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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

IN THIS ISSUE

Morning macro/market musings

- Equity markets are jittery to start the week

More on the recession and the move back to SIRP

- We are now into month #115 of this economic expansion, about double the post-WWII norm and just five months shy of matching the record-long cycle of the 1990s
- Just as was the case back then, hubris has set in, as the consensus believes that the business cycle has somehow been repealed
- Let's highlight a few salient points

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MORNING MACRO/MARKET MUSINGS

HIGHLIGHTS

- Equity markets are jittery to start the week (Caterpillar's stock tumbles)
- Rally (dead cat bounce) looks fatigued
- Weighted Dollar index at a crossroad
- Baltic Dry index breaks down…not good for resource markets
- WTI down as U.S. rig count data outweigh Venezuela output concerns
- China extends its profits recession
- Less to U.S. tax refund than meets the eye
- In U.K., Article 50 likely to get postponed
- Busy week ahead…especially for earnings reports
- Russia and Brazil among few still in a bull market

COMMENTARY

U.S. equity futures are down (Caterpillar's stock is down more than 4% in pre-market trade in the immediate aftermath of its earnings release) and it was a sloppy session overseas. Maybe there is some recognition of what Intel reported at the end of last week, which was a miss on the top-line and negative revenue guidance (sending the stock price down 5.5% on Friday). European markets are down 0.6% at the moment. Asia was mostly in the red too, with India's Sensex slipping 1%, Japan's Nikkei 225 dropped 0.6%, Shanghai was down 0.2% and Hong Kong's Hang Seng composite was little changed (though it pared early gains). It looks like the PBOC liquidity infusions and chatter about Chinese tax stimulus is 'in the price'. And the incoming Chinese data are still weakening and today we saw the earnings at Chinese industrial companies contracted 1.9% on a YoY basis in December (it was -1.8% in November). And in this highly interconnected global economy, we are seeing the effects of the slowing in growth in China, with a lag, hit our shores (see *China's Woes Imperil U.S. Industry Growth* on the front page of today's WSJ). One stock market that has quietly risen to near all-time highs (and is up 7% for the year) is Russia (I should add Brazil too — up 11% YTD). This is likely to receive some added support now that the Treasury Department just removed Russian aluminum giant Rusal from its sanctions list.

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CHART 1: MOEX RUSSIA INDEX

Source: Bloomberg, Gluskin Sheff

To some extent, the global equity market is beginning to look a bit fatigued, and for good reason, as it has managed to add more than $3 trillion of valuation so far this year (last time this happened so quickly was January 2018 and we know what happened next!) — reversing just under half of last year's $6.8 trillion drawdown. The bulls will point to the whippy 6.3% jump in the S&P 500 so far this year, while the bears will claim that the index is still down 9.1% from the prior peak. I see research from Wells Fargo showing that, historically, it takes 63 months for the S&P 500 to hit a new high (on average) after a 20% pullback (and remember, peaks in the stock market lead peaks in the economic cycle, always and everywhere, by a typical 7-month lag). Morgan Stanley is projecting a retest of the December lows (don't think for a second that this will end up being a successful test, either).

Bond markets are pretty well flat but with small upward yield bias in Europe (Italian 10-year yield is up 4.2 basis points to 2.69%). The FX market is pretty stable too, with the DXY U.S. dollar index consolidating near 95.8. This is an interesting situation because the charts show that the weighted dollar index successfully tested its 200-day moving average in the corrective phase in the opening days of January, and in this latest bounce, it could not manage to pierce the 50-day trendline. Which way it breaks will matter a lot to how you want to be positioned — and I see a lot of smart guys who had been dollar-bulls who are now tilting the other way (with the dollar up 7% in the past year and signs that this is biting the U.S. economy). See *Strong Dollar is Worrying for Growth* on page B10 of today's WSJ.

That said, looking at the OECD leading indicator down 12 months running, the prospect for commodity currencies does not look that bright. China may try to stimulate by adding more debt, but that will

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moderate the downward economic trend — but not prevent it from continuing given its array of structural impediments and that is not exactly good news for EM currencies. Sterling could have more upside, but a lot of "good Brexit news" has already been discounted in recent weeks. As for the euro, the economy there is even softer than is the case in the USA, and the lack of political leadership just as acute (see *Italian Populist Attacks Weigh on Ties with France* on page 2 of today's FT).

The Canadian dollar now is facing a key test of its own as it has rallied back to C$1.322 — it would be nice to turn bullish on the loonie, and if Conrad Black is prescient on his latest political commentary, maybe there's some hope, though it will be later this year. See *Scheer Has Real Chance of Taking Trudeau Down* on page A15 of the weekend National Post. The early readings in the aftermath of Prime Minister Trudeau's weekend firing of Canada's ambassador to China (John McCallum) have been universally negative — see *Trudeau fires McCallum, angers Beijing* on the front page of today's Globe and Mail; *Why China sees Meng's arrest as a 'national humiliation'* on page A8; and *Diplomat Jim Nickel takes over as Canada's acting ambassador in Beijing* on page A9.

