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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

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MORNING MACRO/MARKET MUSINGS

A VIX of 11.7x, a P/E multiple of 24x on reported earnings, and high yield bond spreads at 375 basis points seem just a bit at odds with heightened uncertainty in many areas.

North Korea's latest missile launch. Tensions ahead of this Trump-Putin meeting. What seems to be, all of a sudden, a turn for the worse in U.S.-China relations. Only 31 working days left until the U.S. fiscal year ends and we still have no resolution on the health care vote, an unresolved budget resolution, no progress on the tax overhaul plan and the clock ticking on the debt-ceiling issue (which hits a peak this Fall) ... is it safe to say that what we have on our hands is a stagnant policy agenda? And most of the world's central banks are turning more hawkish, at the margin (including the Fed, which seems to want to accelerate the balance sheet tapering process ... and the central bank is back relying on its models which have consistently overestimated growth and inflation for years now).

Cracks are appearing in this nine-year era of a bull market in risk and cyclical assets (see *Clouds Start to Form Over High-Yield Debt* on page 20 of the FT), as well as in the real economy (see *IMF Chief Warns of Risks to Recovery* on page 20 of the FT too). Greg Ip's column today on page A2 of the WSJ may well be the most important read of the day — *Economic Conditions Signal Recession Risk*. Whether or not one is imminent is irrelevant — the risks are not trivial and no asset class is priced anywhere close to the remote possibility of a U.S. downturn. One thing is for sure, this is no time for complacency.

Indeed, the words in yesterday's FOMC meeting that were telling was "mixed" to describe the housing market, auto sales have "slowed" production with "declines", and that capital spending plans for large companies have been "curtailed". I fail to see how this is a very constructive backdrop. In fact, the tone of the minutes was the least bullish since January 2016 (which presage a sizeable pullback in the stock market, if memory serves me correctly) — ditto for concerns surrounding the low-inflation outlook. Very interesting take on this issue on page B12 of the WSJ and some work on this by Notre Dame economists (*The Fed's Words Appear to Spell Worry*). Yet the central bank has already tightened four times, and three of these since last December, and has pledged more in the works (one more hike this year and an early start to quantitative tapering).

Meanwhile, there was nothing strong about the ADP employment data that were just released for June — coming in well shy of expectations (consensus was +188k) as private sector payrolls came in at +158k, and there was a 23k downward revision to May (to 230k). This was the second poorest report in the past nine months. Construction was a notable weak link, down 2k and negative now in two of the past three months. As if to make a mockery of the ISM report, manufacturing employment eked out a modest 6k gain, which actually was the second softest tally since last November, and we have yet to see all the brunt from the announced cutbacks in the motor vehicle sector. And don't look now, but initial jobless claims spiked to 248k in the July 1st week from 244k (consensus was 243k) — a five-week high and second highest level in ten weeks — and continuing claims also rose to 1.956 million from 1.945 million.

Peak housing and peak autos spell a cycle in the very mature stage. The action beneath the surface yesterday was significant, notably the retreat in auto-related stocks in the aftermath of that bombshell from O'Reilly Automotive (issuing a warning that Q2 sales would miss estimates, and not by a little), among the largest specialty retailers of auto parts, which triggered a huge 19% collapse in the stock price (to nearly a three-year low) in its steepest slide since the IPO in 1993. The spillover was obvious as rivals Advance Auto Parts fell 11% and Autozone by 9.6% (all three stocks prices are down more than 30% for the year, in what very well could be a canary in the coalmine … is this on anyone's radar screen?).

Maybe investors are beginning to take stock, because through all the daily wiggles, the S&P 500 is little higher today at 2,432 than it was in the end of May. And futures are down here in the early going. The Euro STOXX 50 is off 1% and the U.K.'s FTSE 100 is off around 0.8%. The selling started out of Asia today, with Singapore sliding 0.7%, the Hang Seng China Enterprise Index sagging 0.5%, Japan's Nikkei 225 losing 0.4%, Thailand sagging 0.3%, Hong Kong's Hang Seng slipping 0.2%, and the Korean KOSPI was flat.

But the real action today is in the fixed-income market.

