Capital Risk

GLOBAL PORTFOLIO STRATEGY

Calm Before The Storm


Photo: Brian McGowan on Unsplash

The investor needs only ask one question this year: how will global growth continue? The US expansion is long in the tooth. Europe is slowing, and China's ability and desire to continue to build the Great Wall of Debt is fading. Growth requires increased employment, higher wages, or higher productivity. The former is brought forward through the expansion of business and investment while the latter through increased skills or technology. Thus, an investor must ask how employment grows at cycle peaks, the need for higher wages, or how productivity arrives without requiring fewer workers? Our answers are short: little employment growth, restrained wages, and profitable productivity growth that lowers the need for further workers.

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The end of the cycle is near. The question is, what is the catalyst to the end? The answer is US business investment, which is retracting.

Combined with declining growth in non-US regions, investing is set up for uncertainty through the US election in November. Caveat emptor.

- Jason Prole

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Highlights

- US **equity** valuations are high, which leaves little room for growth.
- **Interest rates** should decline as inflation expectations recede.
- **Credit spreads** are not pricing in economic uncertainty.
- **Gold** is richly valued and suggests future economic weakness.
- Falling commodity **currencies** (AUD, CAD) suggest the cycle is over.

The Economic View

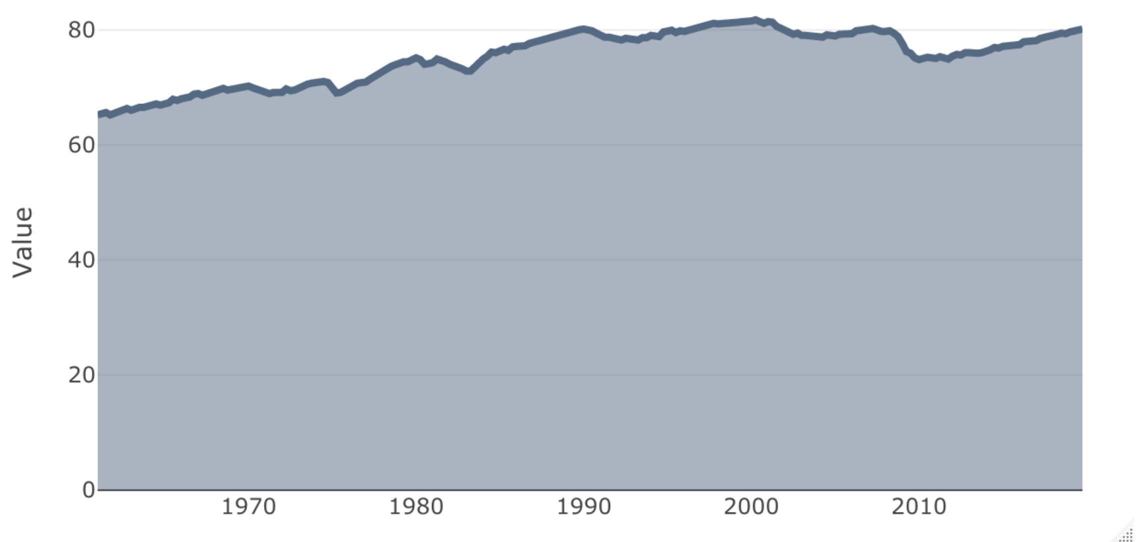
An election year will deliver uncertainty.

The immediate question for the year is, how does the pending US election impact the outlook for the year? Our argument is simple: materially. The probable outcomes for the election are widely divergent in their impact on the economy and global relations. For this reason, neither business nor politics will make progress through the year until the resolution of the uncertainty. Thus, the world will await an election in the US that will define the course of the global economy for the next decade. Investors who basked in the comfort of a decade-long bull market should take heed that the upside is limited. At the same time, the downside is measurable while remaining uncertain about timing.

How will payrolls expand?

A key measure of growth potential is the availability of prime-age workers. They are critically important to a service-based economy where people, not capital, deliver economic benefits. This trait poses a challenge for the US: the prime-age employment-to-population ratio for the US is over 80% (exhibit 1). This level was the peak for the last three cycles in the US. Thus, the question is, where does the US expand when there is not anyone left to hire?

Exhibit 1. Prime Age, 25-54 years, Employment-to-Population (%)



Source: Federal Reserve Economic Database

The Economic View

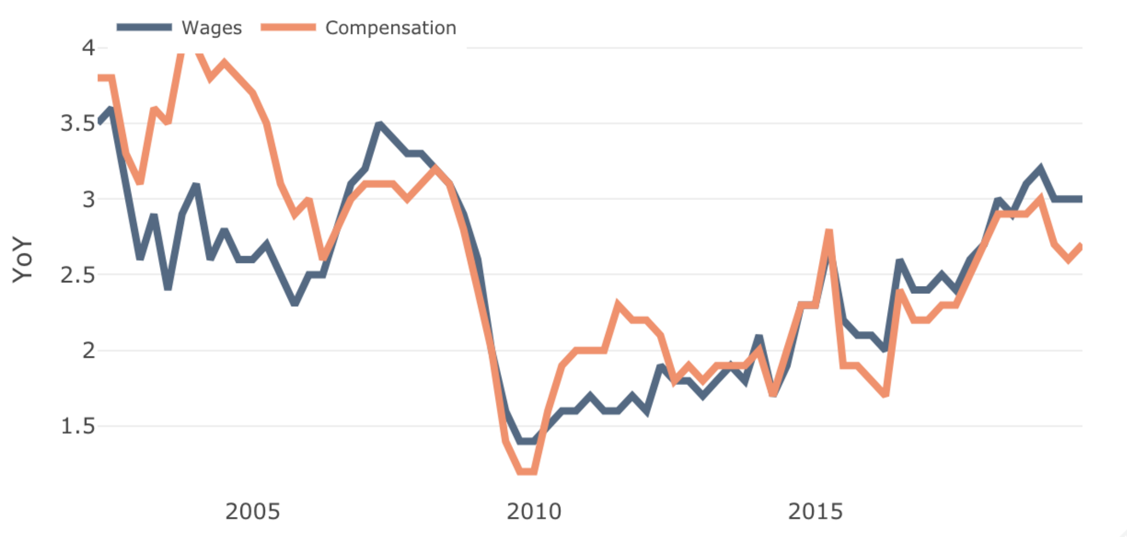
Wages should be *higher* with labor scarce.

