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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave – Free

Dear Readers,

This report was published last week for our paying subscribers. I'm pleased to now share it with all of you as a Free edition. Hope you enjoy reading it.

I WANT TO HOLD YOUR HAND

That's not Lennon or McCartney, it is Janet Yellen.

If you went to sleep at the start of the year and just woke up to see the S&P 500 up 1% on the year, you could be forgiven for thinking that you didn't miss very much — but we could have said much of the same for all of 2015, and yet there was no shortage of volatility, peaks and valleys, intermittent corrections, and sharp bear market rallies along the way.

The era of "buy and hold" is over; the near straight line up in the market really ended with the end of quantitative easing back in the Fall of 2014, and so adding alpha now means being nimble and quick.

The era of "buy and hold" is over

It is a traders' market and it is likely to stay that way for some time yet.

Which brings me to the Fed, which seems to be front and center yet again. At least we know who the boss is and it is not any of the particularly hawkish District Fed presidents — like the four in the past couple of weeks who advocated a rate hike sooner rather than later.

It is now more obvious than ever that when Janet Yellen talks, people listen — as we saw in the initial bullish reaction to her speech in New York on last Tuesday and the follow-through on Wednesday, taking the major averages to the highs of the year.

When Janet Yellen talks, people listen

But I think it is instructive to focus on the one sector that has stuck out like a sore thumb, which is the Banks as they are lower now than they were prior to Janet Yellen's dovish commentary — a Fed that is now on hold as far as the eye can see is not exactly good news for a part of the market begging for expanding net interest margins.

When we look back we will also see that rallies that do not have the Financials participate are rallies you can take to the dance but that you cannot necessarily take home.

Rallies you can take to the dance but you cannot take home

I also have to say that it does make me feel a bit queasy to see *Yellen Rides to the Rescue of Markets* on the front page of the USA Today — I mean, seriously, we are seven years off the lows, with equity returns more than tripling over that span, and we still need to hire Janet Yellen as Mr. Market's hand-holder? Hard to believe but true.

Well, maybe this is not the best time to play philosopher and focus on what makes markets tick today, which obviously is the ongoing drip of financial heroin from central banks (in fact, it may not be Janet who is the boss as much as all the other major central banks like the Bank of Japan and European Central Bank, whose relentless easing initiatives have forced her to the sidelines indefinitely).

The reflation theme is being underscored by the softening in the U.S. dollar

The reflation theme is being underscored by the softening in the U.S. dollar — after failing recently not once, but twice, at the 50-day moving average, the DXY dollar index just made a failed approach of the 200-day trend line and is now faltering quite badly — at a key technical juncture right now actually, and this was clearly one of Janet Yellen's goals (after all, she carefully isolated two sources of concern — China and Oil — and both can be remedied by what? Try a weaker U.S. dollar).

The greenback has slipped 4% on a trade-weighted basis in March, and is on track for its second straight monthly setback — and the sharpest decline since September 2010.

To repeat, the vice on global liquidity from the super-strong dollar — the second most intense dollar bull market on record — which created more losers than winners in the process (what's that about "too much of a good thing", again?), has been broken.

All the major trend-lines are either flat or rolling over, so it is reasonably safe to say that the dollar bull market is over.

Music to the ears of the U.S. manufacturing sector

And consider this music to the ears of the U.S. manufacturing sector, dollar-denominated debt strained Emerging Markets, gold, industrial commodities, resource-based currencies — our beloved Canadian dollar broke through the C$1.30 threshold as an example — and the weakening greenback is a key factor that will help ease foreign exchange pressures in China (as the yuan has been able to depreciate to 16-month lows on the trade-weighted index monitored by the PBOC).

So we have the fed fund futures market basically pricing out any residual probability of a rate hike at the next meeting (down from 10% recently) and a move by November is now being treated as a coin toss — in fact, odds of any move in 2016 got marked down 10 percentage points to 63% … now that is called power from the pulpit).

The two words that Janet Yellen emphasized last Tuesday were "global" (11 references versus four at her February congressional testimony and just once in her last December speech, just ahead of the "you-know-what" hitting the fan) and "uncertainty" (10 Tuesday from three in February and eight citations last December).

The Fed chief is more concerned about the downside risks to growth and inflation from the weakening pace overseas than before, that much is clear — and whenever a central banker is uncertain, rest assured that the only certainty is that he or she does nothing.