Bond yields are taking a more decisive move to the upside here, in lagged response to the FOMC minutes perhaps, up anywhere from 7 to 11 basis points in Europe — a poor showing at the 30-year French bond auction did not help at all. The Germany 10-year bund yield has soared 9 basis points to a 17-month high of 0.56% (with rising volume which is not good) and while there is key chart support just below 0.70%, a break here would truly be messy (as if it isn't already). And there has been a sizeable increase in Japanese Government Bond yields too which ticked up nearly a full basis point today to a four-month high of 0.088% (this is more than a 10% increase or the equivalent of a 25 basis point surge in Treasury rates, so not at all insignificant). One has to wonder if the BoJ is following a back-door tightening of its own because it has not managed to hit its 0% target on the 10-year JGB since late April. The yield on the 10-year T-note has now bounced 23 basis points from the nearby June 26th low and we have just broken above the 100-day moving average just days after piercing the 50- and 200-day trend-lines;

and this followed a failed test late last month of the 200-day moving average to the downside in yields.

Near-term, this could be a bit ominous because any further move above 2.4% (and we are just basis points away) easily sets us up for a retest of the 2.6% high-of-the-range for the 10-year Treasury (which we have seen occur twice in the past six months) which would probably represent a huge buying opportunity because, as we have seen time and gain this entire cycle, the U.S. economy is so heavily indebted that it simply cannot carry market interest rates much higher than where they are today. Each of these bond spams slows down the economy, and as such sow the seeds of their own demise.

To a large extent, much of this yield backup is nothing more than a brief shift in market positioning … hedge funds went into summer extremely net long the 10-year T-note, with the net speculative long position on the CBOT now at 303,388 contracts. And we can see these naked longs starting to bail as the week before, this lopsided bet on lower bond yields at 372,991 contracts was the largest in nearly a decade. This is being unwound and until it closes, there is risk of continued upside pressure, but again, only over the very near-term (you have to go back to April 11th to see the last time the noncommercial accounts were positioned bearishly on Treasuries, something that contrarian investors might like to know).

At the same time, I see on page B11 of the WSJ a reference to the most recent J.P. Morgan Chase survey of institutional investors, showing that the share expecting higher yield activity in the next little while rising in the past week to 32% from 27%; the share expecting yields to decline plunged to 11% from 23%. Let's see in the upcoming round of CFTC data the extent to which this is coinciding with a sharper unwinding of this overhang of speculative long positions in the futures & options pits.

In the meantime, the way to play the stock market will be to fade the utilities and to be long the financials — until signs emerge that we are through this mini-correction in the Treasury space.

Oil prices did take a drubbing yesterday as Aramco cut is prices of lighter crude to its Asian customers and on news that Libyan production has risen to a four-year high of 1 million barrels per day (a 170,000 barrels per day jump in just two months), Nigeria adding 25,000 barrels per day since May as well, and now Iran approaching 4 million barrels per day for the first time since the sanctions were lifted a year ago. So the onus is on the U.S. inventory data to behave, and the oil market may be sniffing this out because WTI crude has recovered more than 1% today to $45.85 per barrel, and let's just say that this is a level of the crude price that would be more consistent with 495 on the S&P 500 energy index than the 477.7 level as of yesterday's close (almost 4% upside).

Other sectors that seem to have a nice tailwind right now are the semiconductors (which have corrected 8% from the recent peak and are showing signs of support here at the 100-day moving average) — aided and abetted by this partnership between Nvidia and Baidu over AI technology development as well as the news that worldwide chip sales soared 22.6% from year-ago levels in May which is the fastest pace since September 2010.

And the boomers that do have money to spend are doing so on "experiences" like hotels, cruise lines and casinos — this equity group has soared 19% so far this year even as all the attention has been on the FAANG stocks (and this story still only makes it to page B11 of the WSJ … time to sell only when this moves to page A1, otherwise, consider it to be underplayed and unappreciated).

And when you see articles like this appear on page 2 of the FT — *Pentagon's Options Narrow in Pyongyang* — you know that global defense stocks are the true defensive-growth sector that will boost earnings no matter how the economy does … the S&P 500 aerospace & defense space has strengthened 16.5% this year and the sector is vividly breaking out.

There is little action in the FX market, though the DXY U.S. dollar index down almost 20 pips to 96.1 (as an aside, if inflation were truly a dilemma for the Fed, wouldn't the gold price be rallying off a softer greenback? Instead, the yellow metal has retreated $3.50 per ounce today to $1,223). If the U.S. economy was truly as robust as the pundits claim, one can legitimately ask how that can be the case with the dollar struggling as much as it is to form a base after a 7% slide from December to June.

