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MACROCOSM

Let's Talk About Something Other than the Election

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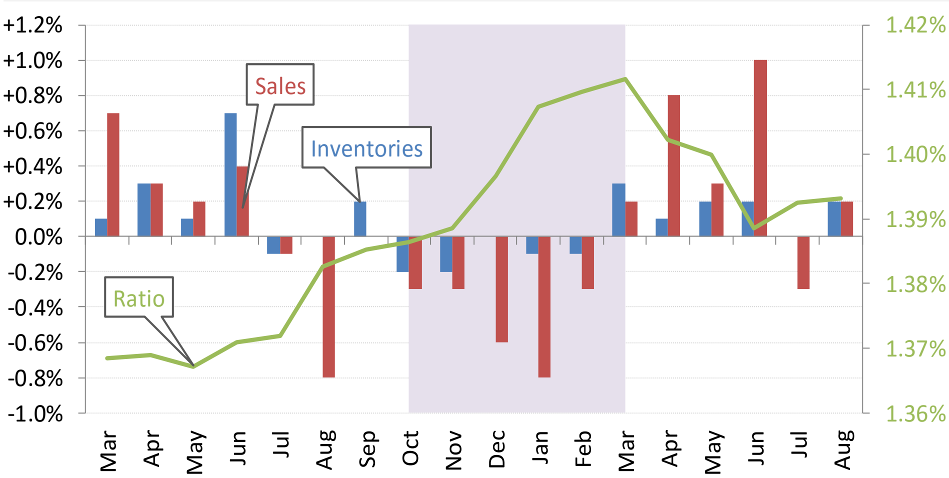
Sure. How about: if the election doesn't cause a recession, will there still be one in 2017?

In many client conversations now, we get asked to comment on the recession forecasts that some high-profile economic strategists are making for 2017. To be sure, we are on high alert for post-election turbulence of various kinds no matter who wins in November, which could conceivably tip the economy over (see "Elections Have Consequences" October 20, 2016). *But for now we want to talk about something other than the election (for a change).* Let's talk about those recession calls, and our own forecast.

- *The election and its aftermath do worry us. But when we leave that out, our baseline view is that we already had a near-recession in Q4-15 and Q1-16* (see "The Recession Caused by Low Oil Prices" January 8, 2016). *We've now emerged from it* (see "Have We Suffered Enough?" February 26, 2016), *and it can serve as something of a "mid-cycle refresh" for the present expansion, not necessarily improving it but at least extending it.*
- One consequence of having had only a near-recession, and not a full-on one, is that high inventory levels didn't get fire-saled away – so growth is being penalized now, and for a couple quarters yet, while it gets worked down gradually (please see the chart below).
- *Other than that – again, abstracting from the election – most of the*

US business sales and inventories **Q4-15/Q1-16 near-recession**



Source: Census Bureau, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, US BONDS, OIL, FX, US FED, ASIA MACRO: We're hearing recession-fears in client conversations. The election could induce turbulence, but abstracting from that, the data we most respect are pointing in a very constructive direction. We had a near-recession in Q4-15 and Q1-16. It leaves an inventory overhang behind, but still serves as a mid-cycle refresh. Too-low oil prices caused that near-recession, but oil has bottomed and will move higher. Forward EPS and sales have broken to new all-time highs. Bond yields and long-term inflation expectations are sharply higher from their post-Brexit lows, but only back to the low levels where they started, and we see no reason for them to move much higher. A December Fed rate hike will be a mistake, but with credit conditions having eased considerably, it shouldn't trigger a recession. We don't understand the recent quarter's USD strength, but given the Fed's gradualism and oil's rally, we don't expect it to strengthen further.

[Strategy dashboard]

critical data we respect most deeply is pointing very much in a constructive direction.

