Creative Global Investments

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Steven Gluckstein
Global Strategist
sgluckstein@cg-inv.com
Tel: 732 768-8843

Creative Global Investments LLC
115 East 57th Street
11th Floor
New York, NY 10022
Tel: 212 939 7256

Creative Global Investments/Europe
5, op der Heed
L-1709 Senningerberg
Tel: (352) 2625 8640
Mob: (352) 691 106 969

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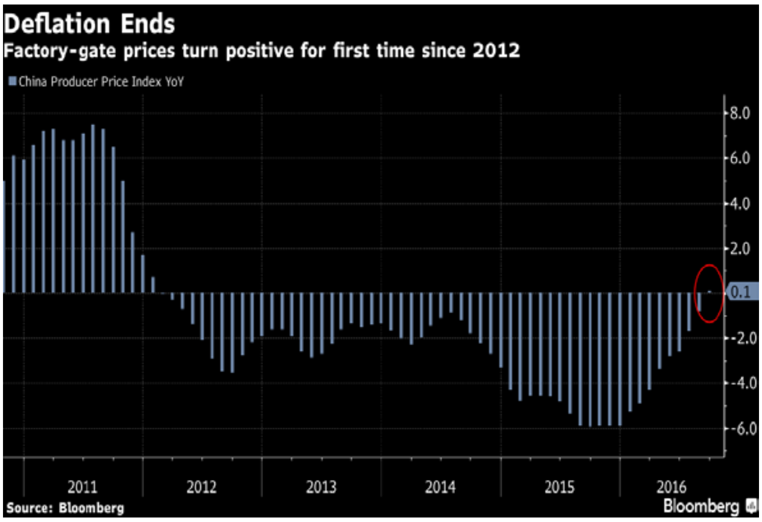
Secular Stagnation, Black Swans and Things That Go Bump in The Night

Although we all grow up, some of us never outgrow our fears. Just as children huddle under the bedcovers in trepidation that one of the “Wild Things” will leap out of the closet after the lights are turned off, many investors now live in fear as the Wild Things of their childhood have morphed into the dreaded “Black Swans” that all but incapacitate them as hiding under the bedcovers has been supplanted by hiding in cash. There’s no shortage of potential black swan events: war, disruptive natural disaster, nuclear (terrorist) incident, crippling cyber-attack, presidential election challenge, major bank failure and some would even argue in the current environment rising interest rates. While conceivable, none of these things can be foreseen with certainty. **Other than portfolio insurance for tail risks, worrying oneself into inaction is a useless and unproductive exercise.**

The U.S. economy and the broader influences of the global economy don’t justify a rate hike now or in December, but the Fed is caught in a trap of its own making. It postponed earlier opportunities to raise rates citing reasons external to the U.S. economy such as China and Brexit while maintaining that it would still raise rates before year end. The Fed has no choice but to raise rates in December to maintain credibility. One could reasonably argue that **the market has already been pricing in an increase as yields have risen over the past month although the flattening yield curve must be disconcerting for the Fed.**

Nonetheless, per recent commentary by FOMC members the economic backdrop for the “data dependent” Fed has been construed to be supportive for a rate increase given the Fed’s dual mandate for full employment and two percent inflation. Headline inflation is set to rise for at least the next six months as oil laps its steep decline of a year ago. Of course, the headline inflation figure is not the metric used by the Fed. The PCE price deflator (1.7% annualized) is the preferred measure of inflation used by the Fed and energy is removed from the core inflation calculations (some oil prices feed through where oil factors into cost of goods sold for some manufactured goods). Some observers may believe that this will provide cover for the Fed to act, but we doubt that the Fed would use it as justification for a move. Chair Yellen has repeatedly referenced the transitory nature of energy prices when they were declining and would have to repudiate that view to take the recovering prices into account to help justify a rate hike.