The Canadian dollar is behaving admirably and there seems to be more upside potential so long as the oil price doesn't collapse because the markets are priced for just one BoC rate hike and it would be reasonable to assume that if Poloz takes back one of the 2015 emergency rate cuts, then he is likely to do both. The emergency ended a long time ago, and it may well be that the central bank may begin to see the virtue in pursuing a stronger-dollar policy … or at least no longer a weak one. With that in mind, I highly recommend a read of *Wanted: Humility, High Dollar* by Philip Cross in today's National Post (who once had the role of being Canada's chief statistician).

And for all that fear of how Canada's housing market was going to crumble, here we have Vancouver, after a multi-month lull, now picking up some steam again (the benchmark price for detached houses rose

8.5% YoY in June and sales volumes, while off the highs, are still nearly 15% above the average for the past decade … so if this is bursting the bubble, I say bring it on! This all suggests that this similar lull we are experiencing in the GTA right now, is unlikely to be permanent, and if there was no crash in a Vancouver market that is much more expensive on any basis, then it is hardly likely to happen in the GTA, either … it is very difficult, even for local policymakers, to stop people from across the country and across the planet, for that matter, from buying property in highly desirable locations.

Regionally, we continue to like Continental Europe (though not as much as Donald Trump seems to love Poland) and Japan as viable turnaround situations — the latter just signing a pro-growth trade pact with the EU, and the country is responding to its ever-declining population base by altering its culture against immigrant labor (Japan's foreign population jumped 7% last year to 2.3 million, most of them guest workers and foreign students). The lone data-point overnight was a bullish one for the euro area (maybe another reason for the bond selloff) as German factory orders rebounded 1.0% MoM in May after the 2.2% slide in April and the YoY trend is solid at 3.7% (keep in mind these are "volumes").

THE FOMC MINUTES IN BULLET POINTS

- The Fed seems confident that that the economy will remain on a moderate growth path
- A downgrade to the outlook from the lack of fiscal policy stimulus was offset by an upgrade to the boost from foreign economic growth
- The Fed still views monetary policy as accommodative and financial conditions as being surprisingly loose
- Only real negative comment on any sector was on autos; mixed on housing
- There was considerable discussion on the traditional measures of unemployment and how tight the labor market is; many policymakers seem antsy about the longer-term inflation outlook as a result; there was much talk (though not universal) on how wages and other compensation are beginning to respond anecdotally
- There was some discussion about NAIRU being reduced but even here, most seem concerned that the jobless rate has fallen to low enough levels to generate higher inflation down the road
- The decline in core inflation is widely viewed (we know Yellen is a proponent) as being temporary and due to just two sectors (drugs and telecom)

- There seems to be quite a few members who want to get the ball rolling on tapering the balance sheet in coming months and in the process keep the funds rate stable near-term, though still keeping the dot-plots intact for one more hike by year-end; it looks like a market consensus is building that the $4.5 trillion balance sheet unwind begins in September (start by allowing up to $6 billion in Treasuries to roll off and $4 billion in mortgage bonds to do so without reinvestment, with these amounts set to rise each quarter); the Fed sees this as being gradual and without generating any economic fallout (good luck with that)
- There was chatter over the frothiness in asset markets, notably *"equity prices were high when judged against standard valuation measures"* (a "few" saw this); "*increased risk tolerance among investors might be contributing to elevated asset prices more broadly"* ("some" saw this); and "*subdued market volatility, coupled with a low equity premium, could lead to a buildup of risks to financial stability*" (a "few" saw this). The Bernanke Fed wanted the equity market to rally sharply (which it did); the Yellen Fed seems to have a different objective (then again, when Ben embarked on the QE stimuli, the P/E multiple on reported earnings was 15x; Janet is dealing with a multiple that now exceeds 24x).

The Fed seems to have rose-colored glasses on regarding this experiment ahead in terms of even gradually unwinding the balance sheet and the impact on the same financial markets that are deemed by at least those around the table (presumably the ones with a Bloomberg terminal) to be excessively exuberant. And at the same time, the view on the economic outlook seems quite rosy, but then again, the central bank has overestimated economic growth consistently for the past seven years. Old habits die hard.

