The No Spin Zone

As we close the books on the first half of 2014, markets remain exuberant with record high prices across the asset spectrum both domestically and globally. Specifically here at home, the Dow and S&P 500 are hovering at or near all-time record highs, while the NASDAQ currently sits at 14-year highs with its sights set on reaching levels equivalent to the tech bubble high of March 2000. The CRB (Commodity Research Bureau) Index a measure of the general price movement for a diversified basket of commodities that include oil, metals, grains, livestock, and sugar, among others, also sits near all-time highs. Credit spreads, both high-grade and high-yield, continue to compress and converge at historically low levels, while commercial and residential real estate values continue to exhibit double-digit annual increases. The story is similar across the globe: Most sovereign debt yields are declining to record low levels, while the broadest measure of global equity performance, the MSCI All Country World Index (ACWI) closed the quarter at an all-time record high. In a nutshell, asset prices continue to march inexorably higher, suggesting that all is right in the world.

On the surface, this is good news because those fortunate enough to be invested in this remarkable run have increased wealth substantially. However, peeling back the onion suggests cracks may be in the armor and gives me cause for concern. Yeah, yeah, I know what you are thinking: Why can’t the team at Ambassador ever maintain a positive view? They are always so negative and pessimistic on the economy and the markets. The reality is that you’re right; we have consistently had a pessimistically biased view of things ever since the Great Recession knocked the world on its backside in 2008. But, as we have stated many times, we tell it like we see it. In other words, we take a pragmatic view and speak the truth as we see it through the Ambassador lens. We don’t follow the herd (the herd has been wrong) and certainly don’t sugarcoat anything. You might not like what you hear (frankly, we don’t like it either... it’s depressing), but you will always get thoughtful, well-intentioned, and valuable advice and insight from us. In fact you might say that, like Bill O’Reilly, Ambassador inhabits the “No Spin Zone.” As such, here is my concise perspective on why it is not all roses out there.

As mentioned above and well-documented since the markets bottomed in March 2009, asset prices have effectively gone straight up. While one might argue that the first one or two legs of the rally (March 2009–2012) were driven by historically cheap valuations across asset classes, that argument doesn’t hold water in my view. The reality is that markets are addicted to global central bank accommodation as massive amounts of liquidity continue to chase alpha returns, dramatically reducing the “risk” premium on what I believe to be the mother of all “risk on” trades, artificial as it may be. The higher that valuations have moved, the less they are buttressed by fundamentals. Said differently, many asset prices are priced for perfection and are at or approaching bubble territory, in my view. Fundamentals don’t support current valuations, particularly with the highest amount of public and private debt on record. This phenomena is an intentional policy of central banks to generate inflation, despite the growing possibility

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of another financial crisis. Old school central bank academicians (Janet Yellen included) strongly believe that zero-bound interest rates and quantitative easing (QE) are the appropriate tools to deal with a cyclical recession. Print money, devalue the dollar, ignite credit, and spur lending and investment, all in the name of creating growth and jobs. The problem is that the Great Recession wasn’t a cyclical recession, but rather one full of myriad structural issues. As such, the Fed’s cyclical tools haven’t worked. Period. And they will continue to fail moving forward, laying the groundwork for and creating the next financial crisis.

This is the crux of the problem, the juxtaposition of record high asset prices and an underlying economy that continues to slow both domestically and abroad, highlighted in the following graphs. Graph 1 compares the relationship between the S&P 500 and U.S. GDP, while Graph 2 on the next page compares the relationship between the MSCI ACWI and global GDP. Notice the trend in both graphs on the right-hand side that illustrates the divergence between equity markets and domestic and global growth rates. Equity markets continue to go straight up while economic growth rates are moving in the opposite direction; simply not a sustainable relationship in my view. Avid readers of The Ambassador Alert and our regular morning commentaries know that we have been beating the growth slowing mantra drum for some time. This is certainly counter to the “Old Wall Street” investment banking firms, nine out of ten talking heads on CNBC, Fox Business and Bloomberg, and the Fed who continue to say year after year that growth is poised to do better the 2nd half of the year or next year based on their “models.” They must all be using the same broken model because year after year they continue to be wrong about the economic recovery, continually revising the short-term growth rates lower on the expectation that growth will accelerate next year. This happened in 2010, 2011, 2012, and 2013 and is happening once again this year. Their inability to assess the state of the economy was never more evident than the results for first quarter GDP. Back in January the consensus forecast among the smartest (tongue in cheek) economists on Wall Street was 2.6%. Fast-forward to the final revision of first quarter GDP of −2.9% and these economists were off by an astonishing 5.5%.