The usual path to attract more workers is by offering higher compensation, which provides an incentive to switch companies or enter the job market. Compensation has two components: the wage and the other benefits (e.g., health care). The latter is significant in the US because of the linkage between health care and employment and the comparably low labor protections by developed country standards.

Both wages and benefits show growth rates slowing from post-recession highs in 2018 (exhibit 2). Indeed, companies are bidding wages upward as labor supply is constrained. The notable outcome is that the growth rate never achieved the high of the prior cycles. This result may be a function of labor force composition. Millennials are the largest cohort in the workforce. Thus, competition for jobs may be higher for them and therefore result in lower wage pressures.

Total compensation is slowing.

Exhibit 2. Employment Cost: Total Compensation and Wages (YoY Change, %)



Source: Federal Reserve Economic Database

One interesting outcome is that non-wage compensation is slowing at a faster rate. This outcome suggests that companies are offering higher wages as the lure while moderating some of the benefits. The ‘money illusion’ in economics

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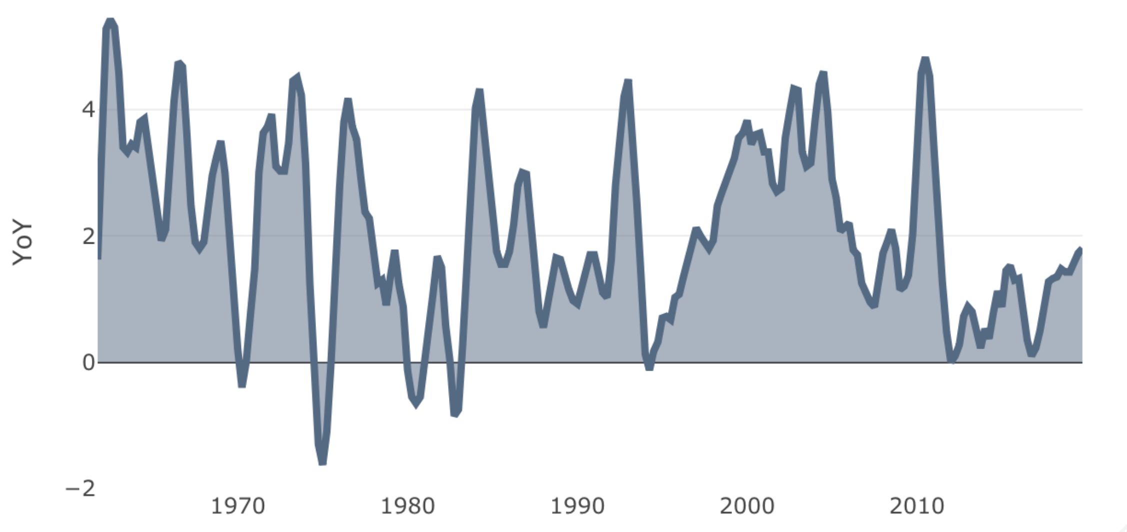
is a good analogy where prices go up in nominal terms but lower in real terms. Whether this is an enduring business strategy in an age of prolific information is doubtful.

The question for business is whether the higher wages are justified in terms of production? Higher wages would not be an issue if the company received more output from the employees. Business productivity is growing at the highest rate since the Great Recession (exhibit 3). On its face, this appears a beneficial outcome: higher wages, productivity, profits, and growth.

Where is the productivity?

Exhibit 3. US Productivity Rate



Source: Federal Reserve Economic Database

There is one problem with this rosy picture. The current rate of growth in productivity is closer to prior cycle lows. It doesn't approach even the mean of the last fifty years! Two explanations are probable and may counterbalance each other to the detriment of business profits.

Service economies do not inherently deploy capital. Employing technology does not necessarily improve the productivity of a waiter or salesclerk. Doctor visits are notoriously long because of the dialog between the patient and

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doctor to ensure proper treatment. So, they gain operational efficiencies (e.g., payment mechanisms) in the back end. The significant cost component is the front-end, where the interactions occur, which remains agnostic to change.

Millennials still have a lot to learn!

The second driver is the Millennial generation, which is the most significant component of the workforce. While they are digital natives, they are still learning their craft. Thus, their productivity is lower relative to those older and more experienced labor force participants.

In combination, the two measures suggest that the current low productivity is a structural artifact of the labor force and the type of economy. The good news is that as people progress, they learn and are more productive. The bad news is that a service dominated economy may have limits to productivity growth. The conflict between these two secular trends will determine the outcome in the long run.

The short-run is a different story. Costs are increasing because of higher wages. Revenue growth is limited because employment is at a peak, which limits the ability of the overall market to grow. Thus, the business deploys market share strategies, which themselves imply higher costs for marketing and related activities.

Slowing revenue will shift the focus to costs.

In the face of increased competition for the marginal consumer, the time-worn tactic is to reduce investment and marginal labor. The decline of investment over the last four-to-six quarter shows that business leaders believe the peak is past and that their supply capability is adequate.

