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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

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NONCONFIRMATIONS

The folks on CNBC were going wild on Friday over the S&P 500 closing above 2,800. Meanwhile, this is just another of the long list of failed attempts at the January high. The bottom line is we have not made any new peaks for 116 trading sessions. And 9 of the 11 sectors — Technology and Consumer Discretionary the outliers — are still trading below their prior highs. As for the Dow, again, lots of celebrating on Friday, but just six stocks accounted for all the advance in a very narrowly based market. And one where the new 52-week high list is looking increasingly circumspect.

All that said, the U.S. stock market has gained ground of late, of that there is no doubt. But it is at odds with so many other markets. Copper is down 16% from the recent highs, and base metals in general are off close to 10%. What does that say about the macro outlook? Why is the yield on the 10-year T-note at 2.83% — down almost 30 basis points from the highs. Shouldn't yields be rising and the curve steepening if the equity market has the story right? Speaking of the yield curve, the 2s/10s spread is down to just 25 basis points, and 5s/10s are at a mere 10 basis points. The forward market has gone to 60% odds of two more rate hikes this year — about the highest this probability has been, and compares with just 30% at the turn of the year.

And even within the stock market, the relative strength chart of the Financials and Transports look very unimpressive at the moment. Ugly, in fact, and these act as canaries in the proverbial coalmine. And that up-day in the major averages on Friday was blunted somewhat by the 20 basis point dip in the Small Caps.

The relative strength chart of the Financials and Transports look very unimpressive at the moment

Not only have bond yields come down, but as Friday's FT duly noted, *"trading in derivative contracts that reflect the behaviour of the 10-year Treasury note yield suggests investors are seeking insurance against a summer shock that pulls market interest rates sharply lower."* The volume of trades in 10-year Treasury call options has been rising discernibly, and this tends to happen when bond investors begin to price in a slowing global economy. In fact, the trading in call options has far outpaced put volumes, which means the market is leaning towards lower yield activity through the summer. Maybe this is Mr. Market's way of calling Jay Powell's bluff when the Fed Chairman glibly remarked on Thursday that *"I sleep pretty well on the economy right now"* (shades of Bernanke sleeping well on subprime eleven years ago).

The credit markets are beginning to flash a bit of a risk-off signal. The Vanguard Intermediate Term Corporate Bond Index Fund is down 3% for the year. The iShares iBoxx Investment Grade Corporate Bond ETF has generated a net loss of 4.4%. The debt binge in this space has been incredible — $6 trillion of net new issuance in the past five years (55% above the credit bubble era of 2002-07!). And the quality so circumspect, as 50% of the investment-grade bond market is rated BBB — almost double the 27% ahead of the financial crisis just over a decade ago (see *How Owning Quality Corporate Bonds Got Riskier* in the Sunday NYT). Again, the main issue here is how tenuous financial conditions really are, and credit is a leading indicator for equities. Yet, Jay Powell is sounding as though he doesn't have a care in the world, outside of how child care is funded. Surreal.

DEBT BINGE

I continue to marvel at how all the bullish pundits talk about how great the global economy is.

Well, I'm not so sure that outside the USA, that economic activity is picking up all that much. I mean, if that was the case, why has the base metals complex slumped 10% in the past month? Why is copper down 15%? And the USA is only feeding off Uncle Sam's credit card extension. Let's think about that for a second — the government goes to the debt markets to blow a further hole in an already unsustainable level of existing obligations (which, let's face it, will never get repaid), cuts households and businesses a nice big cheque, and that's not going to give a transitory boost to spending?

But here's the rub. It is called debt sustainability. The global economy, a decade past the financial crisis, has been fuelled by a record volume of debt. In the past year alone, the world economy has gone an extra $25 trillion into debt! That is more than the total amount of income the U.S. generates annually! In the first quarter alone, global debt boomed more than $8 trillion to now stand at an incredible 318% of world GDP.

In the past year alone, the world economy has gone an extra $25 trillion into debt!

Jerome Powell seemed rather smug on Thursday when he talked about how great he was sleeping — not a worry in the world.

He should actually be quite worried about the servicing capacity of this debt as the Fed raises rates and the dollar firms, undercutting the Emerging Market space in particular — corporates especially as their debt/GDP ratios have expanded sharply in the past decade to 94% from 63%.

If the Fed Chairman isn't concerned, I can tell you that global investors are, because they have withdrawn more than $14 billion from EM financial markets in May and June combined (and equity funds faced a large $900 million pullback in the first week of July too).

