Global Strategy Weekly

Crying with the wolves - what could possibly go wrong?

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Most clients I have met recently seem to harbour similar fears as I, namely that the QE-driven bubble will burst at some stage and lay low the global economy, just as it did in 2007. But despite my bearish (or is it wolfish) howling, virtually no clients think the denouement will come any time soon and that the equity bull market should have at least 12-18 months left to run. Most can see nothing on the immediate horizon that might burst this bubble. Hence it is useful to reprise recent discussions with clients about what might catch them out in the near term.

- I've been travelling for work for a couple of weeks; hence the brief interruption in normal service. Most of you have realised by now that the Global Strategy Weekly never actually comes out weekly. It *used* to be published weekly though in the early 1990s when I worked at Kleinwort Benson under my old boss, the late Roger Palmer. I was thinking about him the other day – one tends to reminisce at my age. He was certainly an unforgettable character. His enduring legacy is that he used to keep the only 'tame' wolf pack in the UK and formed the UK Wolf Conservation Trust, which his wife still runs. I remember the Head of Research refusing Roger permission to bring his wolves to one of our big strategy presentations held in our buildings near Monument Station (now the Walkie Talkie building). Although those were the days before stifling Health and Safety strictures, many of us had reasonable concerns that parading the wolves up and down aisles and getting the clients to pet them might end very badly indeed. Roger being Roger, he went over his line manager's head straight to the Chairman who granted permission. I will never forget the look of fear in some of those clients' faces as the wolves were allowed to roam around the conference room!

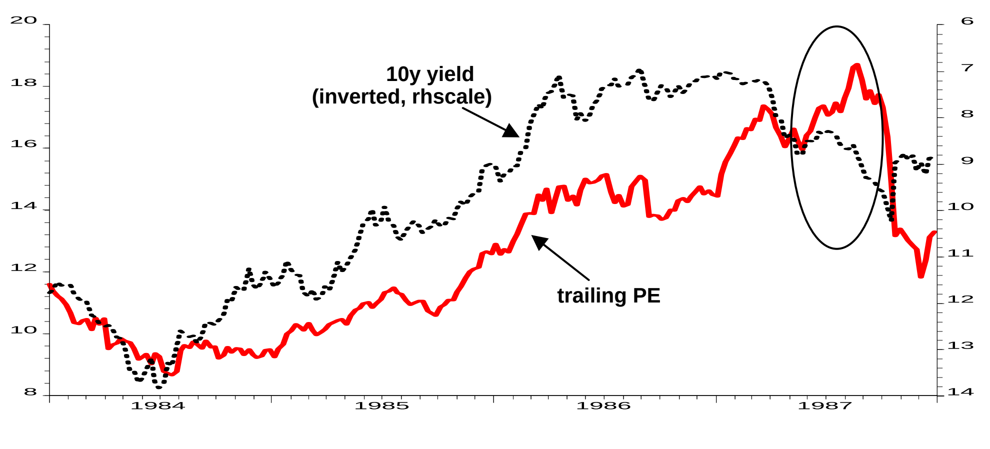
- What are the investment wolves out there currently that clients fear? Very little it appears in the near term. One thing we hear consistently is that they are not interested in being told equity valuations are expensive. They have been for a while and that does not seem to stop the market going up! But valuation DOES matter. With the 30th anniversary of the 1987 crash last week, I cast my mind back to that day when I was a youthful Global Strategist at Bank America Investment Management. For in the immediate aftermath of the crash, the extreme expense of US equities certainly was clearly a major contributing factor.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