The problem for now regarding the loonie is that the CRB index is facing stiff technical resistance at the 50-day moving average and the Baltic Dry Index (global freight rate), which leads the broad commodity market, has more than just rolled over — it has fallen sharply in recent weeks and is back into a bear market (down 35% since mid-December and at its lowest level since July 2017). While there is obvious concern over a further collapse in Venezuelan oil production, that is being offset by the news that America's rig count is on an upward trend — taking WTI back below $53 per barrel today (down 1.6% to $52.85).

CHART 2: BALTIC DRY INDEX

Source: Bloomberg, Gluskin Sheff

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It's a big week ahead with the next round in the U.S.-China trade talks (Vice-Premier Liu He is meeting Lighthizer and Mnuchin on Wednesday and Thursday); a very busy earnings reporting week (126 S&P 500 companies) and many of the tech heavyweights (Apple, Amazon, Microsoft, Facebook, Qualcomm) are releasing their earnings after already having braced the markets for some downbeat numbers; and the January jobs report on Friday. Not to mention the FOMC meeting on Wednesday, followed by Jay Powell's press briefing (at 2:30 pm) — he better have his communication skills honed in by then. Lots to chew on.

As for earnings, which are the key, the companies reporting were the ones primarily responsible for the long bull market — and the same ones that led the steep pullback last quarter. We also have the U.K. parliament voting on amendments to Theresa May's Brexit deal with the EU tomorrow. Sterling has rallied more than 3% this year and at one point breaking above $1.32 today — though profit-taking has set in — as conviction of a no-deal 'hard' Brexit has receded in a material way…more on this below. It seems to me that the most logical course of action for the near-term will be to pursue an extension in Article 50, which is only 60 days away (the U.K. business community is lobbying hard for a delay). Kicking the can down the road is the only way to avoid a serious economic disruption to the U.K. and EU economies post-March 29th. Beyond that, momentum for a second referendum (the so-called "people's vote" is building rapidly).

Below I highlight the most insightful press clippings from this weekend (including today):

Markets Bet on Brexit Outcomes on page 5 of the Sunday NYT business section. This article cites various research pegging the odds of a delay of the March 29th withdrawal deadline at 70%; odds of a calamitous 'hard Brexit' with no trade deal at less than 20%; 40% odds that Brexit never does live to see the light of day. These probabilities are quite bullish for sterling, U.K. equities, but bearish for gilts (and front-end rates).

Payout Growth to Falter on page 31 of Barron's. It isn't just stock buybacks at risk from this year's corporate deleveraging theme, but dividend growth as well.

China's Slowdown Is Only Just Beginning on page 15 of Barron's. A red flag here for the EM complex and commodity markets too — this impressive Aussie dollar rally we have seen in the past week looks highly vulnerable from where I sit.

Divided Congress and an Unpredictable Trump Have 3 Weeks. Can They Deal? on page A16 of the Sunday NYT. It looks to me as though both sides will save face — the $5.7 billion will be released for funding but will be labeled a "smart wall" (maybe Trump will call it the "genius wall"),

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which will have little in the way of concrete and steel but involve drones, sensors and more border patrol agents. My sense is that the government will not be closed again — the polls showed clearly that the White House and Republicans took most of the blame on this file (50% vs. 37% for the Dems, as per the just-released WSJ/NBC News poll). After a 35-day government shutdown, we could end up seeing a flat or negative Q1 GDP print (pundits who salivate over tax refunds don't seem to factor in that the surge in debt-service costs this year are going to overwhelm this brief cash-flow support — a one-off that has no multiplier effect, in any event).

Tax Cut May Not Mean Bigger Refund on page A3 of today's WSJ. So it's not even clear that tax refunds will be that significant, after all (though every economist has been counting on this to provide a backstop for Q1 GDP growth). Plus, it's not even clear when the 800,000 federal workers will end up getting their back-pay! See *Federal Employees Go Back to Work With Payday Uncertain* on page A4 of today's WSJ.

Rocky Markets Hit Pension Plans on page B10 of the weekend WSJ. This is one clear earnings risk for 2019 as many companies are going to be forced to shore up their plans, which were hard hit by the slide in equity prices and bond yields in last year's fourth quarter.

Low-Growth, Low-Inflation Rut Keeps World Economy Wavering on the front page of today's NYT. Janet Yellen is quoted as saying *"it's very possible we may have seen the last interest rate hike of this cycle."* I would tend to agree but it does say something about the fragile and pathetic economic expansion that we would have seen the funds rate, for the very first time since the Great Depression of the 1930s, peak with a 2-handle. What is the 'normal' fair-value P/E multiple or 'normal' risk premium with such an 'abnormal' economic backdrop that cannot cope with such a low policy rate level (looking more and more Japanese)?

