11/11/19

Quarter in Review

The Markets

Q3 was a bit of a roller coaster, equities sold off sharply in the beginning of August, corresponding with the US stating it would increase tariffs on Chinese goods and didn't really recover until September. For the quarter, large and mid-cap equity performed the best up over 1%, **while small cap, developed countries and emerging markets were all negative down 0.5, 1.6 and 3.9% respectively.** On the flip side Long Term bonds (we shifted into them in early July from intermediate term) were up over 6.5% while intermediate and short-term instruments were only up 2.3 and 0.9% QTD. Tips and High yield were up over 1% while global bonds were down around 0.55. REITs were up again this quarter, 7.7%, keeping it strongly in first place this year up 26.4%, while commodities are bringing up the rear down over 5% for the quarter and down 1.2% for the year.

National observations

I am really getting to the point where I would enjoy a quarter when I could say that not a damn thing happened. Don't get me wrong, I am enjoying a somewhat late cycle performance surge, but the headlines make for some pretty sleepless nights. In domestic positive news, there was a bipartisan agreement to suspend the debt ceiling limit for the next two years reached in late July, wait did I just say that was a positive. Most of the other news is negative.

The US China trade dispute has continued with this past June's failure to reach an agreement. We are currently placing 25% tariffs on $250 billion Chinese imports as a result of years of forced technology transfer equivalent to cyber theft from American companies. However, import prices from China have steadily declined since the tariffs have been in place (July 2018) falling over 1.8% annually as Chinese firms lowered the prices of goods to stay competitive while the dollar strengthened. Thus, the American consumer hasn't necessarily felt the effects of the tariffs. Make no mistake, the goal of the current administration is to have US firms move their supply chains away from China, and to reduce, curb or nullify the Chinese technological advancement. But, if the argument also includes reducing the trade deficit with China to fight the loss of jobs, or inflation, the value of the dollar, interest rates or foreign direct investment, then it fails on all fronts. We have the lowest jobless rate in literally decades, there is sub two percent inflation, the value of the dollar is strong, interest rates are low, and we continue to have strong direct foreign investment in US companies. The deficit with China has fallen since the fourth quarter of 2018, but the overall trade deficit is greater than it was prior to enacting the tariffs. We just shifted it to other countries, namely Mexico, which might be reason enough to pass the USMCA! A September 30th article by Harry G.

Broadman in Forbes entitled “Forced U.S. – China Decoupling Poses Large Threats,” calls, instead of tariffs, for the world, via the WTO, to either renegotiate Chinese membership, remove them or be forced to blow up the WTO which the US so strongly backed. In my short existence on this planet, I have rarely seen the “world” rally to do “anything” of substance, let alone kick out the second largest economy from the WTO when most large non-US economies are export dependent. In the end, did this trade spat really start hurting either economy or were they starting to slow prior to the tariffs and rhetoric? I would lay money on the latter.