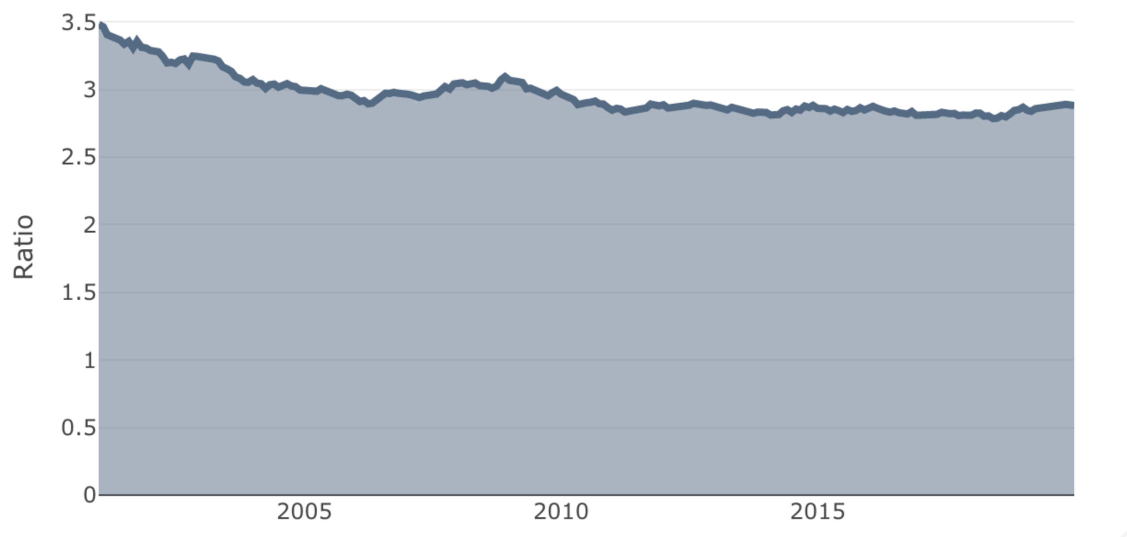
The next shoe to fall is marginal labor, where they sacrifice the least productive workers. This action reduces aggregate demand further and requires further cost reductions. Watch the retail, leisure, professional services, and finance sectors for changes in their employment levels, which will signal the end of the cycle.

Equity Markets

The equity markets are in unchartered territory. The bull run since the bottom of the equity market during the Great Recession extends over *eleven years*. Investment paradigms have collapsed during this period. The perceived value of smaller capitalization companies for their historically higher growth is non-existent (exhibit 4). The financial crisis in 2008 saw the impairment of financial institutions that led to the outperformance of small caps for three years. Still, the modest trend reversed over the following three years. The result is a decade of little change or volatility in the relationship.

The size premium is gone.

Exhibit 4. Relative Performance Global Equites by Size (Large/Small)



Source: MSCI. Capital Risk calculations. Ratio increases reflect large cap outperformance.

The genesis of this outcome is complicated. The argument for small caps rests on their inherently more uncertain business, less efficient information, and higher growth prospects than their larger peers. The reality is that technology may have eroded the cost of accessing information. Further, the proliferation of management practices and technology suggests it's not clear why a small business is riskier than a larger one.

Private equity now controls small stocks.

The answer probably lies in the growth prospects. Private equity has changed the capital dynamics for smaller growth companies. Private equity holds trillions in 'dry powder' that permits smaller growth companies to avoid the

Equity Markets

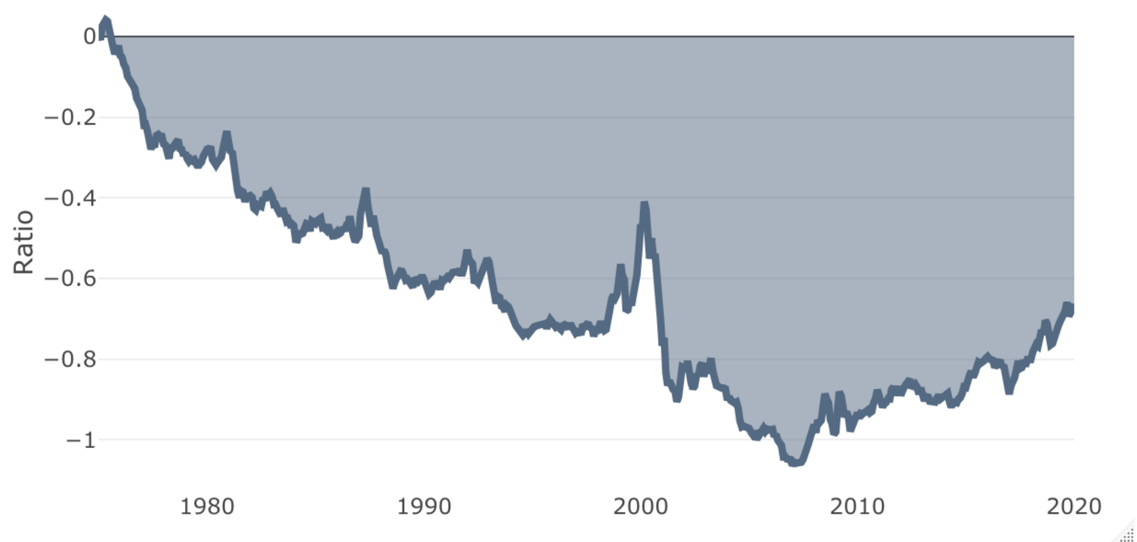
public markets. Thus, they realize their growth prospects in private markets, not public markets. The companies that are present, therefore, provide no embedded excess growth option.

Technology is creating winner-take-all markets.

The disappearance of the small growth option is also a function of another structural feature: the winner takes all nature of technology markets. Technology has unleashed creative destruction across whole industries and consolidated them into one single platform (e.g., Google as the Yellow Pages and Facebook as the White Pages). This ability permits the winners two advantages. They enjoy monopolistic profits and the capability to presumptively purchase early-stage competitors in the private equity markets. These actions allow their earnings to endure.

Exhibit 5. Relative Performance Global Equities by Growth/Value

Value stocks face a similar fate as size.



Source: MSCI. Capital Risk calculations. Ratio increases reflect growth outperformance.

The implication of these structural features also appears in another hallmark investing style: value. For the last decade, growth stocks outperformed value stocks (exhibit 5). This outcome reversed a *thirty-year bull market* for value versus growth stocks. The catalyst is technology.