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That was the message from Yellen's speech. Rate risk is off the table, but the reasons for it — a lack of growth visibility — are why investors did not bid up stocks even more yesterday despite her overtly dovish tone.

I don't think it can be lost on investors that the Fed is less of a sustainable positive force for the equity markets at current stretched valuations.

The market price-to-earnings multiple is two points above its historical fair-value. In other words, the market is priced for operating earnings per share of $140 for the coming 12 months whereas the consensus among bottom up analysts has not budged from roughly $120.

Somehow and some time that bridge is going to close, and if it closes in price action that would shave 100 points off today's level of the S&P 500.

So *caveat emptor* (let the buyer beware) in playing this Fed relief rally.

Not just that, but we are still very clearly in an earnings recession and the quality of earnings is deteriorating at the fastest pace since the Great Recession, seven years ago.

Quality of earnings is deteriorating at the fastest pace since the Great Recession

The trailing price-to-earnings multiple on reported (un-scrubbed) earnings is 23.5x, a high for the cycle. Up until the latest quarter, the range had been 13x (in the third quarter of 2011 when it was time to buy) and 21.7x in the second quarter of 2015 (when it was time to lighten up).

The gap between reported and operating multiples has widened to 320 basis points from 190 basis points a year ago and the widest since the third quarter of 2009.

So it isn't just a lack of quantity, but a lack of quality in terms of the profit picture. Not a pretty one, either.

In that vein, it was interesting to see the sector performance on Tuesday in the S&P 500 (even as all 10 advanced, there was a wide dispersion) — Materials (+0.4%) and Industrials (+0.5%) actually underperformed, and it was the defensive rate-sensitives that topped the leaderboard (Utilities +1.4%; Telecom +1.1%; Health Care rallied 1.2%).

It was an interesting response.

Yellen pushed against rate hike expectations which means a persistent search for yield by investors. She said *"caution is especially warranted"* which means she is downbeat on growth.

Yellen pushed against rate hike expectations which means a persistent search for yield by investors

So the fact that the segments of the market with the highest yields and the lowest correlations with the economy advanced the most — along with having toes in the asset class that the Fed wants to rally the most, so as to improve financial conditions as an antidote to the weakening pace of overseas activity.

But investors with three-to-five year time horizons would be advised to heed the message that we have a Fed that is adopting a strategy that differs from the dual mandate of full employment (which we have) and price stability (which we also have).

We do have a reflation, or even mild stagflation, theme on our hands for those driving by looking through the front window as opposed to the rear view mirror.

This should be constructive for hard assets like basic materials and real estate — and one reason why I like the Canadian dollar because it is a currency play on a reflationary future.

Janet Yellen will continue to hold policy rates negative in real terms as far as the eye can see even with core CPI inflation at 2.3% and rising, core PCE at 1.7% and rising, unemployment south of 5% (and for those who truly are employable, that rate is between 2% and 2½% depending on the measure).

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Money and credit growth is running close to a 10% annual rate (on a 13-week rate of change basis) so deflation or lowflation are frankly a bit of a red herring.

It is not evident to the naked eye just yet, but just as the Fed sowed the seeds in the second half of the 1960s for the unexpected stagflationary experience of the 1970s, something very similar is taking hold this time around.

In sum, this Fed rally has a short shelf life absent a reacceleration in global growth in both the economy and earnings.

So this will remain broadly what it has been — more of an idiosyncratic market of special situations and creative ideas than one of merely playing the major averages and hoping for the best which worked so well from March 2009 to May 2015 (the lack of participation by the Financials remains a concern to me). This is especially the case for "growth stocks" seeing as the Nasdaq 100 has fallen short of getting past resistance so far at its major trendlines.

Now, make no mistake — I am not saying we are in a bear market, but we don't seem to be in a bull market, either. We are in a stagnant or purgatory market where nimble security selection and sector rotation rules the roost.

The S&P 500 peaked intraday on May 20th 2015 at 2,134 and bottomed on Feb 11th 2016 at 1,810; the tighter band is 2,100 on the upside and 1,900 on the downside.

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But as we saw in 2015, if you were in the "right" sectors (always so evident in hindsight) like Health Care, the Consumer and Tech, your total return was close to 7%-plus in what was basically a flat market.