Chances of Recession are Rising on page B10 of today's WSJ. At least there is some acknowledgment of this risk, which is an outlier to others but a base-case for me — when this becomes a page A1 story, it will be all priced in (and I'll be on to the next thing which, will be the recovery — most likely an L-shaped one, however). The latest WSJ poll pegs the R-word call at 25% for the coming 12 months (hardly trivial), the NY Fed model is at 22% odds (though these barely got above 30% prior to two of the past three downturns) and the JPMorgan model has risen to 43%.

Your Wireless World is About to Change on page B1 of today's WSJ. This coming technological revolution is going to be the biggest change we have seen since the onset of the internet in the mid-1990s — some estimates show the efficiency of 5G over the existing 4G network will be as much as 10x more efficient. From a cost perspective, this is going to

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prove to be extremely deflationary (not necessarily in a bad way at all, but will surely reinforce the downward trend that has been re-established in high-quality long term bond yields).

Trend In Loans Worries Investors on page B10 of the weekend WSJ.

This last article was rather concerning in that it showed an incredible statistic — that 27% of first-lien loans (the most senior debt) were backed by companies with new junior debt as a backstop. This is the highest share on record and already has taken out the 2007 credit bubble peak of 18%. This lack of protection for senior debt holders should have them worried since they will be on the hook for any defaults — the pervasive belief that senior bond holders are going to end up getting all their money back is going to be put to a serious test in the coming months and quarters.

MORE ON THE RECESSION AND THE MOVE BACK TO SIRP

We are now into month #115 of this economic expansion, about double the post-WWII norm and just five months shy of matching the record-long cycle of the 1990s. Just as was the case back then, hubris has set in, as the consensus believes that the business cycle has somehow been repealed and a recession is a 2020, 2021 or even a 2022 story. I somehow doubt it.

A few salient points.

A recession is not the end of the world. It is merely part and parcel of the cycle. There is no sense denying their existence or even their inevitability, since we know for a fact that there have been ten NBER-defined recessions in the post-WWII era. Each one the consensus — and the Fed — completely missed. Now is no different. History repeats.

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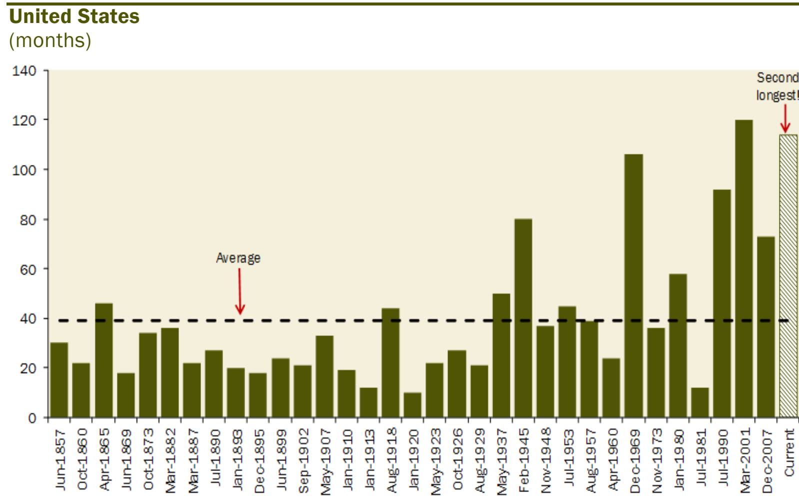
CHART 3: DURATION OF ECONOMIC EXPANSIONS

United States
(months)



Source: NBER, Gluskin Sheff

CHART 4: FED DOESN'T SEE RECESSIONS WHEN IT IS STARING THEM IN THE FACE

United States

Recession Start	Forecast Growth Coming Year (%)	What Actually Happened (%)	Delta (%)
Dec-69	1.2	-0.1	-1.3
Nov-73	2.4	-1.9	-4.3
Jul-81	0.9	-2.6	-3.5
Jul-90	2.0	0.0	-2.0
Mar-01	2.6	1.4	-1.2
Dec-07	1.3	-2.7	-4.0
Average	**1.7**	**-1.0**	**-2.7**

Note: data represents four quarter average of subsequent QoQ (annualized) GDP growth
Source: Haver Analytics, Gluskin Sheff

But the reality is that we have been in recessions and bear markets roughly 15% of the time in the past seven decades. Thankfully, the other 85% belong to expansions and bull markets. But, it is critical for the economists to help investors make decisions when these recession risks rise materially and then morph into reality. If you have a choice, you'd rather not participate in a recessionary bear market, even if you have the luxury of being an investor with a multi-year time horizon.

I'm looking at the various pressure points.

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First, the yield curve. Now, it doesn't have to completely invert for the recession call. It barely did so in the last two recessions. This time, we did see the 1- year/7-year curve invert recently as did the 2s/5s. That's enough for me. This condition in the past correctly predicted recessions more than 80% of the time.

