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SPECIAL REPORT

Personal Observations On The Current Environment

According to market lore, one should never say, "It's Different This Time". But every time is always different: there is a never a previous period that perfectly matches the current environment. That is why forecasting is so difficult and why all model-based predictions should be treated with caution. Yet, some basic common sense can go a long way in helping to assess investment risks and potential rewards.

As I look at the world, it looks troubled enough to warrant a very conservative investment stance, but that clearly puts me at odds with the majority of investors. In aggregate, investors and market analysts are upbeat. Major equity indexes are close to all-time highs, earnings expectations are ebullient and surveys of investor sentiment do not imply much concern about the outlook. There is a strong consensus that a U.S. recession will not occur before 2020, meaning that risk assets still have decent upside. That may indeed turn out to be true, but I can't shake off my concerns about a number of issues:

- The consensus may be too complacent about the timing of the next U.S. recession. The dark side of current strong growth is growing capacity pressures that warn of upside surprises for inflation and thus interest rates.

- Uncertainty about trade wars represents a risk to the global economic outlook beyond the direct impact of tariffs because it also gives companies a good reason to hold back on investment spending.

- Profit growth in the U.S. has remained much stronger than I expected, but the forces driving this performance are temporary. Rising pressures on wages suggest that labor's share of income will rise, leading to lower margins.

- The geopolitical environment is ugly, ranging from a shambolic Brexit process to rising populist pressures in Europe, a flaring in U.S./Iran tensions and possible disappointment with North Korea negotiations.

- The Debt Supercycle may be over, but global debt levels remain worryingly high in several major economies. This could become a problem in the next economic downturn.

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It would be easier to live with the above concerns if markets were cheap, but that is far from the case – especially in the U.S. Credit spreads in the corporate bond market are below historical averages while equities continue to trade at historically high multiples to earnings. Even if equity prices do move higher, the upside from current levels is likely to be limited. Yes, there could be a final, dramatic blow-off phase similar to that of the late 1990s, but that would be an incredibly risky period and not one that I would want to participate in.

Timing The Next Recession

Sad to say, economists do a very poor job of forecasting recessions. As I showed in a report published last year, the Fed has missed every recession in the past 60 years (**Table 1**).[1] One could argue that the Fed could never publish a forecast of recession because it would be an admission of policy failure: they generally have to be seen aiming for soft landings. But private forecasters have not done any better. For example, the consensus of almost 50 private forecasters published in mid-November 2007 was that the U.S. economy would grow by 2.5% in the year to 2008 Q4.[2] The reality was that the economy was then at the precipice of its worst downturn since the 1930s.

The U.S. economy currently is very strong, but that often is the case just a few quarters before a recession starts. Strong growth today is not a predictor of future strong growth. As has been widely acknowledged, the yield curve has been one of the few indicators to give advance warning of economic trouble ahead. Yet, in the past, its message typically was ignored or downplayed, with the result that most forecasters stayed too bullish on the economy for too long.

TABLE 1
Fed Economic Forecasts Versus Outcome

FORECAST MADE	FORECAST CHANGE IN REAL GDP OVER NEXT 4 QUARTERS	ACTUAL CHANGE IN REAL GDP OVER NEXT 4 QUARTERS*	PEAK-TO-TROUGH % DROP IN GDP*
DECEMBER 1969	1.4%	-1.2%	-1.5%
NOVEMBER 1973	2.4%	-4.9%	-7.8%
JULY 1981	0.9%	-1.9%	-2.5%
JULY 1990	1.9%	-0.8%	-0.8%
MARCH 2001	2.6%	1.4%	-0.3%
DECEMBER 2007	1.3%	-0.5%	-4.2%

* THESE CALCULATIONS ARE BASED ON THE GDP DATA AVAILABLE AT THE TIME, NOT CURRENTLY PUBLISHED GDP DATA WITH REVISIONS AND CHANGES TO DEFINITIONS ETC.