But there are some at the Fed that share our views on many items. Here were a few new wrinkles:

- *"Contacts at some large firms indicated that they had curtailed their capital spending, in part because of uncertainty about changes in fiscal and other government policies..."*
- *"Reports regarding housing construction from District contacts were mixed."*
- *"District contacts reported that automobile sales had slowed recently; some contacts expected sales to slow further, while others believed that sales were leveling out."*

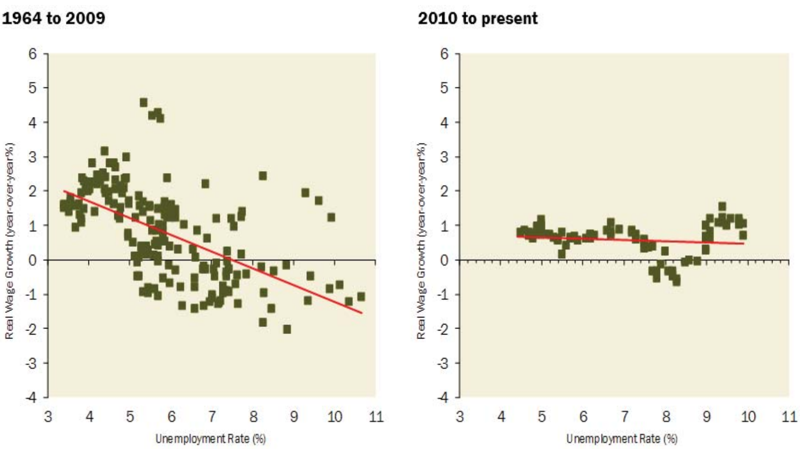
So here we have soft capex, soft housing and soft autos. But yet the consensus view is that the economy is doing just fine. A case of cognitive dissonance?

For all the chatter about how the tight labor market threatened the inflation outlook and how the decline in core inflation was "idiosyncratic", there were some very interesting comments taking the other side of this view:

- *"Several participants expressed concern that progress toward the Committee's 2 percent longer-run inflation objective might have slowed and that the recent softness in inflation might persist. Such persistence might occur in part because upward pressure on inflation from resource utilization may be limited, as the relationship between these two variables appeared to be weaker than in previous decades".* This is what is we refer to as a horizontal-line Phillips Curve, which we illustrate for you below.
- *"With regard to the outlook for inflation, some participants emphasized downside risks, particularly in light of the recent low readings on inflation along with some measures of inflation compensation and some survey measures of inflation expectations that were still low".*

CHART 1: WHAT HAPPENED TO THE PHILLIPS CURVE?

United States: Unemployment Rate & Inflation-Adjusted Wage Growth



Source: Haver Analytics, Gluskin Sheff

As for the bond market …

- *"Participants offered various explanations for low bond yields, including the prospect of sluggish longer-term economic growth as well as the elevated level of the Federal Reserve's longer-term asset holdings."*

Well, the first explanation on low real growth resonates with us. And we may as well have thrown in some of those disinflation remarks right above as well. Now this mentioning of the Fed's balance sheet is interesting because what QE was intended to do all along was spur growth in asset values and the wealth effect on spending — this is much more an equity market story than a bond market story.

In fact, when you go back and look at the announcements of QE1, QE2 and QE3, the Treasury market actually did not rally on these … but the stock market sure did! And you know what, in those intermittent periods when the Fed stopped its balance sheet expansion (only to then precipitate the next round), the ensuing pullback in risk appetite and the correction in the S&P 500 actually caused the bond market to rally on the safe-haven effect!

This is a warning to those who believe that ending QE is going to be worse for Treasuries than equities … on average, the unveiling of QE1, QE2 and QE3, generated an average 27.5% surge in the S&P 500 and the 10-year T-note never rallied once during these phases despite the direct "fund flow" impact from the Fed's buying activity … the stimulus to "animal spirits" had a much greater effect, so the average rise in yield was 63 basis points! Just as when the Fed paused between the QE's, the opposite happened — the S&P 500 gains slowed markedly, rising just 4.3% on average; and the 10-year T-note yield actually plunged 83 basis points.

TABLE 1: QE PERIODS AND MARKET RESPONSE

United States

	Announcement Date	End Date	Change in 10-Year (bps)	Change in S&P 500 (%)
QE 1	25-Nov-08	31-Mar-10	72	36.4
	1-Apr-10	2-Nov-10	-128	1.3
QE2	3-Nov-10	30-Jun-11	59	10.2
	1-Jul-11	20-Sep-11	-124	-10.3
QE 3	13-Sep-12	29-Oct-14	59	35.8
	30-Oct-14	Current	2	21.8
Average during QE			63.3	27.5
Average outside of QE			-83.3	4.3

Source: Bloomberg, Federal Reserve, Gluskin Sheff

Just how many people do you think are aware of this?

