Ashdon Investment Management

Q2 2016 ECONOMIC COMMENTARY

June 2016

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- *US and foreign markets recovered from the first quarter to end at all-time highs.*
- *At quarter end both stock and bond were expensive*
- *US economy continued to show sign of increasing weakness, Productivity slowdown accelerated during the quarter*
- *BREXIT revealed increased headwinds to regional and global growth*
- *Increasing concerns for the Chinese industrial economy as EM currencies levered to US economic activity continued to weaken*

Second Quarter 2016 Economic Commentary

After years of global, coordinated central bank activity, it is clear to us that we are coming to that part of the monetary policy cycle where the central bankers are forced to blink. As I write these words, economic data and equity market index levels seem inconsistent with that statement. The S&P 500 index is making new all-time highs. Unemployment is near record lows, interest rates are very low and inflation is under control. At the same time, the production data and earnings data show real weakness, weakness that is now showing up in GDP figures. Against this backdrop of weakness, the current political environment is poisonous and seems unlikely to offer any helpful input.

During the quarter, US and foreign stock markets recovered from the first quarter weakness and returned to all time high levels. US government bonds traded to historically low yields, and many foreign bonds had yields below zero. Clearly, bond yields are driven lower by central bankers setting short rates lower and by buying long-dated issues to suppress yields and keep key mortgage rates low. Low yields on bonds cause yield-seekers to buy risk assets in search of income, driving up stock prices. At the quarter end, stocks and bonds were both expensive – at or near record-high levels. Such periods are never stable. Prices become increasingly disconnected from fundamentals and adjustments become required.

Our expectation over the last two years has been that the broad equity indices would move "sideways" – neither gaining nor losing meaningful value. We believed that there was a chance that earnings would grow to meet prices, keeping valuations reasonable. However, we have to face the growing probability that time is running out. The global economy, and the US economy in particular, are showing signs of decelerating activity, and corporate earnings are clearly reflecting that slowdown. A weakness in fundamentals and a rationalization of prices could come about via a meaningful sell-off. While it is likely that the stock market could rally to new highs, we think such a rally would be short lived. We continue to advise the following portfolio positions:

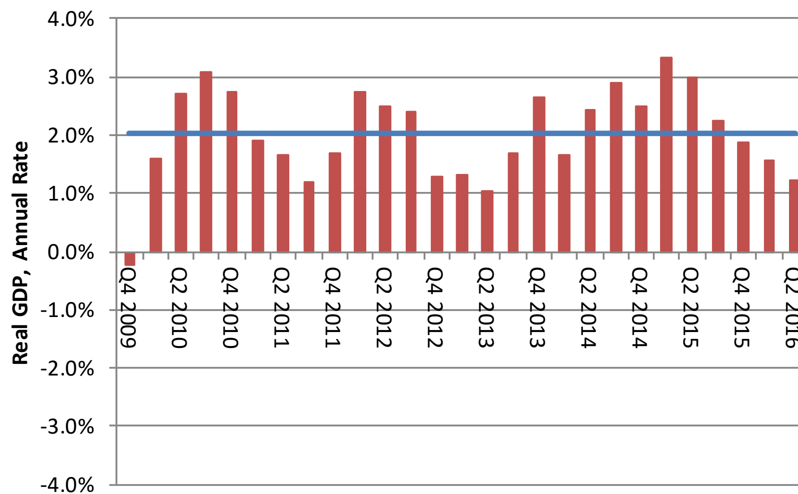
- Increase allocations to cash and equivalents in all cases.
- Tilt toward low-net, even net-short, alternative strategies, where possible
- Build new positions from "dry powder" slowly.
- Hold established positions in client portfolios, if they are quality stocks that can be held for the long-term

We believe a broader economic slowdown in the US within 12 to 18 months is likely.

