Vital Signs

As I have gotten older, it’s become much harder to ignore that my body doesn’t exactly look the same as it did—and it sure hurts a lot more than it used to as well. While this is the natural order of life, many Americans have increasingly decided to fight Father Time. Since 1997, both surgical and nonsurgical cosmetic procedures have soared by more than 500% to 12.7 million in 2015. While these procedures can make you look better, they generally can’t stop the aches and pains or poorer health that comes with age. That requires more physical and nutritional discipline, which is harder than simply going under the knife or syringe.

In a similar vein, many analysts and market commentators have been lamenting this year that financial assets have simply received another face lift, courtesy of global central bankers, contending that the health of the economy and companies has not improved or even deteriorated further. We have steadfastly held a different view: The global economy and company fundamentals likely bottomed in the first quarter. Back in March, I wrote that the market itself was giving us some positive signals that we should expect the data to come through. I called it “reading the tea leaves” at the time; and while it may have seemed a bit speculative then, it looks prescient now.

Since March, the data has indeed improved both economically and at the company level. Specifically, global manufacturing orders and industrial production have bottomed and, in many cases, are now growing again. Retail sales remain resilient and housing has been a real bright spot—even in Japan, where housing starts are up 15% from the end of 2015 and 9% year over year. Perhaps negative interest rates can have a more positive impact than most thought when the Bank of Japan adopted them in January. Finally, in last month’s Positioning, I discussed earnings revisions breadth turning decidedly higher and, on a rate-of-change basis, stronger than we have witnessed since 2012.

But, how do we know these trends will continue? What gives us confidence this year isn’t going to end like the prior two, which both got off to good starts only to fade at the finish. For one, the US dollar remains weaker after topping last December. As noted many times, this should provide a tailwind not only for US multinationals, but for global

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trading too, given the US dollar’s significance in global pricing. Second are oil prices which, in our view, have definitively bottomed. Just as plunging oil prices led to a collapse in rig counts and secondary industrial activity, a stabilizing oil price should lead to a rebound. To wit, June saw the first multiweek increase in the North American rig counts since the collapse began. Finally, we are seeing several of our leading indicators remain in expansionary territory—a stark difference from last year when most of them were either deteriorating or flatlining.

Perhaps the biggest difference between this year and the prior two is the market itself, which quite frankly, tends to be the best predictor of its own direction. As noted in March, the new leadership from the more cyclical sectors of the market was an important sign that something was different with this rally. The good news is that these sectors have continued to lead and have not rolled over. Now, the breadth of the market—the percentage of stocks participating in the upside—is exceptionally strong and it has typically led prices (see Exhibit 1). With breadth making new highs, there is a strong case the broader indexes will make new highs this summer—our view since March. Finally, small-cap stocks are also outperforming, which tends to be a positive signal for future growth and risk-taking. What’s more, this is not just happening in the US. Many regional equity markets are also exhibiting better breadth and small-cap outperformance—including the emerging markets and even Europe, where fears of Brexit, that UK voters will choose to leave the EU, are now extreme.

Late Cycle
While our more constructive view of markets this year has been fairly out of consensus, our view of the fundamental story line has been even more so. We believe the global economy experienced a recession last year and this negatively affected many of the old economy sectors, particularly energy, materials and industrials. It also had a disproportionately negative impact on Europe and emerging markets, which are more sensitive to commodities and the manufacturing/industrial part of the global economy. We believe that recession bottomed in the fourth quarter of 2015, which is about the time we started to notice relative outperformance from industrial and materials stocks. Energy stocks didn’t bottom until January, but they have caught up quickly and are currently the third best-performing sector in the S&P 500 for the year to date, up 11%. The other five sectors leading this year’s performance are utilities, telecom, materials, consumer staples and industrials. This is classic late-cycle sector leadership. Meanwhile, early cycle sectors such as financials, consumer discretionary, health care and technology have lagged the broader index and are down so far this year.

Some of you may be asking, “If we had a recession last year, shouldn’t the early-cycle sectors be doing better, not worse?” Not necessarily, because the old economy sectors were in recession; thus, the cyclical recovery we are now experiencing should affect these late-cycle sectors more than the traditional early-cycle sectors for which things have been humming along unabated for seven years. The real message is that we are closer to the end of the broader economic expansion than the beginning, even if we are experiencing a new cycle in energy, materials and industrials. This is important to keep in mind as we move through the rest of this year and into 2017.
Further supporting this late-cycle view was the May employment data reported earlier this month. New payrolls came in much lower than expected even after adjusting for the Verizon strike, which affected 35,000 workers. Many commentators made the case that we are heading into a broader recession imminently, and this is why long-term interest rates have continued to plummet and now sit at just 1.6% for a 10-year US Treasury bond. The Global Investment Committee (GIC) does not share this conclusion. We believe long-term interest rates have been suppressed more by technical factors—global Quantitative Easing (QE), regulation, excess savings, fear, demographics and limited supply—rather than economic ones; and there is little fundamental information to be gleaned from watching the daily price action of the interest rate markets. Instead, the GIC thinks both economic and earnings growth is more likely to accelerate from here and into 2017 based on our leading indicators and recent data releases.