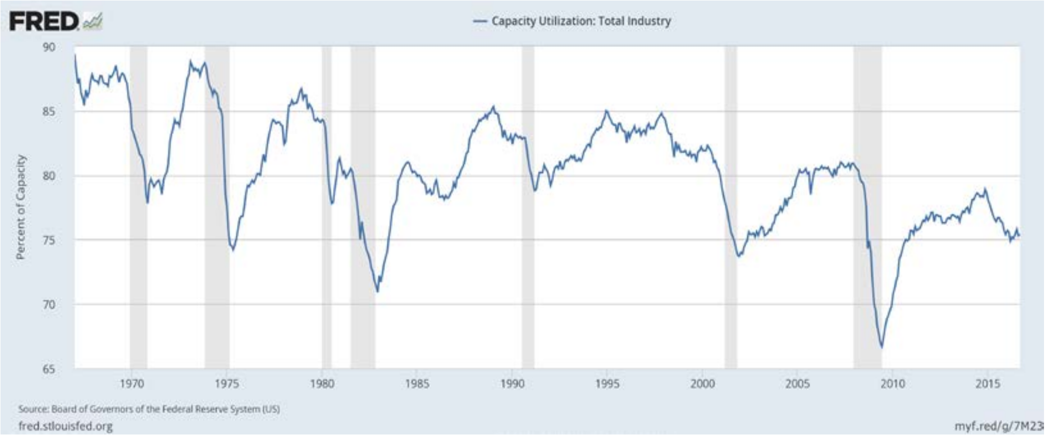
However, there is another source of rising inflationary pressure that isn't transitory and which will affect the core inflation rate. Since before the turn of the century China has increasingly exported deflation to the rest of the world, especially to the USA, its largest export market. Domestic inflation pressures have been building in China through rapid expansion of credit and rising wages that are no longer being offset by rising productivity. Stabilizing economic growth coupled with bottoming commodity prices since the beginning of this year have combined to finally force producer prices higher to result in September being the first positive monthly print for PPI in almost five years.



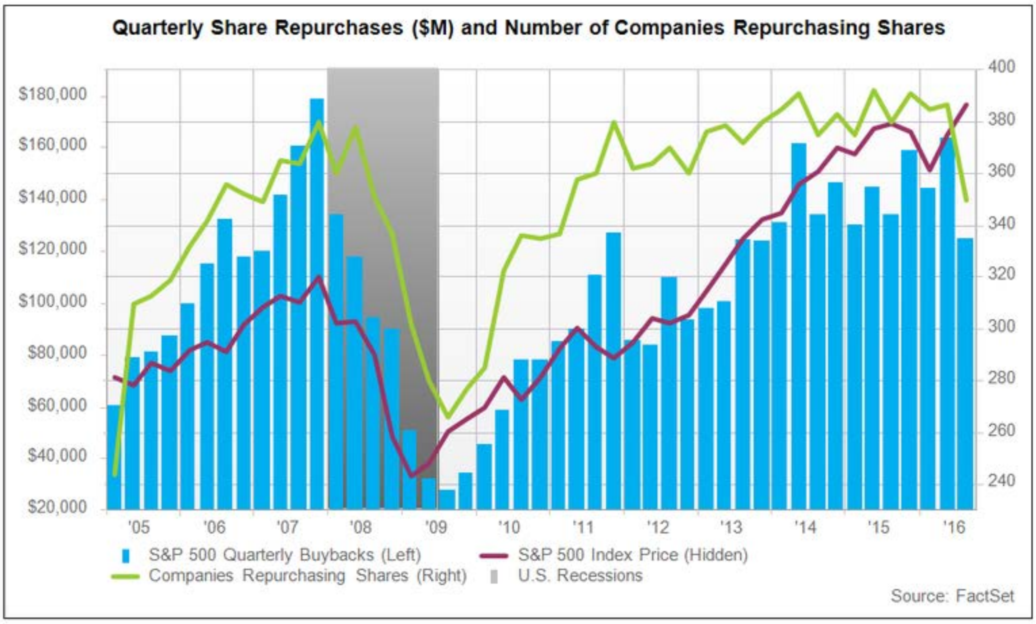
These higher input costs will filter through to export prices and provide some pricing cover for foreign competition. **While this will now become an inflationary input for U.S. consumption, we don't expect that it will immediately push PCE above two percent, which based upon Janet Yellen's comments no longer appears to be the line in the sand that it once was and can't be used to justify raising the fed-funds rate at this time.**

