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By the Way

Monthly commentary from Jack Way

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"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

Recent U.S. economic releases have been better than expected indicating a much improved level of inflation and continuing growth in GDP. As a result, the investment narrative has changed in a significant, if not seismic way, and left many forecasters (myself included) with egg on their face and trying to quickly adapt to the new information. Whereas only a very short while ago a so-called "soft landing" for the economy was considered only a pipe dream, it is becoming more and more an accepted possibility. GDP in the second quarter grew at a solid 2.4% real, supported in large part by consumer spending which continues to reap the benefits of a strong labour market and accumulated household savings. We had already seen the rate of inflation dropping but even so June's 3% CPI level was a pleasant surprise and was backed up by only a 0.1% increase in the Produce Price Index. Perhaps most remarkable was the 3.7% improvement in U.S. productivity which helped hold unit labor costs to only a 1.6% increase despite stronger wage growth. Still, one month or one quarter of positive news does not necessarily make a trend. Federal Reserve policies continue to be restrictive, and the lagged impact of previous tightening efforts is yet an unknown. Despite stimulus measures, China continues to have trouble getting its economy back on the rails, which also negatively affects all other global economies. On the inflation front "reacceleration" of inflation is a major concern for many. Gasoline prices have increased markedly and are always a factor both in reality and psychologically. Other areas like housing and autos are showing some strength which could portend well for the economy but not for inflation. I suspect a reacceleration would not please the FED and keep monetary policy tighter for longer. Although on a more positive note Chairman Powell in his last press conference said given policy lags: "you'd start cutting before you got to 2% inflation".

At any rate, to take the food analogy a step further, there has been plenty of humble pie to go around as forecasters incorporate these improved numbers into their calculations. Even economists, purveyors of the "dismal science", are brightening their outlooks and lowering the chances of any kind of meaningful recession. Stock market strategists (we'll discuss the bond market later) such as those at Morgan Stanley and Citigroup are raising their targets, (J.P. Morgan is the one major broker remaining bearish, at least so far). Finally, many corporate executives have also misread this economy by cutting back on expenditures and inventory in the face of an expected downturn. Now they are forced to scramble to play catch up to try and meet demand while suppliers have significant pricing leverage. For example, car companies are paying a premium for computer chips and still can't get enough; homebuilders are outbidding one another for vacant land; and the hospitality industry is having great difficulty attracting workers back to the job. As an aside, this may explain in some part the strength in the economy and wage growth.

As for equity markets, the S&P 500, and even more the NASDAQ, have continued to ignore gravity. A quote from Peter Lynch, legendary Fidelity portfolio manager back in the 1980's, struck home to me in a painful way, considering my investment approach so far this year. "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." My "mea culpa" is writing about "varied" risk but only considering the risk to the downside. That's old news though; more importantly where are we now?" The S&P is trading at a multiple of almost 20x earnings, a full but not necessarily excessive valuation. It is up from less than 16x at the start of the year, which means, given there has been no increase in earnings in that time, that the total rise in the market came from the multiple. Until last Wednesday, the S&P 500 had gone 47 straight trading days without experiencing a 1% decline. Other positives (or at least indications of an abundance of bullishness) include better breadth, a low put/call ratio, high sentiment

surveys, and a low VIX (a measure of expected volatility). All of the above can also be seen as negatives through a contrarian eye, but history shows such excessively bullish readings are required to drive markets higher and will often persist much longer than expected. As someone succinctly put it, "Every new high is bullish until the last one."

Fixed income markets are dangerous waters for equity guys to wade into given a lack of real knowledge and understanding, but three recent announcements need to be addressed, all of them suggest higher interest rates. First, in a surprise move, Fitch downgraded the debt of the U.S. from AAA to AA citing ongoing fiscal deficits and an "erosion of governance". (What a great euphemism for the circus caused by the buffoons in Washington.) A downgrade, by definition, implies higher interest rates but the immediate impact isn't necessarily a major negative, (S&P downgraded the U.S. debt to AA in 2011 and that rating remains in place without disaster), but in my opinion it is another example of the declining status of the U.S. on the world stage both economically and politically. A shutdown of the U.S. government on October 1st is becoming more and more likely, as the two political parties continue to battle. Secondly the Japanese Central Bank announced an easing in its Yield Curve Control policy allowing bond yields to rise. As the benchmark for the lowest long term interest rates globally, it meant yields across the world would move higher as well. More crucial, Japan is the largest holder of U.S. debt and as the return on Japanese bonds becomes more attractive to local investors, the risk of repatriation and pressure on U.S. financial assets increases. Thirdly the U.S. Department of the Treasury announced its quarterly refunding needs and they are significantly larger and will require much higher interest payments. Treasury has already raised $2 trillion in T-bills just since the debt ceiling was raised. This will not help U.S. budget deficits and puts more pressure on rates. It's worth noting that the net interest cost of the U.S. government is already rising for the first time in 35 years. On the other hand, these high rates are allowing we boomers to spend more and enjoy a better retirement, and S&P 500 companies (ex-financials) are generating an estimated $6.7 billion of income monthly from their cash holdings which is more than double the previous record. Bottom line though, higher interest costs will slow economic growth and impair financial markets, or at least I always thought so.

With improved inflation and growth already priced into these markets what could drive the second half? Perhaps its real industrial growth which has lagged considerably in this cycle. Keep an eye on things like rail volumes, steel production, capex, and manufacturing PMI's for signs of strength.

I leave it to you to follow Mr. Trump's meanderings through the courts, he's worn me out. As well, keep abreast of stories from other candidates; this election could well have broad implications for the future of America.

Some say being early is the same as being wrong; I still like to be early.

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