1 BCA *Special Report* "Beware The 2019 Trump Recession," March 7, 2017. Available at bca.bcaresearch.com.

2 Source: Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters (www.philadelphiafed.org).

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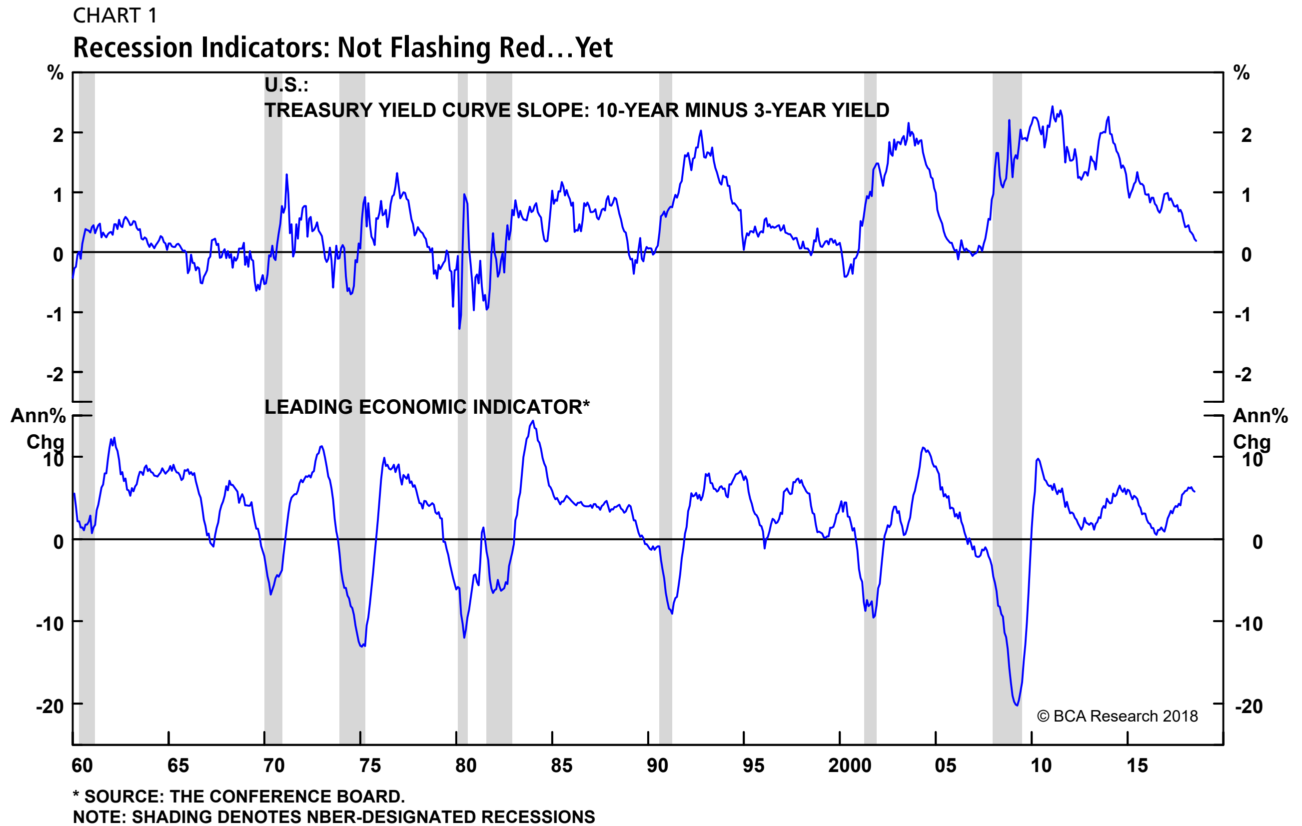
CHART 1
Recession Indicators: Not Flashing Red...Yet



History is repeating itself with a flurry of reports explaining why the recent flattening of the yield curve is giving a misleading signal. The principal argument is that term premiums have been artificially depressed by the Fed's bond purchases. However, the curve has flattened even as the Fed has pulled back from quantitative easing. As usual, the flattening reflects the tightening in monetary policy and, therefore, should not be discounted. To be fair, there is still a positive slope across the curve, so this indicator is not yet flashing red. But it is headed in that direction (**Chart 1**).

The other series to watch closely is the Conference Board's Leading Economic Index. Typically, the annual rate of change in this index turns negative ahead of recessions, although once again, there is a history of forecasters ignoring or downplaying the message of this signal. Currently, the growth in the index is firmly in positive territory, so no alarm bells are ringing.

Overall, there are no indications that a U.S. recession is imminent. At the same time, late cycle pressures and thus risks are building. Anecdotal evidence abounds of labor shortages and supply bottlenecks in a number of industries. Wage growth has stayed relatively muted given the low unemployment rate, but that is starting to change. My colleague Peter Berezin has shown compelling evidence of a "kinked" relationship between wage growth and unemployment whereby the former accelerates noticeably after the latter drops below its full employment level (**Chart 2**). We are at the point where wage growth should accelerate and it is significant that the 2.8% rise in the employment cost index in the year to the second quarter was the largest rise in a decade.