Equity Markets

An argument for the prior outperformance of value is the buyer's curse in mergers. A larger company buys a smaller rival with a generous bid. Thus, the value company outperforms. The burden is then on the acquirer to realize the efficiency gains. The reality is that they are not generally fully realized. It doesn't answer what changed since the Great Recession while it provides a narrative for the prior thirty-years.

Value is in the *income* statement.

Technology permits new business models that are inherently light on fixed capital. Critically, they permit sharing of the benefits at little cost (e.g., Google Maps). Web-based applications and services dominate (e.g., Amazon Web Services). This benefit turned a capital expenditure into a service expense from an investment item. This action has two results: less capital expense with which to assess value and an increase in human capital as an input. Value is no longer on the balance sheet but *in the income statement*.

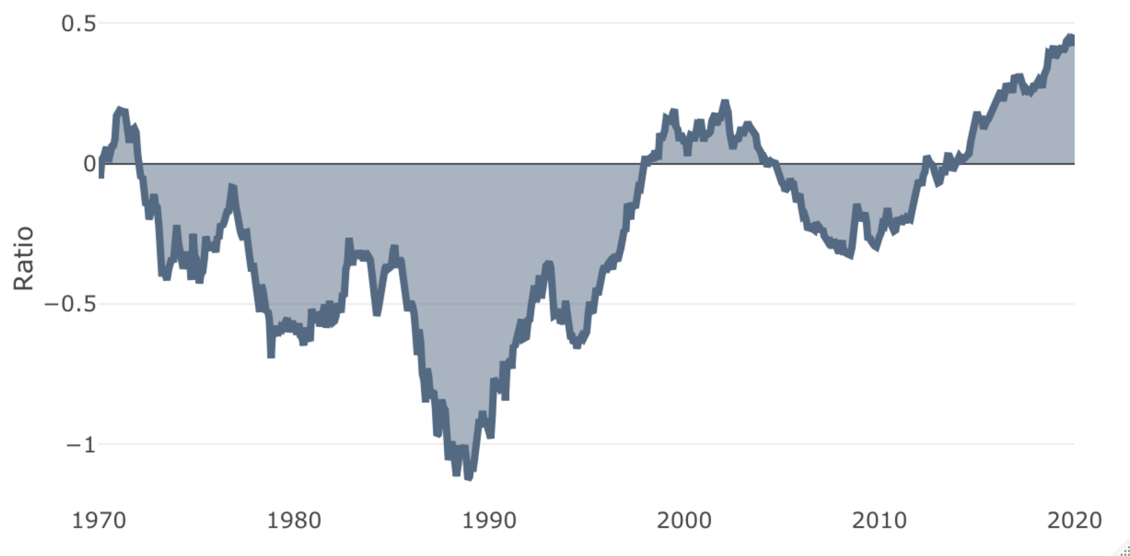
The growth of private equity also supported this outcome. By enabling companies to stay private longer, realizing the value of the assets no longer transpires in the public markets. The proliferation of unicorns, companies with billion-dollar valuations, suggests that there is little probability of them entering the public markets as a value proposition. They enter the public markets as viable *growth companies*.

Value is now in the private markets.

One further dynamic plays out in this structural feature. With technology platforms that can scale globally, the dominant size of the US capital markets helps. Specifically, private equity and venture capital markets ensure that the gains are realized in US capital markets as companies become public. A similar outcome occurred in the Dot-com bubble of the late 1990s. This time the companies have the pretense of profitability, which makes their presence enduring.

Equity Markets

Exhibit 6. Relative Performance of Equities by US/Non-US



Source: MSCI. Capital Risk calculations. Ratio increases reflect US outperformance.

US technology is unmatched.

This outcome manifests itself in the public equity markets in the US. The US enjoyed a bull market for the last thirteen years versus the rest of the world (exhibit 6). The emergence of Japan was a catalyst in the late 1980s for non-US performance. The subsequent crash of the Japanese equity market led to US out-performance for a decade. This bull run was only interrupted by the commodity bubble in the years before 2008. The last thirty years appear as a bull market for the US versus the rest of the world.

China's time is past.

The US delivered out-performance versus the secular growth story of our time, the emerging markets, and China. From the entry of China into the World Trade Organization in 2001 to the end of the commodity bull market in 2010, the emerging markets delivered stellar outperformance relative to the US (exhibit 7). US outperformance since 2010 recovered more than half the performance drag lost to the emerging markets. The question is, where do we go from here?

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Exhibit 7. Relative Performance of Equities by US/Emerging Markets

The US dominated the Emerging Markets.

Source: MSCI. Capital Risk calculations. Ratio increases reflect US outperformance.

When forecasting the future, particularly over long horizons, the same caveat always applies. Events can happen that change the trajectory. Still, some guideposts exist to help us frame the future.

First, we expect the trend of private equity and its US-centric approach to continue. The reasons are simple. Massive amounts of 'dry power' measured in the trillions yet to deploy by private equity. The primacy of Silicon Valley as the hub of technology, and the performance incentives in the US.

Growth is the story and the US leads.

Second, since the assets need to go somewhere, the decision is relative. The dire demographics outlooks for both Europe, Japan, and China ensure that their population growth is slower than the US. That leaves productivity gains as the marginal driver of outperformance. It is hard to make a case that the US will trail these other regions. Thus, US growth should be higher in the aggregate.

