Economy tanking amidst Fed hot air ahead of Sept 21st Fed Funds rate decision; valuation implications
T.W. US$ Index: 90.66; US 10-yr: 1.70%; S&P 500: 2139; Oil: $43.44; Gold: $1,315; Silver: $19.28 9/20/16



Introduction:
Let's take a look at economic and geopolitical developments from last month and from prior periods. On the economic front, noteworthy is that August 2016 sales and production are showing intensifying and renewed weakness in the US:

- Pre-inflation-adjusted August retail sales declined across all major sectors.
- Medical costs in August, as tabulated by the BLS, jumped the most in 32 years, compounding at 5.1% (meanwhile, real world health outlays, which include rapidly growing deductibles and coinsurance spending, and constitute over 20% of an average working family's budget, have been expanding by "multiples of 5.1%" for years.
- (Marketplace premiums under the Affordable Care Act (ACA) have gained even more attention amidst unfavorable financial results from some insurers, as well as initial reports of steep premium increases requested for 2017.)
- Real average earnings declined by 0.1% in August as real retail sales declined by 0.5% month-to-month, with annual growth at a 30-month low, an intensifying recession signal (sources: BLS, BEA).
- Industrial production was down by 1.2% year-over-year in August and 1.3% below the pre-2007 recession peak; the US manufacturing sector has seen four consecutive quarters of contraction; this is unprecedented outside of formal recessions (source: Fed).
- The civilian labor force participation rate continued to hover near a four-decade low of 62.8% in August, despite a plethora of part-time job creation, which gets captured in the series, skewing it to the upside; most of the new jobs that continue to be created by the US economy are low-paying, part-time (lack benefits) positions. Plus, over 94m Americans between 16 – 65 of age are not in the labor force!
- Net US employment gains since the 2007 recession for people between 16 and 65 through year end 2014 have been immigrant-based.
- The Obamacare train wreck, besides negatively impacting new full-time job formation and payroll expansion beyond 49 employees, has resulted in multiyear double-digit increases healthcare premiums, pummeling disposable income, a one-two economic punch.
- The 2015 household-income boost reflected IRA withdrawals and census-gimmicked interest income.
- Meanwhile, both European and Japanese economies remain very weak as well, and, ominously, global tit for tat fines appear to be increasing (after Apple was ordered by the EU to pay Ireland $14bn in back taxes, the DOJ announced on 9/16/16 that it had fined beleaguered Deutsche Bank an outsized $14bn for its role in mortgage lending during the 2000s housing bubble).
- Geopolitical tension/instability -- whether in the Chinese Sea or the Black Sea or the Mideast-- is on the rise.
- In addition, increasingly widespread voter dissatisfaction with unrepresentative governments on either side of the Atlantic, as spearheaded by June 24th's "Brexit" vote, threatens the crony/statist status quo, including central planning-determined asset valuations. The central planners will likely continue to respond by "doubling down" on an imperiled status quo, fanning financial repression/ZIRP/NIRP while inducing yet more public disenchantment.
- In a related fashion, increasingly imperiled pension funds and more frequent reduced retirement benefit announcements threaten to turn voter disenchantment into outrage, fueling a potential overthrow of the plutocratic status quo.
- Finally, on October 1st, 2016, China's yuan becomes part of the global fiat money-based SDR (special drawing rights) fiat currency regime, which, combined with continued expansion of yuan-based dual currency agreements, could further reduce demand for dollars overseas. This will likely force the Fed to soak up "dollars coming home" via a de facto expanded QE program to purchase Treasuries and agency bonds foreigners are selling. Against such a backdrop, the Fed is unlikely to raise the Fed Funds rate.

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A closer look:
We need to revisit Deutsche Bank's DOJ fine. Same could prove to be a dangerous spark in a banking system brimming with "combustible" derivative risks; a world in which debt has increased by roughly $60trn -- only some $10trn shy of one year's global GDP -- since 2007!

In this regard, Deutsche Bank's leading global derivative exposure of over 42trn euros (approximately $47trn at current exchange rate) is well known, and the financial sector's derivatives-based counterparty risks or default risks (inability to live up to contractual obligations vis-à-vis each other), in symphony with mushrooming debt, loom much larger than in 2007. At last count, there was $492trn in worldwide, off-balance sheet, OTC (non-exchange-traded, non-regulated) derivative exposure (some seven times global GDP), of which $384trn or 78% constitute interest rate (sensitive) contracts.