This year — again a year that looks flat but has actually been a wild roller-coaster ride — being in the right sectors (bond proxies like Utilities and Telecom barbelled with softer-dollar proxies like Materials, Industrials and Consumer Staples) and again, the returns again have been a touch better than 7% thus far (and that is not annualized!).

From my lens, we have rallied too hard and too fast off the February lows and I don't expect this Fed induced rally to have a lot of legs.

A two-multiple point forward price-to-earnings multiple expansion in barely over a month does not happen too often.

We have enjoyed a great run back up to the top of the range and at a time when the Q1 earnings season is going to prove to be very challenging.

At the same time, sentiment is no longer a tailwind — complacency has set in, perhaps a tad too much of it. Market Vane Consensus Bullish equity sentiment was at 47% a month ago is at 56% today and the VIX back below 14x is hardly a green light to add more to positions.

Sentiment is no longer a tailwind

And the fact that the two best performing sectors so far this year are Telecom (+15.3%) and Utilities (+13.9%) and among the worst are Financials (-5.4%) and Consumer Discretionary (+1.3%) is not a very favorable pro-cyclical mix and attests to a generally defensive tone in an otherwise range-trading market.

As for the economy, it was nice to see the upward revision to fourth quarter GDP growth to 1.4% at an annual rate from 1.0%, and the initial print of 0.7%, but the tracking for the current quarter is now just +0.6% and this would then make it 10 of the 27 quarters since the recession ended where growth came in south of 1½% — so that is over 35% of the time we have been mired below 1½%, double what is normal in a typical expansion.

I am not calling for recession, but I see many economists hanging on to their one-in-four probabilities for the coming six-to-12 months (Wells

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Fargo the latest) which just doesn't jive with a forward price-to-earnings multiple some two points above the norm, and using GAAP earnings, that spread is even more acute.

Doesn't jive with a forward price-to-earnings multiple some two points above the norm

This is a market desperately searching for a theme — very much an idiosyncratic, stock-specific, and special situation (idea)-driven, not to mention dominated more by the technicals than is typically the case.

Ultimately, what we pay for as equity investors is for profits, and while the overall economy is not in recession, profits are, and the national accounts data from the Bureau of Economic Analysis last Friday showed pre-tax earnings dropping at a 7.8% annual rate in Q4, the biggest decline since the first quarter of 2011.

This followed a 1.6% decline the prior quarter — down in four of the past six, actually — and this dragged the annual trend down to -11.5% YoY, the lowest since the "Great Recession".

Profit margins are now being squeezed big-time — compressing to 12.7% in Q4 from 14.2% in Q3 and 15.1% a year ago (profits as a share of gross domestic income came in at 7.5% in Q4, far off the Q2 2013 peak of 10%).

Again, while it is true that the economy is not in recession, capital spending sure is, ditto for net exports, and so what is hanging the thread together is the consumer and housing and even here, we are seeing a loss of some momentum in recent months.

So there is limited visibility on earnings or the economy, that was Janet Yellen's macro message Tuesday, and then we have to assess the political risks that surround us globally.

Look at the world around us.

In a word, instability. In two words: no leadership.

In a word, instability — in two words: no leadership

We have a horrible primary season on our hands stateside as the candidate's trip over themselves claiming to be the greatest anti-free-trader and anti-Wall Street crusaders.

Populism at its best.

The two frontrunners — Hillary and The Donald — have the highest unfavorable ratings. She is being pushed to the left, and let's face it, The Donald is a loose cannon and is totally unpredictable.

Elsewhere, President Obama has all but checked out, which became pretty clear with his truly lame response to last week's terror attacks in Brussels.

U.K. Prime Minister David Cameron is in deep trouble with this Brexit vote and the separation crowd now has a modest lead in the polls and no doubt the tragic events at the heart of the European Union will only embolden this group.

Angela Merkel's fortunes have faded with their refugee policy, as the German state elections reveal her growing vulnerability.

Iran is back testing missiles and nobody outside of Bibi Netanyahu seems to be paying any attention.

Putin is dictating foreign policy in the Middle East and appears in the process to have successfully stabilized the Assad regime.

Putin is dictating foreign policy in the Middle East

There is also the tense political backdrop in Brazil (largest economy in South America) — which adds more to the global political uncertainty theme.