CHART 5: 2-YEAR T-NOTE YIELD LESS 5-YEAR T-NOTE YIELD

United States
(percent)

Shaded regions represent periods of U.S. recession
Source: NBER, Gluskin Sheff

The behavior last year of the most economically-sensitive equity sectors, in absolute terms and relative to defensives/essentials, has also signaled a 67% recessionary impulse.

Global liquidity conditions should be considered as well. The world monetary base, after rising at over a 4% annual rate this cycle, is now running at -6.6% on a year-over-year basis. It first started to turn negative last June. And it led the market peak. We also have the assets on the G-4 central bank balance sheets, after expanding at a 10% average annualized pace over the past decade and providing tremendous support for risk assets everywhere, now fractionally negative on a YoY basis. The trend turned down below the zero-line in November, just ahead of the late-year intense drawdown and volatility.

We made the point last week that the 'hard data' segments of the Conference Board's leading economic indicator have not budged, in aggregate, since last April. This is a red flag. Not just that, but the OECD leading indicator has declined now for twelve months in a row. Fully 92% of the 38 member countries are seeing their leading indicators contract. Such a duration and widespread nature of this decline happens 15% of the time in the past, and more often than not, in the lead up to recessions. The implications for U.S. exports is markedly negative.

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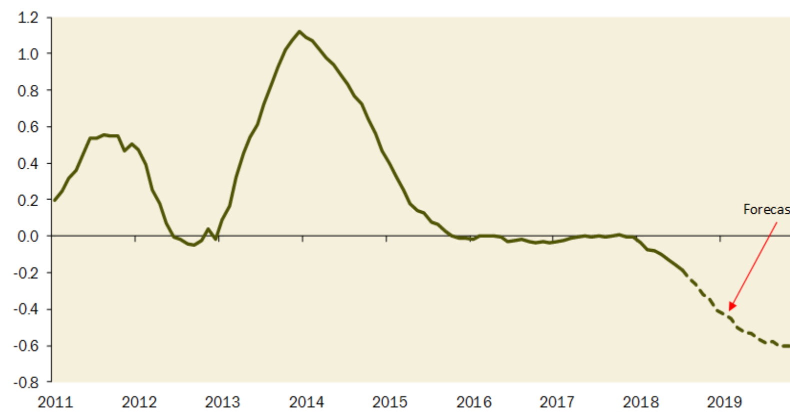
CHART 6: SHRINKING FED BALANCE SHEET

United States
(12-month change; $ trillions)



Source: Haver Analytics, Gluskin Sheff

I often say that there is no such thing as a sure thing, and risk contradicting myself since I did say recessions, like recoveries and expansions, are inevitable. Now, it is fanciful to say that the stock market has correctly forecasted 9 of the past 5 recessions. That is pure bunk. Pundits seem to cling to a view of the S&P 500 having to decline 20% to render it a bear market. Well, we came close but did not have the market decline 20% in 1990-91 but we had a recession in any event. Conversely, the S&P 500 sank 30% in the Fall of 1987, and there was no recession.

What matters most is whether we saw the peak in the stock market last Fall. The legendary technical guru, Stan Weinsten, is convinced (as am I) that we are currently seeing a classic technical bounce off oversold conditions. Stan is of the view that the market has peaked for the cycle, and for an economist, this is a huge call. This is because every stock market peak presaged an economic expansion peak 100% of the time in the past. And the average lead time from the peak in the market to the peak in the business cycle is 7 months (the median is 8). This puts the second quarter in play.

Take note — in a recessionary bear market, the S&P 500 goes down 35% through the piece. And the piece typically lasts 16 months. Ahead of the recession, the stock market is down an average of 10%, where we are now. And the bottom is generally three months before the recession ends.

Then we get to the Fed, and this is most important, because its thumbprints are over every bull and bear market, and every expansion and recession in modern history. There have been 13 Fed tightening cycles in the post-WWII era and 10 landed the economy in recession.

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Not once did the Fed staff economists see the recession the very month it began. Surprise! The three exceptions were the 'soft landings' of the mid-1960s, the mid-1980s and the mid-1990s. These periods were unique in that they were early to mid-cycle — as in, nowhere close to the tenth year of expansion. The output gap was not closed so there was a long runway for economic growth. Oh yes — and the stock market in those phases had not yet hit the cycle peak — as seems to be the case this time around. And the Fed cut rates aggressively to engineer these soft landings when the economy slows but does not contract — on average, the funds rate was sliced 175 basis points. So it really does not excite me much at all that the current Fed has been slow to reverse its tightenings and, in recent weeks, has only jawboned about not having to raise rates further and is only considering to start the process of ending Quantitative Tightening.

CHART 7: FED TIGHTENING CYCLES

United States

First Hike	Last Hike	Result
October 1950	May 1953	**Recession**
October 1955	August 1957	**Recession**
September 1958	September 1959	**Recession**
December 1965	September 1966	Soft Landing
November 1967	June 1969	**Recession**
April 1972	September 1973	**Recession**
May 1977	March 1980	**Recession**
August 1980	December 1980	**Recession**
March 1983	August 1984	Soft Landing
January 1987	May 1989	**Recession**
February 1994	February 1995	Soft Landing
June 1999	May 2000	**Recession**
June 2004	June 2006	**Recession**
December 2015	???	???

