Follow the Money

By Carl H. Scholtz
October 18, 2016

For many investors, 2016 has been a strange and difficult year. Most of us are fundamentally driven investors who look at both the global economic data and the bottoms up company specific data to determine where to allocate capital. It does not take a genius to figure out that when a recession is imminent, you may be best served by stepping to the sidelines. So, with generally mediocre and weakening economic data throughout the year, why is it that the market seems to be indestructible? Even after the United Kingdom voted to leave the European Union, a major economic event with broad implications for the European economy, currency and trade system, the market was down sharply for only two days. Within a week, the S&P 500 was making new highs. What gives? The answer is the flow of money. The capital markets have been so overwhelmed by the excess liquidity and the flow of excess cash that the weak fundamentals have not been weak enough to cause a severe drawdown.

The phrase "it's different this time" is commonly used by people (or investors) when the data is telling them one thing and they do the opposite. It rarely is "different this time." Thus, when I see key economic data that point to a recession over the next 12 months, I take particular notice. Industrial production data is a great example. There have only been two other periods since 1926 where industrial production has been negative year-over-year for two consecutive months or more without being in a recession or on the precipice of one. Currently, industrial production has been negative year-over-year for 13 straight months. The prior record without a recession was 4 months. If it was only industrial production, I may be able to dismiss it as the rise and fall of the U.S. energy patch. However, there are multiple other areas that raise concern. Corporate profits, which typically peak 18 to 36 months before the beginning of a recession, are set to be down year-over-year for six consecutive quarters, including down 4.3% in the second quarter. Besides the earnings ramifications for the stock market, this kind of corporate profit recession has implications for future hiring and capital spending. Other closely watched indicators such as the Leading Economic Index ("LEI") and the Labor Market Conditions Index ("LMCI") are turning negative as well and have historically been great predictors of a recession. On the back of U.S. GDP growth of about 1% in the first half of 2016, the data just doesn't show a strong economy. The point is more to the fact that any rational investor would tread cautiously.

Despite the weak economic data and corporate reports, the market is +5.85% for the year with low volatility and minimal drawdowns outside of early February. Stocks go down because there are more sellers than buyers. When you have a group of global investors who are mandated to buy, the fundamentals start to matter less. The first obvious area of excess liquidity is being driven by central banks. The combination of the Fed, the European Central Bank (ECB) and the Bank of Japan (BOJ) alone has kept short rates extraordinarily low as well as implemented significant bond purchases as part of "Quantitative Easing" programs as a means to aiding economic growth. Both the ECB and the BOJ are even running out of available bonds to purchase with the ECB planning to relax its rules and the BOJ even purchasing stocks as of several years ago. The real impact of these actions is to soak up all of the supply of bonds and drive rates to extremely low levels. For example, German 10-year rates hit negative 0.18% in July. Investors literally had to pay the German government for the privilege of holding their bonds. Suffice it to say, this kind of extreme bond positioning has forced many investors out on the risk curve in a move toward return, especially high yielding equities (or "bond proxies"). Yet, the money flows haven't just been driven by central banks. Over the past 18 months, corporations also have been on an epic buying spree. In an effort to boost their earnings per share given the languishing global economy, many companies have aggressively bought back stock. Overlaid with big activist pressure and a low cost of borrowing, S&P 500 companies have spent more than $850 billion in the past 18 months buying their own stock. The first quarter of 2016 was the highest level ever at $161 billion. The one area going the other way is the equity mutual fund data where year-to-date outflows have been $120 billion (offset by ~$45 billion of equity ETF inflows). The buybacks have utterly dwarfed this number though. Lastly, the IPO market has been the weakest since 2009, so there isn't much new supply coming to market. For these reasons, the world has been awash in liquidity, and much of the market is being driven into the U.S. stock market in particular as the best economic house in a bad neighborhood.

One of our biggest concerns is that these money flows may be peaking. The Fed has already ended its own QE program, raised rates one time and seems poised for another hike in December. There are rumblings that the ECB is considering tapering its QE program in March, and the BOJ has changed course by targeting a zero 10-year bond rate as opposed to driving rates further into the negative. More definitive, however, is the recent rollover in corporate buybacks over the last quarter. In the second quarter, S&P 500 buybacks were down 21% from the first quarter and 3.1% year-over-year. A big part of this is that companies have been paying out more in dividends and buybacks than they earn. To cover the gap, they have been borrowing money, but this isn't sustainable. Simply put, if the money flows continue to diminish, it is very hard to see equity markets staying elevated without a corresponding improvement in the fundamentals.

Taken together, the landscape appears troubling, but all is not lost quite yet. The economy has been muddling along for several years and there are still some other positive data points to suggest it may continue. Specifically, I would point to a solid September PMI data point and retail sales, an oil price recovery (and its impact on the energy industry), higher wages and a more stable U.S. dollar, which should reduce the FX headwind on corporate profits. We thus remain focused on the money flows. As long as the liquidity remains, a long market drawdown doesn't appear likely. If the liquidity continues to dry up, the fundamentals had better improve quickly.