As it relates to the employment data specifically, we have looked at past economic cycles as a guide. What it tells us is that the employment market tends to peak approximately 34 months before the onset of a recession. Exhibit 2 does a good job of laying this out and the broader conclusions for investors. First, on a four-month rolling basis, US employment appears to have peaked in February, 2015. This has been a gradual affair until the past two months. Second, these data are highly volatile and affected by temporary conditions like the Verizon strike. Therefore, we would not be surprised to see a rebound to the more gradual pace of deterioration later this summer. Third, the stock market has generally done quite well in the two years after the peak in employment and about 10 months before the onset of an eventual recession. Specifically, the S&P 500 has rallied 16.4% on average during these two years. This time around, the S&P 500 is flat since the peak in employment, suggesting we may have a big catch-up once we can get past all of these political events this summer. All three of these points support our overweight in equities and the continued rotation toward late-cycle sectors.

**Reality Check on the Fed**

While the Federal Reserve’s actions have always been a factor to consider for investors, they have taken on a new level of importance this cycle given the extreme skepticism around the Fed itself, its recent track record and/or ability to curtail asset bubbles and therefore its role in the financial crisis. As a result, it seems that almost everyone is now a Fed watcher and has an opinion about what it should be doing with monetary policy.
Notwithstanding the Fed’s role in creating the financial crisis itself, the Fed’s postcrisis management of the situation has been about as good as could be expected. The big debate now is how fast the Fed should and will be able to normalize the extraordinary policies it has been utilizing this cycle. However, there is one major flaw in how most investors are thinking about this normalization process that could affect how it ultimately plays out.

First, there was an incredible amount of attention put on the Fed’s first rate hike of the cycle last December. To me, this really misses the point of what has been going on for the past several years. Exhibit 3 is presented as a means of understanding what the Fed has been doing since the Financial Crisis and why they may not be as schizophrenic as many Fed watchers and market commentators have suggested. First, the chart shows the federal funds rate going back to 1985. Second, while the trend has been down during this longer period as the broad interest rate complex has also fallen, there are cyclical moves around expansions and recessions.

Notice in the Great Recession how the federal funds rate quickly dropped to zero to deal with the financial crisis and aftermath. However, the Fed realized this wasn’t enough to stop the negative economic loop associated with downturns. Enter QE, Operation Twist and other unconventional monetary policies. While it’s hard to know exactly how much these policies have stimulated economic activity, the Atlanta Fed has built a model to interpret these policies in terms of the federal funds rate. As you can see on the chart, the model estimates that QE and other extraordinary policies were able to lower the effective federal funds rate by another 3% after they had reached the zero bound, effectively taking the fed funds rate to -3% at its trough. Not coincidentally, -3% is approximately where the Taylor rule—or the central banks’ guideline for altering interest rates based on economic conditions—suggested the federal funds should be given the dire condition of the US economy at the time. Most importantly, it worked by stopping the economic contraction and then supporting the economic expansion we have enjoyed since the advent of these policies.

We can also see on the chart that the Fed began to normalize its policies in 2014 with the end of QE—yes, tapering is tightening, which effectively raised the federal funds rate by 3% and took it back to zero. Therefore, the Fed’s 25-basis-point hike in December was far from the beginning of policy normalization. In fact, one could argue we are over 75% of the way through with this policy normalization cycle based on historical experience. In every prior rate tightening cycle by the Fed going back to 1985, the Fed has raised the federal funds rate by exactly 4%, at which point the economy peaked and then rolled over. Assuming the Fed has already raised by 325 basis points, according to the analysis above, we would only have 75 basis points, or three more hikes, to go. As a result, we think the Fed is right to be slow and careful with its next moves. This is not schizophrenic at all since the margin for error at this stage of the cycle is small. Taking the analysis a step further, we continue to believe the Fed is on hold until December for its next hike and then may be able to hike twice more in the first half of 2017, at which point the economic expansion is likely to finally roll over into recession. This jibes quite nicely with the labor market analysis above and the recent rotation toward late-cycle stocks.

**Brexit Update**

Given the recent market action, I would be remiss not to offer our current views on the upcoming referendum for the UK to leave the European Union—the so-called “Brexit.” While we have no particular insight around the outcome of this vote, there is no doubt the risk of a “Leave” outcome has increased over the past month based on the many polls and betting sites we monitor. At the moment, we think there is now a 40% chance that Brexit happens, up from 25%-30% just a month ago. This rise has not been lost on the market, with the cost to hedge such an outcome moving dramatically higher as seen in the one-month implied volatility for the British pound (see Exhibit 4, page 5). Not since the financial crisis itself, has it been so expensive to hedge the
Our experience with such events leads us to treat this as a “known unknown”—meaning we know the event is coming, but we are uncertain of its outcome. With fear rising as we approach the event, the financial risk has been somewhat mitigated already, if not completely. Should the Brexit actually occur, we suspect there will be a few more scary days for financial markets, but the recovery should be quick. We use 9/11 as a means of providing some context for readers. Unlike the Brexit, 9/11 was an “unknown unknown”—meaning markets were unaware of this event before it occurred and therefore unprepared for its impact on asset prices. Very little hedging had taken place, leaving sentiment and positioning more “normal” than what we are witnessing today. Unsurprisingly, the S&P 500 fell 13.5% in the five days following the completely unforeseen horrible acts of 9/11. Perhaps shockingly, the S&P 500 then recovered all of those losses in the next 13 days, ending the year up more than 5% from Sept. 10. The bottom line is that we recognize Brexit could lead to a bad outcome for financial markets with increasing likelihood as we approach the actual event. However, a lot of bad news has now been priced and we fully expect a sharp recovery no matter what the outcome.
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S&P 500 INDEX This capitalization-weighted index includes a representative sample of 500 leading companies in leading industries in the US economy.

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