However, we see little evidence of upward wage pressure and even less of wage-driven cost-push inflation. Media stories of retailers having difficulty filling temporary holiday worker positions along with unfilled positions for skilled manufacturing workers help create an impresion of tighter labor conditions reinforced by near-record job openings. We view this as somewhat illusory since, in our view, the data is partially explained by the demograpics of a growing but rapidly aging population that has kept the labor participation rate historically low. We believe that many workers have recently started to return to the labor force not due to the enticement of rising wages but out of necessity as they experience a deteriorating standard of living due to mounting pressures on household budgets driven by rapidly escalating health care costs, taxes and lower returns on retirement savings. It is not because they have a choice but because they lack an alternative. The continued late-cycle growth in jobs without accompanying wage pressure proves that slack in the labor market still exists. **The low headline unemployment rate no more justifies a rate hike than the inflation rate—proving that raising the fed-funds rate is all about saving face.**

Chair Yellen speaks of the possibility to run a "high pressure" economy with robust aggregate demand and a tight labor market to reverse some of the negative effects of the Great Recession. Many interpret this to mean that the Fed will stay "lower of longer". They're right. Some like Jeffrey Gunlach, CEO of DoubleLine Capital believe that this indicates Yellen subscribes to Larry Summer's hypothesis that secular stagnation or a lack of demand is responsible for pushing down growth. We believe that this point of view can no longer be so easily dismissed now that we're in an environment of both real and nominal global negative interest rates. Ample anecdotal evidence exists when one surveys the lack of loan demand plaguing most developed markets despite record low interest rates. The entrenched output gap with five decades of declining capacity utilization and underinvestment in productive assets adds to a compelling case.



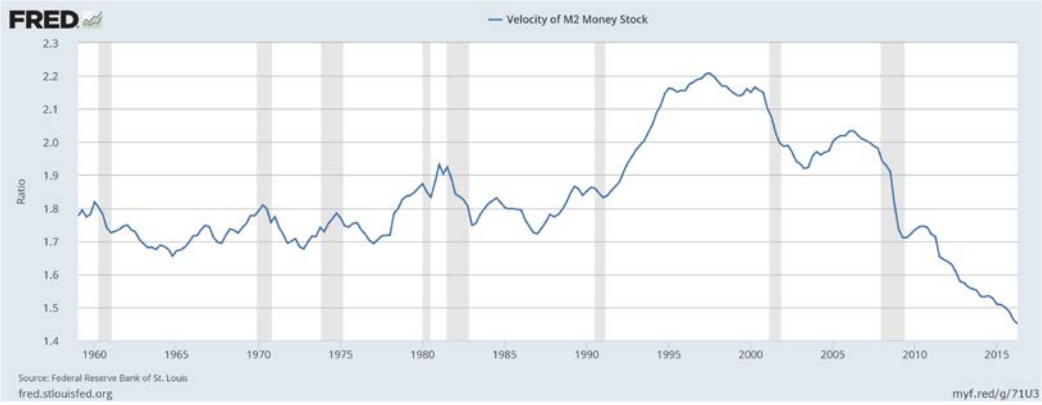
Although small, we note a nascent rise in capital spending coincident with a significant decline (see graph below) in the number of companies buying back shares in the second quarter. It's not yet a trend but perhaps we're seeing the first early signs that company managements are beginning to reallocate capital away from financial engineering to direct investment in their operations. **If confirmed, this has positive implications for the economy but removes a pillar of support for higher stock valuations in place for the entire run of the current bull market.**