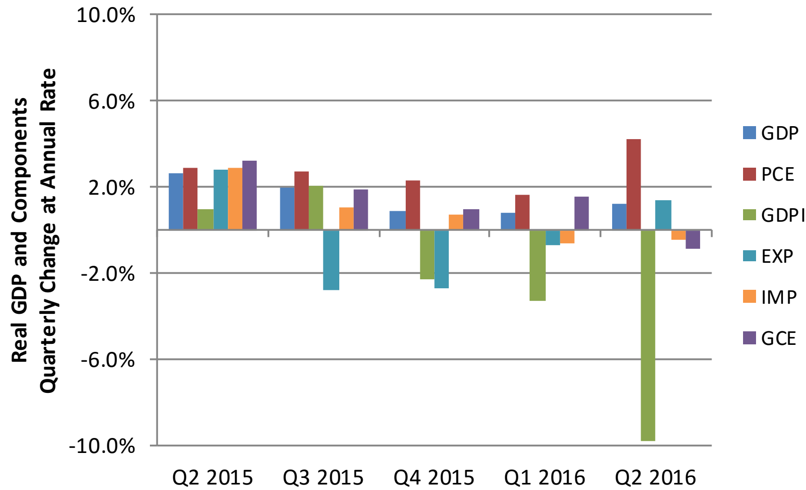
US Economy

GDP

The Advanced estimate for second quarter GDP growth came in at +1.22% annualized for the quarter. GDP grew by +1.23% from the quarter one year ago. First quarter GDP was revised up slightly from 0.5% to 0.8%.The average year-ago quarter rate of change in GDP has averaged 2.0% since 2009, a clear demonstration of the continued modest pace of growth that has been in place since recovery began. This slow, but persistent growth rate is consistent with the post-credit crisis environment that characterizes this economic cycle.

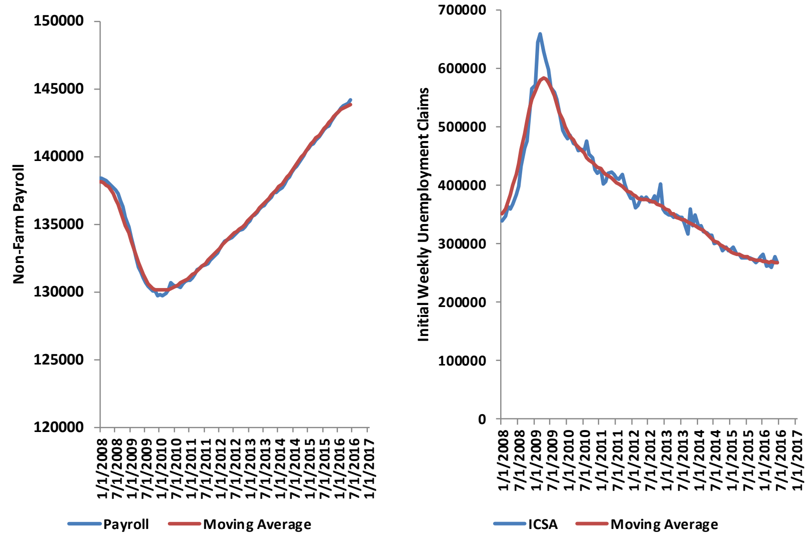


Consumption expenditures continued to drive GDP growth in Q2. Consumption growth (PCE) advanced +4.2%. Government consumption contributed, as did Net Exports. However, the degree of weakness in Private Investment was a surprise. Gross Domestic Private Investment (GDPI) declined -9.7% for the quarter. The previously strong contribution from Housing ("Residential Fixed Investment" a component of GDPI – Gross Domestic Private Investment) reversed and fell by -6.1%. Most other investment categories also contracted in the fourth quarter and GDPI declined. It is clear that some of this decline in activity is attributable to ongoing declines in the Energy sector. However, there is growing evidence that the industrial component of the economy is beginning to slow. This Advance release will be revised twice more before becoming final. We will watch the direction and size of revision closely – particularly for consumption - going forward.

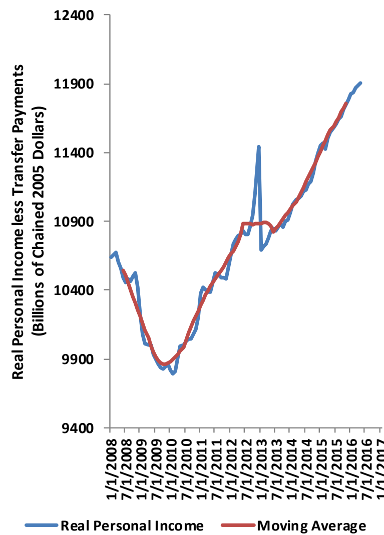


Unemployment

Labor data continues to be a bright spot in the US economic picture. The charts below show trends in total payroll and new claims for unemployment insurance. Total employment continues to grow to new highs. Unemployment claims continue to decline to very low levels. The unemployment rate at the end of Q3 was very low (4.9%). Reliable employment is critical to disrupting the disinflation/deflation forces that are at work globally. There is no evidence thus far that employment is weakening.

