Fasten Your Seat Belt

January 21, 2016

By Peter Scholtz

The recovery has been slow since the deep 2008-09 recession. This has led leading economists to expect a rather lengthy expansion, slowly absorbing the large amount of economic slack. This is reasonable. I have never been a fan of measuring average cycles and forecasting an end based on an "average" economic cycle. I have seen a cycle last one year and one effectively lasting 17 years. A cycle ends due to conditions, not time, and six months ago I thought this cycle could last several more years. However, it is starting to take on "end of cycle" characteristics such as Fed tightening and accelerating labor costs. Beyond the United States, cracks in the global economy continue to grow. It is now time to prepare for potential weakness in the stock market as a result of these deteriorating conditions. The current situation is unusually complex so I have broken down the problem into pieces, hoping that together they form a picture of what is likely to happen in 2016.

U.S. Economy: The U.S. economy appears to continue to "muddle" along. On the positive, the United States is finally beginning to see wages accelerate as the labor market tightens. Increasing wage growth has been the sole hope for increasing economic growth through strong retail sales and a better housing market. Unfortunately, some economists are now forecasting slower job growth perhaps due to higher wages or difficulty in finding people for certain positions. In addition, Mexican immigration is now negative, so there is a lack of new labor supply. The wages took too long to pick up and there is no longer enough slack in the labor market in order to hit the optimal scenario of strong job and wage growth. Average Hourly Earnings are expected to increase from 2% per year to 2.5% while payroll growth is predicted to be around 200,000 per month as opposed to the 250,000 we have seen recently. The problem is that the increase in wages will be partially offset by the slowdown in job growth. Similarly, the consumer balance sheet has improved, but there are some offsets to spending. Consumer debt has declined, and debt service as a percent of disposable income is at the bottom of the range. The consumer is also benefiting from low gasoline prices. However, consumer behavior seems much more conservative than in the past, perhaps as a result of the recent recession. The new "smarter consumer" seems content to live more within their means. Strengthening rents and the beginning of a rate hike cycle are not helping either. As such, real consumption has been decelerating since April. Beyond the consumer, other areas of the economy remain lackluster. The trucking industry, a good economic indicator, is very weak. Industrial production peaked in August and is off its highs for the first time in this cycle. Housing is growing, but more moderate than past cycles. The economy's productivity has been stuck at a low 0.5% per year and has persisted for three years at this level. It is usually closer to 2%. Further, the strong dollar has taken its toll on both exporters and overseas profits. Our imports are growing at 2.8%

while our exports are growing at only 1.8%, creating a drag on our economy. All of this adds up to real GDP growth year-over-year in steady decline since July, falling from 3.1% to 1.5%.

Global Economy: Unfortunately, the mediocre U.S. growth is one of the bright spots in the global economy. The key variable on the world scene is China. The Chinese Yuan has been declining, and it has started a massive capital flight out of China. As noted by the widening spread between the official Chinese Yuan exchange rate and the Yuan traded freely on the Hong Kong market, the Yuan remains overvalued. China's reserves have dropped 20% trying to stem this problem. The core issue here is that the Chinese industrial complex is very weak. Capital spending on factories and empty cities was 45% of Chinese GDP. The U.S. capital spending figure is around 15%. The disruption is the transition from an export-led industrial economy to one that is more consumer oriented. Giving its people more wealth and individual economic freedom has both political as well as economic risks. To ease the transition, the Chinese are attempting to stimulate their economy, but it is still decelerating. The real tell for the rest of the world is that Chinese imports and exports are hitting new lows. It is contributing to weakness in Taiwan, Japan and the rest of Southeast Asia. Japan's consumer is very weak. Even India, a strong beneficiary of lower oil prices, has started to see its PMIs drop and its economy slow. Elsewhere, the commodity economies like Brazil and Russia are still mired in recession. Canada, our largest trading partner, has no growth. Europe is OK, but there are no signs of meaningful acceleration. Overlaying this global weakness is a rising dollar that has put additional pressure on companies and governments outside of the United States that have borrowed in dollars. The value of their debts have ballooned in local currency terms resulting in credit insurance (CDS) prices to rise. Financial strains and potential debt defaults are beginning to appear.