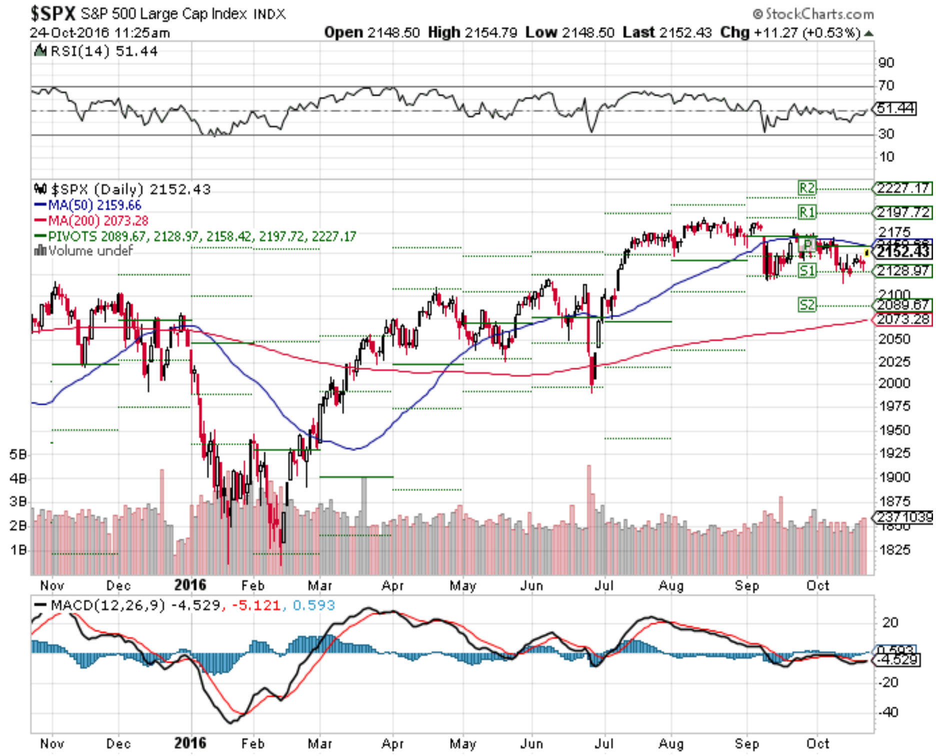
Most market participants have been caught off guard by the strength of the US dollar. Frankly, we've also been surprised by the extent of its resurgent strength. On the other hand, given the ongoing easing by the European Central Bank, Bank of Japan and the People's Bank of China juxtaposed to the incipient tightening by the Fed, a rising dollar would be the expected natural outcome**.** The dollar has broken through resistance on the daily chart and while it is overbought, we see little likelihood of a trend reversal near term. Neither do we see the dollar breaking out of its long-term trading range.

As the futures market continues to price in an increasing probability (currently 73%) of a December rate hike, we expect that the dollar will grind higher to test the 100 level where it peaked last year in front of last December's rate rise. We anticipate similar price action running up to the December FOMC meeting (with perhaps a minor dip after the November 2nd meeting). We believe that the Fed will emphasize a shallow and elongated glide path for further rate hikes in its meeting statement and subsequent press conference that will provide the catalyst for 1) the dollar succumbing to profit taking as it finally rolls over and 2) lower Treasury yields that we still believe will revisit lower levels in the absence of stronger U.S. economic growth. However, if the other major central banks sustain (or even increase their stimulative efforts as the ECB has hinted), any dollar weakness could be temporary with the strong dollar a drag on S&P 500 earnings during the first half of 2017.

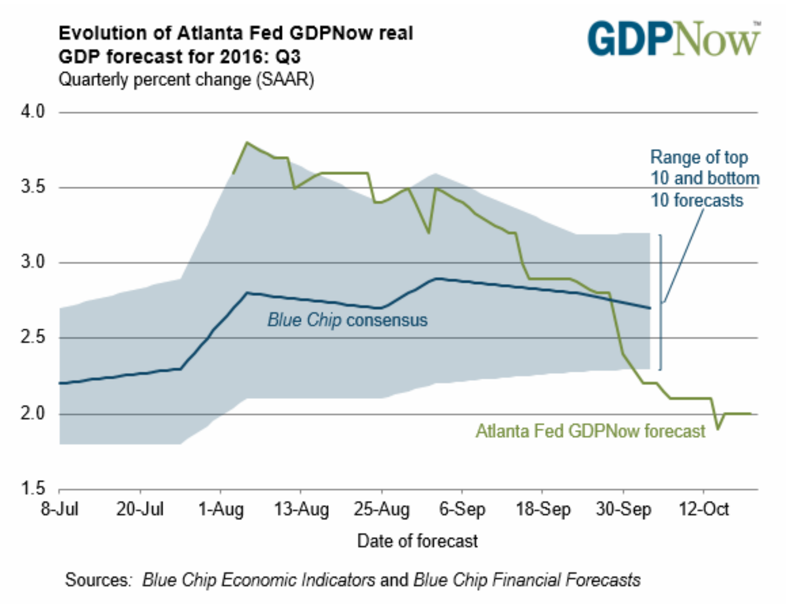
Even if the Fed decides not raise rates in December, it has still been quietly draining liquidity from the system through the repo market. We noted the same behavior earlier this year (see "Fed Policy (Or the Lack Thereof) Exposed" February 10, 2016), **which helps explain the resilience of the US dollar that continues to confound so many traders.**



