Economic & Market Update, December 2015

Attempting to See the Future

By Richard Morey

From the title of this report you should know up-front the goal will be challenging, as predicting the future is, to say the least, difficult. Actually this is only half correct. With sufficient in-depth, objective analysis it is quite possible to determine *what* will occur in the economy and markets. This does not, however, tell us *when*. Given this, our approach is to follow what we can know, then use patience to wait for the "when."

In the financial media we constantly hear mass confusion as to what all the numbers actually mean. Part of the confusion is due to the fact that few realize there is a natural order to how economies progress. There is a clear sequence to events, and if the factors that occur first are moving in one direction, this tells us where the economy is headed in the future. Dr. John Hussman describes this sequence as follows. (While his description may be a bit hard for some to understand, the rest of this report should make it clear to everyone):

"The earliest indications of an oncoming economic shift are observable in the financial markets, particularly in changes in the uniformity or divergence of broad market internals, and widening or narrowing of credit spreads between debt securities of varying creditworthiness. The next indication comes from measures of what I've called "order surplus": new orders, plus backlogs, minus inventories. When orders and backlogs are falling while inventories are rising, a slowdown in production typically follows. If an economic downturn is broad, "coincident" measures of supply and demand, such as industrial production and real retail sales, then slow at about the same time. Real income slows shortly thereafter. The last to move are employment indicators — starting with initial claims for unemployment, next payroll job growth, and finally, the duration of unemployment."

The first thing that pops out is the fact that employment numbers are at the very tail-end of the process. Today's employment numbers give us a snapshot of where the economy was over 9 months ago. Given the fact the Fed has been focusing primarily on (heavily skewed) employment data to try to determine the health of the economy, this truly is "the tail wagging the dog."

We will now go through Dr. Hussman's list of factors telling us the future trajectory of the economy in order. Please note he came up with his sequence based on a massive amount of rigorous analysis. At the same time, when you think about it the results make perfect common sense.

Oddly enough, the first factor is related not to the economy but to markets. Having contemplated this fact for many years, I still have no idea how a stock market signal is the first key sign showing an economic downturn! This first factor is "changes in the uniformity

KEY TAKEAWAYS

There is a sequence of economic events which occur that can accurately predict the future trajectory of the economy. As the economy approaches recession, the following appear in order:

>Divergence of Stock Market Internals – Near the end of economic growth and a bull stock market a smaller and smaller group of stocks continue to have gains while the majority languish. At this time four stocks account for most of the entire market's gains: Facebook, Amazon, Netflix and Google.

>Widening Credit Spreads – As recession nears the interest paid on lower-rated (junk) bonds increase relative to safer bonds. This spread has now grown to recessionary levels.

>New Orders Decline – As of Dec.1st manufacturing is officially contracting.

>Unsold Inventories Increase – The ratio of inventory to sales has ballooned, again to recessionary levels.

>Commodities/Raw Materials – With fewer orders for new goods & a backlog of inventory, demand for raw materials declines. Commodity prices have recently crashed to **15 year lows**.

>Industrial Production has now dropped back to 2009 levels.

>Retail Sales – Have steadily declined since early 2012 and are now at recessionary levels.

>Employment is the last factor in the cycle. Businesses attempt to keep current employees as long as possible due to hiring and training expenses.

Based on all the relevant data, it appears as if the U.S. has either recently entered recession or quickly approaching one. Two "wild cards" could tilt the economy, positively or negatively:

1-On the "positive" side, the Federal Reserve Board might be able to put it off – for a while – by another round of massive quantitative easing, i.e. printing money.

2-However, the other largest economies, i.e. China, the Eurozone, & Japan, are in even greater danger than ours at this time. Plus, the geopolitical situation is in an exceptionally dangerous state. Given the breadth & depth of international concerns, these negative influences are likely to overrun any Fed actions that could delay recession.