Opportunities still exist for select countries and across sectors. What is different is that decision to choose only emerging markets or non-US equities

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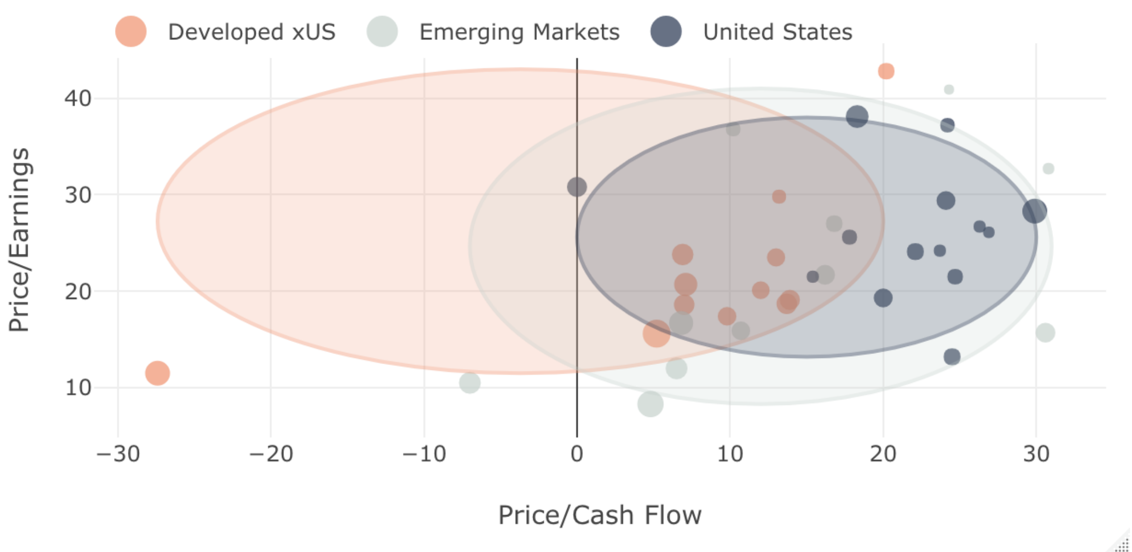
is no longer sufficient. The investor must select countries or sectors to deliver out-performance. In the absence of specific insight, the default position should be the driving factor of the last decade: US large growth stocks.

US growth stocks lead but political risk exists.

The argument for large US growth stocks is not without risk. The dominant position of the market leaders will face regulatory scrutiny that will probably entail some form of limits on their power. Europe is already leading the charge for anti-trust. Google remains verboten in China. Democratic insurgents in the US are calling for restrictions on technology. Thus, while their product market risk is low, their *political risk* is extraordinarily high.

Non-US markets provide value.

Exhibit 8. Global Equity Valuations by Region and Sector



Source: S&P Indices. Size of marker reflects the dividend yield (larger is higher).

Valuations in the US are not out of line with the Emerging Markets. The US enjoys less dispersion than Emerging Markets (exhibit 8). While the earnings multiples are systemically higher in the US, their cash flow multiples are lower. This divergence is the result of the EM Financial sector's negative cash flows. The higher dispersion in the Emerging Markets provides an opportunity for selection while providing modestly less risk from lower valuations.

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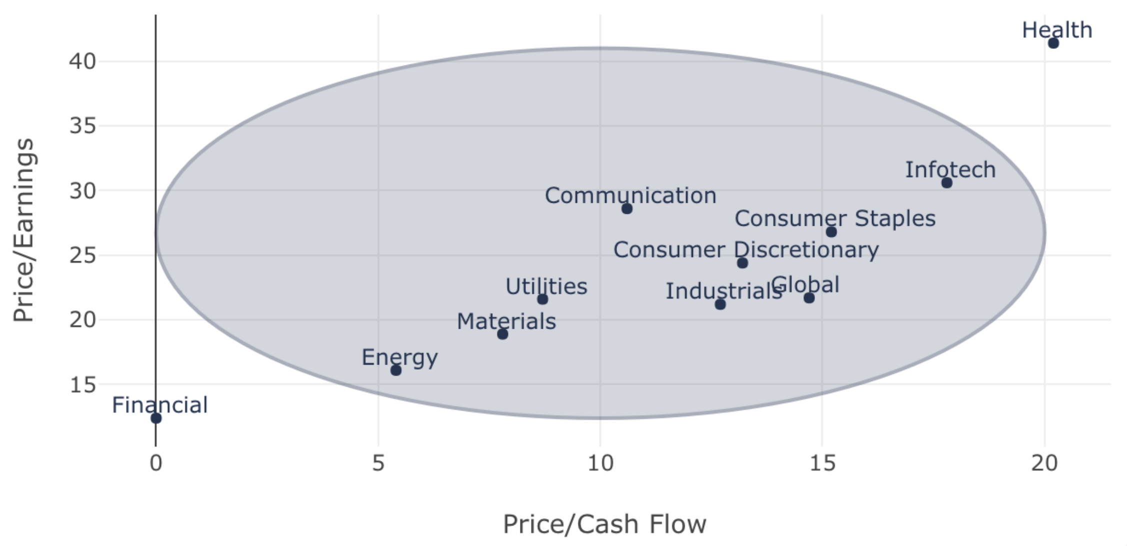
Sectors matter in the US and globally.

The same is not valid for the non-US developed markets. Except for Health Care, all sectors are lower than their US parallels. Critically, the sector cash flow multiples are systematically smaller. Since a dollar is a dollar, the investor must ask whether paying *nearly two times* for a US dollar is a good value versus the non-US counterpart? This decision is acceptable if the growth prospects for the non-US markets are *half* those of the US. This conclusion is a stretch, even with the lower growth trajectory for non-US regions.

Global valuations are modestly high. The US is the driver of these high valuations. In the US, the cash flow multiple is 23, and the earnings multiple 22, which are yields of about 4.5% and 4.3%. Relative to the approximate 1.9% yields on 10-year US Treasuries, these yields offer insufficient equity premium. Thus, the investor should seek value in specific US sectors or non-US equities.

Exhibit 9. Global Equity Valuations by Sector

Health Care is simply too high.



Source: S&P Indices.