- For us, the single most important critical variable is the oil price. We predicted the near-recession in Q4-15 and Q1-16 when we saw our expectations for an oil price collapse more than fulfilled – indeed we were expecting more than just a near-recession (see, among many, "Another 'Reverse Oil Shock'?" Tuesday, July 28, 2015).
- We are quite confident that oil double-bottomed at WTI $26 in January and February (see "Oil: Priced for Perfection in an Imperfect World" January 20, 2016), and having already doubled, is still headed higher this year. We won't repeat our arguments for that here (see, among others, "On OPEC's Production Target" September 28, 2016). The key is that our target-price of $65 is consistent with the ongoing repair of the various damages that were done by too-low prices in the near-recession in Q4-15 and Q1-16, and should support the extension of the present expansion.

With that as a general statement of our outlook, let's examine the recession-calls out there, and look case-by-case at the economic variables in play around the world. For convenience, we'll use a question-and-answer format.

What recession concerns are you hearing from clients?

- Some recession-calls we hear about are based on large-scale secular threats, most often demographics or debt-overhang.
- While valid, these are nevertheless "broken clock" issues that are irrelevant until they are suddenly relevant (Meredith Whitney, are you there?). We won't deal with them directly in this report.
- The more pointed recession-calls seem to be based on cyclical notions that the present expansion is approaching natural exhaustion, or as we often hear, is "getting long in the tooth."
- *We don't believe expansions die of old age*. To be sure, the fastest growth usually comes at the beginning, off the low base set by the prior recession. But expansions end only when subjected to shocks – typically excessively tight monetary policy, too-high energy prices or a credit crisis.
- To be sure, one could argue that such shocks are not exogenous, but in fact symptoms of the high capacity-utilization or "imbalances" or "excesses" associated with a lengthy expansion. Fine – but for a credible recession call, we need to see or credibly expect those shocks themselves, rather than just cite the number of years the expansion has lasted. *We are not seeing those shocks.*

How about the slump in US earnings and sales?

- *Many clients are citing, as evidence of an aging expansion, the slump in both bottom-line earnings and top-line sales. We think that's a backward-looking view.*

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[About us]

Recommended Reading

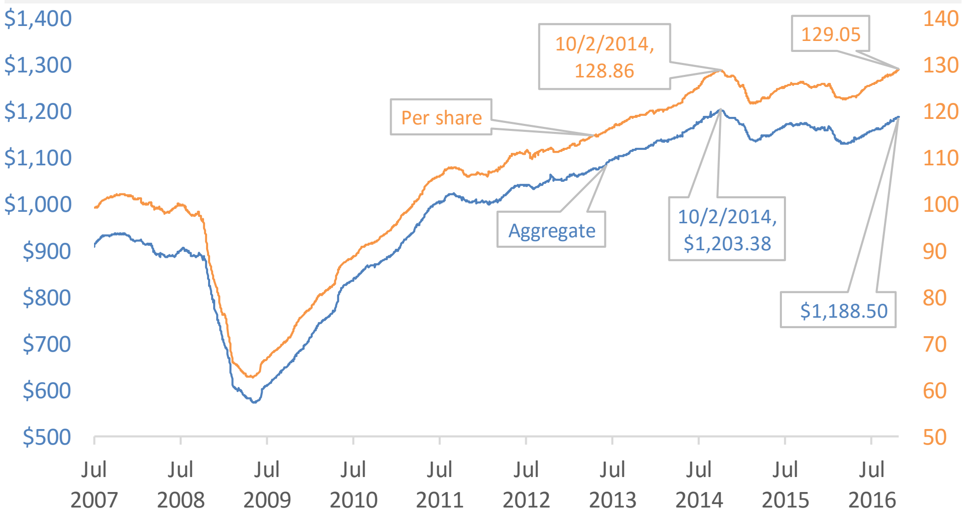
The yawning gap between free trade principle and practice
Reuven Brenner
Asia Times
October 24, 2016

What do financial markets think of the 2016 election?
Justin Wolfers and Eric Zitzewitz
Brookings Institution
October 20, 2016

