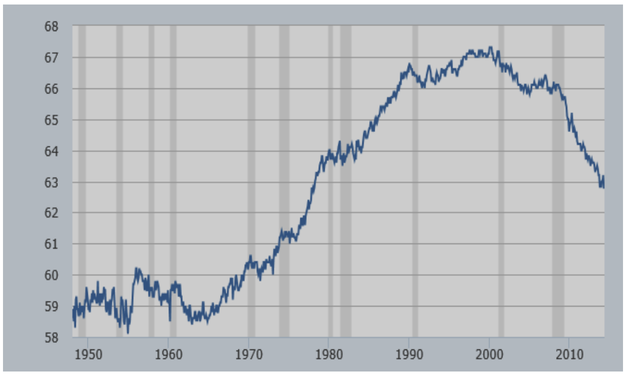
Strategic allocation musings

In the eye of a recessionary storm? Is a "Wile E. Coyote moment" ahead for investors?

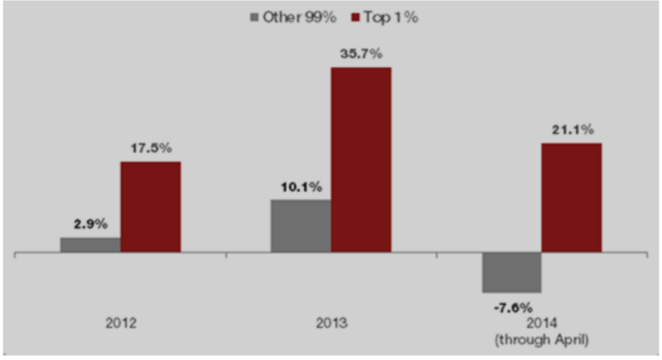
June 2014

Civilian labor force participation rate in %



Source: http://research.stlouisfed.org/fred2/series/CIVPART

Growth in # of homes sold: other 99% and most expensive 1%

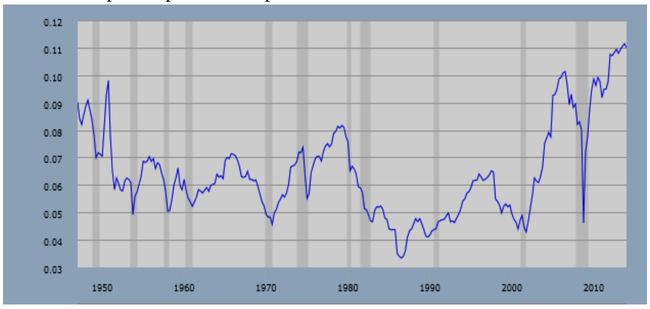


Source: http://www.redfin.com/research/wp-content/uploads/sites/4/2014/05/growth_in_number_of_homes_sold_overall.png

The business cycle and the political economy:

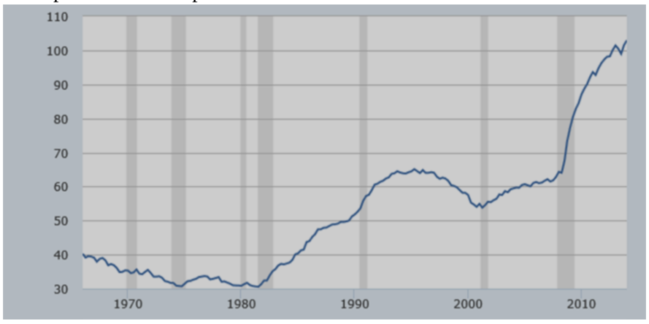
The QE/Keynesian induced, narrow (crony capitalist, Statist-centric) recovery has boosted S&P 500 and financial sector earnings to record highs, "frosted" hiring, and bloated federal debt to unprecedented post WWII levels: (www.yardeni.com/pub/ppphb.pdf; http://economix.blogs.nytimes.com/2014/04/02/the-wealth-gap-is-growing-too/?_php=true&_type=blogs&_r=0; www.forbes.com/sites/alejandrochafuen/2013/10/30/death-by-extortion-how-politicians-and-crony-capitalists-are-destroying-the-american-dream/)