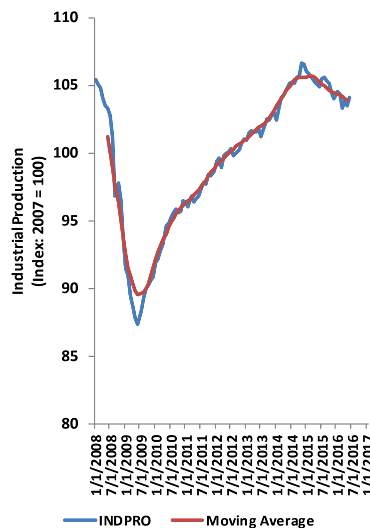


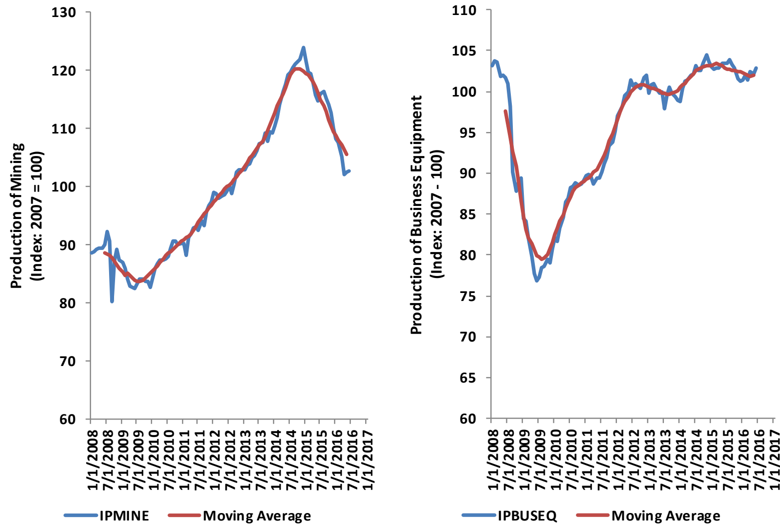
Finally, worker wages in the US continue to grow. Real Personal Income (less Transfer Payments), the key measurement of salaries for workers, has continued to grow at an attractive rate. RPI is important for those assessing the economic condition of the economy. In times of weakness, RPI will flatten or decline in response to a broad down turn in economic activity. RPI shows no weakness at this point in the cycle