[Reading home]

- We pointed out a year-and-a-half ago that a slump was coming (see "Houston, You're the Problem" March 9, 2015). It was clearly predicted by the rollover in S&P 500 *forward* earnings that started in early October 2014 – driven at first by the collapse of energy sector earnings, but then finally infecting the S&P 500 ex-energy as well, during the near-recession of Q4-15 and Q1-16.
- *Now that's over* (please see the chart below). *On a per-share basis, S&P 500 forward earnings broke to new all-time highs last Friday.* On an aggregate basis, they have recovered to within just 1.2% of all-time highs (the difference reflects the small cumulative effect of share buybacks).

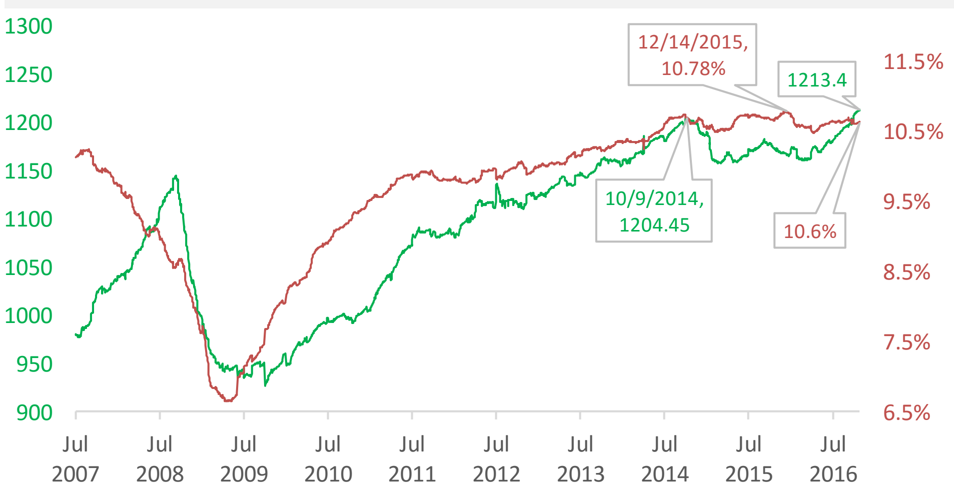
S&P 500 forward earnings Consensus, bottom-up



Source: Bloomberg, TrendMacro calculations

- Forward top-line sales have broken out to new highs, too, even more aggressively (please see the chart below). With implied