Aftertax corporate profits as a percent of GDP



Source: http://research.stlouisfed.org/fred2/graph/?g=cSh

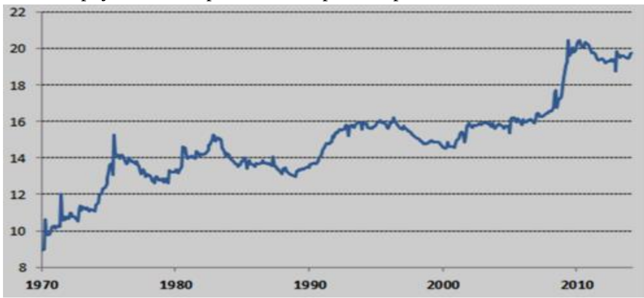
Total public debt as a percent of GDP



Source: http://research.stlouisfed.org/fred2/series/GFDEGDQ188S

This is thanks to artificial demand created by massive Fed-sponsored government spending growth/debt expansion and interest rate suppression; to rampant growth in regulations (www.regulations.gov; www.cnsnews.com/news/article/ali-meyer/new-epa-regs-issued-under-obama-are-38-times-long-bible), which is throttling small business, the wellspring of job creation; and to starkly increasing welfare and entitlement spending (transfer payments such as food stamps, disability, Medicaid, unemployment, Social Security, and Medicare), which largely reflects a plunging labor force participation rate:

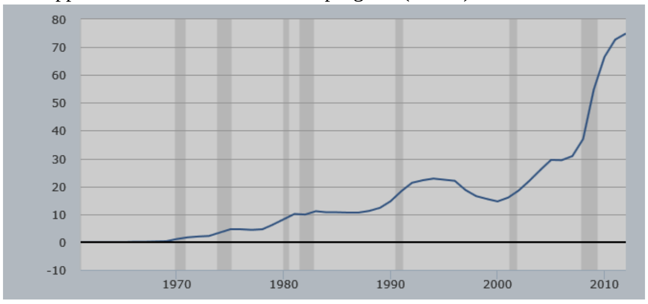
Transfer payments as a percent of disposable personal incomes



Sources: Bloomberg; www.socialsecurity.gov/OACT/STATS/table4a6.html; www.richmondfed.org/publications/research/region_focus/2012/q2-3/pdf/feature3.pdf

For one transfer payment example, consider food stamps:

US supplemental nutrition assistance program (SNAP) -- in bn of $

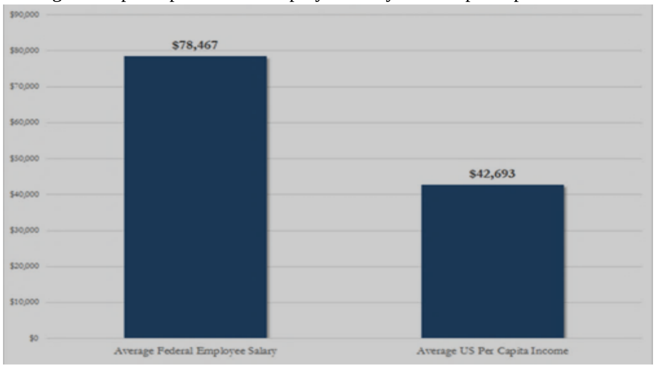


Source: http://research.stlouisfed.org/fred2/series/TRP6001A027NBEA

Or consider that in 2012, 86.4m full-time private sector workers supported 108.6m benefit recipients and 16.6m government workers, 4m of which worked for the federal government (www.census.gov/hhes/www/cpstables/032013/perinc/pinc07_000.htm). Those federal employees' average salary in 2012 was 84%

higher than that of the private sector employees that funded federal payrolls:

Average 2012 per capita federal employee salary and US per capita income

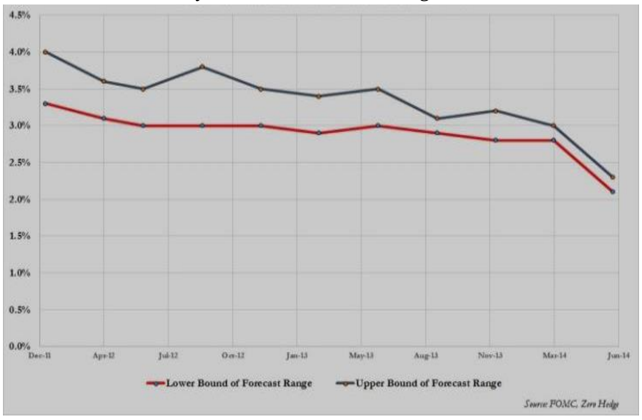


Sources: http://www.opm.gov/, http://www.nber.org/, Zero Hedge

Is it any wonder that the six of the ten wealthiest counties in America are clustered around the Beltway, where plenty of lucrative jobs are on offer in tech contracting, other professional services jobs, local school systems, and major federal agencies such as the Department of Defense? (www.forbes.com/sites/tomvanriper/2014/04/01/americas-richest-counties-2014/, http://dc.about.com/od/federaljobs/a/BestGovtJobs.htm)

Meanwhile, the so-called US economic recovery, which according to the Bureau of Economic Research began in June 2009, is old in the tooth at 60 months; the average post WWII recovery has lasted 58.4 months (www.nber.org/cycles/cyclesmain.html) Said differently, historically speaking the recovery is overdue to flip into a full-fledged recession. This is all the more true given the subpar, contrived nature of the current upcycle. But don't tell the "contrarian indicator" Fed that:

Fed's "central tendency" forecast for 2014 GDP growth

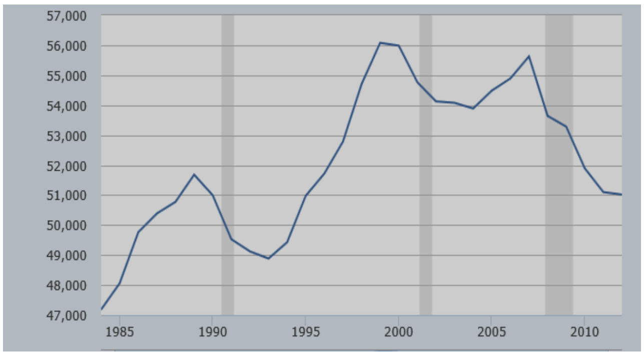


Sources: FOMC, Zero Hedge

The impaired consumer:

Consumption is about 70% of GDP. As can be seen below, real household income, even as immensely flattered by understated inflation, has been weakening for the better part of the past 15 years (if inflation measurement had remained unchanged over the past three decades, the CPI would have shown annual inflation rates approximately twice what the BLS recorded over the same period. (http://www.shadowstats.com/alternate_data/inflation-charts)