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CHART 2
Faster Wage Growth Ahead

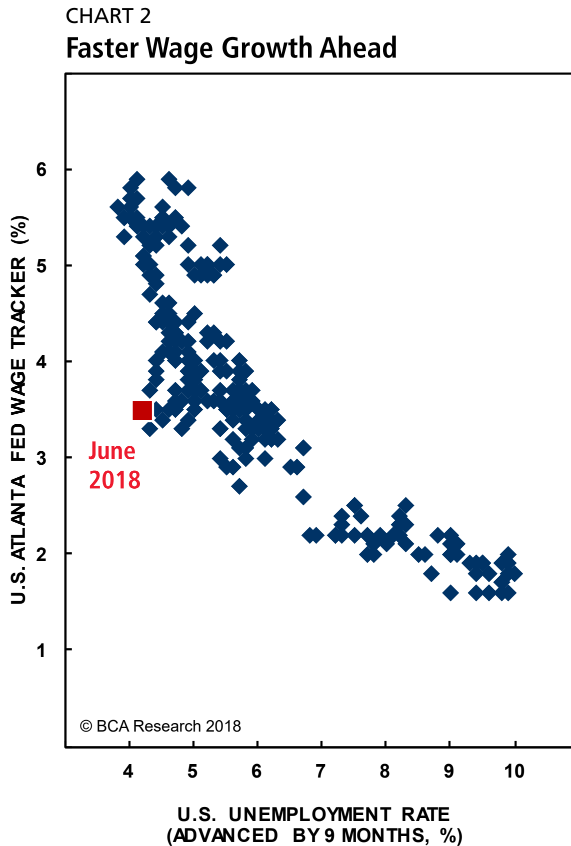
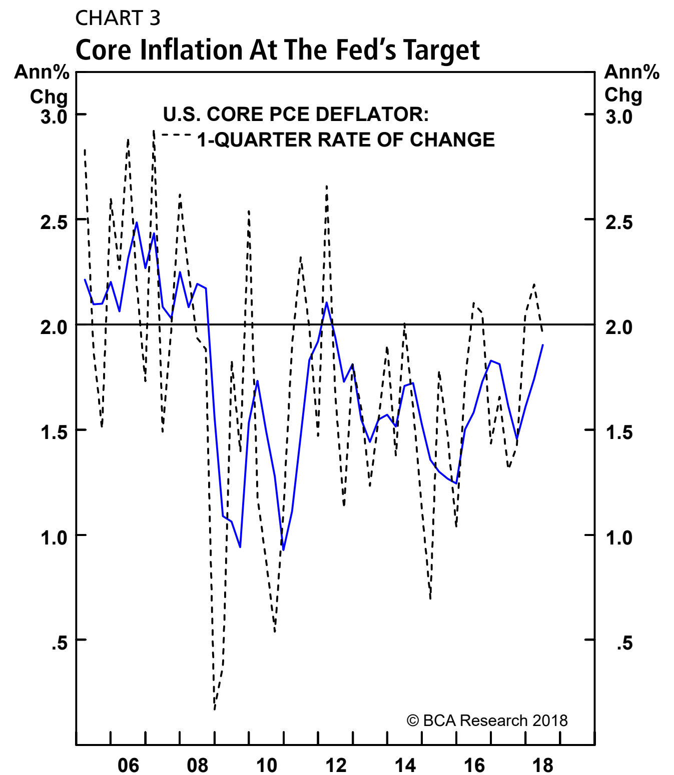


CHART 3
Core Inflation At The Fed's Target



It also should be noted that the Fed's preferred inflation measure (the core personal consumption deflator) has been running at around a 2% pace in the past three quarters, in line with its target (**Chart 3**). As capacity pressures build, an overshoot of 2% seems inevitable, forcing the Fed to react. Current market expectations that the funds rate will rise by only 25 basis points over the remainder of this year and by 100 basis points in 2019 are likely to prove too optimistic.

Admittedly, there is huge uncertainty about what interest rate level will be restrictive enough to damage growth. Historically, recessions did not occur until the fed funds rate reached at least the level of potential GDP growth. The Congressional Budget Office estimates that potential GDP growth will average around 4% over the coming year, and the funds rate probably will not reach that level in 2019. However, additional restraint is coming from the strong dollar, and lingering high debt burdens mean that rates are likely to bite at lower levels than past relationships would suggest.

Trade Wars Etc.

President Trump appears to believe that the large U.S. trade deficit is largely a reflection of unfair trade practices. The reality is obviously more complicated, even if there is truth to the claim that the playing field with China is far from level. The key drivers of trade imbalances are relative economic growth rates and relative real exchange rates.