Two outliers exist in global sectors: Financials and Health Care (exhibit 9). The argument for Health Care is challenging to make. It bears the weight of multiples that are close to double the global average and suggest buyer

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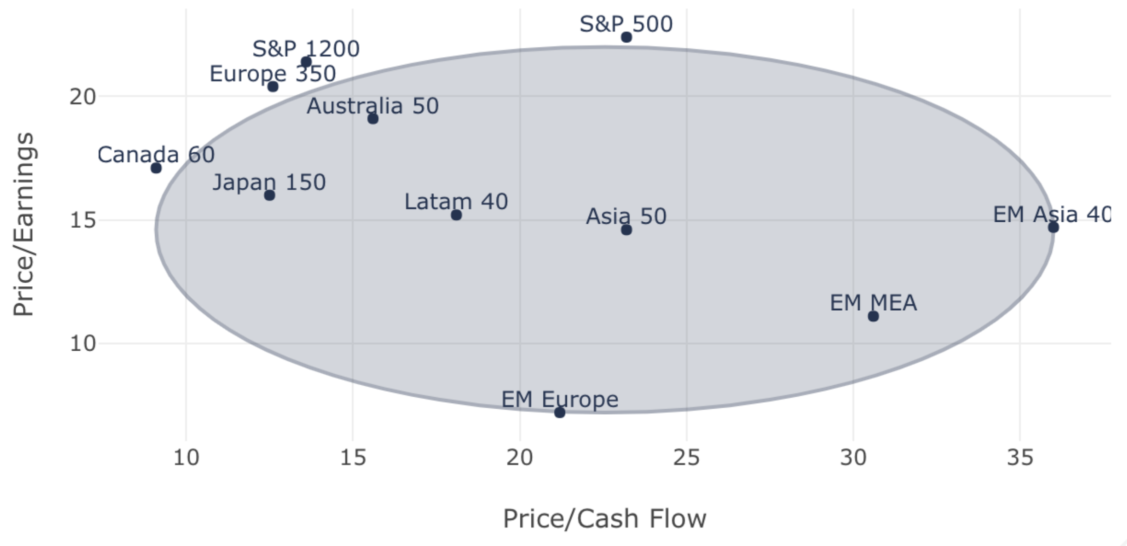
beware. In contrast, the Financial sector resides at the other extreme with low valuations. Negative cash flows for the Financial sector at a market peak is such an ominous indicator that it gives pause when considering *any* sector.

Exhibit 10. Global Equity Valuations by Region



Source: S&P Indices.

The commodity run is over.

The argument of where not to invest is straightforward in practice. Canada, Japan, and Australia offer lower relative valuations. Their investment requires a positive outlook for commodities and expanding global trade. This argument is difficult at a market peak. Emerging Markets and Asia come with high relative valuations and volatility. Thus, caveat emptor.

Europe shows value.

The S&P 500 offer high relative valuations. The question is the durability of their cash flows. The high technology component suggests that they are durable in the near-term. Europe also enjoys reasonable cash flow valuation and benefits from lower commodity prices. Thus, the two leading developed markets are the choice until the economic outlook clears.

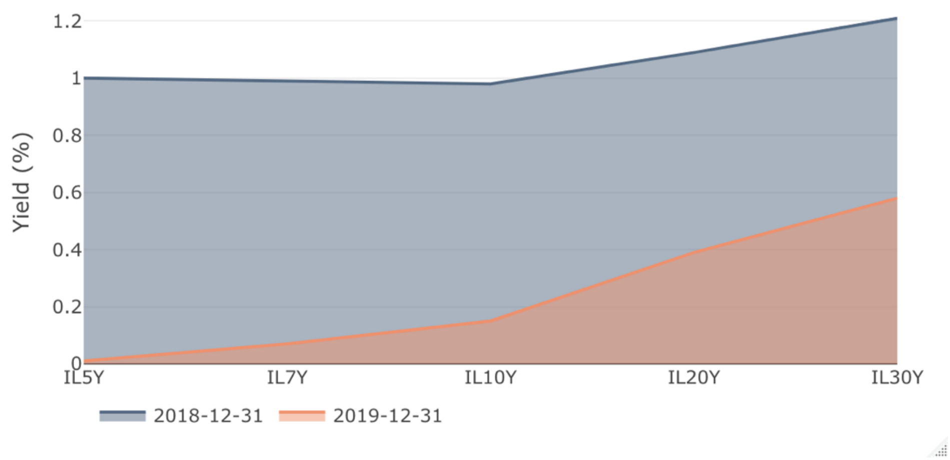
Interest Rates

Yields portend caution.

Interest rates are telling us a story. The question is whether we wish to listen. Nominal yields fell across the world over the last year. This action is either the result of diminished inflation or growth expectations. Unfortunately, the root cause for a decline in either one is the expectation of lower demand. Thus, the story is straightforward: bond investors expect *growth to decline*.

The US Treasury Inflation-Protected (TIPS) yields show a weakening economy. Yields are barely above zero out to 10-years (exhibit 11). This is particularly significant because of the embedded deflation protection in the bond that rewards zero or the inflation rate. Thus, the implied inflation rates are below zero due to the presence of this put option.

Exhibit 11. US Treasury Inflation-Protected Yields



Source: Federal Reserve Economic Database

UK TIPs yields suggest deflation or *Brexit fear.*

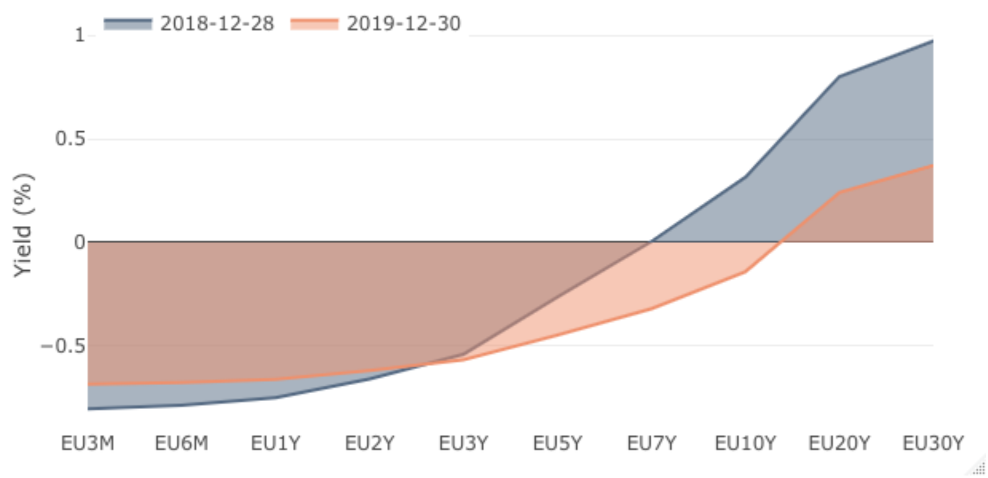
A similar outcome is evident in the UK, where all the rates are below *minus* 2% through the 20-year tenor. The specter of Brexit on the horizon looms. These yields seem incongruent with a world where trade and the currency may go down, which would result in *higher* prices. The implication is that the market is pricing in uncertainty to such an extent that the only possible outcome is deflation as a result of lower demand.

