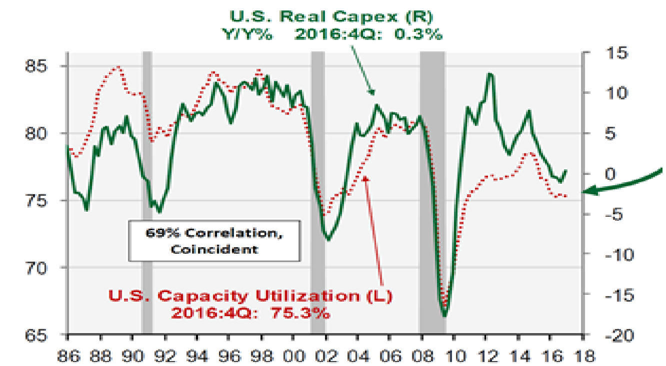


Source: Thomson Reuters, Barclays Research

Earnings and profits have recently been supported in many cases by creative accounting, share buybacks financed by low rate corporate debt issuance, and offshoring of production to lower cost or lower tax countries in the case of international companies. Given the Dollar's recent strength and the prospect of rising rates, the effectiveness of these techniques may have run its course, leaving companies scrambling for organic growth. It is typical at this later point in the cycle to see an uptick in mergers and acquisitions by those with adequate war chests and strong book value ratios; with the accompanying cost controls, expense reductions, division consolidations and employee layoffs to follow.

It is difficult to envision an improvement in profitability, or a reacceleration in the hiring cycle this year without some tangible stimulus in the form of lower interest rates, significant tax relief, or a sizeable fiscal stimulus. The former is not likely given the Fed's recent commentary, and in any event would likely have minimal effectiveness after the last seven years of low rates. The latter two are likely to be a 2018 phenomenon, at best, and will likely fall short of market expectations given the ongoing dysfunction in Congress.

An additional area of concern is the reluctance of businesses, particularly in manufacturing, to ramp up capital spending on new plant and equipment. The Capacity Utilization rate, which measures the overall slack in the economy or at an individual firm at a given point in time, has fallen to just above 75%, which is consistent with prior recessionary periods. It is also strongly correlated with Capital Spending, whereby firms with excess capacity in their existing means of production have little incentive to invest in new capital formation.



Source: Cornerstone Macro

As an example, US auto inventories are high and junk financing default rates are back to 2000 bubble levels, which may compound industry problems if the economy slows, instead of improving. Auto production is now rolling over and we expect to see double digit declines in Q1 and potentially continued sluggishness into Q2 as automakers work to clear out excess inventory. Under these conditions, line expansions or new U.S. production facilities are hard to imagine.

Capital investment, and its implication for expected sales growth, is a significant contributor to overall GDP growth. Despite an expected pickup in capital spending in the Oil and Gas industry, it is hard to forecast a robust economic recovery until this excess capacity begins to be absorbed across many industries.

Inflation on the Rise?

US inflation was up 2.5% y/y in January and may be on the way to the 3% level in the first half of the year. Major drivers include a December uptick (2.7%) in U.S average Hourly Earnings (3 month rolling avg), following an increasing pattern for the last two years, and a much more significant y/y increase in energy costs as the price for oil is up over 60% from a year ago. Continued inflation growth will put pressure on the Fed to increase interest rates. Remember, we still suggest that the single largest factor in the market's success or failure in 2017 will come down to what the Fed chooses to do, or not do, and when any action is taken.

Potpourri

There are a number of other factors that we're watching to evaluate the case that the world in 2017 is going to see stronger and more uniform growth based upon policy shifts in the U.S and Britain. Evidence for success would be continued strength in commodity indices like oil, copper and gold, which are typically associated with economic growth and inflation. The two biggest influencing factors would likely be the strength of the U.S dollar and prospective U.S. tax policy changes. Each will likely have offsetting effects on manufacturing exports, and the decisions of companies to repatriate or build new U.S. facilities.