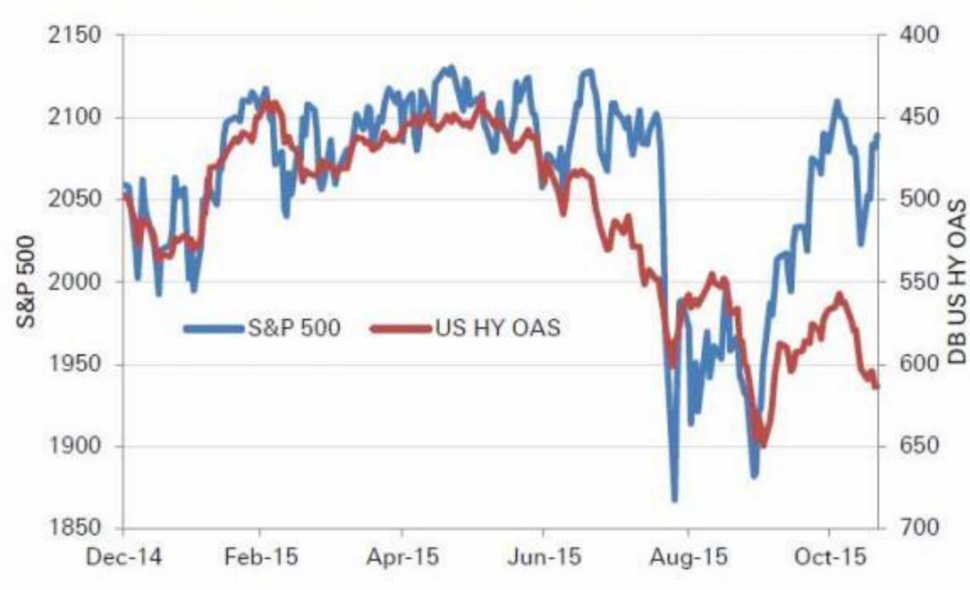
or divergence of broad market internals." This refers to whether or not the majority of stocks are moving up or down. Near the end of bull markets, i.e. right before markets come crashing down, we often see the stock indexes being held up by a smaller and smaller group of stocks. Near the end investors become wary of most stocks but still cling to the notion a few cannot possibly ever go down.

We definitely have this going on today. In fact, we now have an acronym for the four stocks holding up the market: FANG representing Facebook, Amazon, Netflix and Google. Through the end of November, the U.S. stock market has gone up only 1% so far this year. But if we remove those four stocks it has lost money. In fact, if we remove the top 10 "mega-cap" stocks from the S&P 500, the remaining 490 have dropped over 6% so far this year. At this time over 40% of stocks are below their 200 day moving average, meaning they have, overall, been going down not up for some time. This is classic textbook market action indicating the stock market is on dangerous ground.

The next factor that shows if the economy is headed up or down is "the widening or narrowing of credit spreads between debt securities of varying creditworthiness." A widening credit spread means lower-rated corporations see the interest they have to pay on their loans rising compared to safer bonds. Widening interest rate spreads indicates investors are now worried about the solvency of weak companies, i.e. they are beginning to worry they may not get their principal back so demand higher interest payments for taking that risk. Now keep in mind ***total U.S. corporate debt in the U.S. has doubled in the last 5-6 years.*** This is historically unprecedented. Large numbers of companies that will go bankrupt in the next recession have been able to borrow billions at relatively low rates. As a result, huge losses are coming to the high-yield corporate bond market. And it has already begun. For the year, the high-yield bond market has lost approximately 3%.

The chart below shows the S&P 500 stock index (blue line) versus the spread between high-yield and the safest bonds (red line, inverted scale). The high-yield spread line has already risen approximately 40% from its low earlier in the year. Perhaps the most interesting part of this chart involves what has occurred in the last several weeks. Normally high-yield bonds move in tandem with the stock market. When stock investors are enthusiastic they don't expect companies to go bankrupt and default on their bonds. But in recent weeks the stock market line went back up while high-yield bonds are going nearly straight down. One of these is "wrong," i.e. either the high-yield bond market will turn around or stocks will fall.