Source: Gluskin Sheff

It's too late — the Fed has already overtightened, as it has done so often in the past. At Jackson Hole last August, Jay Powell poked fun at the concept of estimating the 'neutral rate' — or R-star in central bank parlance. He called it being guided by constellations. And the projections of where this inherently unobservable rate is are subject to frequent revisions. But then he talked less than two months hence about how the Fed was miles away from 'neutral' and that it may have to blow above it. And lately, he has been walking these prior hawkish comments back. In

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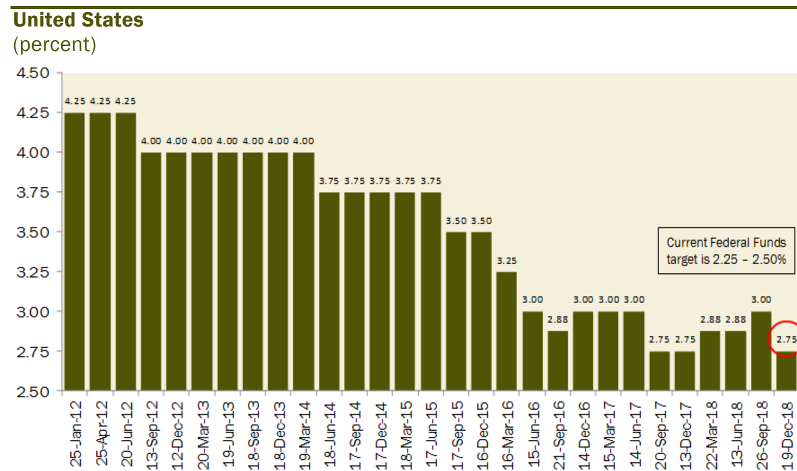
fact, at the last FOMC meeting, the Fed cut its estimate of the neutral or natural policy rate to 2.75% from 3.00%.

CHART 8: MEDIAN FOMC TERMINAL FUNDS RATE FORECAST



Source: Federal Reserve, Gluskin Sheff

Now to give the Fed some credit, it did cut this estimate over the years in recognition of excess debt, a lack of capital deepening creating a sluggish productivity backdrop, aging demographics and accelerating technology (as in the Fourth Industrial Revolution — principally connectivity). But when Jay Powell became Chairman last year, the Fed not only stopped reducing its estimate of the neutral rate, it raised it (before cutting it back at the December meeting). From our lens, the neutral funds rate is no higher than 1.75% — so the last two hikes, not just the one in December, will be written about in the history books as classic policy missteps.

The Fed has raised the funds rate nine times already and, together with the runoff of the balance sheet, the cumulative de facto tightening has come to over 300 basis points. Once again, a degree of monetary restraint that has caused recession risks to become elevated. Even the New York Fed's recession-probability model has moved up recently to the highest level in eleven years to roughly the same level it was just prior to the last three downturns.

Compounding the situation surrounding the long and variable lags between prior Fed policy tightenings and the inevitable negative impact on the economy, is the unprecedented level of economic uncertainty around the world. The Economic Policy Uncertainty Index (GDP-weighted for 20 countries) hit its highest level on record last month, with items such as Brexit, trade frictions, a weakening Chinese economic backdrop, the US government shutdown and unsustainably high debt levels all at

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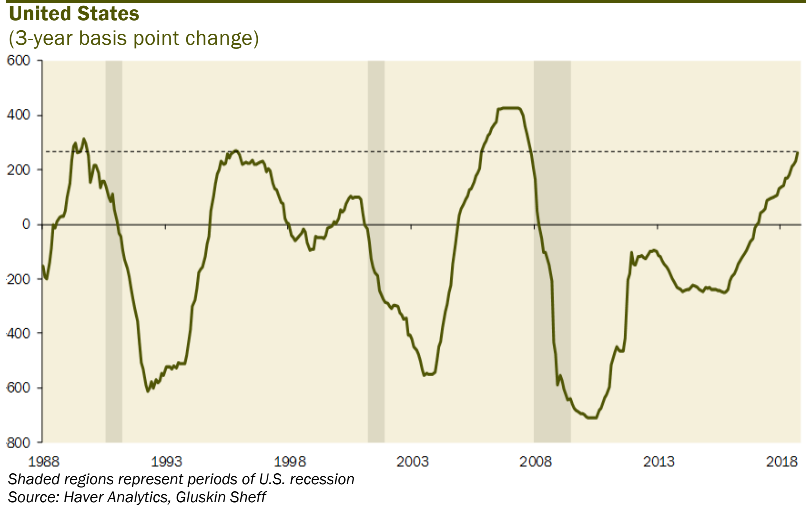
play (I suppose we can now add the chaotic situation in Venezuela to this list).