Graph 1: S&P 500 vs. U.S. GDP
Given the growing divergence of the markets and the economy, something has to give. Either economic growth will accelerate and achieve escape velocity aligning with the markets, or asset prices will experience a meaningful correction to more accurately reflect soft and declining economic conditions. The herd (Old Wall Street, the Talking Heads, and the Fed) will try to convince us all that higher growth is on the horizon and that current monetary policy supports that path. Bottom line: They will continue to be wrong. Growth is slowing, the economy is weak, monetary policy is flawed, and structural issues like the long-term unemployed, declining labor force participation, healthcare, and entitlements remain unsolved. Unfortunately, the Fed will continue to dig in its heels and attempt to solve the structural economic challenges with cyclical policies that fail to accomplish anything, other than widening the wealth gap and increasing the probability of an imminent financial crisis. While the Fed is currently on pace to finally end QE3 in the fourth quarter this year and talk is growing (the herd) of an earlier rate rise, it remains my view that the Fed will inevitably resort to another round of QE at some point. Unfortunately, that is the only strategy they know. They don’t know how to get out of the way and allow markets and the economy to clear on their own. I guess that is why they call it a “central” bank, because they are “central” planners. Central planners are smarter than everyone else and know what is best for us, so we should all take solace knowing that we are in good hands.

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Unfortunately, these “good hands” are responsible for giving us −2.9% GDP growth in the first quarter but promise us that the second half will be better. We’ve heard that before, and we’ll hear it again. These “good hands” tell us that inflation is subdued and that it isn’t going to be a problem. Tell that to the folks out of a job who pay over $3.50 per gallon on gasoline and struggle to eat given food inflationary pressures. At the end of the day, the Fed will continue with policies that devalue the dollar in an attempt to cure the economic woes. These policies will continue to hamper economic growth rather than buttress it, as the weaker dollar erodes the consumer’s purchasing power (it takes more dollars to buy goods). This in turn creates less and less disposable income, thereby slowing consumer spending and retarding economic growth. In equation form, it looks like this:

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\text{Fed QE} = \text{Weaker U.S. Dollar} \Rightarrow \text{Commodity Inflation} \Rightarrow \text{Lower Consumer Spending} \Rightarrow \text{Lower GDP}.
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As always, I hope my view is dead wrong. However, when objectively looking at the state of things, my conviction grows stronger and stronger each and every day. The reality is we have been in a state of stagflation post Great Recession, and I suspect that we are going to be here for years to come. Stagflation is defined as a condition of slow economic growth and relatively high unemployment accompanied by a rise in prices. This, in my view, is precisely what our economy has been mired in since 2009 and portends to be mired in for years to come. As the equation above highlights, Fed policies will continue to contribute to the slow growth/stagflationary environment until the Fed decides to change course. Sadly, I don’t believe they will change course. Consequently, don’t be fooled by record high asset prices and a market that is dangerously calm. Numerous market metrics, including the CBOE Volatility Index (VIX) and SKEW (Black Swan Index) credit spreads, etc., are trading at levels last seen just before the market meltdown in 2008/2009. This is not to suggest that a market crash is imminent, but the more disconnected markets become from underlying economic growth, the more likely a correction is in the cards. Please don’t misconstrue this piece as fearmongering as that is not my intention. I simply call it like I see it and this a “No Spin Zone.”

To end on a positive note, I hope you all enjoy your summer with family and friends. Perspective is important. It doesn’t matter if I am right or wrong; we can all only control what we can control, and unfortunately, that is not a whole lot in the grand scheme of things. As such, work hard, play harder, and enjoy life with the ones you love.

— Matthew T. Resch, CFA
Co-Founder & Managing Principal