The other seemingly more important domestic news was the fact the Fed cut rates twice in the quarter as “insurance” against the economy pushing into stall speed. The more interesting and relatively esoteric news which the WSJ had a great explanation article entitled “Fed Boosts Amount of Liquidity Offered to Financial System” and video, were the “technical” issues with the repo market (the overnight market where financial firms borrow cash and lend securities). This lending rate (which should be close to fed funds) popped and at one point hit 10% because financial entities stopped lending to each other. The Fed stepped in and lent over the latter half of September to quell the unrest in the market, but the Fed should be paying close attention to who needed the money and why, not necessarily why institutions weren’t lending. Since October of 2008, the Fed has been paying interest on both required and excess reserve balances. Under Basel III, banks are now required to hold an amount of high-quality assets (stuff that can be turned into cash quick), to fund cash outflows for 30 days, otherwise known as the liquidity coverage ratio or LCR. It started in 2011 but full implementation wasn’t completed until four years later in 2015. This was created to make the banks have a bigger cushion during a liquidity crisis and prevent the Lehmans and Bear Stearns from happening again. This was the equivalent of monetary tightening because banks had to keep this money physically in the vault, on their books or at the Fed instead of lending it out. While the Fed funds rate was around 15bps, the Fed started paying interest on those deposits at the Fed, both for domestic and foreign owned banks doing business here, in an effort to make banking not completely unprofitable. During the 1970s even when the Fed wasn’t paying interest, banks kept about 30% of their total cash to total reserve required at the Fed. This number fell all the way to 2% in 1999 and didn’t rise higher than 8% until August of 2008, meaning money wasn’t being held at the Fed. What was the bigger problem, (and part of the reason for the LCR under Basel III) was that **the percentage of total cash to total liabilities fell from around 13% in the 1970s and early 80s all the way to just about 3% prior to the 2008/9 recession**. Since the Fed started paying interest on required and excess reserves (IORR or IOER), the interest rate has always been higher than effective Fed Funds rate (the rate which banks lend to each other overnight). The effective federal funds rate actually just became equal to IORR or IOER (there wasn’t a difference in rate between the two) in November 2018, almost exactly ten years after they started paying interest. **Meaning there should have been the same incentive to lend between banks or keep money at the Fed, unless hmm the credit quality wasn’t the same?** At the high point in September 2014, banks had over 22% total cash over total liabilities. Since that time, they have drifted back down to 10% (excess reserves have declined). All this time the amount of **total cash to the total reserve balance has averaged 91% vs the 3% prior to the recession (all the banks reserves are at the Fed.)** Bottom line, by the Fed having to step in they have (via thin air) increased the reserve balances by over $120 billion during this time period. So who is in trouble, and why did they need to go to the discount window… oops that is so 2008, I meant the repo window. This IS something to watch, the last recession had liquidity issues as well, and we should definitely be mindful if this is a canary.

Oh, and one last small thing, instead of passing USMCA, tackling immigration or medical prescription costs this year, congress has decided to hold closed door impeachment hearings of everyone's favorite president, because… wait for it.. he used his political office in an improper manner. This worked out super well for the Republicans in the 90s, let's see how this slow-motion car crash unfolds.

International observations

Internationally wasn't lacking for news which started with the selection of Christine Legarde (the chairman of the IMF) as the next head of the European Central Bank (ECB) in early July. Her accommodative monetary views will not differ greatly from the outgoing President Mario Draghi. In other central bank news, Turkish President Erdogan removed the country's head of the central bank in early July. The Lira hasn't sold off as much as anticipated, and not nearly as much as it did from January until May of this year. But Erdogan has definitely consolidated power since the failed 2016 coup d'état attempt. The UK declared Boris Johnson, the new PM, in late July as he campaigned on a Brexit as of the end of October, even if it meant leaving with no deal. Hong Kong's protests of the extradition law broadened into a wider protest for freedoms and liberties, it feels are under threat. The protests have become more and more violent on both sides, and with Chinese growth slowing to 6.2% in July (the slowest it has been since 1992), its patience is waning. OPEC and its allies are extending production cuts into 2020, only to have Iran seize a British oil tanker in retaliation for the early seizure of its own tanker by Gibraltar authorities. In corporate news in July, Deutsche Bank started to cut close to 18k jobs worldwide as Christian Sewing tries to reduce ancillary and non-profitable business units from the 17th largest bank in the world.

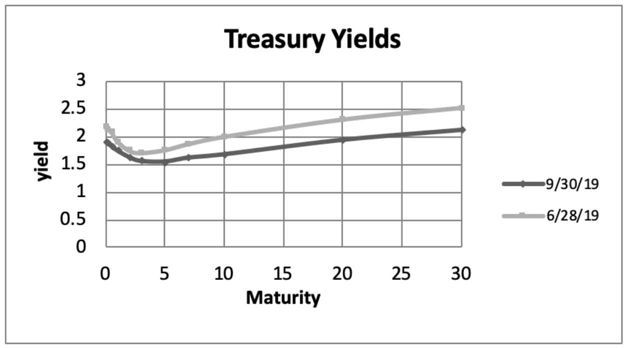
In the beginning of August, the US stated they would impose an increase of 5% on $550 billion of Chinese imports. The new tariffs would be 30% on $250 billion and 15% on $300 billion effective October 1, 2019. China retaliated with state run agriculture firms not buying American farm goods. The US imposed additional sanctions on Venezuela, while Argentina's President Macri lost a primary election by 15%, sending the Peso down 21% by the end of the quarter. Also, in South America the burning of the Brazilian rain forest brought an unusual outcry by French President Macron, as illegal deforesting has increased, and fires have become much more prominent, while policing and regulation haven't countered it much. Singapore reduced its current year GDP estimate from 1.5-2.5% to 0-1% as more evidence of a global slowdown surfaces.