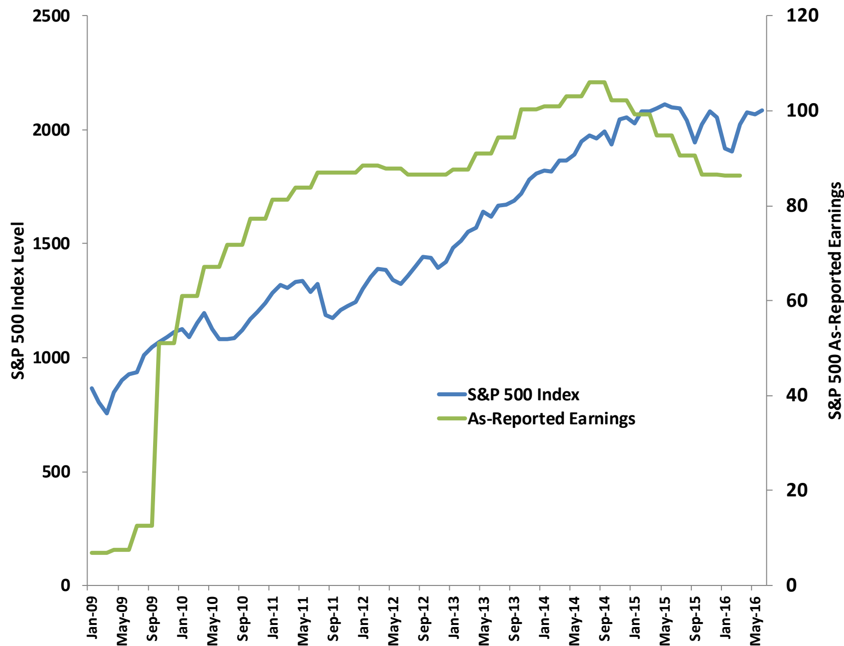
Industrial Production

Employment and Consumption data point to continued economic strength in the US. However, the slowdown in Production data that we have discussed over the last several quarters persists. The production slowdown has accelerated and broadened. The charts below show overall Industrial Production and the sub-industry Mining Production, illustrating how the bulk of the decline in production is due to the slump in commodity prices. However, production measures for Business Equipment are also soft. Output per Hour, the most watched measure of productivity, declined in the first quarter (most recent data – see comments at www.ashdon.com/communications/market-views).





The production slowdown is seen in US corporate earnings. The chart below shows the history of the S&P 500 index level and as-reported earnings. Earnings collapsed in the Great Recession of 2008, but rebounded strongly when the FOMC and others stepped in to stabilize the economy. Earnings grew well for a time and company prices increased in a reasonable way. However, in 2014, production, then earnings began to turn. The decline in earnings has now extended seven quarters. Since 1988 there hasn't been a period of earnings decline of this duration that did not precede a recession. Analysts expect earnings to tick up later in 2017 and 2018, but analysts' estimates have been far too optimistic since 2014.



With Production continuing to weaken combined with earnings weakening, Productivity may break trend and weaken further, indicating that the drivers of US economic expansion have lost their momentum. While the consumption economy continues to roll ahead, the spreading weakness in the industrial economy is worrying. As long as consumption remains robust, the US economy can continue to grow. But the overall situation means that *a broader economic slowdown in the US within 12 to 18 months is an outcome we must plan for.*

Global Economy

Political influence played an unusually large roll in markets in the second quarter. BREXIT dominated the news and investor attention for the month June, interrupting a recovery rally that started late in March. In our view, BREXIT by itself isn't the important point. The rapidly growing sentiment towards decreased globalism, increased protectionism and internal political tensions that BREXIT revealed is more important to investors. We see these forces as near-term headwinds to regional and global growth.

Against that backdrop, the currency adjustments between the developed and emerging world continued. We have found that currencies are providing a good basis for monitoring the global economy. In the developed market, values of western currencies were largely unchanged – except for the British Pound (which weakened violently in the wake of the BREXIT vote and lost over 12% of value against the US dollar). In the remainder of the Eurozone, hints of change are beginning appear. A macro manager we work with has made the case for a strengthening Euro ahead. He has noted that trade among developed countries has shifted in favor of European producers, so much so that the current account for the Euro region is now positive and growing larger every day. In the east, the Japanese Yen continued its strengthening trend. While the Japanese economy is not vibrant, BoJ policies seem to have stabilized the economy and short-term threats are largely mitigated. While inflation in Japan is very low, prices are stable. As the currency is approaching its long-run level, we wouldn't be surprised to see the Yen level out ahead.

After a volatile first quarter, the Chinese Yuan continued its path toward fair value against the dollar and did so in an orderly way. This eased the fears of many who believed that an unruly currency adjustment would interfere with the internal adjustments in the Chinese financial system. The weakening trend of EM currencies against the USD appears to have reached an inflection. Many EM currencies strengthened during the second quarter, largely in sync with the oil and commodity rebound. The Russian Rubble and Brazilian Real were perfect examples. However, EM currencies levered to US economic activity continued to weaken. The Chinese Yuan and the Mexican Peso offer examples. Our view is that markets are anticipating weakness in the US to affect the economies of our major trading partners – like Mexico and China. Those currency moves are consistent with the weak production data we see in the US and make our concerns for the Chinese industrial economy even more relevant.

The global economy continues to make its way through the later stages of a very long cycle of growth built on debt. We continue to emphasize that deleveraging is never a painless process. Policy makers have made innovative, even heroic efforts to buy the time to get global economies rebalanced without crisis. Evolving data seem to pointing to spreading economic weakness. Unfortunately, we cannot predict the exact path ahead. However, we have a clear sense of the shifting balance of risks for investors. With US production softening, the Yen strengthened, and the Euro threatening to strengthen, we will be watching for signs that weak production is propagating into consumption and/or jobs. With valuations for stocks and bonds at all-time high values, we judge that allocations should reflect a cautious stance.

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