Interest Rates

The continental cousin of the UK, Europe, also suggests that growth prospects are dim. Yields from 10-years and out are down over 50 basis points on the year (exhibit 12). Whether the cause of lower growth or inflation expectations, the implication is the same. Demand expectations are falling.

Long yields in Europe foretell slowing growth.

Exhibit 12. Euro Sovereign Yields

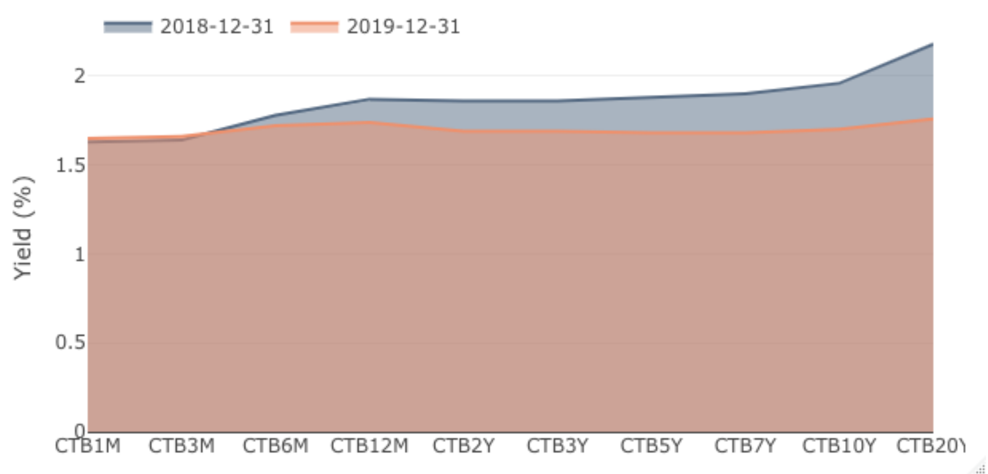


Source: ECB Database

Canadian yields have fallen with the demand for oil (exhibit 13). The interesting outcome is that the front-end of the curve is resilient. This outcome would suggest a monetary policy response will arrive soon rather than later.

Why are near-term Canadian yields so *high*?

Exhibit 13. Canada Treasury Yields



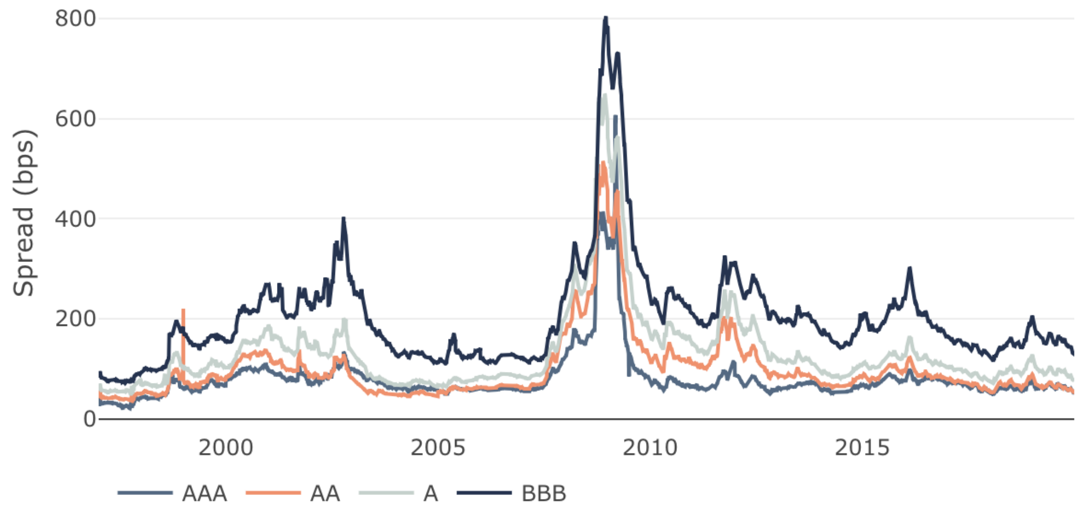
Source: Statistics Canada

US Corporate Spreads

Spreads are too narrow.

Credit spreads indicate that the economy is doing fine. Most spreads are near *20-year* lows (exhibit 14). These levels are inconsistent with what the government yields are saying. Indeed, in a world of low yields, the extra spread promised on corporate credit is appealing to those requiring cash flows. This precise outcome should give investors in corporate bonds pause. Investors are receiving *too little* for the risk.

Exhibit 14. US Corporate Spreads



Source: Federal Reserve Economic Database

Spreads offer risk *without* reward.