In any event, if there was emphasis made in this set of minutes, it is the Fed's desire to be pre-emptive, even with measured rates of inflation low and the economy mixed. It is rare to see two sentences in any set of minutes virtually the same, and in different pages too:

- *"However, a couple of participants expressed concern that a substantial undershooting of the longer-run normal rate of unemployment could pose an appreciable upside risk to inflation or give rise to macroeconomic or financial imbalances that eventually could lead to a significant economic downturn"* (page 9).
- *"Several participants expressed concern that a substantial and sustained unemployment undershooting might make the economy more likely to experience financial instability or could lead to a sharp rise in inflation that would require a rapid policy tightening that, in turn, could raise the risk of an economic downturn"* (page 10).

And we know that one of these *"participants"* is Janet Yellen herself, because at her semiannual testimony to Congress on February 14th, she said:

- *"As I noted on previous occasions, waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly, which could risk disrupting financial markets and pushing the economy into recession".*

So the Fed is in the business of being pre-emptive. The question historians will answer is whether this is a 1937-38 repeat when it tightened prematurely as the economy was still healing from the prior financial market and asset collapse; whether this is a repeat of 1994-95 when the Fed played this "stitch in time" routine and managed to engineer a rare "soft landing" for the economy, even if the liquidity drainage wreaked havoc with Mexico, Orange County and the mortgage market; or whether this ends up being a repeat of 2004-06 when the Fed indeed had overstayed its welcome in the prior easing cycle, and even with inflation subdued, had sowed the seed for the housing and credit bubble that ultimately had to be burst.

The economy may end up being spared, but what we do know about these three prior episodes, in fact, what we know about all thirteen periods of Fed tightening in the post-WWII era, is that these cycles don't end without the financial excesses of the bull market condition becoming exposed, and then expunged.

AUTOS IN REVERSE

Question is what does this mean? The front page of yesterday's NYT, as mentioned yesterday, contained an article on looming production and employment cuts ahead.

The June FOMC minutes found that:

> *District contacts reported that automobile sales had slowed recently; some contacts expected sales to slow further, while others believed that sales were leveling out … and some contacts in the automobile industry reported declines in production that they expected to continue in the near term.*

And all I hear is: *"well, who cares about the auto sector — it doesn't have nearly the importance in the economy as it used to"*.

Wrong, wrong, and wrong.

Go back to prior expansions, and you will see, for example, that auto sales bottom early and lead the recovery. They are a quintessential leading indicator. And they tend to peak 1 to 2 years before the onset of recession, and this time around they hit their highs in late 2016. This puts next year into play, and that means we have to start buying some umbrellas.

But this notion that the auto sector isn't important anymore because there are fewer than one million jobs directly employed in this sector belies the other 12 million positions in other industries that are linked to motor vehicle activity, directly and indirectly, across both the goods-producing and services industries. Batteries, fuel cells, rubber, glass, entertainment and communication equipment, cooling systems, fuel pumps, computerized engine diagnostics, cable, bearings, wiring harnesses, lighting/signaling systems, sensors, cameras, video players. If I missed anything, it's because I'm exhausted. Not to mention rentals, leases, garages, dealers, insurers, and lenders in the services industries.

The spinoffs and multiplier impacts are massive, which is why my hair stands on end when I hear people say *"ahh …it's only the auto sector"*. As the retrenchment spreads and begins to move down the chain to all the suppliers involved, look for a cascading effect that will dampen at least 10% of private sector employment in the coming year.

Forewarned is forearmed.

WHY DO BONDS REMAIN BID?

I keep getting asked how the longer end of the Treasury market has managed to behave as well as it has considering equities are scaling new highs — never a correction, always a rotation — and the jobs market tightening up to levels not seen in sixteen years.

Well, here it goes.