US equities continued to rally through 1987, despite sharply rising bond yields



Source: Datastream

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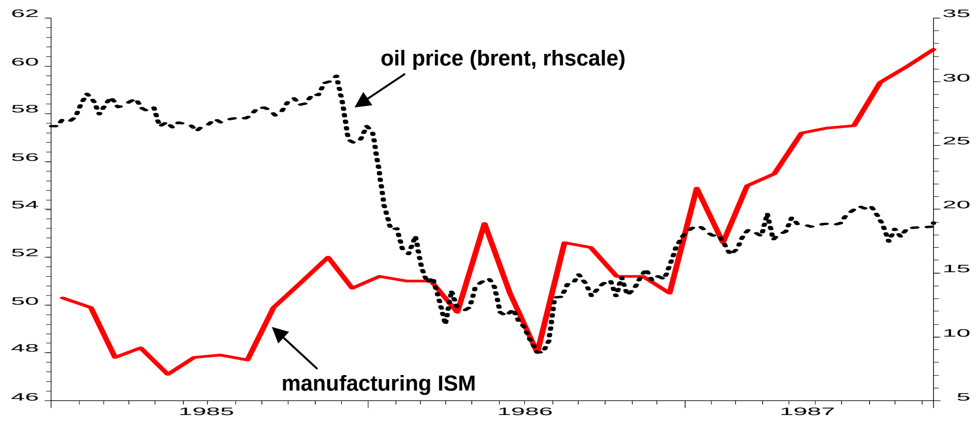
A retrospective macro-narrative was inevitably wrapped around the 'Black Monday' 19 October 1987 equity market crash. My 30-year recollection is pretty good: 1987 saw a buoyant equity market rising briskly through most of the year as the oil price recovered from the previous year's collapse (from $30 to $8, see chart below). After a year in the doldrums the US economy started to accelerate notably through 1987 as the impact of 1986 interest rate cuts and a lower dollar worked. By the time of the Oct crash the US ISM had surged from 50 at the start of the year to over 60 - a level seldom ever reached (see chart below). Amazingly the ISM has just last month exceeded 60.0 for only the second time since 1987. Spooky!

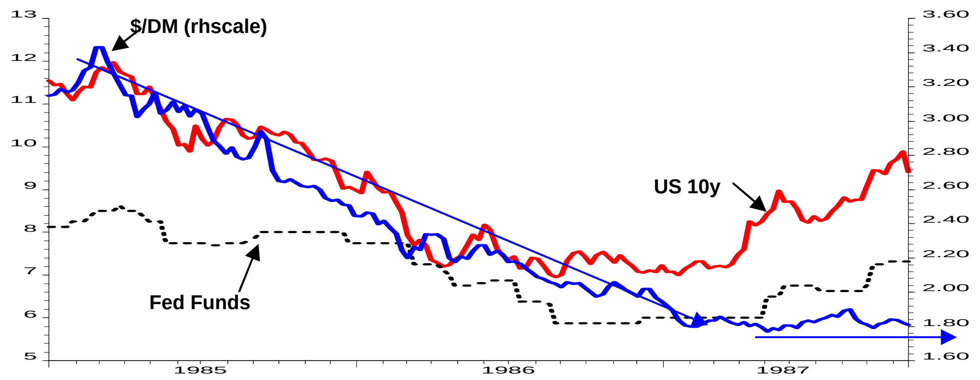
US manufacturing ISM and Brent Oil Price (Jan 1985-Oct 1987)



Source: Datastream

In February 1987, the G6 nations (Italy was in a strop) signed the Louvre Accord which agreed to stop the engineered decline in the dollar that had been ongoing since the 1985 Plaza Agreement (see chart below). One of the reasons for the dollar's continued decline had been the ever burgeoning US trade data and that this data release had become the most market sensitive of all economic releases – even more important than the US non-farm payroll data (I remember spread-betting companies making a spread price on the monthly deficit)! As the US economy recovered in 1987, and the trade deficit continued to grow, the Fed began to raise interest rates to help stop the dollar falling in line with the Louvre Accord (see chart below).

Dollar stabilized in 1987 due to higher US rates and the Louvre Accord



Source: Datastream

So when, much to everybody's surprise West Germany raised interest rates at the start of October 1987, tensions rose sharply between the US and West Germany. US Treasury Secretary James Baker's blunt criticism the weekend before Black Monday (as it became known) unsettled the markets. The fear was that the dollar could resume its rapid decline (indeed this was explicitly threatened by Baker – link), and this would ultimately have to be met by much higher US interest rates to prevent a collapse and ultimately a US recession would ensue.

