July 17, 2017

DO NOT FIGHT THE CENTRAL BANKS!!

If you are not familiar with the investing axiom "don't fight the Fed" then it is worth a Google search as it is famous in the investing world and a major market mover especially for macro investors. Basically it tells investors to go long on equities when the FED is in accommodative mode (i.e. lowering rates) BUT be cautious when the FED is tightening or raising rates (such as now).

We are now in a very unique situation where we have many of the central banks GLOBALLY in synchronous tightening mode….the US has done its 3rd rate hike in 6 months, the Bank of Canada surprised all with its rate hike (and more to come), China is now tightening, the ECB is considering decreasing its massive QE program, the UK is now moving towards tightening, etc.

The problem with tightening is that it removes liquidity from the economy and this is bad for equity markets as liquidity is the fuel that keeps the party going! Central banks globally are now telling us that it's time to reel in this party as they are seeing risky excesses everywhere (i.e. frothy equities, real estate bubbles, massive corp debt etc.), and it is their mandate to try to limit these excesses and the subsequent economic-financial damage that occurs at the end of all these long cycles/parties created by very loose policies and accommodative Central banks.

Timing the exact top in these market cycles is impossible, but the fact that we are seeing so many Central Banks tightening tells us that we are very, very late in this cycle and this clue should have investor alert antennas very elevated right now.

This is especially true in the context of such a long bull market (second longest ever) and at a time of rich valuations (likely the second most expensive ever).

As always there are the greedy Bull arguments to stay the course a little longer and the fearful Bear arguments to raise cash ASAP—here are some of these viewpoints:

BULL ARGUMENT—STAY THE COURSE (a little longer)

1. Rates are still relatively low so still accommodative for cheap buss borrowing and consumer spending (through more cheap debt accumulation) and this will keep spending-revenues and earnings going, the bulls claim

2. Earnings last quarter were "excellent" (at 13% growth) and analysts expect the same this quarter (reporting just started this week fyi and expectations are for 6% growth)…this data will be important as will the CEOs guidance and outlook for second half of 2017

3. NO Recession in the cards is the consensus so any 5-10% correction is a buying opp.

4. Global economy is now picking up with the EU expanding and EM also doing ok with the falling US dollar

5. The unemployment rate remains very low and claims have not yet turned up—once the weekly unemployment claims start rising (i.e. firings) then this is trouble, BUT not yet so the bulls stay invested

6. Trump—if he gets the new Health Care Bill and/or Tax reform and/or Infrastructure spending through Congress then markets will respond very positively to this. You can be sure that he is feeling massive pressure here as the 2018 midterm elections happen only months away, and with his approval rating at only 36% he needs to pull a big rabbit out of the hat or face annihilation-embarrassment in the 2018 election. Trump is aware of this so he will work very hard to find this rabbit…and at any cost as this guy hates losing…if he is successful then the short term effect could be higher markets

BEAR ARGUMENT—BE VERY CAUTIOUS

1. The most important bear argument would be that many Central banks are now tightening and the axiom tells us "do not fight the Fed"…especially as it is the 3rd rate hike for the USA within 6 months (financial folk lore says it's time to exit markets after the 3rd rate hike in any rate hike cycle).
   But of equal importance is that at the same time the US is now about to start reversing its QE (Quantitative Easing) to QT ("Quantitative Tightening").
   Nobody knows how this will play out BUT it will pull liquidity out of the market-economy for sure (i.e. the cash that will be used to buy all these bonds and MBS that the FED is selling will NO LONGER be available to go into equities and real estate)!!
   If QE allowed for substantial financial asset growth from 2009-2014 (by pushing liquidity into the economy-market-and financial assets) then I expect QT (or removing cash from the economy) will do the reverse…this is a huge red flag for me as we simply do not know how this will play out as it has NEVER been done before on such a massive scale

2. Retail sales are again weak and there is no wage growth…the consumer is therefore tapped out as he-she has already pulled consumption from the future (and accumulated debt)! Declining discretionary Restaurant sales confirm this, which have been very weak to negative over the last 5/12s.
   IMPORTANT FACT--More US retail stores closed in the last 12 months than in all the 2008-09 financial crisis period!!!! And this is more than just Amazon (Louis Gave).