Inflation and Fed Policy: The oil weakness is in its final stages, and the markets will likely be in balance by late 2016. Influenced by speculators, oil should bottom in price well before the end of 2016. Service inflation is at a six year high. The effect of rising oil prices, combined with higher health insurance costs, rising rents and higher wages, will create higher headline inflation of around 2% later in the year. Since before 1960, the Fed Funds rate was never below the core inflation rate until 2009. This creates distortions, bidding up prices of certain assets and creating investments in projects that would not be economic otherwise. Ultimately, it can also create rapidly accelerating inflation. The Fed, sensitive to this problem, wants to raise interest rates four times over the next year to get back to a "normal" interest rate. They wanted to raise rates in September but held off due to turbulent global conditions. Conditions have not improved, but they raised rates recently anyway to stem their loss of credibility and show confidence in the domestic economy. Raising rates also strengthens the dollar which aggravates the global financial stress. They will probably not raise interest rates as much as advertised for although "normal" is good, rising rates will strain the system. If they have to lower rates and renew quantitative easing due to weak global economic conditions, you can be sure we are in real trouble. Either the Fed raises rates, creating financial strains, or they keep rates the same indicating concern of economic weakness. The Fed does not have good choices.

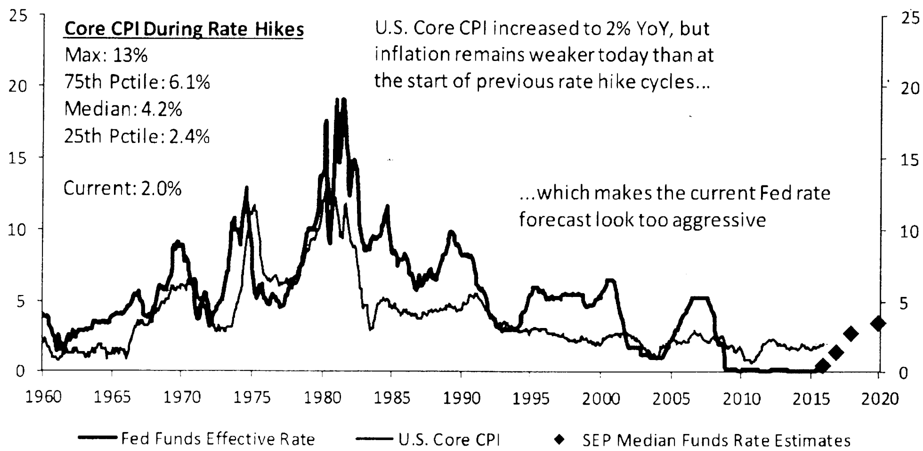
Capital Markets: The trade weighted dollar has broken out to new highs, dampening U.S. exports, U.S. companies' foreign profits and putting stress on overseas dollar borrowers. Lower quality bond rates have widened, especially in the energy sector, both in the United States as well as abroad. U.S. oil company bankruptcies are starting to accelerate. Petrobras in Brazil is in serious trouble. Carl Icahn believes we are in "the beginning stages of a junk bond problem." Bond funds have experienced outflows since the Fed raised rates while stock funds have had retail outflows all year. The S&P 500 looks sick. The stock market technically is weak and the S&P looks like it is rolling over after a strong six-plus year run. This weakness is highlighted by the fact that only a few mega-cap names seem to be "working." While the S&P 500 was down 0.73% for 2015, the average (median) stock was down 4.73%. Coupled with the narrow leadership, S&P earnings for the last two quarters have had negative growth and little growth is expected for 2016. Valuations are above average and offer little support to stock prices. With U.S. quantitative easing over, stock market volatility has increased. It is hard to imagine an explosive move to the upside in this environment.

Conclusion: The risks are rising for the U.S. economy. There are no signs of an imminent recession, but many indicators continue to decelerate. With the Fed wanting to raise rates and the dollar continuing to strengthen, exports and commodities have been weak, and world credit stress continues to build. If the United States does not have a recession, it will have recession-like characteristics that will be reflected in the stock market. While the market may have a near-term bounce, lower stock exposure and investing in defensive names seems to be the best strategy for most of 2016.