CHART 9: 'BALANCE SHEET ADJUSTED' FED FUNDS RATE

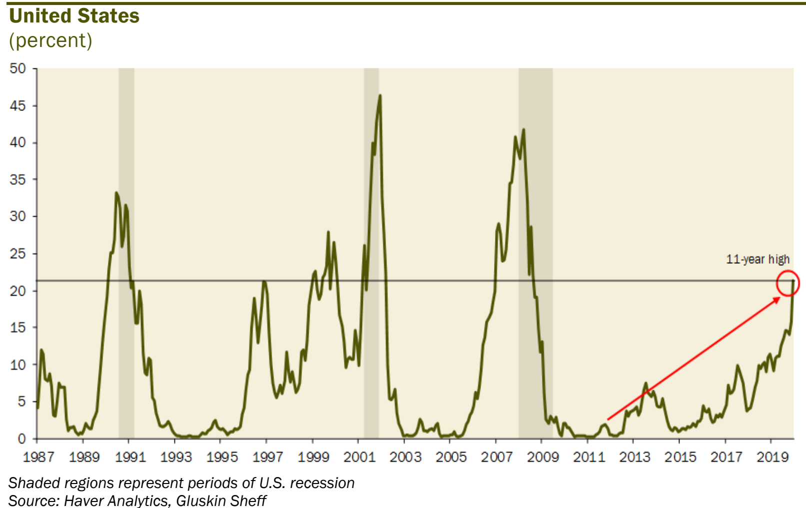
United States
(3-year basis point change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 10: NY FED PROBABILITY OF U.S. RECESSION NEXT 12-MONTHS

United States
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Once again, one has to keep the lags in mind. Monetary policy influences the economy with lags that are long and variable. There is nothing the Fed can do now that can prevent the recession as the lags from the prior tightenings percolate through the economy this year. Just as the easings in late 2007 could not prevent what unfolded in 2008 — but when the lags from the easings kicked in, the recovery was able to

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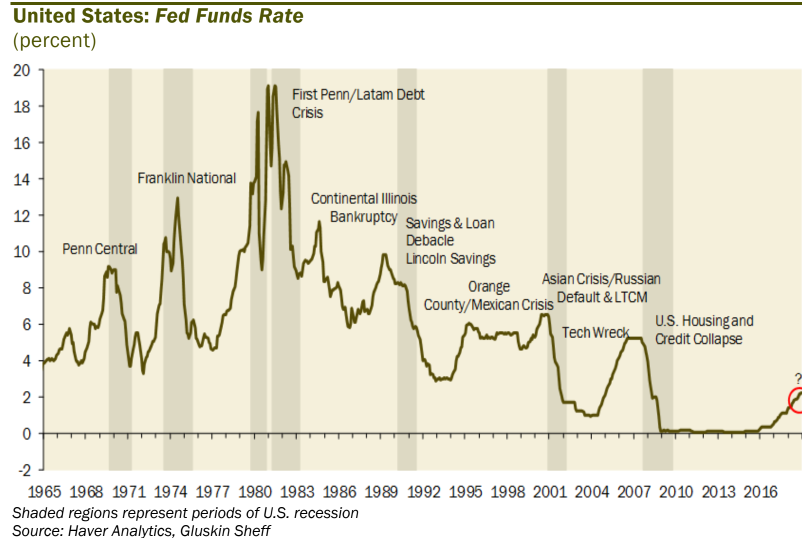
take hold in 2009. But as for this year, it's baked in the cake (as in the recession).

CHART 11: FED TIGHTENING CYCLES AND FINANCIAL EVENTS

United States: ***Fed Funds Rate***
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

While many of our indicators point to the second or third quarter of this year as the time of the next recession, I readily admit that the timing could be off. The one metric that will tell me it has arrived, believe it or not, is the laggiest of the lagging indicators — the unemployment rate. When the jobless rate has climbed 0.4 of a percentage point from the cycle low, both on an average and median basis, that is the month the recession began. That's all it takes. Four-tenths of a point. Now to clarify — the range on this is +0.1 percentage point to +0.6 of a point. So think about that for a second — all it would take would be for the jobless rate to rise to 4.1% (for the norm) and no higher than 4.3% for the recession to take hold. People are surprised to hear this but it is the change and not the level that matters — change always occurs at the margin. Go back to the last time we had such a tight labor market in late 1969 — the unemployment rate was 3.4%. Within a few months, it was at 3.9% and the recession, to practically everyone's surprise, had kicked in. It won't be different this time — and remember, we bottomed at 3.7% and have since ticked up to 3.9%.