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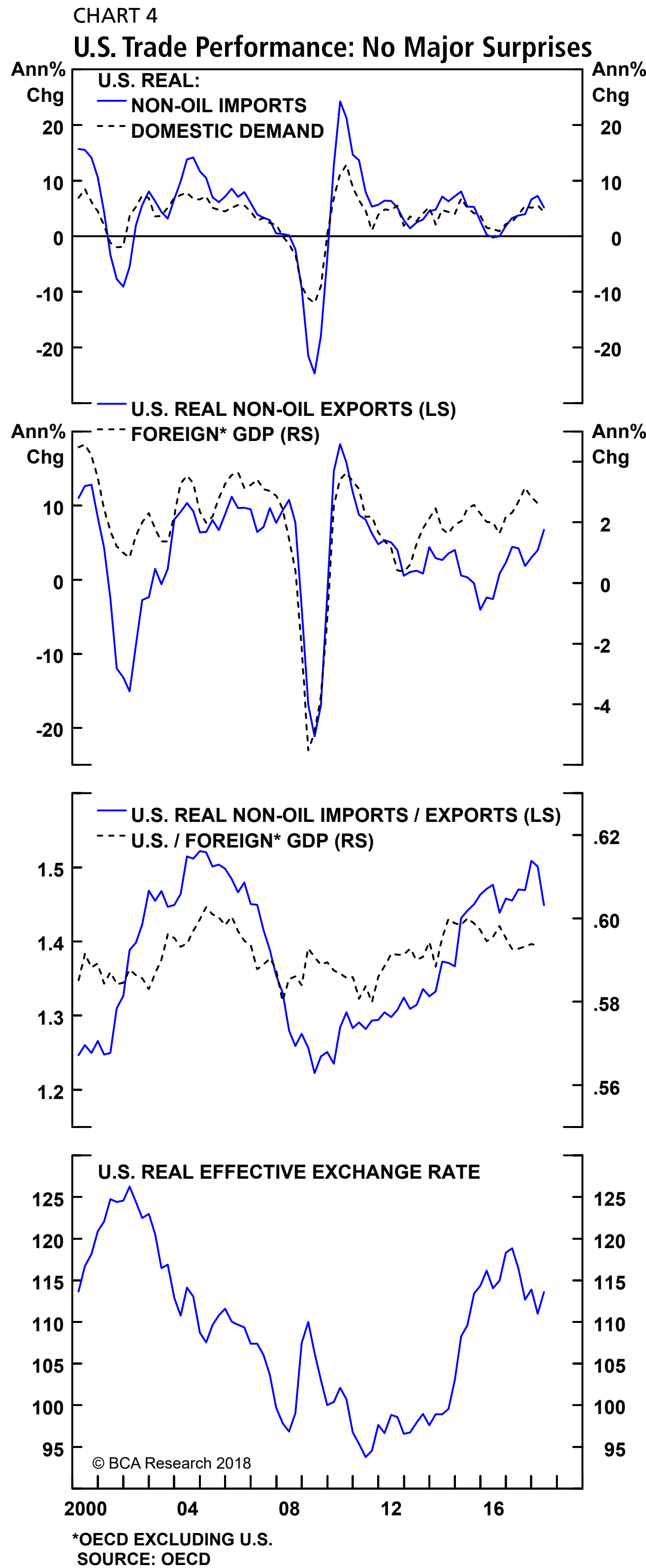

The trend in the volume of U.S. non-oil merchandise imports has been exactly in line with that of domestic demand for goods (**Chart 4**). In other words, there is no indication that the U.S. is being "taken advantage of". The growth in U.S. non-oil exports has been a little on the soft side relative to overseas growth in recent years, but that occurred against the background of a rising real dollar exchange rate. Overall, the trend in the ratio of U.S. real non-oil imports to exports has broadly followed the ratio of U.S. real GDP to that of other OECD economies. The periods where the trade ratio deteriorated somewhat faster than the GDP ratio were times when the real trade-weighted dollar was strong, such as in the past few years.

The irony, which seems to escape the administration, is that recent policy actions – tax cuts and efforts to boost private investment spending – are bound to further boost the trade deficit. This may partly explain the clumsy attempt to encourage the Fed to slow down its rate hikes in order to dampen the dollar's ascent. Of course, that will not work – the Fed will not be deflected from its policy course by political interference. Meanwhile, the administration's imposition of tariffs will not change the underlying drivers of the U.S. trade deficit.