While well-known risks are typically discounted in the marketplace, the US government hitting Deutsche Bank with a $14bn fine on 9/16/16 that approximated the already pummeled market value of its equity on said date could potentially unleash a domino effect on the global financial system akin to "Lehman on steroids eight years later." The global financial meltdown risk associated with a counterparty risk contagion spurred by the likes of mega-exposed money center banks cannot be brushed aside in today's fragile financial and economic environment.

The aforesaid is especially true as money center banks have made huge bets -- and commensurately have immense potential loss exposure -- on interest rates staying low or heading lower, which is not an academic discussion. Consider the 10-year Japanese Government Bond (JGB) losing nearly 20% of its value during the past month or so associated with a "spike" in interest rates from a record low -0.3% in July 2016 to -.04% as September 16th.

Source: http://www.tradingeconomics.com/japan/government-bond-yield

Precisely this kind of derivatives contract-based interest rate exposure risk, the global nature of interest rates, central banks' enormously leveraged balance sheets, and those institutions' absolutely unprecedented portfolio-based exposure to rising interest rates make major central bank-based interest rate increases highly unlikely. For color, consider that the aggregate balance sheet of major central banks is up from $3trn in 2007 to nearly $19trn currently -- and that central banks are purchasing additional bonds and even stocks (!) at approximately $200bn clip per month (prior to the Fed getting back into the QE game overtly):

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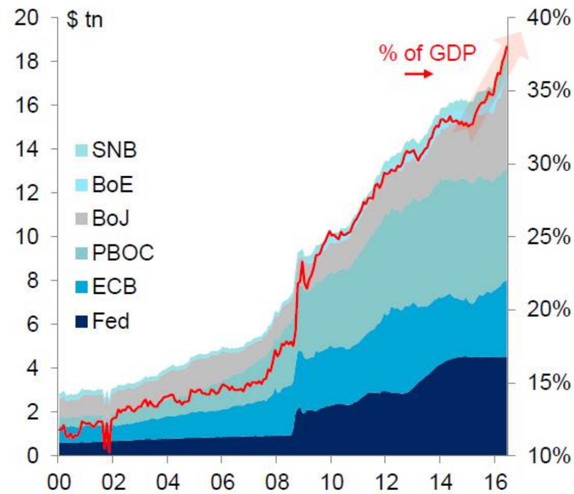
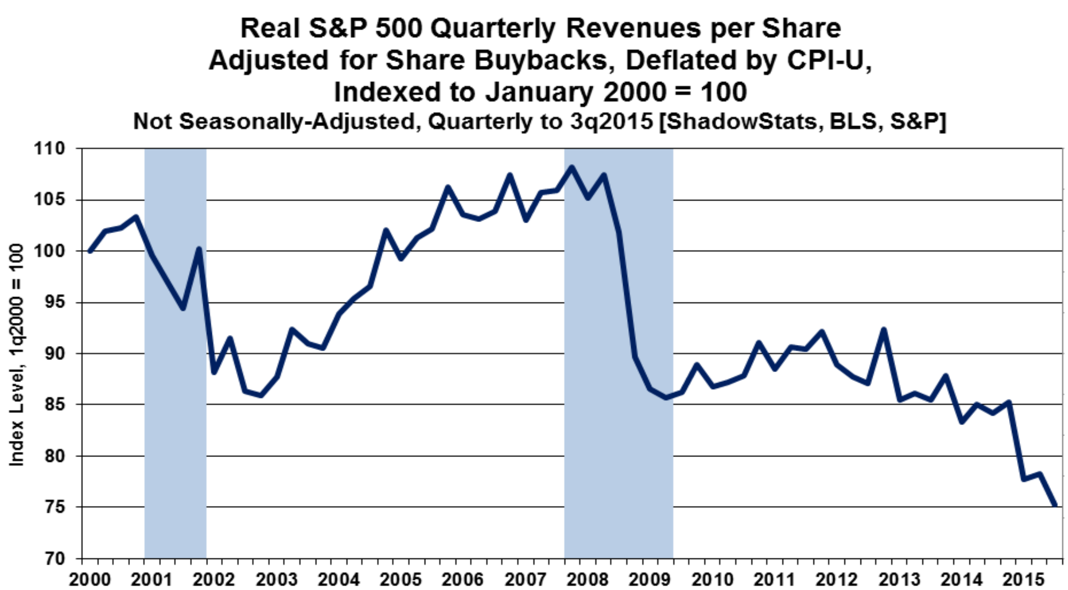
Aggregate balance sheet of large central banks in $trn and as a % of GDP



Sources: Citi Research, Haver

These aspects, on their own, speak volumes about the Fed's likely "no Fed Funds rate change" or possibly even a shift to a dovish stance in order to prop up the stock market ahead of the US presidential election (it is no secret that Keynesian Yellen has strong Democratic/statist propensities, and that her Fed chairpersonship could be threatened should Trump win).