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CHART 12: UNEMPLOYMENT RATES AND RECESSIONS

United States

		Unemployment Rate		
Trough Date	Recession Start	Trough	Recession Start	PP Change
Jun-53	Aug-53	2.5%	2.7%	0.1
Mar-57	Sep-57	3.7%	4.4%	0.6
Feb-60	May-60	4.8%	5.1%	0.2
Feb-69	Jan-70	3.4%	3.9%	0.5
Oct-73	Dec-73	4.6%	4.9%	0.3
May-79	Feb-80	5.6%	6.3%	0.6
Dec-80	Aug-81	7.2%	7.4%	0.2
Mar-89	Aug-90	5.0%	5.7%	0.6
Apr-00	Apr-01	3.8%	4.4%	0.5
Mar-07	Jan-08	4.4%	5.0%	0.5
			Average	0.4
			Median	0.4

Source: Haver Analytics, Gluskin Sheff

The next question is what sort of recession this is going to be. I sense it will be a mild one since the imbalances this cycle are outside of the household sector, which represents approximately 70% of GDP. The U.S. banks are well-capitalized this time around too. So this is not at all a repeat of what we saw in 2008-09. But I wouldn't draw too much comfort from that. Go back to the modest downturn in 2001-02 and just because GDP wasn't affected much, profit margins sure were. A mild recession during the tech wreck didn't stop the Nasdaq from collapsing 80% from the peak and the S&P 500 by 40%. So there is really no correlation between the severity of the economic downturn and how far equity markets decline from the high to the low.

It is always imperative to follow the excess liquidity and the bubble that gets created each time the Fed overstays its accommodative policy stance. Again, this time is no different except that the culprits have changed, which is typical. The Fed helped nurture, and then destroy, the commercial real estate bubble of the late 1990s, the tech bubble of the early 2000s and the housing bubble of the last cycle. This time around, the bubble is on corporate balance sheets as firms were incentivized to borrow money at historically low interest rates, principally to buy back their stock. This still goes down as the weakest capital spending cycle of all time, so it's not as if this debt went to productive use that will generate some positive internal rate of return to cover the future debt-servicing costs.

There is no shadow of a doubt that when interest rates are supressed for as long as they were, that malinvestmet followed, as well as a plethora of companies who managed to access credit on terms and with

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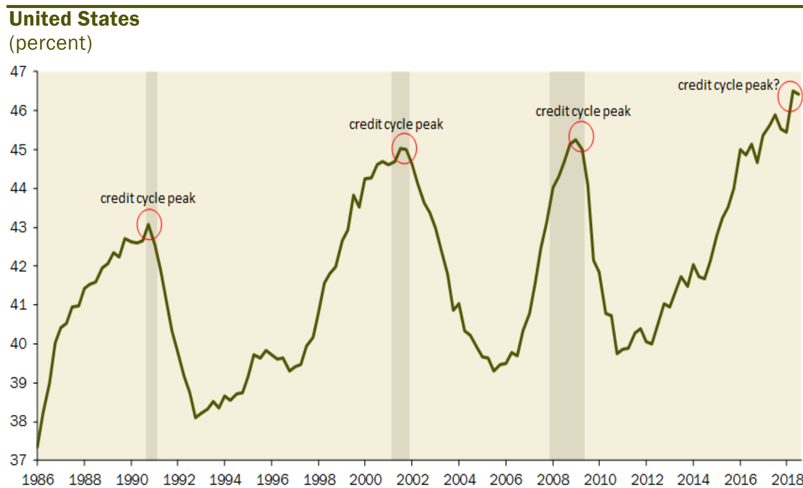
borrowing costs that in no way matched their inherent default risks. Like most countries, the United States once again fought a debt bubble by adding on more debt, and while households did delever some, the blowout in corporate balance sheets (and governments) has been palpable. The Fed has rolled the dice here, tightening into a $50 trillion (248% of GDP) aggregate debt burden. There's not a snowball's chance in hell that there will not be an impact on the economy this year as 1% of GDP gets siphoned into debt servicing.

The chart of corporate debt-to-GDP this cycle looks a lot like the mortgage debt-to-GDP ratio of a decade ago. The ratio now has risen to a record high of nearly 50%, and peaks in this metric, like so many other measures listed above, lead peaks in the economic cycles. Look at how close the 'recession bands' are to the peaks in the corporate debt ratio.

CHART 13: CORPORATE DEBT-TO-GDP RATIO

United States
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

While many focus on the high yield market, it actually is now exceeded in size by the leveraged loan market, which is in a bubble of its own. And it is the junky nature of today's investment grade market that really has me unnerved. This is now a $6 trillion market, but half of it is rated BBB or worse — the lowest quality segment before hitting junk. The BBB space has expanded from $600 billion a decade ago to over $3 trillion now. The median debt-to-EBITDA ratio has jumped from 1.9x a decade ago to 3.2x presently, so debt ratios have soared no matter the measure.