I have no way of knowing whether current trade skirmishes will degenerate into an all-out war. There are some glimmers of hope with the EU and U.S. promising to engage in talks about reducing trade barriers. But the more important issue is what happens with China. While China has an economic incentive to make concessions, I cannot imagine that President Xi wants to be seen as giving

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CHART 5

Spectacular U.S. Earnings Growth

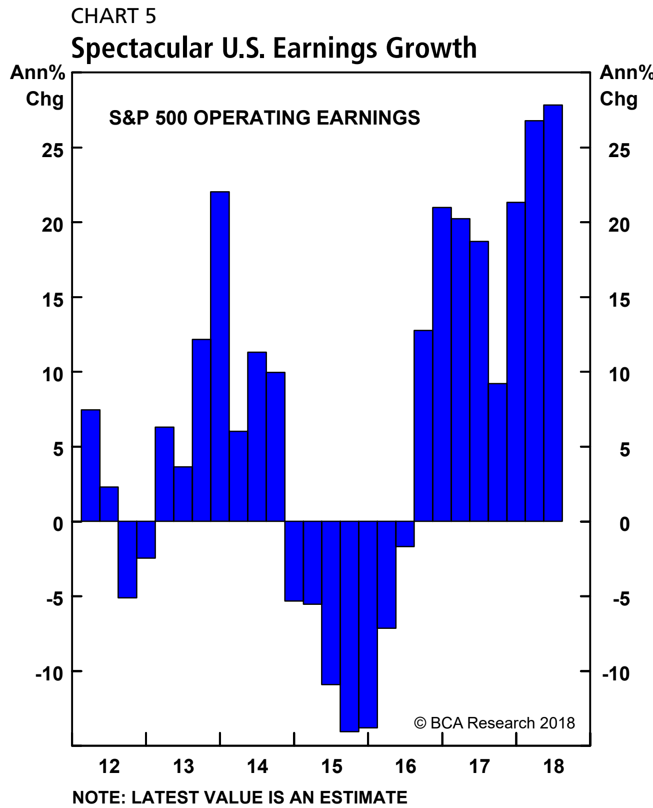
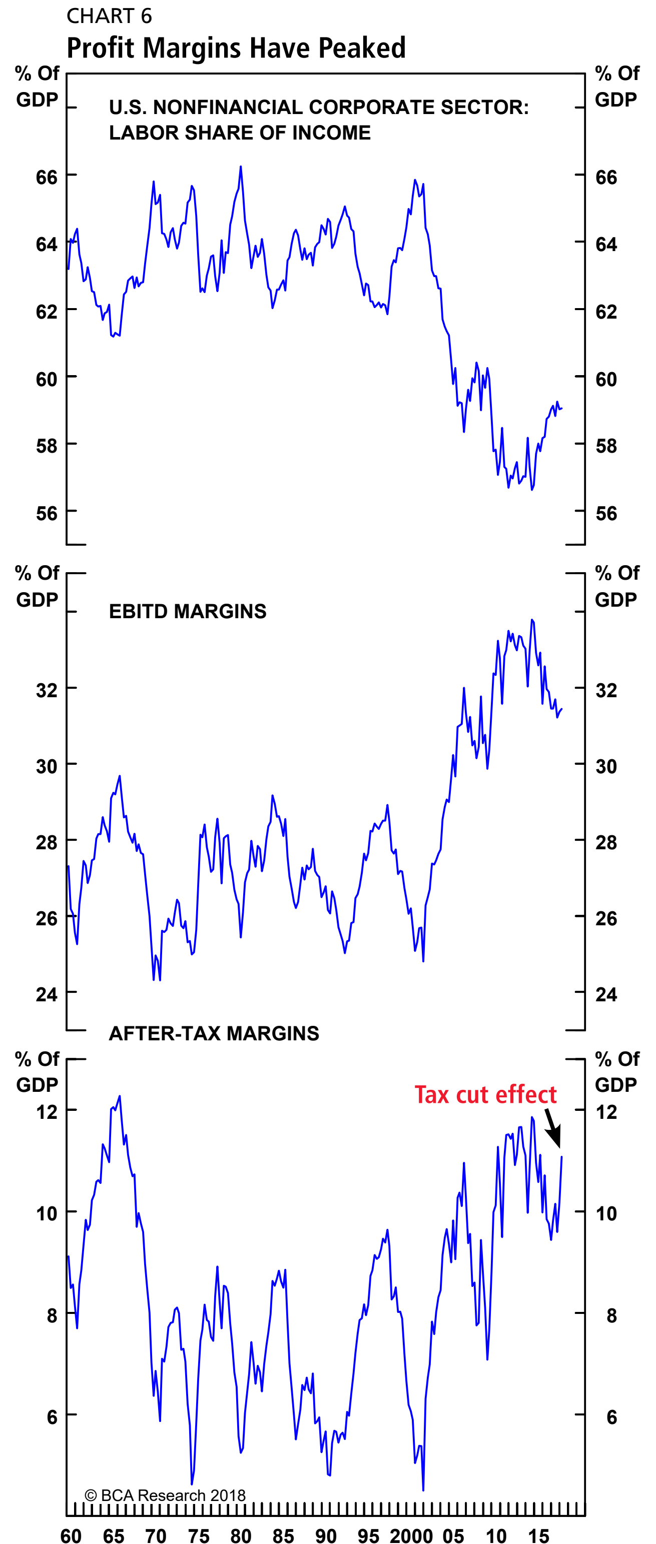


CHART 6

Profit Margins Have Peaked



ground in the face of U.S. bullying. My rather unhelpful conclusion is that trade wars are a serious risk that need watching but are unforecastable at this stage.