Those are the events as I remember it as clearly as if it were yesterday – actually I can't remember yesterday. Of course the machines took over the selling in the form of Portfolio Insurance programmes, but speaking to my colleague Andrew Lapthorne, he reminds me we also have similarly pro-cyclical 'doomsday' vehicles today – with so much money being run by volatility targeting, risk parity and CTA/trend following quant funds. A fascinating article by stockmarket guru Robert Shiller in a NY Times article to mark the 30th anniversary of the crash, suggests that it was not the Portfolio Insurance that was responsible for the crash, as most official post-mortems suggested, but fear passed by word of mouth. Shiller thinks, in the internet age, **there is even more scope for fear to spread like wildfire to set off a market crash** - which would of course be limited to 20% in any one day due to circuit breaker rules.

So, for me, the trigger for the 1987 crash was the *fear* of US recession caused by the likelihood of US rate rises to stem a hypothetical dollar collapse. I am clear in my mind both at the time and now, that the US equity market was priced for a continuation of rapid economic and profit growth and this was under threat. The Dow was on nose-bleed valuations, especially as it had ignored the bond sell-off for most of 1997 (was it really 30 years ago that US 10y yields briefly crawled back above 10% - the last time we would see double-digit yields). None of this would have mattered if the US equity market had been cheap. **In my view the record 25% 'Black Monday' October 19 decline was due to a horrendously expensive equity market suddenly confronted with the fear of recession. Equity valuations matter.**

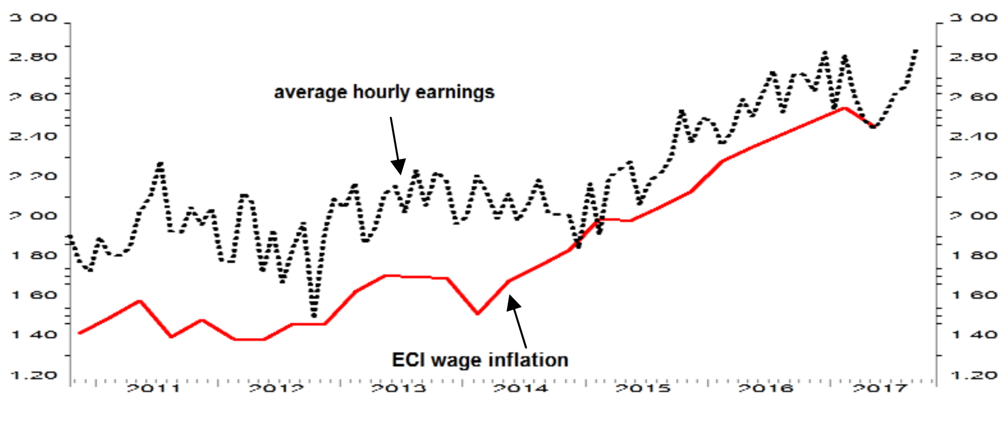
Could the same happen again? Of course it could. It could happen *tomorrow* given the extreme expense of US equities and the near universal consensus of a continued acceleration in the economic cycle – despite the Fed also in the midst of a tightening cycle. As the excellent David Rosenberg of Gluskin Sheff points out, of the13 post war Fed tightening cycles, 10 have ended in unexpected recession. But **at these extremes of equity valuation it might not even be an *actual* recession that produces the next precipitous equity bear market, but the *fear* of a recession,** however misguided that fear may or may not be.

Now is there anything out there that can cause a rapid change in market expectations of future economic growth? Not according to most investors we speak to. But let's try and think of some things that we maybe need to watch out for.

The *expectation,* or more importantly the *fear* of more rapid Fed rate rises threatening the economic recovery might be one thing to watch out for. I certainly don't think that the imminent naming of the new Fed Chair would cause such a reaction. Anything else?