S&P 500 **Forward sales per share** **Implied margins**

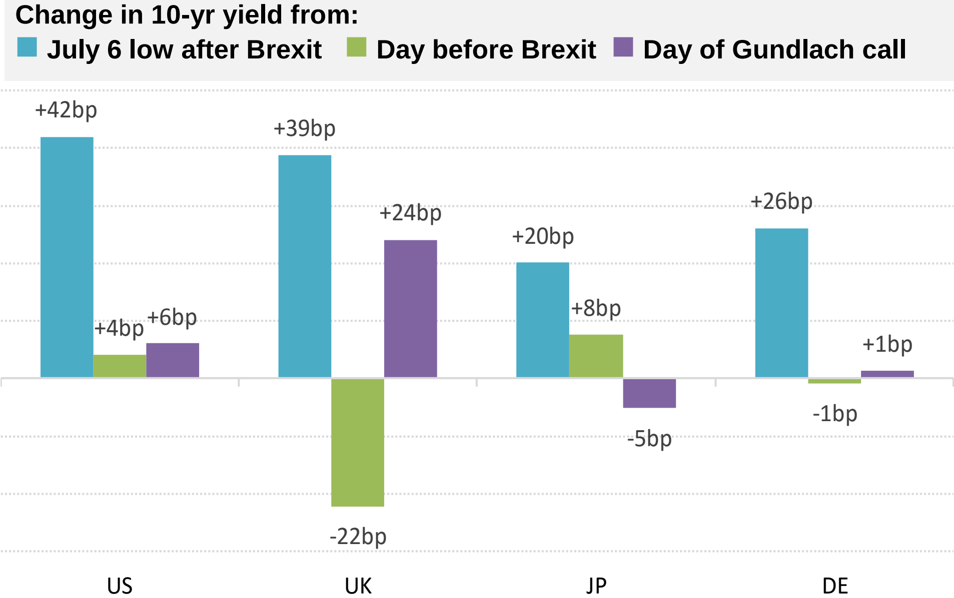


Source: Bloomberg, TrendMacro calculations margins having held steady at record levels throughout the two years of forward earnings rollover, this bodes well for future profitability.

What about the back-up in long-term government yields? Doesn't that pose a risk to equity valuations, and imply a resurgence in inflation?

- A large back-up in long-term government yields could be a blow. Many investors – and banks, including central banks – are precariously positioned, having "reached for yield" now for many years. Low yields undergird relatively high equity price/earnings ratios. And if they imply a flare-up of inflation, that would put accommodative central bank policy at risk.
- *Fortunately, so far there is actually no meaningful back-up in long-term government yields. The "big, big, moment" for yields that celebrity bond manager Jeff Gundlach announced has not arrived* (see "Gundlach and Load" September 12, 2016). True, there has been a large back-up from the risk-off crazy-low yields seen in early July, in the wake of the Brexit crisis. We said at the time those yields wouldn't last (see "On the Brexit Referendum" June 24, 2016). But measured against the day before the Brexit referendum four months ago, or since Gundlach's widely-followed call six weeks ago, yields are mixed, and hardly changed at all (please see the chart below).

Change in 10-yr yield from:

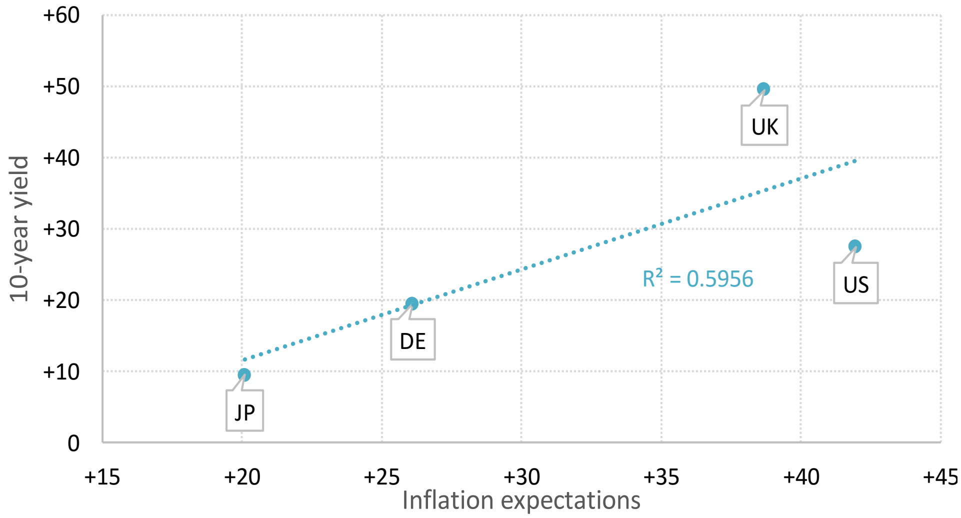


Source: Bloomberg, TrendMacro calculations

- The only exception is the United Kingdom, where yields have not fully recovered from their steep risk-off drop following the Brexit vote. They have made it about half-way back since Gundlach's call.
- We take it as axiomatic that long-term yields are primarily determined by long-term steady-state inflation expectations. Indeed, July's record low post-Brexit yields coincided exactly with all-time lows in swaps-implied 5-year 5-years-forward inflation

expectations. In fact, since those lows, the recovery in inflation expectations has mapped closely to the back-up in yields (please see the chart below).