In early September, Hurricane Dorian, a cat 5, and the strongest to hit the islands since 1935, ravaged the Bahamas, with an estimated death toll at 70 and over $8 billion in damage to the Caribbean. In an attempt to stave off some of the trade issues, China removed overseas investment limits in the country's stocks and bonds. The Hong Kong Exchange made an unsolicited offer for the London Stock exchange at GBP36.6 billion, which the LSE rejected. Also, in early September, the ECB cut rates by 10 bps to negative 0.50% and said it will start buying debt on November 1st to the tune of 20 billion Euros a month. In the middle of the month, several Saudi Arabian oil fields were attacked from what most analysts believe to be Iranian drones, despite the Houthi rebels claims it came from them in Yemen. Oil prices jumped around a bit as Saudi's production was cut in half, removing 5% of the world's daily production. By the end of September, their production was over 80% of the original output but heavier oil than consumers were previously purchasing. China's industrial output rose 4.4% in August - the lowest level since 2002, while the OECD cut its global growth forecast to 2.9% from 3.2% only fourth months prior. In corporate news, Mitsubishi had an oil trader lose $320 million in derivative transactions disguised as hedges. In the UK the Supreme court ruled that Boris Johnson's suspension of parliament was unlawful, squashing his desire for a no deal Brexit by closing Parliament over October 31st. Lastly, the WTO ruled in favor of the US authorizing them to impose nearly $8 billion in tariffs on European goods due to the illegal state aid provided to Airbus SE.

Interest Rates

Insurance/precautionary Fed Funds cuts, similar to the 1998 cuts, were made in defense of the economy as the Fed tries to pull back some of the tightening of 2018. The global and domestic economies are definitely slowing down and the Fed (albeit not all members agreed in direction or amount) decided to try to get ahead of it, removing the chance the economy would enter into stall speed. At the end of September, the Fed had cut twice, putting the target at 1.75 to 2%, and from the middle of August to the middle of September the yield curve was fully inverted. Since the September rate cut, the 30-year bond is back above the fed funds rate, but the rest of the curve is still beneath. (At the end of October the Fed cut again and the curve has since normalized) While the inversion is often a harbinger for the end of an expansion, when the curve snaps back above the funds rate, it is typically a much shorter time period until a recession hits.

Years	9/30/19	6/28/19	Difference
0.08	1.91	2.18	-0.27
0.24	1.88	2.12	-0.24
0.5	1.83	2.09	-0.26
1	1.75	1.92	-0.17
2	1.63	1.75	-0.12
3	1.56	1.71	-0.15
5	1.55	1.76	-0.21
7	1.62	1.87	-0.25
10	1.68	2	-0.32
20	1.94	2.31	-0.37
30	2.12	2.52	-0.4



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage has continued to drop over the quarter from 3.75% to 3.64%. 15-year conforming balance essentially stayed the same from 3.18% to 3.16%. The Mortgage Bankers Association information as of 11/06/19 showed the 30-year conforming balance FRM down from 4.12% with .37 in points to 3.98% with points staying the same. Jumbos loans were barely down from 4.01% with .28 pts to 3.97% with .24. 15-year conforming balance FRMs were also down from 3.48 with .32 in points to 3.38% with .31 points. Along with mortgage rates the S&P Case Shiller index also slowed, up only 3.2% year over year for August. This slow down isn't worrisome but more a return to long run averages.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 111.9 down from July's peak of 112.2. Since April the index has barely had half of its components in positive area. Without the stock market, claims and the leading credit index, the contraction would be much worse. ISM new orders were negative again in September and have been negative since April. Since the curve was inverted the 10 year/fed funds spread also subtracted from the index. Since the most recent October cut to the funds rate, the curve has once again normalized which will mean a positive spread and contribution going forward. But this should be taken with a grain of salt because once a curve normalizes after an inversion, a recession is typically around the corner. Building permits were negative in September - the only month of a relatively good summer period. But since May of this year, many economist and real estate experts expect the next real estate recession to come in 2020, however they don't anticipate it will have the same size effect on the economy as 2008-2009. As this is the second month in a row the index was down, we will have to wait until late November to read about October's report. This isn't a strong signal one way or the other but was probably enough to help the fed cut again.