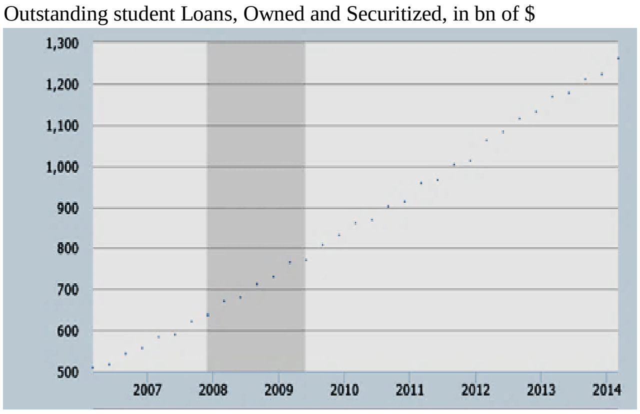
Real median US household income in $



Source: http://research.stlouisfed.org/fred2/series/MEHOINUSA672N

With labor force participation (top left chart on first page) plummeting to levels last seen nearly four decades ago; a sustained loss of higher-paying, higher value-added manufacturing jobs; and growth in part time jobs thanks to Obamacare legislation as attested to by a preponderance of evidence (www.forbes.com/sites/theapothecary/2013/07/31/who-can-deny-it-obamacare-is-accelerating-u-s-towards-a-part-time-nation/; www.forbes.com/sites/gracemarieturner/2013/08/27/its-fact-not-anecdote-that-obamacare-is-turning-us-into-a-part-time-nation/), median household income has remained under sizable pressure. Needless to say, sustainable economic growth cannot be achieved when 70% of its makeup, consumption, remains impacted by real income contraction. This is all the more true if a sizable portion of the up-and-coming generation, i.e., college graduates, are wrestling with unprecedented student loan debt (please see below) juxtaposed against a very weak job market that has kept many from "taking flight." In 2012, 21.6m or 36% of the nation's young adults aged 18 to 31 -- the so-called Millennial generation -- were living in their parents' home, according to an analysis of U.S. Census Bureau data (www.pewsocialtrends.org/2013/08/01/a-rising-share-of-young-adults-live-in-their-parents-home/). This is the highest tally in at least four decades.

Outstanding student Loans, Owned and Securitized, in bn of $



http://research.stlouisfed.org/fred2/series/SLOAS

To add insult to injury, both food and energy prices keep on rising (please note that ag and dense energy assets remain key allocations: http://dkanalytics.com/wp-content/uploads/2016/10/10-Global-ag-assets-

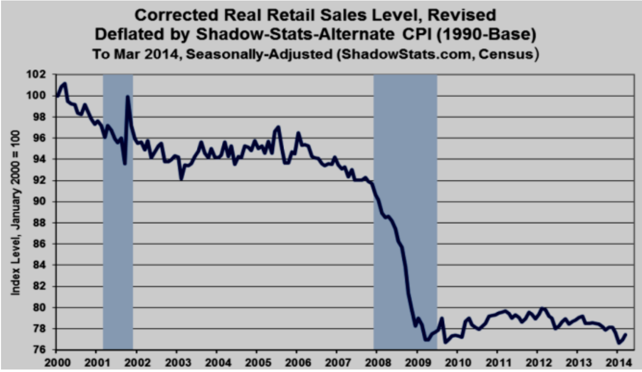
January-2014.pdf, http://dkanalytics.com/wp-content/uploads/2016/10/9-Dense-energy-November-2013_.pdf), further draining consumer purchasing power. On the food front, the BLS's seasonally adjusted increase in the price index for meats, poultry, fish, and eggs just hit a historical high, which also resulted in an all-time high in the same price index (http://data.bls.gov/timeseries/CUsR0000SAF112?output_view=pct_3mths). On the energy front, recent gasoline prices have reached the highest average level since 2008, and the average national cost per kWh in May rose 3.8% year-over-year to a record high (www.bls.gov/ro3/apmw.htm; www.zerohedge.com/news/2014-06-20/inflation-only-if-you-look-food-water-gas-electricity-and-everything-else). People paying progressively more for food and energy necessities will generate additional consumption-based economic growth headwind.

Speaking of headwind, and in sync with our theme of increasingly narrow, crony/Statist economic growth, retail profits, traffic, and comparable store sales have been increasingly punk in the very chains that cater to the majority of Americans that haven't been able to materially avail themselves of crony largesse. Some Q1:14 headlines:

- Wal-Mart profit plunges by $220m as US store traffic declines by 1.4%
- Target Profit drops by $80m, 16% lower than 2013, as store traffic declines by 2.3%
- Sears loses $358m in first quarter as comparable store sales plunge by 7.8%, and Kmart's comparable stores sales sagged by 5.1%
- JC Penney thrilled with loss of only $358m for the quarter
- Kohl's operating income plunges by 17% as comparable sales decline by 3.4%
- Costco profit declines by $84m as comp store sales only increase by 2%
- Staples profit dives by 44% as sales collapse; hundreds of stores to close
- Dollar General profit tumbles by 40% as comp store sales decline by 3.8%
- Lowes misses earnings expectations as customer traffic was flat (http://davidstockmanscontracorner.com)

Noteworthy: a clutch of high-end retailers, such as Nordstroms, Tiffany, Saks, and Ralph Lauren, had "constructively sunny" Q1:14 results, tough winter weather notwithstanding. Trouble is, the top ten to twenty high-end retailers only account for roughly 50m sq. ft. of retail space, or less than 0.5% of the national total.