Dollar

The broad-based USD index broke out to the upside in November, strengthened over the remainder of the year, and is up nearly 10% from the lows last May. It is now up 3.6% year-over-year, and has been consolidating this year in a trading range. The Fed's most recent commentary indicated concerns about continued strength of the dollar negatively impacting U.S exports, in addition to putting upward pressure on interest rates. Absent any intervention by global monetary authorities, we expect the dollar to continue to move higher this spring on the prospects for higher relative U.S. economic growth and higher U.S. policy rates.

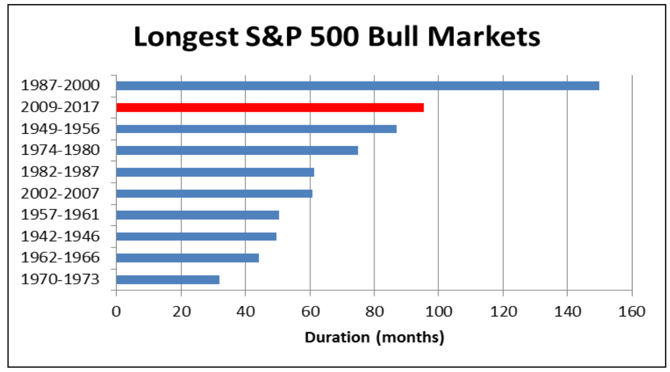
Taxes

The U.S. statutory corporate tax rate is currently the second highest in the world at 39%, and there are rumored proposals to cut it to 20-25%, a level lower than Canada (27%), China (25%) and Mexico (30%). The controversial Border Adjustment Tax being proposed by the House is much less likely to see passage. It would be placed on all imports, and could be as high as 20%, while leaving exports largely untaxed, and would be similar in construct to taxes already used by many of our foreign competitors. It is fiercely opposed by retailers and other U.S firms heavily reliant on imports for their sales, or those with little or no export business.

While there is considerable disagreement on what changes are to be made, Treasury Secretary Mnuchin has indicated he expects tax legislation to be ready for a vote prior to the August recess in Congress, and that it will focus on middle class tax cuts and corporate tax simplification. He also indicated that any cuts for the highest earners would be offset by removing deductions. In any event, it is highly unlikely that any tax changes would be retroactive to 2017, so the market's reaction this year may be a bit premature.

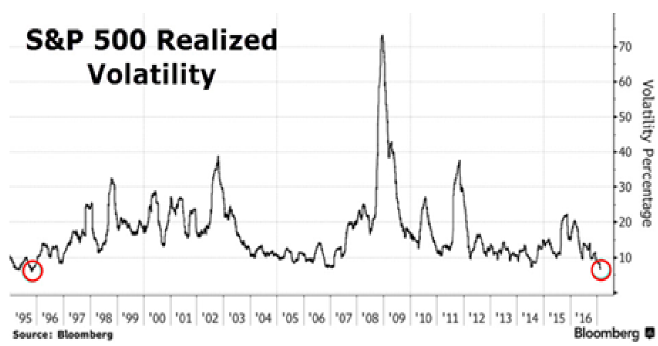
Markets Just Don't Care

Despite an array of economic statistics that contradict the "don't worry—be happy" mindset revealed in the "soft" data surveys, global stock markets have continued to post new highs. It appears that investors are willing to suspend caution today in hopes for a follow-through on economic growth and earnings later this year, ignoring what some see as worrisome valuations.



As of publication the current bull market is now the second longest on record, and is up nearly 10% since election day. It's been over a year since we had a 10% correction, and we are back to the "buy-the-dips" mentality that prevailed through late-2000 and early-2008. Few would go so far as to call this a manic bull market, and we view it as more of a 'reluctant' bull market.

The VIX index is frequently used as a measure of the market's expectation of stock market volatility over the near term, and is seen as a gauge of investor fear (higher values) or complacency (lower). The chart below shows that investor complacency is at levels not seen in the last 20 years, and was last seen in the year before the 2007 peak in the markets.