Jobs

At the time of this write up, **nonfarm payrolls** posted an **increase of 128,000 jobs for October** (consensus was 85k). The average monthly nonfarm gain in 2019 is 167k compared to 187k, 182k and 223k for 2016, 2017 and 2018. The Household survey's unemployment rate is 3.6% down from a January high of 4% and the lowest since 1969. The median duration of unemployment was 9.3 months, the average for the past two years, but above the long run average (since 1967) of 8.7 months. My belief is that because employers are finding it hard to find qualified people to fill positions, we are not going to grind much lower on any of the above stats. Aggregate weekly hours index hit another all-time high this quarter of 111.6, **but temporary help services were down in September**. Since 2018 temporary employment has lost about 20k jobs or about -0.15%. If we see it lose about 2% year over year then it is a sign that we are close to a recession (this Christmas season will be a good indication via temp hiring). Claims has been bouncing around the low 200k numbers for the past couple of years and doesn't look like it could possibly go lower. The **labor force participation rate is at 63.3 ticking higher than the long run average** for the past four months. The ISM employment survey number slipped under 50 in the third quarter and again is there now in October. Manufacturing employment slipped into negative territory in September and then again in October, but that was counting the striking workforce at GM. The Q3 forward GDP estimate of 2% was pretty close as the preliminary estimate as the Q3 year over year was 2.03% and using the quarter to project forward was around 1.92%. This jobs report shows us slowing, not dipping into recession. I think we are getting close and we should start to really see the signs in early 2020.

Industrial production

Q3 IP was positive for the first time this year up 0.20%, but revisions to Q2 wiped out the entire gain. Q1 revisions put it at -.78% and Q2 is now at -.34%, so adding in Q3 we are down almost 1% for the year. In 2015 we saw IP fall over 4% even while manufacturing employment increased slightly. This year IP hasn't fallen as much but jobs have slowed as supported by ISM last three reports ending October. Utilities bounced back with a strong quarter because of the hotter weather, but mining was down for the quarter about 1.3%, and manufacturing was down about 0.3%. The positive Q3 number was entirely utilities. With October being a record warm month, November and December will have to be much colder to produce similar utility results. Over the past 12 months IP was down -.1%. Although **these numbers are certainly not as bad as 2015**, with the rest of the world and parts of our economy slowing down, these numbers are integral part the several stats NBER looks at to judge the peak of the expansion.

Housing

New home sales for September were 701k per year, while August was 706k and July 665k. All three about the same as the long run average. Falling mortgage rates definitely helped the summer buyer, but affordability issues are being talked about more and more as all the Case Shiller indexes start to slow down, 3.2% year over year ending August for the national index, while the 20-city was up only 2% and the 10-city was up 1.6%. Major metropolitan areas are slowing down price wise. There are obviously tons of reasons why home prices are declining, even as single family housing starts won't probably touch a million annually for a while (meaning less housing). But the demand is simply not there, the next generation is way more mobile, and strapped with huge student loans to even think about saving for a six figure down payment on a house. The family dynamic has also changed with people waiting longer and longer to have children and thus the need for a home or a larger apartment isn't there like it used to be. In fact, housing affordability has forced a lot of college grads back home. Housing is slowing as mortgage rates have probably hit a bottom for the time being.