3. Signs of the last inning are multiple with declining auto sales, declining housing, declining credit growth at all levels, a peak in consumer confidence, a peak in margin use, peak profit margins…again reflecting that the consumer is tapped out, and which signifies for me the top for this cycle. But more important is the fact that the FED also sees this as late innings as they never raise rates until the late innings as they attempt to cool all these excesses that have accumulated from very loose policies i.e. QE, ZIRP, NIRP globally

4. Narrow breadth on stocks—the five FAANG stocks are the main stocks moving the markets and these are very frothy…smacks of the Nifty Fifty era…

5. The Bond market's signal continues to be one of caution with the 10 yr. stuck at 2.3% DESPITE rising interest rates. The short end of the Yield Curve is controlled by the FED but it's the markets that moves the 10 yr. and they are flashing caution as the Yield Curve remains very flat. Real trouble only happens when the Yield Curve inverts BUT history tells me that 85% of the time a flattening leads to an inverted curve (since 1975) and an inverted curves almost always leads to a recession!! This has my attention. Additionally, I know that China has the second largest economy globally and its Yield Curve is now inverted…that is a worry for me based on what history tells me, which is market's decline on average 38% with recessions…

6. We have seen no 5% correction in over a year—a rare event!!

7. Complacency is very high as reflected by the VIX Fear Gauge below 10 and the percentage of bulls vs bears

8. Flat GDP growth is a worry especially as the FED raises rates and starts QT—the Atlanta Fed GDPNow model projected second quarter GDP would be 4.1% just a few weeks ago and now it is at only 2.4%!! That is quite a drop and signals weak economic growth!

9. US Money Managers cash levels are <u>now lower</u> than at the market peaks at 2000 or 2007 so another sign that the herd is all in!!! (Barron's)

10. Several Leading Economic Indicators have turned down in the last 2 -3 months (OECD Composite LI, Conference Board LI, ERCI weekly index)

11. I see bubbles in many places, and I am sure the FED does as well forcing them to raise rates DESPITE no inflation and weak growth (GDP and retail sales)….e.g. cryptocurrencies (Bitcoin)

CONCLUSION

We are clearly in the last inning of this cycle-plain and simple!

Let's look at the KISS Facts:

The Fed and other Central Banks are tightening (which always occurs in the late innings) and this "shrinking liquidity" ALWAYS slows the economy and markets (yes with a variable time lag) as they want-need to "cool the economy and bubbles"!!

I am reminded that the famed Stan Druckenmiller has always stated that it is "liquidity that drives the markets" and not earnings and now this is in reverse! So what I hear from the FED is that now is a time to exert caution with my clients equity exposure.

AND this is happening at a time of tepid GDP growth and with a consumer that is showing severe spending fatigue (re declining auto's, housing, restaurants sales etc.). Again I sense caution and defense is needed with tightening under these circumstances.

There is also very weak wage growth further curtailing consumer spending (esp. now with the higher interest rate charges on mortgages, credit cards, loans etc.)!!

AND all of this is happening at a time when the Markets are very rich (and this the second longest bull ever)!! This all spells RISK to me.

Yes markets could climb further into 2018 (in fact they often do soar in the last 6 months before the end of the cycle as the HERD's greed factor goes viral-wild), BUT I have to go with the current facts and they tell me to remain defensive ESPECIALLY as we enter into the two worst months for the markets (Aug-Sept).

Finally, we have all had great gains over the last 7 years and so now is a logical time to be cautious—plain and simple.

I am also reminded about how confused some 'great minds" were in previous late cycle innings—e.g. in Jan 2008 , Fed Chairmen Ben Bernanke stated "the Federal reserve is not currently forecasting a recession" yet the recession had already began in Dec 2007!! My point is to avoid the media chatter around these times and look at HISTORY as your guide and history tells me to be very cautious right now!!!!!

I think the odds of a repeat Fed "Policy Mistake" is very high….but the FED knows that it must do something as the TRUMP agenda-gridlock has flat-lined despite all the optimism just 6 months ago…consequently this **is NOT A TIME TO FIGHT THE FED folks!!!**

My investing strategy makes the most money at two times in the Cycle --#1 Is around the large turns as we always have dry powder (to buy low) and the proper mind set to buy low (vs running) and
#2 throughout the middle of the cycle as we get fully invested in quality dividend growers. But equally important is #3 and that is to AVOID losing money at the large turns. We are overdue for a large turn folks in my humble opinion!!

Terry

PS—some attachments below that are worth reviewing IF YOU ARE so inclined

ATTACHMENTS

#1 A US view of Canada with rising Rates, housing and debt...better sit down for this one folks

#2 A second one on Canada and its surprising rate hike –do not agree 100% BUT we are underweight Cdn banks!!!!

#3 Macro review from Steve Blumenthal—packed with good info

#4 W Smead on FANG…stay away from FANG is my advice esp. ETFs with FANG

#5 Need to watch the 10 yr. –it is stuck at 2.3% DESPITE 3 rate hikes……….bond market NOT seeing what equity herd is seeing…

#6 Buffet Ratio Globally—stock market cap: GDP…very very expensive…

#7 Tom Bradley (from PHN) in my camp on bearish viewpoint

#8 We need to conserve energy folks!!! Smaller environmental footprint like they do in the EU!!!!