Figure 1: S&P 500 (LHS) vs. US HY Spread (RHS) year-to-date

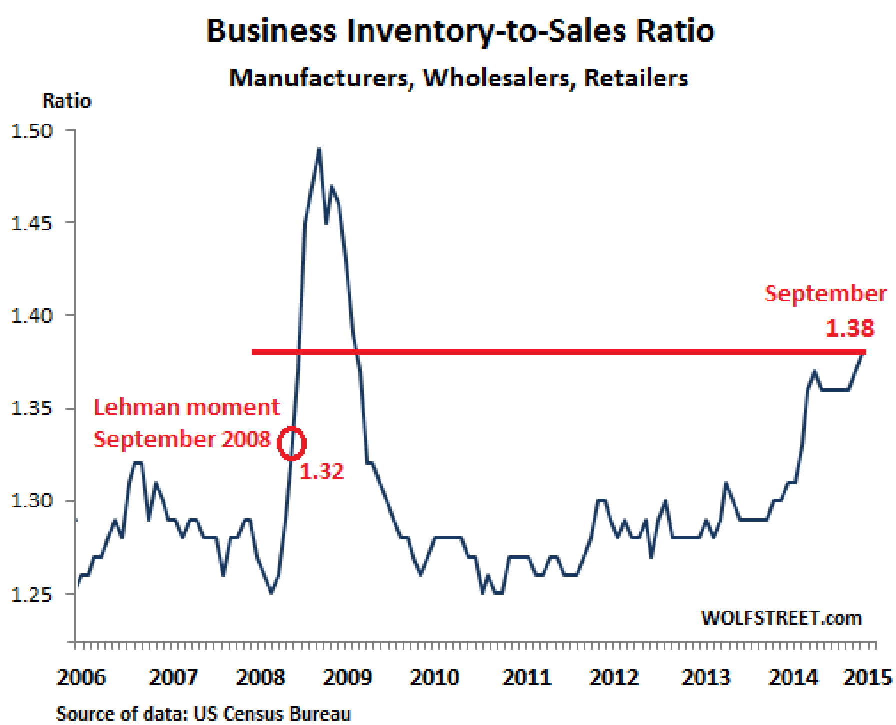


Source: Deutsche Bank, Bloomberg Finance LP as of 23-November 2015. Left had axis represents S&P 500. Right hand axis represents the Deutsche Bank US HY option adjusted spread index

So our first two earliest indicators of an economic downturn are convincingly negative at this time. Now let's turn our attention to the next factors.

Moving back to Dr. Hussman's list of the order of economic events, "the next indication comes from measures of what I've called "order surplus": new orders, plus backlogs, minus inventories." For new orders to we go FRED (Federal Reserve Economic Data). Their measure of new orders is on a scale from 0-100, with 50 being the line between expansion and contraction. At the end of 2013 new orders stood at 64.9. Today it is 50.1, for a drop of 22.8%. New orders have been falling all year, and when they hit 50 our economy is usually entering a recession. Then today (12/1) we received new data showing manufacturing nationwide fell below 50, down to 48.6, the lowest point for manufacturing in this country since June of 2009.

Going back to Dr. Hussman's sequence, he said, "When orders and backlogs are falling (as they now are) while inventories are rising, a slowdown in production typically follows." When companies already have large amounts of unsold inventory they slow down or cease new production until that inventory is sold. The following chart shows the amount of inventory companies have versus how much they are selling. A high number indicates they have more inventory than sales. Our inventory levels are presently so high relative to sales that we are in clear and present danger of having what is called an "inventory liquidation recession."



Before returning to Hussman's list, I would add one important factor to consider: commodities and raw materials. In the chain of events that ultimately lead to sales, new orders come first, followed by purchases of the raw materials needed for production. These materials can be wood, chemicals, metals, etc. When these prices are falling, it means production will be slowing down going forward.

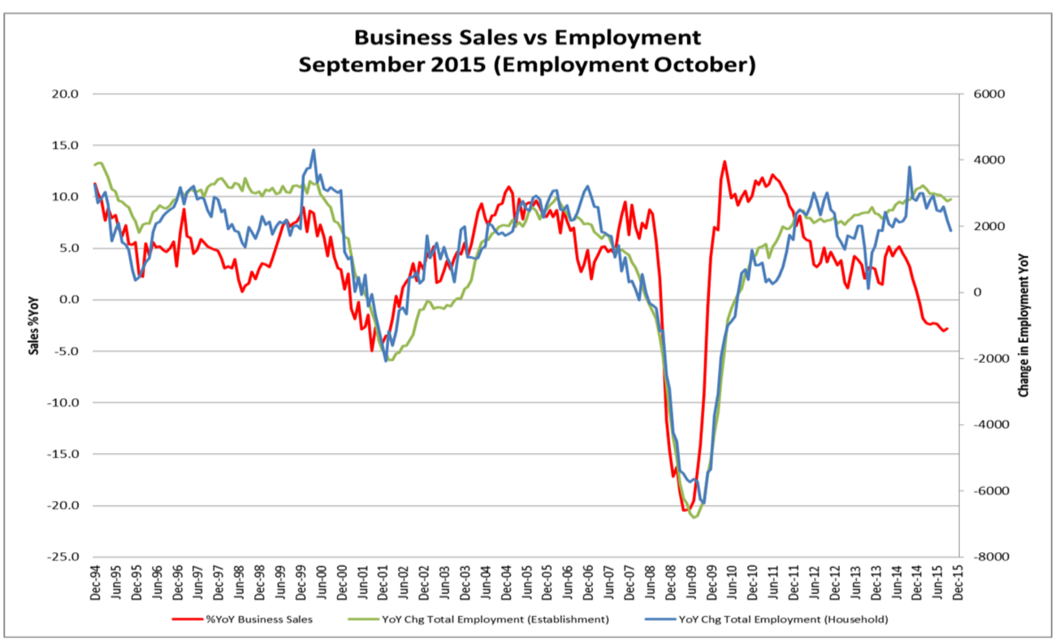
In a good economy the prices of commodities and stocks are highly correlated, i.e. they usually go up together. An expanding economy leads to more purchases of raw materials. The chart below shows the commodities index, which recently hit a 15 year low, versus the S&P 500:

Again, one of those lines is "wrong." You simply cannot have raw materials selling for less than they did 15 years ago in an expanding economy. And you certainly cannot have stocks near their all-time high as this is occurring.