Change from July 6 post-Brexit low



Source: Bloomberg, TrendMacro calculations

- This still leaves long-term steady-state market-implied inflation expectations at levels which, had it not been for the post-Brexit divot, would otherwise be at or near the lowest in the history of the data. The only exception is the UK – where implied inflation expectations have run back up to the top of the trading range of the last four years, presumably due to the very large weakening in sterling.
- We don't see any particular reason to think that, at this moment, inflation that has been weirdly low for seven years will suddenly return to normal, or even go higher than normal.
- Sure, if we are right that the oil price will continue to rise through the rest of this year, then in January and February of 2017 the year-over-year comparables will be dramatic, and that should feed into inflation statistics. But it shouldn't have much impact on core inflation, and there's no reason to think it should have any impact at all on long-term steady-state expectations, as it will wash out of the statistics just one year later.
- Gold isn't acting like higher inflation is ahead. And for those who insist that wage growth leads to inflation – don't worry, supposedly near "full employment," average hourly wages aren't growing any better than they have been for the last five sluggish years.
- In the US, the stronger dollar of the last quarter isn't pointing to inflation, either. Arguably that reflects growing certainty that the Fed will hike the funds rate in December – and that tightening of policy itself is a separate argument against rising inflation or inflation expectations.
- Yes, other major central banks aren't giving signs of being ready for similar tightening, and most major currencies have weakened against USD. But for those currency moves to make a difference to

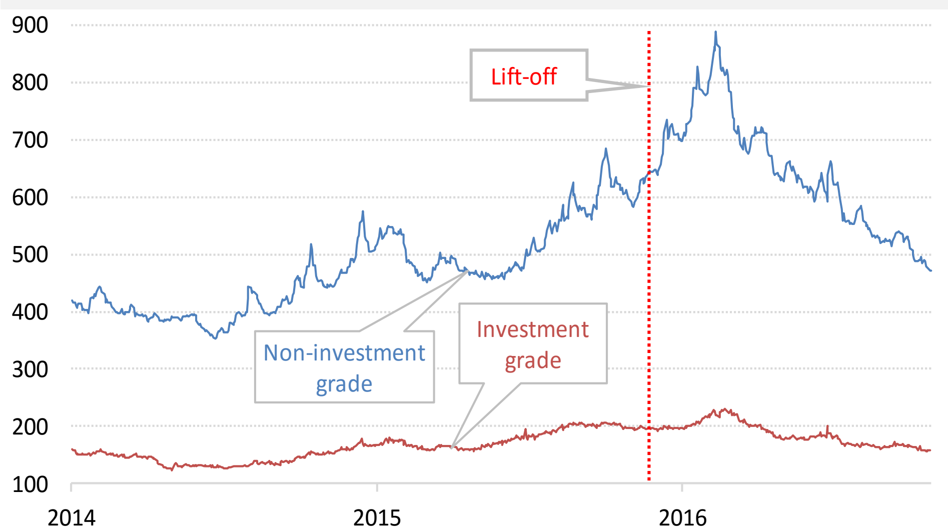
inflation, they will have to be very big moves, like sterling's – and to effect long-term expectations, those same big moves would have to be thought to repeat year after year. Currency aside, more than half a decade of seemingly ultra-easy policy hasn't led to inflation so far in those nations (which makes it rather comical to have Fed chair Janet Yellen talk about the possibility of "temporarily running a 'high-pressure economy,'" as though that, finally, would be the right magic wand for her to wave to restore inflation).

- *Until further notice, we think low inflation expectations – and concomitant low long-term bond yields – are a durable regime.* Sure there could be some drift – for instance, the US 10-year could drift up to 2% and beyond, and only be back to where it was at the beginning of the year. But that's noise, not signal.
- The only secular influence we are watching that might move inflation and yields durably higher is the transformation of the present stream of China's outbound foreign direct investment into a wave (see "More Anbang For the Buck" April 13, 2016). At this moment, unfortunately, the protectionist impulses sweeping the world are beginning to put up barriers against Chinese investment – but we said we weren't going to talk about the election.