Turning from bonds, derivatives, exploding debt, and central bank balance sheet risks to the economy and to equities, it is increasingly clear that over the past year, the spreading domestic and global economic malaise has overwhelmed even ZIRP-enabled stock buyback-fueled EPS levitation. S&P 500 GAAP earnings per share are down 8.4% year-over-year through 6/30/16. A multiyear S&P 500 EPS levitation effort defied a protracted lack of top-line growth, highlighting the low quality, artificial, and unsustainable nature of the current profit "recovery." For flavor, consider, on an inflation and share-buyback-adjusted basis, that S&P 500 sales per share into late 2015 were actually lower than S&P 500 sales per share prior to the onset of the 2008 recession:



Sources: ShadowStats, BLS, S&P

For more granularity on the nature of the constantly ebbing earning quality, also over a protracted period of time, consider this depiction:

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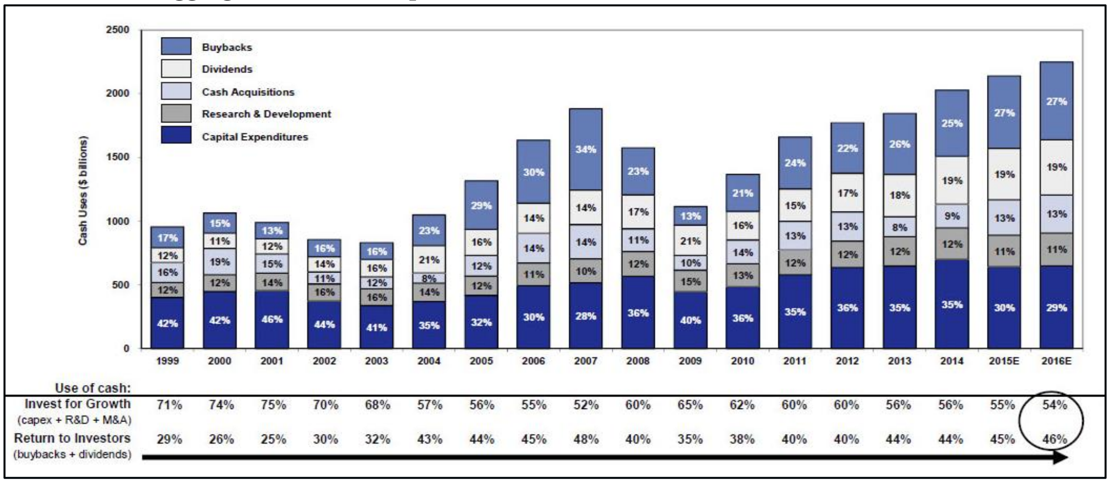
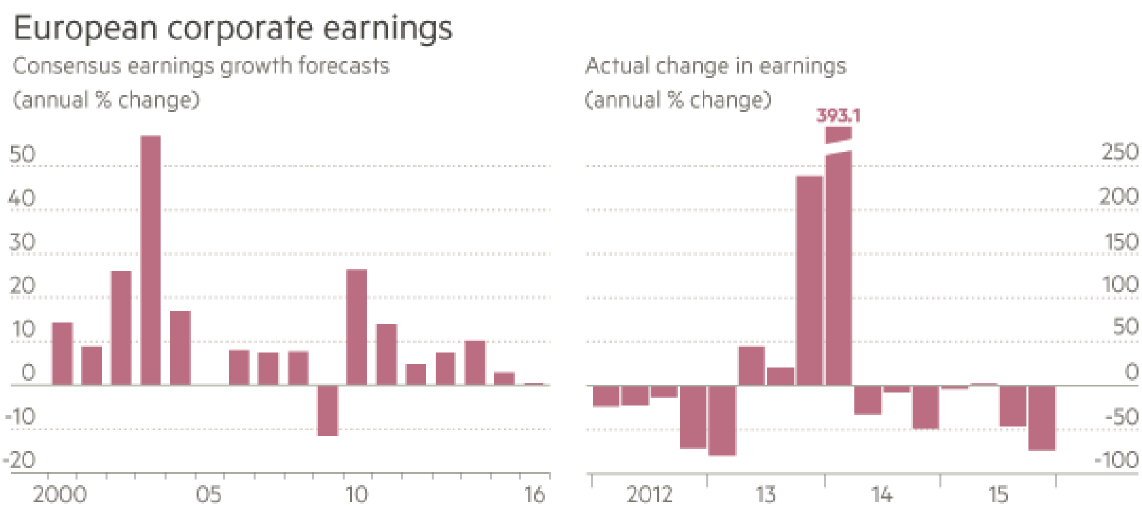
Breakdown of aggregate S&P 500 corporate cash use with Goldman Sachs forecast for 2015 and 2016