And weak Q1 retail results are by no means an outlier of a lingering trend of weak consumption growth. In fact, indexed for what one computation of "real world inflation," national retail sales have been bottom-bouncing since 2009:



Ultimately, consumption growth, and especially home sales (please see top right hand chart on first page), reflect real income developments. Consumer income, in turn, mirrors gainful employment traction -- or there lack of, particularly as the personal savings rate continues to decline (recently to under 4.0% from 6.6% in June 2009) and non-student loan access remains limited. Weakness in this realm is proving to be the underreported Achilles Heel of both the current upturn and the economy's strategic health. The much bandied about decline in the "U3" unemployment rate from 10.0% in October 2009 to 6.3% currently (http://data.bls.gov/timeseries/LNS14000000; www.bls.gov/news.release/empsit.t15.htm) as well as the recent alleged payroll gains -- which continue to reflect outsized growth in part-time/minimum wage jobs -- are indicative of a series of apparently politically motivated obfuscation:

1. The ranks of U3 unemployed, which constitute the most watched/discussed unemployment report, are reduced by those that have not actively looked for work within the past four weeks prior to the unemployment survey; as a result, those individuals disappear from the U3 unemployed ranks. In a tough job market, such tabulation may well be a demonstratively misleading indicator of unemployment.
2. Pre-1994, the more encompassing U6 unemployment rate (currently at 12.2%) included people that had been unsuccessfully looking for a job for one year or more; in 1994 the Clinton administration saw to it that the BLS no longer included such unemployed workers in the U6 statistic, arguably another instance of misrepresentative tabulation of unemployment, especially in a very difficult job market since 2009. In an effort to capture the "roll-off" of long-term discouraged workers that had previously been included in the U6 unemployment statistic, John Williams of ShadowStats has "funneled" that cohort into his own composite rate of US unemployment wherein, aside from attrition, they do not disappear into the "Twilight Zone" even as they leave the BLS defined headline labor force. William's estimate of US unemployment stood at a whopping 23.2% in May. (http://www.shadowstats.com/alternate_data/unemployment-charts)
3. To add insult to injury, on the employment side we have been receiving what appears to be seriously flawed headline job growth numbers thanks, in essence, to a

faulty premise that jobs created by start-up companies since the downturn have more than offset jobs lost by companies going out of business. Furthermore, if a company fails to report its payrolls because it has gone out of business, the BLS assumes the firm still has its previously-reported employees and then adjusts those numbers in accordance with industry trends. In a nutshell, and if typical, little-discussed substantial downward revisions in recorded payroll growth are anything to go by, current monthly payroll growth numbers may well be overstated by roughly 200,000. (http://explistats.com/; www.shadowstats.com/article/no-633-may-employment-and-unemployment-money-supply-m3.pdf; http://www.brookings.edu/blogs/jobs/posts/2014/05/02-big-payroll-gains-anemic-labor-force-growth-burtless)

Is free market capitalist America open for business?

There is growing incidental evidence that the implementation of FATCA coupled with an increasingly globally assertive NSA surveillance stance are beginning to negatively impact the vigor of US exports, US overseas investments, and international trade and finance involving US participants (http://strategicinvestment.com/, January 2014 issue on FATCA; www.forbes.com/sites/realspin/2014/05/30/explaining-the-wormy-morass-of-obamas-fatca-tax-evasion-law/; personal experience).

At home, America has long been becoming less entrepreneurial. The pace has accelerated worryingly since the late '00 years:

Firm entry & exit rates in US: firms being destroyed faster than created?