The Consumer

The **Conference Board's consumer confidence index stood at 126.3 as of September 2019.** The index has remained volatile with some concerns around business conditions and job prospects, but the index remains relatively high even with the unending trade talk. The **University of Michigan's Consumer Sentiment September number was 93.2** much stronger than August, but under the year's average. Neither of these two numbers look necessarily bad when you couple them with Personal income, Disposable Personal Income, Consumption expenditures and Personal Consumption on Durable goods all at or above a 4% annual growth rate. Income gains are definitely not at the long-term average of over 6% (back to 1960s), but they are above the long-term personal consumption of durable goods average at 5.69% compared to 4.72%. Consumer credit is also growing at a healthy clip of 4.89% year over year ending September, but this is being led by the nonrevolving consumer credit section over 5% a year. **To put our student loan problem into a bit of perspective, it took 64 years prior to 2007 to amass 1.5 trillion in nonrevolving debt… it only took another 12 more to accumulate another $1.5 trillion to double it… And that makes up 74% of the total consumer debt which now stands at $4.1 trillion.** The country's savings rate surprisingly at the long-term average of 8.3% which is a good thing considering the retirement train wreck that is and will continue to happen. Read this: (https://www.forbes.com/sites/greatspeculations/2019/03/20/the-retirement-crisis-is-much-worse-than-you-think/#4e78042a3949)

Inflation

As of September, **CPI was up 1.73% and PCE was up 1.33% year over year.** This is an interesting problem that the Fed is facing as it looks to PCE normally as their gauge to whether they are meeting part of their mandate. Since they started cutting the feds funds rate in July, CPI reversed course and was up around 1.76% for Q3, whereas quarter over quarter PCE has remained at 1.4ish. July saw a pop in CPI coming from Energy, but as that reversed in August and September CPI fell again and was only up 0.1% and 0.0% for the two months respectively. Core CPI (removing food and energy) is up 2.4% over the last twelve months, with medical services and shelter up the most at 4.4% and 3.5% respectively over the past twelve months. Apparel and Medical care commodities were both down 0.3%. year over year. Since the Fed cut in late July, the market segments that performed the best were Long Term Bonds and REITS. Sectors like emerging markets and commodities which aren't as directly affected by rate cuts performed the worse (probably around global growth concerns).

In Closing

We are now **123 months** into an economic expansion making it the longest expansion since the National Bureau of Economic research start keeping track of them in June 1857. So, recapping a bit, the Fed cut interest rates twice over the summer, (and one more time in October but this is a Q3 write up) and it started to provide repo liquidity when the rate spiked to close to 10%. The leading economic indicators are still looking pretty good but only half of them are positive and those that are aren't looking as solid as they once were**. Jobs were up 565k for the quarter**, the exact same amount in Q3 2018. The average for the year has only been 167k per month vs. the 223k of 2018. Household unemployment continued to decline, while the participation rate continued to climb. **Industrial production is down close to 1% for the year**, not as bad as 2015, but coupled with everything else, this isn't helping. Housing benefited from some good summer sales were up 9% year over year ending September. But rates have bottomed, refis are done, and affordability isn't getting better. Existing home sales and Building Permits have been negative year over year in almost every month this year except for September. New housing under construction year over year has been dropping since its peak in August 2018. We are slowing, and economist and real estate experts expect the next housing recession to start in 2020. The consumer sentiment has retracted a bit, but it is still at pretty strong level, while personal income and outlays recorded a pretty strong quarter. The issue I will keep harping on is the damaging effect of student debt on our economy as a whole. I truly believe the answer is not to keep throwing government funds at students for schools that don't provide an education which is required by the economy once they graduate. School cost will NOT come down as long as the supply of money is freely flowing, you can't fight basic economics. We as a society need to be choosier in the institutions we send our children to, and walk away from those institutions that don't provide a better future for our kids, but instead straddle them with a life time of debt, and a skill set that firms simply don't need or want. Housing and school debt will keep the economy less nimble and unable to provide the funds to innovate and truly produce, whether that is in manufacturing or service. Can someone please wheel away the podium now…

As of this write up my model is still calling for the likelihood of a recession less than 20% but I am not feeling as confident. The yield curve as of early November has normalized (if you want to call it that). If you look historically at when recessions happen after the curve inverts they range dramatically. But if you look at how long it takes to tip into recession after the curve normalizes, just after it has inverted, the time is much shorter and consistent. The above stats are still not flashing yellow, and therefore I have not moved out or lightened my equity position to date. I have however removed the tactical long duration positioning, as most economists agree that the Fed has stopped cutting rates until 2020. Duration extending is not for the faint of heart, and while the Fed was cutting it was the right place to be. It seems like we are getting close, and this time there might not be a strong catalyst that pushes us into recession but the simple fact we are at the peak of a cycle.