Sources: Compustat and Goldman Sachs

Discouragingly, European EPS growth has materially lagged America's historically subpar, contrived EPS growth (annual GAAP S&P 500 EPS as 6/30/2007 was $84.92; annual GAAP S&P 500 EPS as of 6/30/2016 stood at $86.92), yet another clear confirmation of globally weak economic growth as Europe is home to the world's single biggest economic region, GDP wise:



Sources: UBS, Bloomberg, FT

In a nutshell, marked financial repression-based (or asset bubble) risks for investors and central banks alike, tremendous derivatives-based counterparty risks, increasingly anemic GDP growth, artificial EPS "rolling over," an aging global "economic recovery," teetering defined benefit pension plans, and mounting political instability clearly suggest that the Fed and other central planners/central bankers will not engage in tightening for as long as possible -- as long as confidence in and demand for fiat money lasts, in other words. Moreover, an American economy increasingly hobbled by a "toxic public policy stew" (US regulatory compliance costs have been estimated at $2trn p.a., federal regulations -- de facto laws --are increasing in excess of 5,000 p.a., and the rule of law remains under attack) and featuring a tremendous increase in financial leverage (overleaf) simply cannot "afford" higher interest rates without triggering a politically untenable recession of potentially unmatched post WWII depth and breadth. Shockingly, just 1% higher average government borrowing costs would raise government interest payments/government spending by a whopping $195bn p.a., while corporations have been binging on debt-financed stock buybacks for years, further increasing the economy's interest rate sensitivity. Commensurately, "Volcker style 1980 tough love," or a 20% Fed Funds rate, is no longer even remotely possible, even if a plummeting dollar brought about large inflationary pressure, a very material risk that could be "around the corner."

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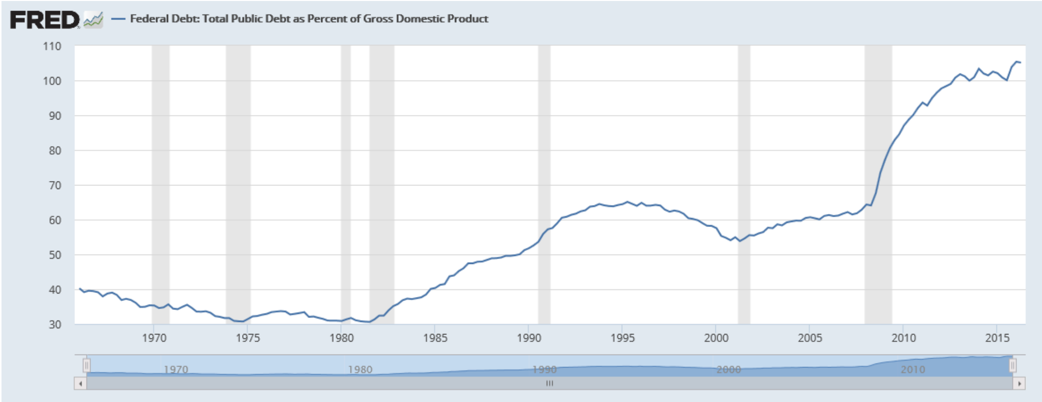
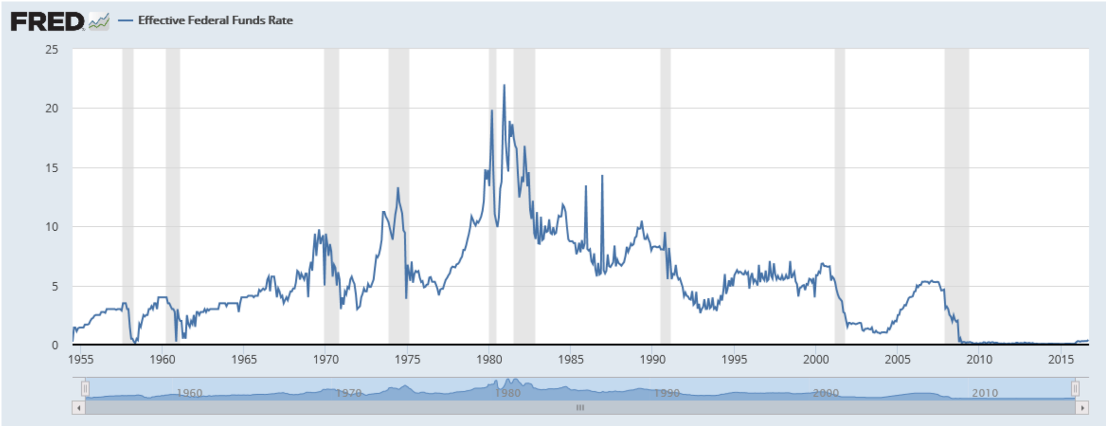