There was so much enthusiasm over the S&P 500 moving above 2,800 again, the Nasdaq hitting an intraday high, and the Dow suddenly back through 25,000. Meanwhile, volumes have been at their lows for the year. Breadth is lagging. Industrial metal prices are hardly flagging economic acceleration. And the canary in the coalmine, EM equities, are 12% below their highs in March.

NOT EVERYONE IS AT 4%!

Everyone seems to be forecasting 4% real GDP growth for the second quarter — but there is a hold-out. The New York Fed. It is at 2.8%, which is down from 3.2% two months ago. Just as the district bank has trimmed its Q3 forecast to 2.6% from 3.0%. What do they see that almost nobody else does?

In any event, there were two nonrecurring events that supported second quarter growth. One obviously is the fiscal stimulus — in the past, the swing in real growth in that initial peak quarterly impact is more than three percentage points, on average. Let's not forget that. And the pre-tariff buying of U.S. energy and food was so intense, that in the three months to May, export volumes of the former has soared 30% at an annual rate and the latter by 14% (as Chinese soybean buying skyrocketed). This is why the net exports are very likely to contribute at least a full percentage point to headline Q2 growth — and over half of that from oil and soybeans.

SENTIMENT SEDIMENT

The early July reading on consumer sentiment was lacklustre to say the least — the University of Michigan survey sliding from 98.2 to 97.1. Business conditions compared to a year ago fell to 124 from 132, a 12-month low. And business expectations for the coming year sagged to 98 from 107 in June, the lowest it has been since September 2015. Consumer spending intentions really took a hit — down to 162 from 166 in June; homebuying plans sagged to 132 from 137 (lowest since December 2008); and intentions to buy a car went into reverse big-time to 127 from 140 — the worst showing since 2013.

SOME GOOD WEEKEND PRESS CLIPPINGS

Low-Cost Index Funds Are Losing Their Allure (WSJ, page B1).

> *"The flood of money into low-cost index funds is slowing in 2018, testing Americans' unprecedented embrace of passively managed investments during a nine-year-old bull market for stocks."*

The flood of money into low-cost index funds is slowing in 2018

Indeed, passive inflows so far this year are down 44% from the same period in 2017, and in June ($3.4 billion) hit a four-year low.

Don't Get Too Excited by the Earnings 'Surprise' Party (also page B1 of the WSJ).

Companies who are beating their EPS estimates are not seeing their stock prices move up that much at all, in contrast to the prior nine years of the cycle. Another classic late-stage characteristic.

Latest Version of US 'Exorbitant Privilege' Lends Hand to Trump on page 18 of the weekend FT.

> *"Risks lie ahead. For now, American privilege remains exorbitant."*

The Economy Is Not Trucking On (page 14 of Barron's).

A massive shortage of workers in the transportation sector poses a great constraint on growth. Costs in this sector are accelerating as a result, which can be assured to percolate through the rest of the economy. There are 500,000 long-haul truckers in the USA, and the industry says there is a shortfall now of 50,000.

Costs in this sector are accelerating as a result, which can be assured to percolate through the rest of the economy

> *"Truck drivers are crucial to the economy. About 75% of freight in the U.S. is moved over the highway, and labor expenses equal about 40% of truck company sales…"*

On a YoY basis, truck transport prices from the PPI data reveal a near-8% trend. Conclusion: *"To attract more drivers, trucking outfits will have to raise pay…the road ahead is paved with higher shipping costs."*

It's not just trucking, either, but airlines too. Delta just announced that it is boosting fares and adding fewer flights than planned. Rising costs also caused the number-two carrier to lower its profit outlook for the year.

Wireless Prices Take Upward Turn (page B3 of the weekend WSJ).

"Americans' cellphone bills are rising for the first time in nearly two years as wireless service providers pull back on promotions." This prior source of deflation is now moving in the other direction.

Bank Earnings Are Climbing, But Lending Isn't Keeping Up (B1 of the Saturday NYT).

> *"Overall, lending at the four banks grew only 2.1 percent in the second quarter from a year earlier, according to an analysis by the New York Times. That represents a slowdown from the 3 percent rise in the first quarter."*

So it would seem, again in a classic late-cycle signpost, that the banks are starting to tighten up their credit guidelines.

Fed Shrugs at Trade Woes In Congressional Report, Offering Upbeat Outlook (page B3 of the Saturday NYT).