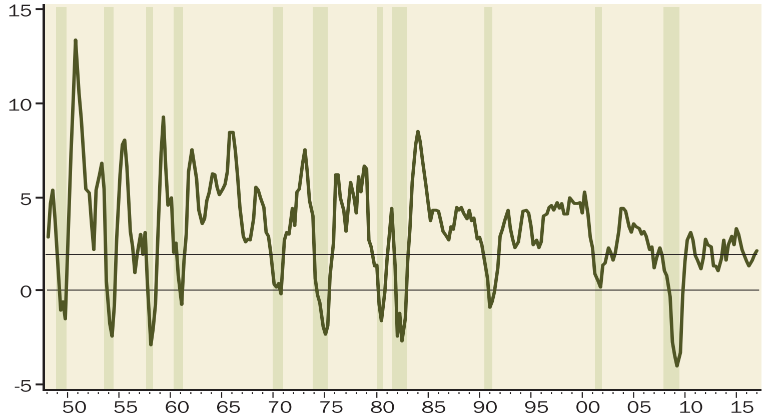
It comes down to the Fed. When it tightens policy in the early and middle part of the cycle as we saw in 1984, 1985, 1994 into early 1995, and

2003 to 2006, the bond market sells off. The Fed is taking the carry away and the reasons why — escalating inflation pressure and accelerating growth — trigger the run-up in yields.

But the tightening that takes place once real GDP growth has already slowed to 2% or lower, as has been the case now for the five of the past six quarters, is very bullish for what it means for the next phase of the cycle. In fact, this is the first cycle for this to happen — Fed tightening with growth this weak. Usually by the time the pace of real economic activity has come down to where it is currently, the Fed is already done its rate-hiking cycle.

CHART 2: REAL GDP

United States
(year-over-year percent change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Since there has never before been a period where a Fed rate-hiking cycle failed to lead to economic deceleration, you be the judge as to where the next chapter is, and something tells me closer to 1% growth than 2%. With core inflation likely to slow to 1% as well, possibly lower, all of a sudden a 2.85% yield on the long bond doesn't seem so unreasonable … with potential for the next big move to be down, not up.

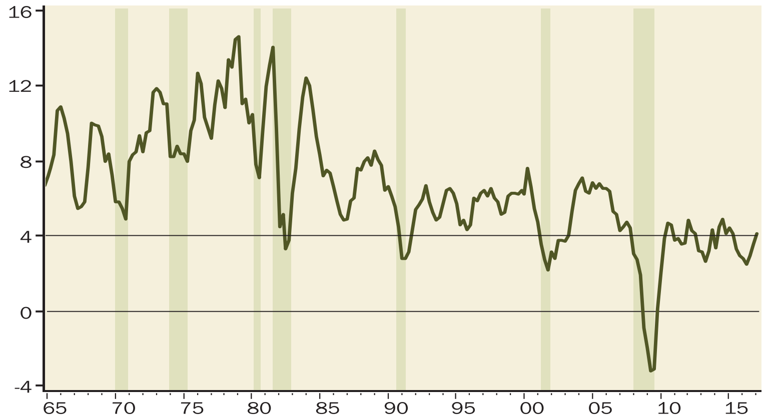
Go back to prior cycles and see for yourself: Q1 2007, Q1 2001, Q3 1990, Q4 1979, Q1 1974, Q4 1969, and Q2 1960… like a charm, all were quarters when real GDP growth softened on a YoY basis to 2% amidst a Fed tightening phase. And in each case, the Fed had stopped in its rate-hiking campaign or was about to terminate the program. Only in this one has the central bank chosen to tighten beyond that threshold — indeed, for the first time ever, the Fed waited for growth to slow to 2% and then began to raise rates … starting in the fourth quarter of 2015. And remember — the lags to the real economy, as history shows, are long, variable, and most often, insidious.

Not only that, but every time an economy slowed to 2% on a YoY basis from the cycle high, recession was not far behind. This is not to say one is coming soon, but it is to say that there is very little cushion and the Fed is not stopping, and even as things stand, we have not seen all the lags percolate through the real side of the economy. When the Fed stops tightening — whether through rates or its $4.5 trillion balance sheet — is when we get hit with a severe financial strain…. commercial real estate in 1990, Mexico/Orange County in 1995, Asia in 1998, tech wreck in 2000 and the housing crisis in 2007. Some things don't change, and one of them is what type of bell rings at the peak of the Fed tightening cycle — the central bank has already made it clear that is sees excesses in commercial real estate, swaths of the equity market and high-yield bonds (maybe investment grade too) … I didn't hear them mention a bubble in Treasuries as being a chief concern.

In any event, nominal GDP growth at 4%, as an aside, is already at a pace that coincided with all the past seven recessions back to 1970.

CHART 3: NOMINAL GDP

United States
(year-over-year percent change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

So when asked what the bond market knows — it knows the contours of these charts and what they imply.

Gluskin Sheff

Gluskin Sheff at a Glance

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For further information, please contact: research@gluskinsheff.com

Notes:

1. Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.
2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.
3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

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