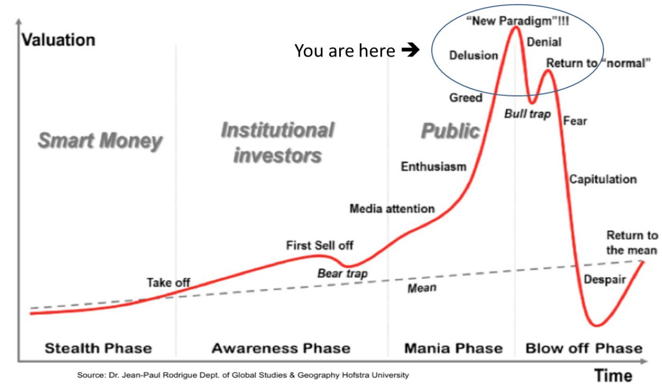
While the VIX is not intended as a market timing indicator, it does reveal market sentiment and the *magnitude* of investor complacency. In our experience, sharp, sometimes violent, moves in the markets are often preceded by heightened complacency, because investors are not prepared for a downturn and may panic as the selloff gains speed. In our opinion, caution is warranted at current market levels.

Proceed With Caution

Given the near-term headwinds of a higher dollar and the export pressures discussed above, the uncertainty surrounding the likelihood of passage (and the slipping timeframe) of many of the Trump administration's economic stimulus measures in Congress, and questionable strength in China and Europe, we expect U.S economic and earnings growth to be disappointing relative to market expectations. We see Q1 GDP in the 1.5-2.0% range, with uneven growth throughout the year. This should result in another year of 2.0-2.5% GDP, and sluggish earnings growth as the most likely case.

Oil prices are likely to be range bound for much of the year as a resurgent supply from the fracking fields battles announced production cuts from OPEC. The reality is that the OPEC cuts are likely to be less than announced, as they typically are, because the membership has historically cheated on its targets. Due to technology improvements, an increasing slice of the U.S. oil exploration and production industry is now profitable at much lower price levels than in the past. As a result, we expect to see increasing and profitable U.S. production going forward, resulting in higher levels of oil inventories relative to expectations, and keeping a lid on oil prices absent an unexpected pickup in global growth.

To the extent that this tempers recent inflation pressures, it would allow the Fed the ability to move more deliberately in normalizing rates. Despite the minimal growth pressures, we still see inflation ticking upwards, probably into the 2.5-3.0% range for the year, assuming wage pressures don't accelerate from recent trends. We also see housing and healthcare inflation as more stable than over the last several years.



The beginning of a recession, or even a bear market, is alternatively known as the peak of the previous cycle. By definition, recessions are back-dated to the prior peak revealed in a select group of economic data series, and are generally not recognized as they begin due to a lag in data reporting, and revisions. What is also generally true is that "soft" data surveys are frequently coincident to lagging indicators; where responders may actually feel the most positive as an economic or market peak is approached, and the most despair as the bottom is plumbed, as seen in the chart above.

That said, we are not calling for an imminent recession, nor a bear market at this point. However, we recognize that there is a disconnect between what investors hope will happen with respect to tax policy, infrastructure spending and growth expectations, and the most likely outcomes, which is troubling. Should investors come to accept a lesser reality, markets could face a shock. While mixed signals may provoke 'paralysis by analysis', the better plan is to proceed with caution while monitoring our risk profiles.

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Now What?

We have remained mildly cautious on the broader equity markets even as they have continued to move higher this year. Our perception of market risks remain elevated and we maintain our underweight positions in small caps, international and emerging market equities. We maintain our positions in high quality, medium duration bonds, but would begin to lower weightings to longer duration high yield bonds and interest rate sensitive securities if the Fed gets more aggressive on rates.

It could be several quarters before the true impact of Trump's policies are felt in the actual data, as opposed to recent expectations and measures of confidence. Even so, we feel U.S. equities and bonds will continue to provide a better risk/return than overseas markets.

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

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