Why yes; wage inflation has been the dog that didn't bark this year - or indeed the wolf that didn't howl. Wage inflation actually slowed this year against the expectations of some naysayer commentators (ie me) of an acceleration (and yes I do mean an *acceleration* rather than a rise). But it was notable that in the September payroll release, average hourly earnings jumped sharply to 2.9% - a high for this cycle (see chart below).

US Average Hourly Earnings and Employment Cost Index wage inflation (yoy%)

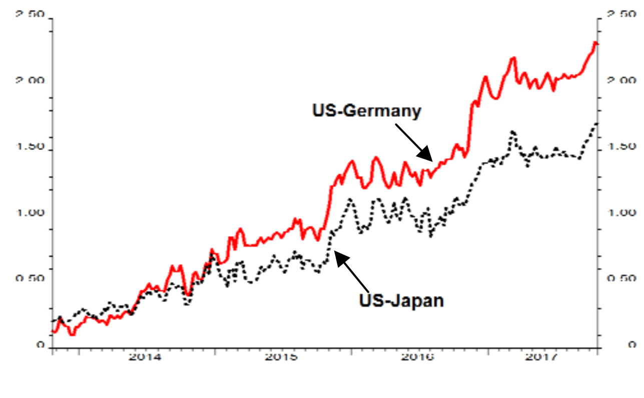


Source: Datastream

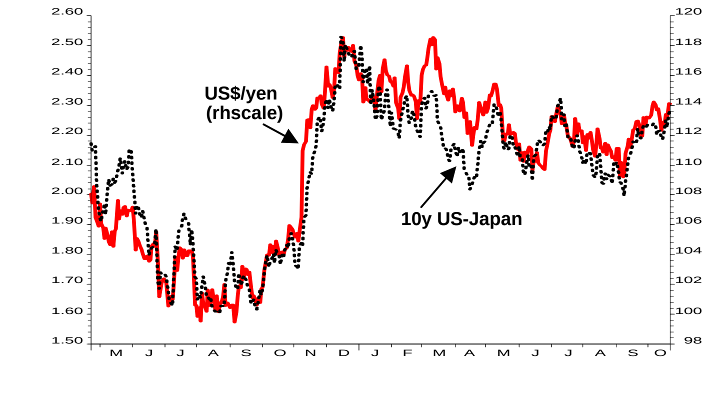
This jump in wage inflation, like the decline in non-farm payrolls, is seen as an aberration caused by Hurricanes Irma and Harvey. But if for whatever reason it is not an aberration and the Phillips Curve is reasserting itself, similarly high wage inflation data in the months ahead could cause a rapid reappraisal of the pace of Fed rate hikes. At these high equity valuations, that could really scare investors.

Any expectation of faster rate hikes will impact the yield curve, which has already been flattening rapidly – a usual prelude to decelerating economic activity. In addition, the dollar is likely to reverse the weakness we have seen since the start of this year, which was in large part a result of an unwinding of ultra long speculative dollar positioning against the euro (as suggested by the CFTC data). That has now completely reversed and speculators are very short the dollar. The catalyst for the resumption of the dollar's rise may have been a sharp recent widening of the US 2y spreads with both Germany and Japan as investors embrace the near certainty of a December US rate hike, but this could go considerably further if investors actually begin to believe the Fed's own forecasts of future interest rates (ie the Fed dots).

US 2y yield versus Germany and Japan



Dollar begins to rise again as US bond yield spreads widen



Source: Datastream

The nightmare scenario for equities would be if US wage inflation flickers back to life and investors not only decide that *they* are too far behind the Fed dots, but they also decide that the Fed itself is behind the tightening curve. In that scenario yields would jump sharply higher across the curve, but especially at the short end and the dollar would soar.

Two critical long-term trend-lines to watch: First our head of technical analysis, Stephanie Aymes, highlights that the breakout point for the 30y downtrend in the dollar against the yen is around Y123/$ (chart left below). Second, as 10y US yields "smash" above the multi-month support of 2.4%, they can rise all the way to 3% and still be in a bull market (see below).