Source: https://fred.stlouisfed.org/series/GFDEGDQ188S

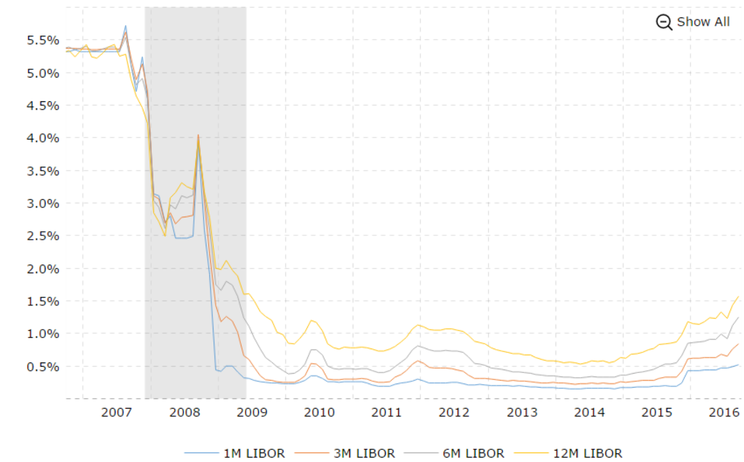
So look for the Fed to keep the Federal Funds rate near zero on September 21st, thereby extending already absolutely unprecedented, de facto ZIRP even further into the future:



Source: https://fred.stlouisfed.org/series/FEDFUNDS

In fact, the Fed could point out that with one-month LIBOR, the London interbank offered rate (the rate banks charge each other for short-term, dollar-based loans, the one-month Libor being loosely comparable to the Fed Funds rate), already rising substantially this year, the "reputationally necessary" tightening sought by the Fed has "already occurred:"

LIBOR



Source: FT

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Conclusion:
A "no rate hike Fed" on September 21st, which we fully expect, would extend a de facto zero interest rate policy further into the "twilight zone," as mentioned. It would also likely rob the Fed of its remaining strands of credibility. This, in turn, would likely send the buck lower, the stock market higher still (further and even more dangerously divorcing it from underlying fundamentals, which are worsening), dollar-based precious metals higher, and possibly USD bonds lower as international investors finally realize what a hoax the Fed's rising short-term US interest rate story has been, thus sell dollars and, by extension, Treasuries, in ever greater numbers.

(Needless to say, and as we've just witnessed, equities sell off when conviction grows that the Fed will hike rates, and especially after it actually does so, as happened in the wake of last December's 0.25% Fed Funds rate hike, when the stock market swooned and precious metals quickly recovered and began to rally. We think the Fed "gets it," and is loath to crater the equity market for political reasons and also because it would be disruptive to the balance sheets and P&Ls of the very Fed member banks that own the Fed, a private sector entity.)

Given over $16trn of offshore dollars, any such development that gains momentum could end up "feeding on itself," i.e., ignite the process of a material repricing of the dollar, dollar bonds, precious metals, and scarce real assets priced in dollars. Is your portfolio allocated constructively, i.e., is it liquid enough (preferably in T-Bills, to minimize bail-in risks) to take advantage of what could be a marked currency and asset repricing ahead? Moreover, is your portfolio positioned for another $4trn in Fed QE (central bank government bond and agency bond purchases, and possible beyond that) "to offset an economic shock" or a political/financial shock, including rising discontent over growing pension fund benefit cuts and rising pension fund insolvencies requiring an "unparalleled bailout/monetization?" The Fed re-entering overt QE to the tune of all prior Fed QE to date (talk about "doubling down") would likely "turbocharge" a repricing in the global value of the dollar, dollar bonds, precious metals priced in dollars, and scarce real assets priced in dollars. And, while same would almost certainly (further) underpin any near-term upward trajectory of the stock market, it would also provide investors holding considerable equity stakes with a grand opportunity to profitably reduce exposure (especially in high P/E stocks) prior to the current earnings compression gathering speed, which would render stocks so overvalued that "gravity would take over."

Greetings,
Dan Kurz, CFA
DK Analytics

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