Will a December Fed rate hike trigger a recession, perhaps by making the dollar too strong?

- We still can barely bring ourselves to accept that the Fed will hike at the December FOMC. We believe firmly that it should not do so (see "On the September FOMC and BOJ" September 21, 2016). But if something like today's conditions obtain in December, it won't be the same kind of dangerous error that lift-off was last year (see "On the December FOMC" December 16, 2015).
- Then financial conditions had already tightened dramatically, thanks to the effect of too-low oil prices on corporate bond spreads (please see the chart below) – which, from cycle narrows had

Corporate bond spreads-to-Treasuries Basis points



Source: BAML, Moody's, TrendMacro calculations already effectively imposed multiple rate hikes. The Fed could clearly see the results across a broad front of sharply weakening macro data, but despite claims of being data-dependent, chose to ignore them.

- Then in January, Fed Vice Chair Stanley Fischer said on CNBC that four more rate hikes were "in the ballpark" for 2016, ignoring many months of Yellen's carefully preparing markets to accept gradual rate hikes only as evolving data might justify them.
- Now financial conditions have gradually eased. Corporate bond spreads are below their long-term averages again, and while not back to cycle narrows, are once again supportive of growth. And most macro data is at least stable.
- Yellen has carefully re-established gradualism as her watchword (the curve now expects only three rate hikes over the next three years). *So if conditions and the data hold up, and Fischer can keep his mouth shut, we should be able to endure a December hike without triggering a recession – though we'd be better off without it.*
- Yes, USD strength is troubling. We're not sure it would mean much, if anything, for inflation or for real earnings. But we know that it would put China in the touchy position of having to weaken RMB versus USD further, without triggering protectionist backlash. We think the powerful stabilization China has experienced over the last year has been, in large part, both because it has fully expertly transitioned to tracking a "reference basket" of currencies instead of just USD (see "Yuan Direction" February 16, 2016) and, at the same time, because USD trading in a narrow range has made China's job relatively easy. *This has taken China off the table as a global systemic risk, but a sufficiently strong dollar could put it back on.*
- We have expected USD to weaken this year while the oil price has recovered, based on our research showing a durable inverse relationship going back almost half a century (see "Dollar Strength: A Crude Connection" April 23, 2015). While oil has almost doubled since Brent's bottom in late January, the trade-weighted dollar is about unchanged on net – first weakening by about 6.1%, and then almost fully recovering.
- We doubt the Fed has all that much to do with this anomaly. We don't see how expectations for three rate hikes in three years can explain the degree of USD strength we've seen. Brexit is surely part of the explanation – the bulk of the USD rally happened right after the referendum. Computationally, the sharp drop in sterling alone accounts for almost a third of the 6% USD rally.
- *So we're not especially worried that USD can get much stronger from here. In fact, we see little reason why it has been as strong as it has, and all else equal we would expect it to weaken.*

Bottom line

We're hearing recession-fears in client conversations. The election could induce turbulence, but abstracting from that, the data we most respect are pointing in a very constructive direction. We had a near-recession in Q4-15 and Q1-16. It leaves an inventory overhang behind, but still serves as a mid-cycle refresh. Too-low oil prices caused that near-recession, but oil has bottomed and will move higher. Forward EPS and sales have broken to new all-time highs. Bond yields and long-term inflation expectations are sharply higher from their post-Brexit lows, but only back to the low levels where they started, and we see no reason for them to move much higher. A December Fed rate hike will be a mistake, but with credit conditions having eased considerably, it shouldn't trigger a recession. We don't understand the recent quarter's USD strength, but given the Fed's gradualism and oil's rally, we don't expect it to strengthen further.