The quote from Fed Chairman Powell has the proverbial 'kiss of death' all over it — that the financial system is *"substantially more resilient than during the decade before the financial crisis."* Meanwhile, total U.S. debt relative to GDP is now around 250% compared to 230% prior to the 2008 credit collapse. So how exactly can anything be considered “resilient” given this massive debt load?

This then takes me to the companion NYT article titled *College Debt Isn’t Shrinking. It’s Likely Shifting to Parents* (page B1 as well). This is another huge constraint on middle-class families as we are up to 40% of student debt that is now being carried by ma and pa. This is a crisis that didn’t get much lip service from the Fed last week, which instead advised Congress on how it is a lack of child care funding that is the chief hurdle from the economy. Meanwhile, we have a $1.4 trillion albatross over the country and the cost of servicing this debt is on an upward path.

This is a crisis that didn’t get much lip service from the Fed last week

> *“Millions of people are in default, and many young people are graduating into adulthood facing payments that limit their ability to buy homes and to start families of their own…many parents are going deeper into debt to pay for their children’s education.”*

Republicans in Tariff-Hit States Give Trump Benefit of Doubt (page 3 of the weekend FT). Well, I seem to recall during the election campaign that Donald Trump indicated that he could walk down Fifth Avenue gunning people down and his base would still support him. That seems to be the case, indeed.

> *“…in the 15 states that are most likely to be affected by the tariffs tit-for-tat, according to a Brookings analysis, Mr. Trump has a 57 per cent approval rating. That is five points higher than his support in those states during the 2016 election.”*

(The main states hit being Michigan, Indiana and Wisconsin).

IS INFLATION’S RETURN REALLY DEBATABLE?

The data, after all, are the data.

Two years ago, the inflation rate was sitting at 1%. A year ago, it was 1.6%. And today, the rate is all the way up to 2.9%. Average hourly wages for private sector workers are running at 2.7% on a YoY basis. And producer prices in June were up 3.4% year-on-year, even with commodity prices topping out and the dollar on a firmer footing — the fastest pace in six years. And yet, where is the Fed funds rate? Far below all these measures of inflation at a 1.75%-2.0% band. It is absolutely incredible that the real policy rate is still negative at this late stage of the cycle, replete with massive fiscal stimulus and a fully-employed economy.

STICKING WITH THE OIL THEME

Indeed, even with the return of Libyan output and the gimmickry being espoused by the President to tap the SPR. The reality is that the production collapse in Venezuela shows no sign of abating — losing an additional 50,000 bpd in June (the decline in the past year now totals 700,000 bpd). Underinvestment in Angola has caused its output to drop 300,000 bpd in the last year. We could well see Iran's 2 million bpd go by the wayside once the U.S. sanctions begin in November. So even with Saudi Arabia opening up the taps, raising output by 400,000 bpd in June, the market is and will remain in deficit. Let's also not forget that the latest U.S. inventory data have come in far below analyst estimates.

The bottom line is that the world's spare capacity is equivalent to just 1% of global oil consumption — that is razor thin. Saudi Arabia may be boosting output now, but at the expense of its spare capacity, which, together with Kuwait and the UAE, currently amounts to just 2.1 million bpd. Tight.

The bottom line is that the world's spare capacity is equivalent to just 1% of global oil consumption

As the IEA said in its just-published monthly report:

> *"Rising production from the Middle East Gulf Countries and Russia, welcome though it is, comes at the expense of the world's spare capacity cushion, which might be stretched to the limit. This vulnerability currently underpins oil prices and seems likely to continue doing so. We see no sign of higher production from elsewhere that might ease fears of market tightness."*

Gluskin Sheff at a Glance

Gluskin Sheff + Associates Inc. is one of Canada's pre-eminent wealth management firms. Founded in 1984 and serving high net worth private clients and institutional investors, we are dedicated to meeting the needs of our clients by delivering strong risk-adjusted returns together with the highest level of personalized client service.

OVERVIEW

As of March 31, 2018, the Firm managed assets of $9.0 billion.

Gluskin Sheff is a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) and is 17% 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 team is an exemplary group of investment professionals deep in talent, ideas and experience with industry leaders in risk management and client service — all with the objective of providing strong risk-adjusted returns and the highest level of personalized client service.

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ALIGNED

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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$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately $6.3 million[2] on April 30, 2018 versus $3.1 million for the S&P/TSX Total Return Index[3] over the same period.

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

Notes:

1. Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.
2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.
3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

IMPORTANT DISCLOSURES