Earnings Galore, But…

It's confession time. The performance of U.S. corporate earnings has been far better than I have been predicting during the past few years. In several previous reports, I argued that earnings growth was bound to slow sharply as labor's share of income eventually climbed from its historically low level. I certainly had not expected that the annual growth in S&P 500 operating earnings would average 20% in the two years to 2018 Q2 (**Chart 5**).

In defense, my original argument was not completely wrong. Labor's share of corporate income bottomed in the third quarter of 2014 and that marked the peak in margins, based on national income data of pre-tax profits (**Chart 6**). Margins have fallen particularly sharply for the national income

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measure of non-financial profits before interest, taxes and depreciation (EBITD). I believe this is a good measure of the underlying performance of the corporate sector as it is unaffected by policy changes to taxes, depreciation rates and monetary policy. This measure of margins used to be very mean reverting but currently is still far above its historical average. Given the tightness in the labor market, there is still considerable downside in margins as wage costs edge higher.

An unusually large gap has opened up in recent years between S&P earnings data and the national accounts numbers. While there are several definitional differences between the two datasets, this cannot explain the large divergence shown in **Chart 7**. The national income data are generally believed to be less susceptible to accounting gimmicks and are thus a better reflection of underlying trends.

CHART 7
A Strange Divergence In Profit Data

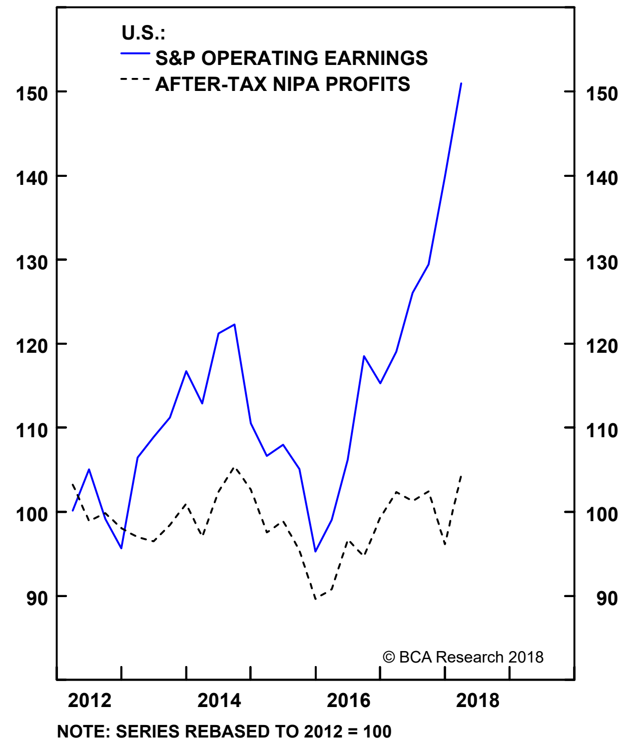
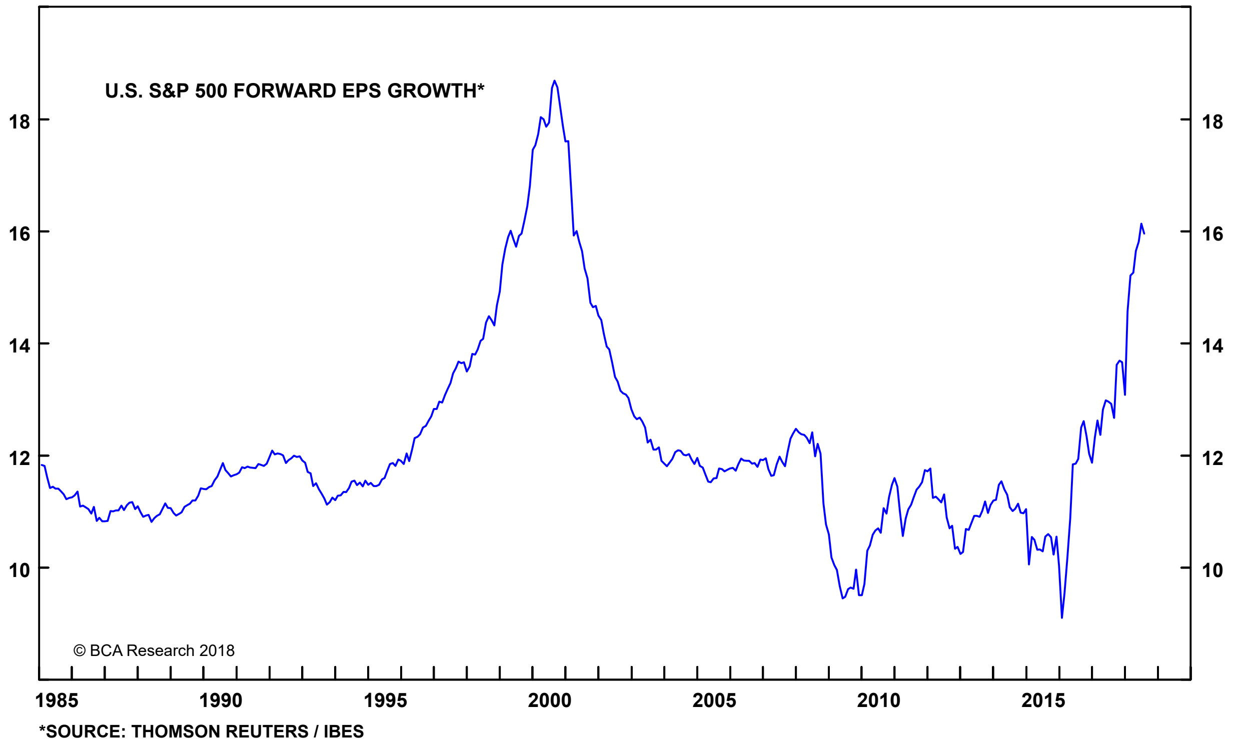