Returning to Dr. Hussman's list, once we have examined new orders, we then turn towards industrial production and retail sales. The following chart shows industrial production has now slowed down to a level that has always been associated with recessions:

Finally we get to retail sales. Once again, the data shows retail sales have fallen to levels normally associated with recession:

The very last factor indicating the trajectory of the economy involves employment. The chart below shows business sales (red line) versus employment (blue & green lines). As you can see, sales growth has fallen below 0%, while employment still has gains. While I have never heard a definitive explanation as to why employment is the last economic indicator to fall as we enter recession, common sense tells us why. It takes a lot of time and resources to hire and train new employees. Near the end of economic expansions most are confident the economy will continue to expand. When sales begin to drop, employers hope it will be transitory, so they hold onto their employees for as long as they can. Since it takes around nine months to get the average employee trained, and since it's costly to lay off people, it's better to wait for a while to make sure the economy truly is slowing down before downsizing. In fact, the very best employment reports usually occur right as we are entering a recession. This makes looking at employment data the single worst factor to consider when attempting to predict the trajectory of the economy. And this is the single factor the Fed is most focused upon!



Of course, as we have written about numerous times, the employment picture is already far from healthy. We have the smallest percentage of working-age people employed in well over 30 years, while the majority of the new jobs that have been created are either poorly-paid and/or part-time. Plus, the Bureau of Labor Statistics continues to add thousands of new jobs each month based on their guess as to how many new companies were formed versus the number that went out of business when in fact more companies have been shutting down than starting for several years. Even so, employment numbers tell us absolutely nothing about the future state of the economy. Oddly enough, if anything strong employment reports several years into an economic expansion is indicative of the end of that expansion.

Summary

Looking at all the relevant economic numbers in sequence, the data strongly suggests the U.S. has either recently entered or is about to enter a recession. In fact, in most of the charts in this report the numbers have never fallen this far without leading to a recession throughout history. This does not, however, guarantee an imminent recession. The numbers all strongly suggest this, but then again many of the best indicators have shown us on the verge of recession on and off for several years. This is the nature of economic forecasting in which there are literally thousands of moving variables. Two "wild cards" could either prevent us from recession or drive us straight into one.

First, the Fed may take some extraordinary action to ward off recession for a while longer. Of course, at this moment they are seriously contemplating the exact opposite. Even though they are only considering raising overnight lending rates a miniscule .25%, given the weakness of the economy this would probably be sufficient to push us directly into recession. Still, it does appear as if Fed action has contributed towards keeping our economy just above contraction for several years, and perhaps they will reverse course and quickly print several trillion dollars more. Perhaps whatever they do will be enough to keep the economy afloat (barely) for a while longer.

On the other hand, the world is becoming increasingly more dangerous each month. Economically, China, Japan and the Eurozone remain either in recession (Japan), dropping quickly (China), or one misstep from financial calamity (Eurozone). And in terms of geopolitics it is hard to remember a more dangerous time since the Cuban missile crisis. Given the precarious state of the U.S. economy, any of the myriad world problems could push us right back into recession.

To conclude, my prediction is we already entered recession several months ago, a fact that will be officially discovered in late spring or early summer. While my confidence level in this prediction is only fairly high, one thing is certain. The U.S. economy will have another recession. And given the amount of "dead wood" that has accumulated over the last several years, i.e. the large number of companies that already would and should have gone out of business but for the fact the Fed has kept interest rates so low these terminal businesses have been able to continue to borrow enough to stay afloat, this next recession is likely to be one of the worst we have ever seen. When we combine the extent of the domestic corporate debt that will go into default with the unprecedented global debt and geopolitical problems in the rest of the world, I am afraid the ultimate outcome for this economic cycle may be jaw-dropping in its severity. The next recession will probably be significantly worse, and longer, than what we experienced in 2008-2009.

The other thing I know with certainty is that the stock market is presently more over-priced than at any time in our history, except at the end of the "doc.com" bubble of 2000. When you combine an over-priced stock market with a severe recession, you get a stock market crash. Finally, the last thing of which we are sure is that the safest investments, i.e. what we own for our clients at Secure Retirement, will be in great demand as all this occurs.