Source: http://www.brookings.edu/research/papers/2014/05/declining-business-dynamism-litan

It is well known that the wellspring of job formation -- and thus sustainable GDP growth -- resides in new/small firms able to establish themselves and grow. In contrast, S&P 500 companies tend to displace domestic employees via overseas outsourcing and technology. An increasingly business formation/business expansion toxic, private property-gutting public policy cocktail is being forced upon the free market sector of America, smothering investment, productivity, and payroll growth. Cases in point:

- SCOTUS decisions within the past decade such as Kelo et al. vs. New London, Massachusetts vs. the Environmental Protection Agency, and the National Federation of Independent Business vs. Sebelius.
- Progressively more unbridled, commerce constricting regulatory excesses -- call it "unelected legislating" (http://thehill.com/blogs/congress-blog/energy-environment/206654-the-epa-president-obamas-legislative-body) by the executive branch -- is effectively going unchallenged by both the legislative and the judicial branches. This is substantially eroding the key Constitutional separation of power/checks and balances doctrine, whose very purpose was to prevent abuse of power and to assure due process rights (www.steynonline.com/6439/the-merger-of-the-party-and-the-state).
- At a recent summit, Sam Zell had the following to say: "If you wanted to see the economy go wild, just cut all the regulations in half." www.forbes.com/sites/briansolomon/2014/03/27/billionaire-sam-zells-profanity-filled-advice-for-reinventing-america/; www.forbes.com/sites/vannale/2014/02/26/master-of-invention-john-spirk-on-why-small-businesses-need-less-regulation/. This sounds like sage advice on the heels of our lethargic recovery and the second downward revision to annualized real GDP growth in Q1:14, this time to -2.9%, from 0.1% initially -- and the -2.9% tally is likely a very generous one. If a non-governmental measure of inflation, such as the arguably more household experience conform "Billion Prices Project" (http://bpp.mit.edu/BPP), is used, the picture is even more menacing: Q1:14 inflation of 3.9% (vs. BEA's 1.3%), which points to deeply recessionary real GDP growth of -5.6%. And for those convinced that the Q1:14 weakness was primarily a weather-related anomaly, consider that in Q1:85 the winter was also very cold, but real annualized GDP growth back then was a robust 3.7% http://research.stlouisfed.org/fred2/series/GDPC1/downloaddata.

Potential retail property writedown risks:

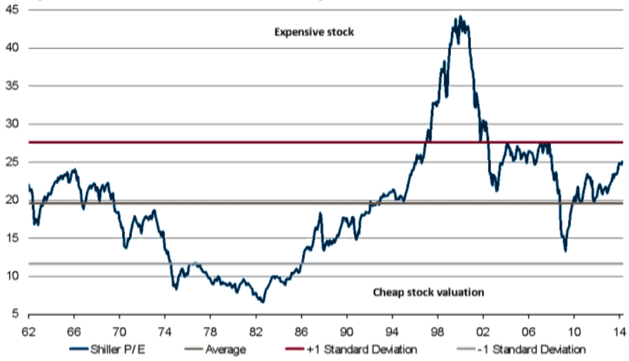
There are 47 sq. ft. of retail floor space per capita in the US, eight times as much as any other nation (per capita). Yet 50% of workers aged 25 to 44 report that they have less than $10,000 of total savings; half of all Americans between 50 and 64 have no retirement savings; and 10,000 baby boomers will be turning 65 every day through 2030, crimping retail sales (www.pewresearch.org/). So what's the rub? The massively overbuilt, urban sprawl retail complex will likely need to be substantially pruned; 3bn sq. ft. out of nearly 15bn sq. ft. have been making the rounds (www.theburningplatform.com/2014/05/25/retail-death-rattle-grows-louder/). The "overstoring of America" malinvestment -- a stunning 10bn sq. ft. since 1990 -- is an outgrowth of a relentless search for yield among fixed income investors thanks to long-standing interest rate repression by the Fed. Wall Street rode to the rescue with securitized yield starvation relief offerings.