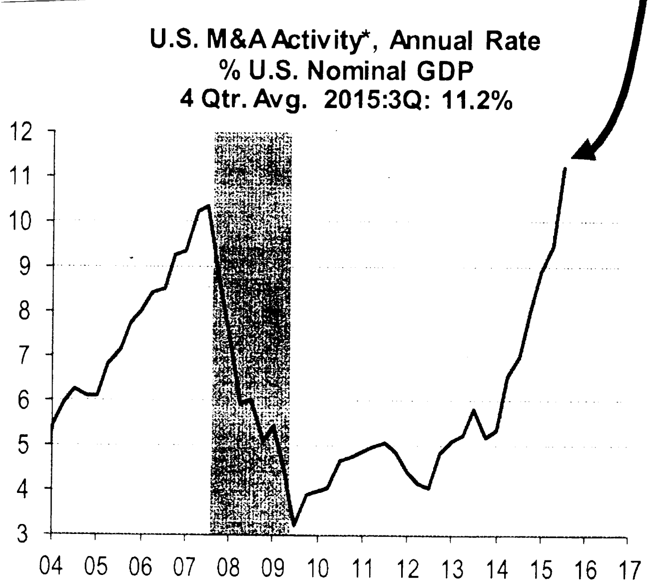
U.S. Equities Poorly Positioned for Fed Rate Hikes

In addition to the likely negative impact of Fed rate hikes on equity multiples, the inflation backdrop in the U.S. raises concerns about the impact of higher short rates. From 1966 till 2004 the Fed never raised rates when core inflation was 2% or lower. The Fed's proposed 1% increase in the funds rate for 2016 would tighten policy at a time when the recovery in inflation remains subdued.

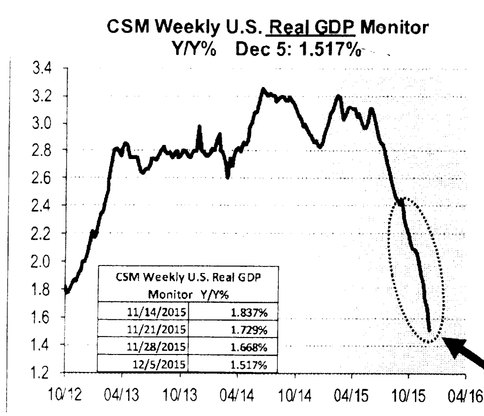
Core Inflation Remains Unusually Low for Rate Hikes



What happens when this declines?



* Proposed, Pending, & Completed Deals.