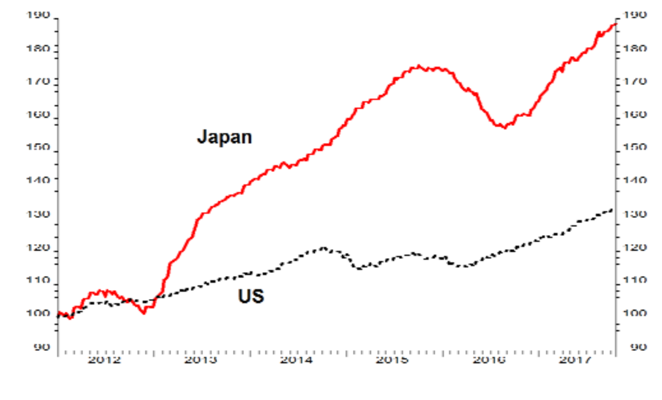
If dollar resumes rise watch out for a rise to Y123

If US 10y breaks abve 2.64% watch out for a rise to 3%

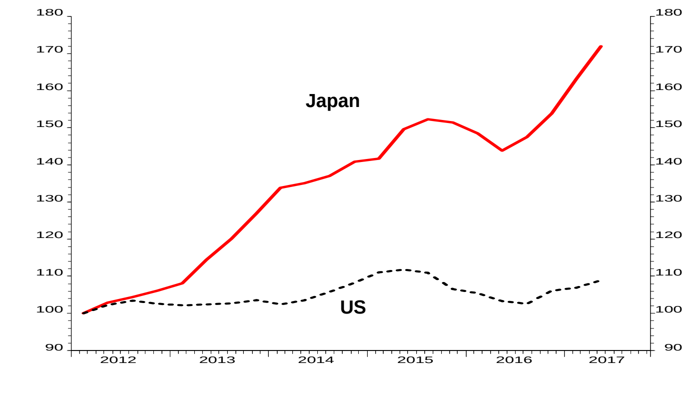
Source: Datastream

How might a resumption of the dollar's rise damage the US equity market? The equity markets' rise this year has been fuelled by profits growth and the expectation of a continuation of the current trend. **Much of that rise in US profits is the direct result of the dollar's weakness so far this year.** Take a look at the two charts below, both comparing US and Japanese profits. On the left, we show forward earnings expectations (TOPIX and S&P500) while on the right we show whole economy profits measures. The key difference is that the stockmarket profits measures have considerably more exposure to overseas earnings and the currency as well as not including smaller and unquoted companies. Hence it is notable that Japanese whole economy profits have considerably outperformed Japanese stockmarket profits, while on the other hand it is startling how US whole economy profits have *underperformed* US stockmarket profits. I think it's mainly down to dollar weakness this year.

Stockmarket profits (indexed Jan 2012=100, local currency)



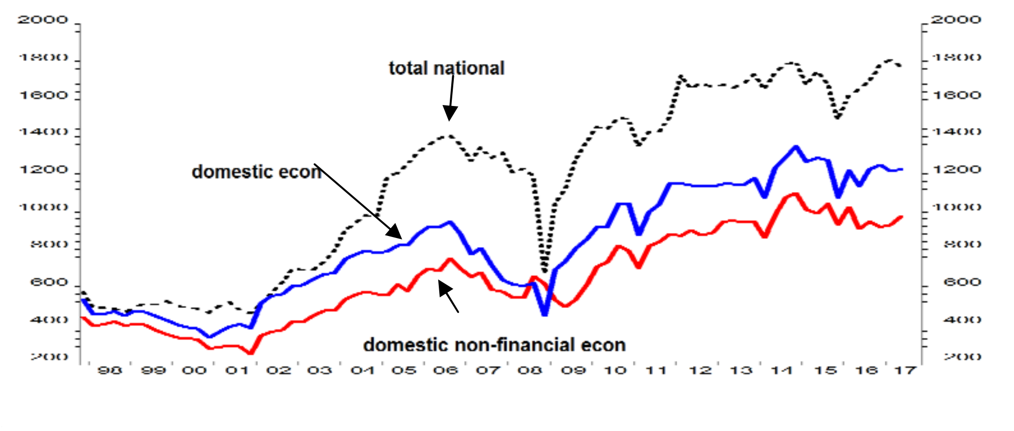
Whole Economy profits (indexed Jan 2012=100, local currency)