"Investment grade" national credit tenant financing and off-balance sheet operating lease structures that managed to skirt the economic reality of on-balance capital leases proliferated. Now huge potential asset value writedowns loom for banks, insurance companies, and pension funds. Can the next TARP be far away? How much bigger would the Fed's balance sheet get? And could this augment a new round of QE, bringing us closer to a higher sovereign risk premium "tipping point?"

Lofty equity valuations:

With a recession appearing closer than ever, operating leverage-rich, historically outsized S&P 500 bottom line residuals could easily suffer a 40% plus correction in the not too distant future. A forthcoming earnings compression of 40% plus at current S&P 500 index levels would result in a TTM GAAP earnings-based P/E well into the 30s and a loftier long-term normalized GAAP-based P/E:

Long-term normalized GAAP earnings Shiller P/E



Sources: Robert J. Shiller, CS; http://www.forbes.com/sites/baldwin/2014/04/16/is-spy-a-129-stock/

Given the QE-laced stock market -- in the ultimate irony, even the central banks are "piling in" -- equities as an asset class are arguably no longer a leading indicator, but appear to have become a lagging indicator, a mantle the stock market debatably assumed as we moved into recession in 2007/2008. Even then, the stock market, ever more a creature of the Fed, was the last market to "know about it."

Central banks investing $29trn into equities

www.ft.com/intl/cms/s/d9dfad02-f462-11e3-a143-00144feabdc0,Authorised=false.html?_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2Fd9dfad02-f462-11e3-a143-; www.zerohedge.com/news/2014-06-15/cluster-central-banks-have-secretly-invested-29-trillion-market

The nearly five-fold increase in the Fed's balance sheet since late 2008 suggests the stock market's new lagging indicator function is even more entrenched today (please see above chart). The Fed will likely continue -- in contrast to firm earlier conviction (I was wrong) -- to reduce monthly QE for a time. But this will probably only "set the table," given our increasingly QE dependent economy and capital markets, for much stouter QE down the road. In the interim, market caps may first need to take a bath.

"In the eye of the storm?" allocation thoughts:

How should investors allocate given the current state of the aging "fiat money, fiat law" determined business cycle? Clearly, as we have been advocating for the past year, "if you can't beat the cronies, join them" -- or, make "Blue Chip" lemonade out of rule-of-law policy lemons. Yet the law of economics is like the law of gravity, to which even Wile E. Coyote has to succumb, sooner or later:

In light of historical overvaluation prior to potentially stout earnings erosion as well as prior to possibly materially higher discount rates in the not too distant future (bonds have been in a 30-year bull market), contemplate reducing portfolio equity exposure. As regards the resulting funds:

- Consider staying in cash with a portion; cash is the ultimate option with which to purchase currently overvalued assets, should they have a big correction.
- Consider increasing physical gold allocations in view of expanding global geopolitical uncertainty, mounting sovereign solvency risks, growing political economy-based misallocation (inflation) risks, and rapidly rising monetary inflation risks; the Fed's balance sheet is nearly five times as big as it was five and a half years ago, and rising real world inflationary experience/expectations can animate the money multiplier, as occurred in the stagflationary '70s, quickly leading to "too much money chasing ..."

- Consider increasing exposure to select scarcity assets, especially in the pivotal dense energy and ag sectors. Said asset valuations should remain strategic beneficiaries of both sustained supply limitations and the fact that have proven to be good inflation hedges.
- Consider taking a smallish, short-term punt on an even bigger, yet likely fleeting, 10-year bond bubble as recessionary signs mount. Investors should be positioned to take potential profits quickly/limit losses as Treasuries' safe harbor status continues to erode markedly thanks to rising sovereign solvency and monetary inflation risks amidst negative "real world" yields. Said caution is given a boost by Fed deliberations about "exit fees" on bond fund sales, which some are calling "financial repression light" heaped on top of the "QE main course." (www.ft.com/cms/s/0/290ed010-f567-11e3-91a8-00144feabdc0.html#axzz35YXplq3O; www.europac.net/commentaries/bond_trap)

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