CHART 8
Insanely Bullish Long-Term Earnings Expectations



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Analysts remain extraordinarily bullish on future earnings prospects. Not only are S&P 500 earnings forecast to rise a further 14% over the next 12 months, but the current expectation of 16% per annum long-run earnings growth was only exceeded at the peak of the tech bubble (**Chart 8**). And we know how that episode ended!

I am inclined to stick to my view that earnings surprises will disappoint over the next year. The impact of corporate tax cuts will disappear, and both borrowing costs and wage growth are headed higher. A marked slowdown in earnings growth will remove a major prop under the bull market.

Brexit

As a Brit, I am totally appalled with the Brexit fiasco. It was all so unnecessary. Yes, the EU has an intrusive bureaucracy that imposes some annoying rules and regulations on member countries. However, OECD data show that the U.K. is one of the world's least regulated economies and it scores high in the World Bank's Ease of Doing Business rankings. In other words, there is no compelling evidence that EU bureaucratic meddling has undermined business activity in the U.K. The vote for Brexit probably had more to do with immigration than anything else, and that also makes little sense given that the U.K. has a tight labor market and needs a plentiful supply of immigrant workers.

History likely will dictate that former Prime Minister David Cameron's decision to call for the Brexit referendum was the U.K.'s greatest political miscalculation of the post-WWII period. Not only was the decision to hold the referendum a mistake, but it also was foolhardy to base such a momentous vote on a simple majority rather than a super-majority of at least 60%. Adjusting the referendum result by voter turnout, those backing Brexit represented only around 37% of the eligible voting public.[3]

Clearly, the government was unprepared for the vote result and divorce proceedings have moved ahead with no viable plan to achieve an acceptable separation. Meanwhile, the inevitable confusion has created huge uncertainty for businesses and is doing significant damage to the economy.

This is not the place to get into the minutiae of the Brexit morass such as the Northern Ireland border issue and the difficulty of agreeing new trade relationships. Those have been well aired in the press and by many other commentators. My lingering hope is that the enormous challenges of coming up with a mutually acceptable deal with the EU will prove intractable, resulting in a new referendum or election that will consign the whole idea to its grave. We should not have to wait too long to discover whether that is a futile wish.

Investment Strategy

Equities are still in a bull market and we are thus in a period where investors are biased to be optimistic. Bears have been discredited and the current strength of the economy gives greater credence to the market's cheerleaders. I have been in the forecasting business for long enough (45+ years)

[3] The referendum result was 51.9% in favor of Brexit, with a voter turnout of close to 72%.