Source: Datastream

One can also see how US stockmarket profits are buoyed by the weak dollar another way, by dissecting the US whole economy profits data. The sharp rebound over the past year in national profits (ie US company profits made both at home and aboard) is not in any way as pronounced when you look at domestic profits (ie all company profits earned in the US, whether US or foreign owned) – and especially if you exclude financials (the red line).

US whole economy profits ($bn, post tax with IVA and CC adj)

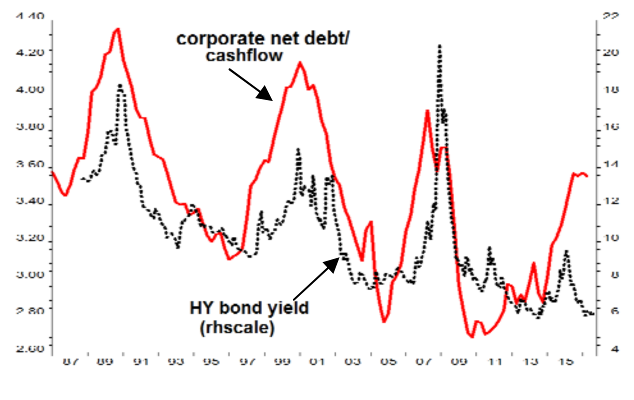


Source: Datastream

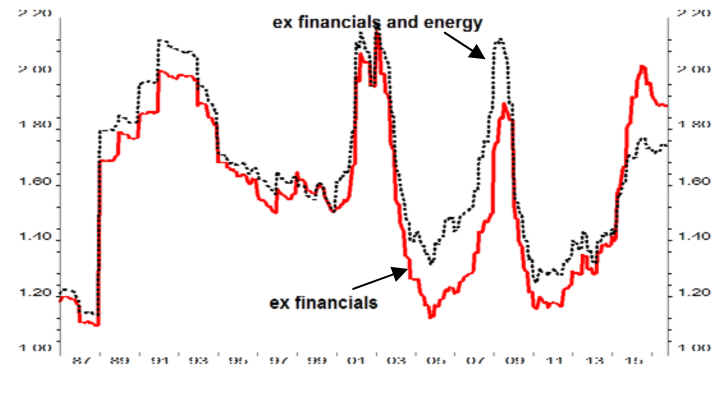
So a reappraisal in the market's expectations on the pace of Fed rate hikes, perhaps because of higher than expected wage inflation data, would likely trigger both a rise in yields along the length of a flattening curve and a resumption in the dollar bull market. When the equity market is ridiculously expensive and priced for profits perfection, these events (or indeed as in 1987, the *FEAR* of these events) could prove catastrophic for QE inflated equity markets.

What about corporate credit markets? If you are a regular reader you have been bored to tears by our theme that US corporate debt will be the 2007-like vortex of debility in the next downturn. Even the moderate, reasonable, and usually well behind-the-curve, IMF suggests a staggering 20% of US corporates are at risk of default in the next economic downturn – link.