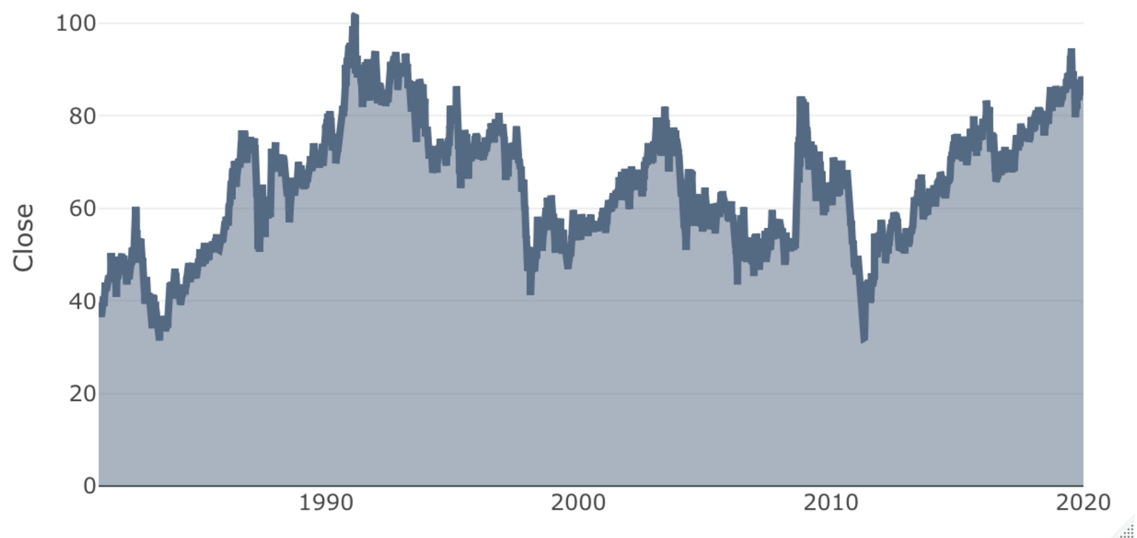
The wide spreads that occurred in the dotcom bust, the Great Recession and the commodity bust of 2016, should give investors pause for corporate bonds. A five-year bond would realize a loss of roughly five percent on a 100-basis point expansion of spreads. The implication is that the investor is holding the equivalent of a treasury bond with *more risk*. A recession would deliver a multiple of this spread expansion and would strongly suggest that the embedded equity put option in corporate bonds is a risk *not worth taking*.

Commodities

Commodity weakness is broad and says demand will slow.

The commodity sector is notorious for its ever-present bull and bear market cycles. In the face of a slowing global economy, industrial commodity prices abate as demand weakens. The ongoing trade war with China makes the agricultural complex challenging to gauge. One indicator is providing a degree of conviction that aligns with the story on interest rates (exhibit 15). The ratio of gold-to-silver is at a level that usually expresses *recession*.

Exhibit 15. Price Ratio of Gold/Silver



Gold indicates volatility ahead.

Gold is always the asset-of-last-resort. When people think the world is going to end, they seek refuge in the yellow metal. Both gold and silver have industrial applications, so their prices tend to follow each other. They diverge when demand for gold rises during periods of uncertainty. They converge when the demand for silver increases as the economy expands. This divergence is why the ratio is so worrisome now.

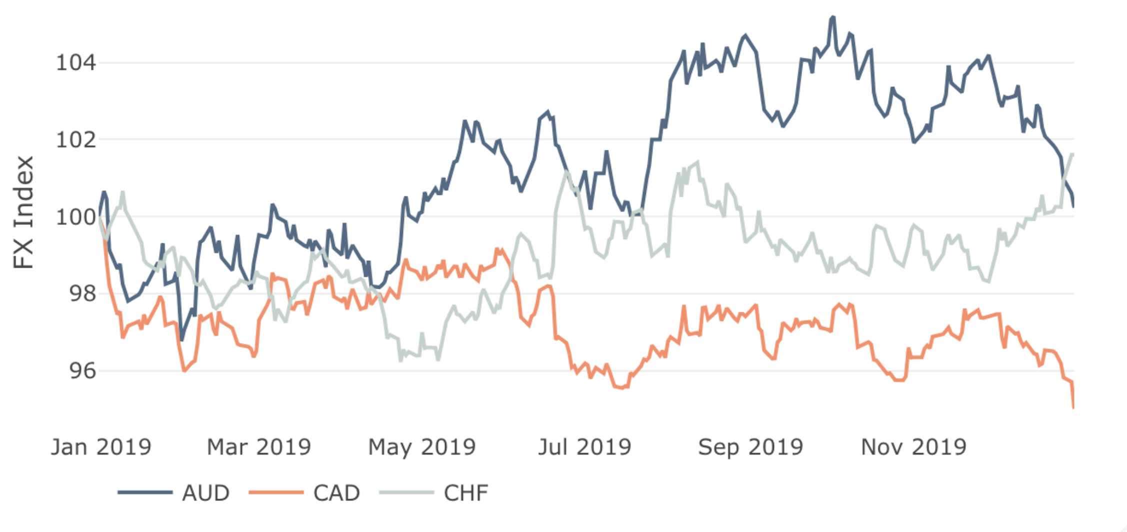
The Gold/Silver ratio shows that the demand for silver is low, or the demand for gold is high. Either one is a signal that the economic good times may end. People are piling into gold to protect their assets from uncertainty, or industrial demand is weak. The commodity market narrative is similar to interest rates: *economic uncertainty awaits*.

Currencies

Commodity currencies are collapsing.

The end of the commodity and economic cycle is nigh. The two leading commodity currencies, the Australia and Canada, are retreating versus the US dollar (exhibit 16). For added measure, the Mexican Peso is falling as well (not shown). Individually, neither would be a concern. The collective declines suggest that the commodity cycle is over, and demand will wane in the near term. As economic weakness permeates the world, support for the US dollar will grow for the foreseeable future.

Exhibit 16. Normalized Currency Rates



Source: Federal Reserve Economic Database

The Swiss Franc suggests trouble ahead.

An interesting analog to the story on gold is the Swiss Franc, which is growing versus the US dollar. This outcome is surprising given the positive carry for the US dollar versus the Swiss Franc. The reality is the view of the Swiss Franc as a haven during uncertain times. So, like gold, it is suggesting that investors are parking money is a safe asset in advance of economic uncertainty. The universal story outside of the equity market is that we are living a prologue to a global slow-down. The question is when, will the *equity markets join the story*?

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Disclosures