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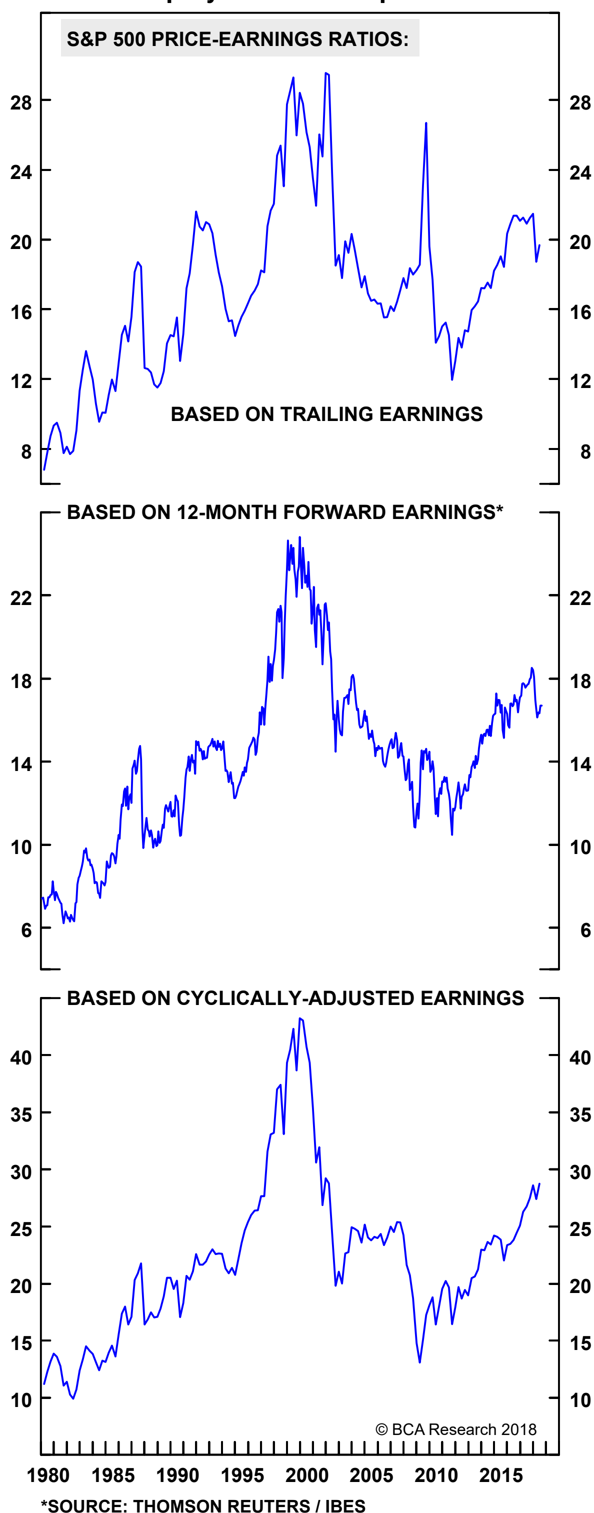
CHART 9
The U.S. Equity Market Is Expensive



*SOURCE: THOMSON REUTERS / IBES

to be suitably humble about my ability to forecast where markets are headed. I am very sympathetic to the famous Keynes quote that "the market can stay irrational longer than you can stay solvent". Investors will have their own set of preferences and constraints about whether it makes sense to stay heavily invested during times when markets appear to have diverged from fundamentals.

The U.S. equity market's price-earnings ratio (PER) currently is about 20% above historical averages, based on both trailing and 12-month forward earnings and more than 30% above based on cyclically-adjusted earnings (**Chart 9**). Yes, interest rates are low by historical standards, giving scope for higher PERs, but rates are going up and profit margins are at historically elevated levels with lots of downside potential.

I fully accept that equity markets can continue to rise over the next year, beating the meagre returns available from cash and bonds. For those investors being measured by quarterly performance, it is difficult to stay on the sidelines while prices march higher. Nevertheless, I believe this is a time for caution.

The perfect time for equity investing is when markets are cheap, earnings expectations are overly pessimistic and the monetary environment is highly accommodative. Currently, the opposite conditions exist: valuations are stretched, earnings expectations are euphoric and the Fed is in tightening mode. It does not seem a propitious time to be aggressive.

The future is always shrouded in mist, but there currently is an unusually large number

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of important economic and political questions hanging over the market. These include the timing of the next recession, the related path of monetary policy, the outcome of the U.S. midterm elections, trade wars, U.S.-Sino relations and Brexit, just to name a few.

The good news is that our Annual Investment Conference on September 24/25 will be tackling these issues head on with an incredible group of experts. I am looking forward to hearing, among others, from Janet Yellen on monetary policy, Leland Miller and Elizabeth Economy on China, Greg Valliere on U.S. politics, and Stephen King and Stephen Harper on global trade. It promises to be an exceptional event and I hope to see you there.

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