This is quite low

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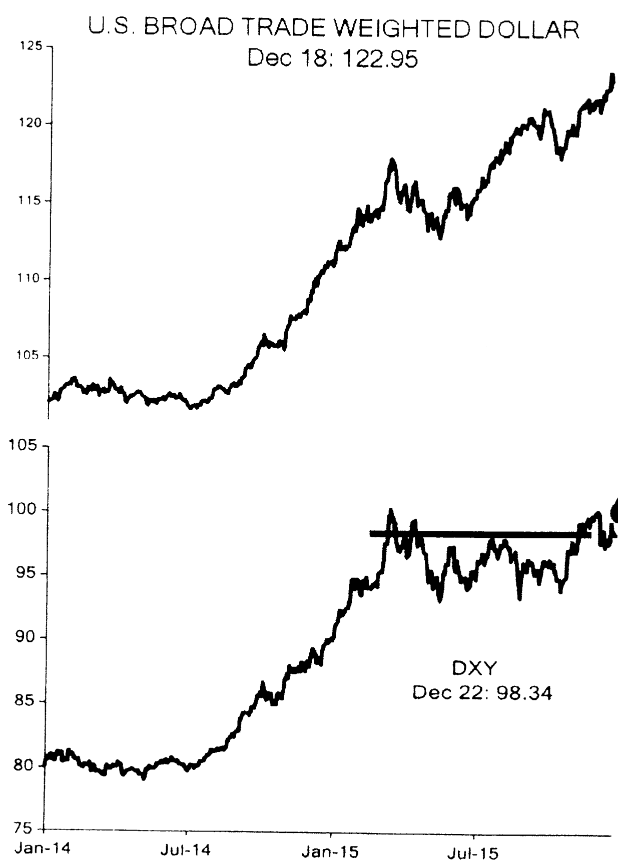
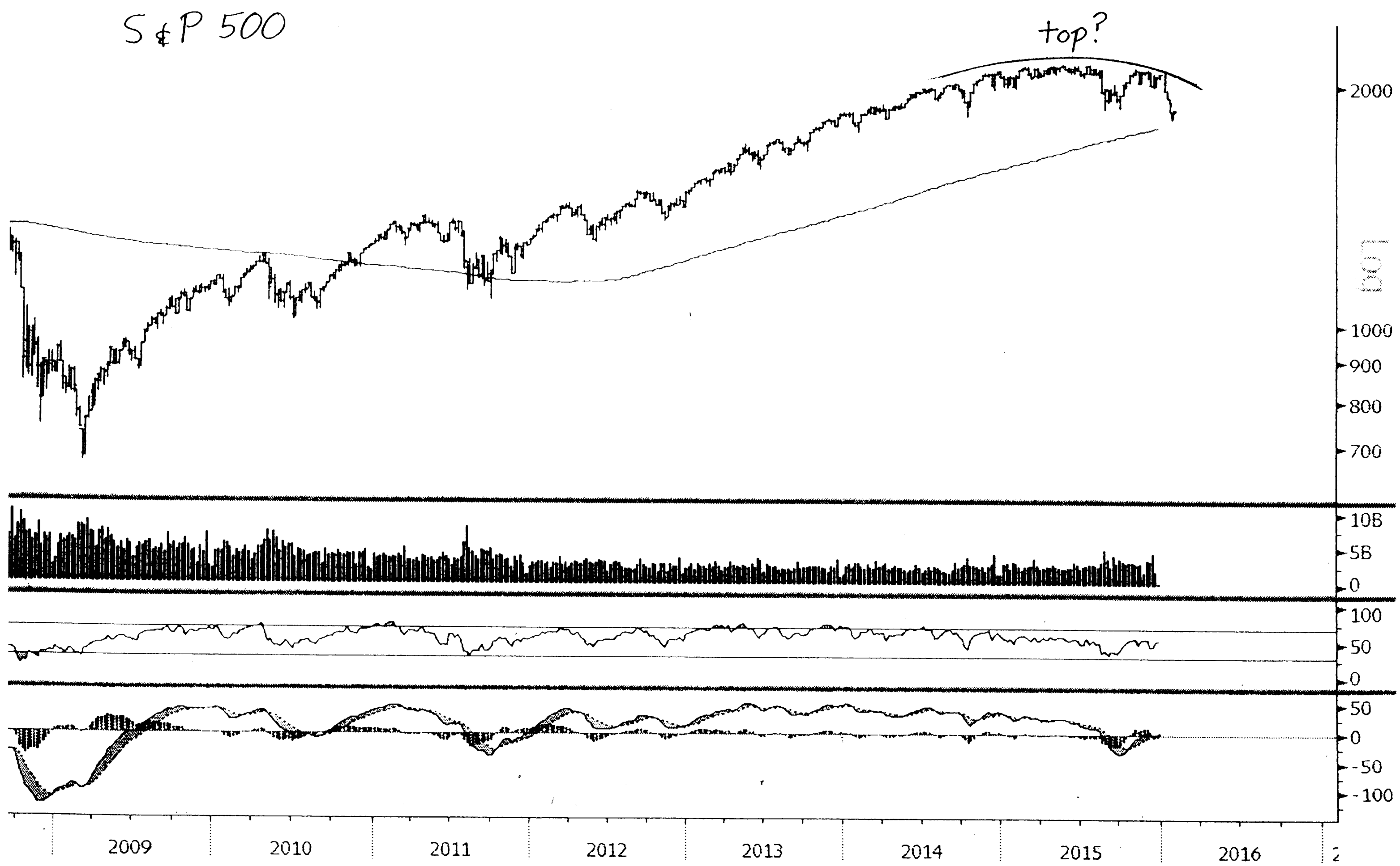
Trade-Weighted Dollar Continues to Make New Highs

Although DXY has been basically unchanged over the past nine months, the TW$ has continued to make new highs. DXY is composed of mainly the euro, the yen, and the pound, ie, it does not include currencies of China and South Africa. This TW$ strength helps explain the weakness in commodity prices, and it puts downward pressure on US inflation in general, including the **core PCE deflator**.

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