Secessionist forces in Spain are alive and well.

Italy is in the midst of a Banking crisis.

In France, Prime Minister Francois Holland is now backing away from labor market reforms.

China's leadership has lost credibility, Abenomics isn't working and the Modi revolution in India has largely fizzled.

And of course, terrorism is back on the front burner in Turkey, Brussels and Pakistan where the threat is building.

All of this uncertainty caps the upside in equities, even if the response thus far has been muted to say the least.

All of this uncertainty caps the upside in equities

Concluding on the bond market, I am convinced that if it were not for the fact that 10-year Japanese Government bond yields were trading at -9 basis point and German bunds at +0.16% (on the back of rampant central bank intervention), the 10-year Treasury note yield would be closer to 4% right now rather than the 1.8% level we have on our hands today.

Never before has 1.8% on 10-year money looked so good, and even as deflation fears subside, we still have this bizarre situation (the creation of the central banks in fact) where average yields on the $23 trillion of global sovereign bonds outstanding have just dropped below 0.7% for the first time in recorded history.

So as cautious as I am on equities, this "TINA" (There Is No Alternative) theme for the stock market is not going to go away either, and that is one reason I am not more negative than I am. Not when we have a 2.4%

S&P 500 dividend yield; fatter than the 10-year Treasury yield by a full 60 basis points.

In fact, we have reached a state where fully half of the U.S. stock market now trades at a yield premium to the 10-year Treasury note. Or here in Canada, where the TSX gives an investor over a 3% dividend yield right out of the gate and 4%-to-5% yields in stable sectors like Telecom, Utilities and Financials.

We are already seeing the early signs of inflation-protection in the very asset class that is most sensitive to the switch from deflation fears to inflation jubilation.

The purest form of this reflation theme is obvious in the recent behavior of Treasury Inflation-Protected Securities (TIPS), where breakeven levels — the market-based measure of inflation expectations — have jumped to their highs for the year at over 1.6% for the 10-year breakeven.

As I said at the top, this is a choppy year that doesn't look to offer much from the averages, but beneath the surface, what probably pays well are those stocks that few are willing to own — the unloved ones — and those that have blown up with a catalyst for change.

Back to "Safety and Income at a Reasonable Price" (SIRP) strategies

So as I search for a market theme, for the most part, it is simply about playing yield, earnings stability and low volatility — back to "Safety and Income at a Reasonable Price" (SIRP) strategies — on one end of the barbell and inflation protection on the other side of the barbell sounds like a reasonable strategy to me.

In terms of regional exposure, the country that has the most visibility right now is Canada, which has emerged as a bastion of political stability in a sea of global instability, and one of few countries where fiscal policy has grabbed the torch from monetary policy, which means that the Canadian dollar's switch from a flightless bird to a loon with wings likely has some durability.

Oil has taken a bit of a breather as it's had a nice run but the pipelines serve as a low beta way to play Energy, but with a near-5% dividend yield and 8% payout growth. The Canadian Banks have had a nice run but the yield of 4%-plus remains attractive and also a low-risk way to play the recovery in oil via reduced concerns over loan-loss provisioning.

Corporate credit also looks very good even after the nice recovery in recent weeks

Corporate credit also looks very good even after the nice recovery in recent weeks. High-Yield corporate bond yield spreads have come in 200 basis points to be sure, but there is still quite a bit of juice left in the orange.

Take note that in each year since 2009, when the Great Recession ended, we have seen at least one day when the High-Yield spread broke below 600 basis points and they currently sit near 700 basis points.

Corporate credit is an area where you stand a good chance at current yield levels of say 8% for High-Yield debt and 4% for BBB-rated paper to generate equity-like returns in a safer part of the capital structure, in fact, in our own asset mix, the latest shift we have made is from stocks to corporate credit and regionally from Europe and the U.S. into Canada.

Gluskin Sheff at a Glance

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As of December 31, 2015, the Firm managed assets of $8.3 billion.

Gluskin Sheff is a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) and remains 27% owned by its senior management and employees. We have public company accountability and governance with a private company commitment to innovation and service.

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Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively among the largest clients of the Firm. Our clients are our partners, through performance-based fees that are earned only when pre-specified performance benchmarks for clients' investments are exceeded.

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

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