Notwithstanding a shallow glide path for future rate hikes, even a quarter point raise is not without meaningful risk to the economy. Just look at the aftermath of last December's rate increase to see the market repercussions of what many viewed as an innocuous move. **Most market strategists and financial pundits observe that currently there is no sign of a recession. What a surprise! They never see it without the benefit of hindsight in the rearview mirror.**



Third quarter earnings have been exceeding analyst estimates by 7%, which is above the average of the past five years per FactSet. This further supports the view of the Fed that the broad economy is strengthening even though the FOMC now expects real GDP growth of only 1.8% for this year, which is below trendline for the past five years. The economy is forecast to grow 2.0% next year before slowing to 1.8% in 2018, tepid by the standards we've become used to until the current economic expansion.



This is the quarter's busiest week for earnings with 40% of the S&P 500 reporting so we'll know within days whether the early outperformance for corporate earnings will be sustained. However, given the lowered estimates for just 2.0% GDP growth in 2017 juxtaposed to analysts' consensus forecast for 12.4% S&P 500 earnings growth next year, a disconnect exists that must eventually be resolved. Although forward guidance by managements has so far been mixed, we view it as insufficient to dissuade bottom-up analysts from maintaining higher 2017 estimates. Although top-down strategists may be tempted to modestly trim estimates, the degree to which they do so will be largely determined by their forecast for oil prices that most believe will average higher prices next year. On the other hand, better than expected earnings and more optimistic forward guidance could ignite a market rally. **Most investment professionals have been raising cash and tilting portfolios in a more defensive direction and are consequently unprepared for improved earnings expectations, which could cause the market to "melt up" as they are forced to chase performance given more recent cautious portfolio posturing.**

While we've cautioned for some time that the stock market is vulnerable to correction, now is not the time. Through the second calendar quarter, S&P earnings have declined for five quarters in a row. The better than expected earnings reported to date for the third quarter appear likely to break the cycle of down earnings. Per FactSet, with 23% of the companies in the S&P 500 reporting actual results for Q3 through last Friday, more companies are reporting actual EPS (78%) and actual sales (65%) above estimates compared to the 5-year averages. In aggregate, companies are reporting earnings that are 7.0% above the estimates. This percentage is above the 5-year average (+4.4%). The blended earnings decline of 0.3% is much better than the estimate of -2.0% at the start of the month. We still detect skepticism among investors regarding the potential for companies to exceed estimates and guide higher. **If last week's reporting trend carries through to this week with its broader mix and much larger (178) number of S&P500 companies set to report, investor skepticism may start to abate.**

The headwinds building for the market aren't new. Political uncertainty that has paralyzed many investors will be resolved when voters go to the polls in two weeks. And while there will eventually be a reckoning by market forces, we suspect that it will occur from higher levels. **Don't fear the things that go bump in the night.**

Carlo R Besenius, CEO & Head of Global Strategy
cbesenius@cg-inv.com
office: +(352) 26 25 86 40
mobile: +(352) 691 106 969
Luxembourg/Europe

Steve Gluckstein, Global Strategist
sgluckstein@cg-inv.com
office: 212 939 7256
mobile: 732 768 8843
New York, NY, USA

Sabine CJ Blümel, Head of Global Automotive Research
sblumel@cg-inv.com
office: +44 (7785) 301588
London, UK

Marc Peters, Head of Global Industrial Strategy
mpeters@cg-inv.com
office: +(352) 26 25 86 40
mobile: +352 621 36 44 50
Luxembourg/Europe

Gary Schieneman, Managing Director,
Global Accounting and Finance
gschieneman@cg-inv.com
office: 917-868-6842
New York, NY, USA

Allison M Cimon, Director of Sales & Technology
amcimon@cg-inv.com
office: 646 228 4321
Boston, MA, USA

Feliks Lukas, Director of Corporate Consulting
flukas@cg-inv.com
office: 212 939 7256
mobile: +(385) 9848 8951
Kastela, Croatia

Jennifer Crisman, COO
jcrisman@cg-inv.com
office: +(352) 26 25 86 40
Luxembourg/Europe