US top-down net debt/cashflow and HY yields



US Stockmarket net debt/EBITDA

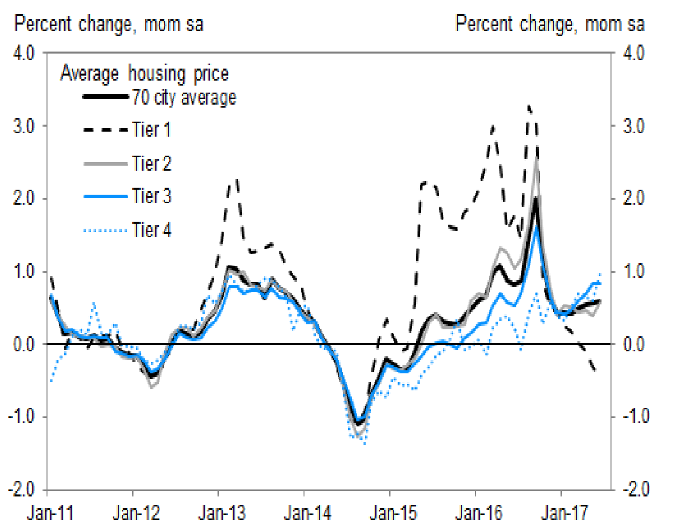


Source: Datastream

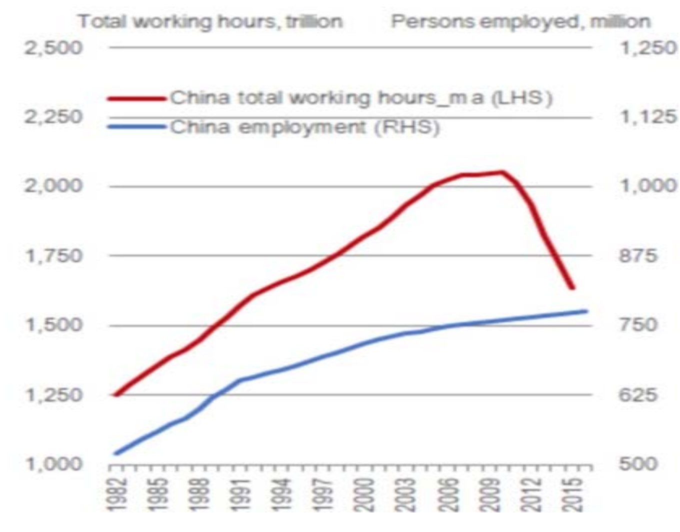
I certainly believe QE has also inflated US corporate debt prices way above what they otherwise should be. Indeed looking at the top left-hand chart above, it is clear that typically, the corporate debt market would be in revolt by now in the face of the cyclical debauchment of corporate balance sheets. The fact that both yields and spreads are near all-time lows is, like over-extended equity valuations, a ticking time-bomb waiting to go off. (The chart on the left uses top-down corporate balance sheet data from the Federal Reserve Z1 Flow of Funds book. But the right-hand chart is *stockmarket* data from Datastream and shows a higher peak recently for quoted stocks, tying up closely with Andrew Lapthorne's bottom-up analysis.)

Finally a word on China...which does not seem to concern clients at the moment. Incredible when you consider that a little over a year ago China was investors' number one concern. What changed was that the dollar's weakness this year subdued jitters about renminbi devaluation and the plunge in Chinese reserves. Potential trade tension between China and the US, threatened by Donald Trump in his election campaign, was thus headed off. So one thing investors might need to keep an eye on as a risk to the investment outlook is what happens if the dollar bull market reasserts itself. For although on the surface the Chinese economy looks stable, increasingly volatile swings in credit policy are necessary to keep the show on the road – most apparent in the boom and bust cycle in house prices (see left-hand chart below). A stronger dollar may necessitate another shift towards easy Chinese policy, including a weaker renminbi. That could cause trouble. And finally….a most interesting chart I spotted on Twitter from former UBS Chief Economist George Magnus who is now at the China Centre at Oxford University and definitely knows his China onions. George posted this chart (on the right-hand side below) which comes from The Conference Board. It certainly does not square with the superficially benign Chinese economic data ... so definitely one to watch.

Chinese month property price inflation (mom%)



This might be the most interesting chart I have seen for years



Source: Zero Hedge, George Magnus on Twitter, @georgemagnus1

Albert Edward's MAD2MAR historical recommendations over the past 12 months