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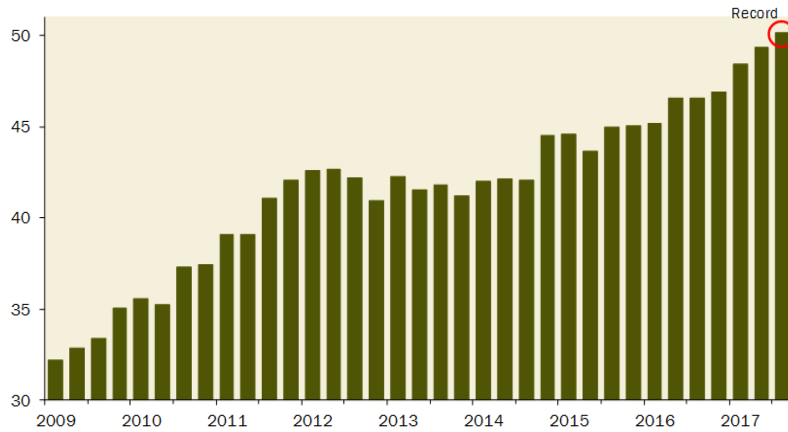
CHART 14: BBB SHARE OF INVESTMENT GRADE BONDS

United States
(percent)



Source: Haver Analytics, Gluskin Sheff

In fact, more than one-third of BBB-rated debt has balance sheet ratios consistent with the junk bond market. This is important because a key risk for the coming year is when a literal tsunami of debt refinancing takes place ($4 trillion in the next 4-5 years) is that of a cycle of "fallen angels" taking hold — when that BBB tranche is at the precipice of getting downgraded to non-investment grade status. We have seen this happen at the end of every credit cycle, but not with a massive $3 trillion of corporate debt near the cut-off. The difference from being downgraded to A from AA isn't the same as being downgraded from BBB to BB because in the case of the latter, institutional investors with quality mandates like pension funds and insurance companies can no longer own your debt. So what happens is a dramatic widening in spreads and the cost of debt capital, with the commensurate tightening in financial conditions negatively affecting risk appetite in general, will have knock-on effects through the real economy.

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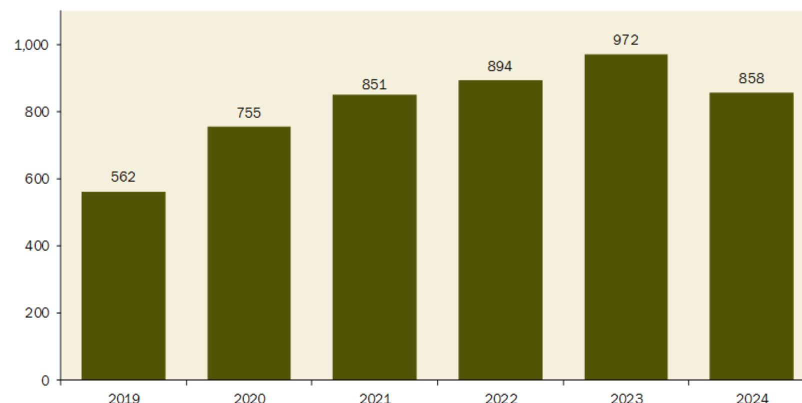
CHART 15: A RECORD AMOUNT OF CORPORATE DEBT IS COMING DUE

United States
($ billions)



Combination of High Yield, Leveraged Loans and Investment Grade bonds
Source: BofA Merrill Lynch Global Research, BofA Merrill Lynch, Gluskin Sheff

What is noteworthy mind you, is that less than 5% of this vulnerable BBB debt now has a 'negative' ratings outlook attached by the major credit agencies. This may seem like yet another situation where S&P and Moody's and Fitch are looking after the issuers rather than the investor, but that may not be the case. What is likely happening is that these marginal companies in the worst part of the investment grade universe have shown the agencies what their capex plans look like for the coming year. And as the survey data suggest, capital spending is going to be curtailed this year as receding corporate cash flows receive stiff competition from rising wages and debt servicing costs. The key for these companies in the Chinese year of the pig is not to get slaughtered, so the primary emphasis will now be on debt retirement and debt servicing. Hence my belief that we will see a capex-led recession, as we did for different reasons perhaps, just under two decades ago.

And there's another constraint on the corporate sector which is otherwise known as "crowding out" because when you add in the deficit, government debt rollovers and the Fed's balance sheet unwind, we are talking about the total gross supply of Treasuries coming on to the market approaching $3 trillion this year (from $2.7 trillion in 2018). This new approach towards restraint is already seen in the fact that investment-grade corporate bond sales have already shrank 15% so far this year (and banking sector issuance is down 40%).

In recession bear markets, the S&P 500 goes down an average 35%. There is ample evidence to suggest that in these phases, we go through a classic 50% retracement of the prior bull market condition. You can do the math. And not just that, but the difference between a fundamental bear market and a technical correction, is that in the former, the trough in the forward P/E multiple is 10.5x and corporate earnings endure a

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10% haircut; in the latter, the buying opportunity occurs at a 14.5x P/E (and earnings don't typically go down at all). If you believe all we have had on our hands is some turbulence and a corrective phase with no recession, then you do want to be buying the stock market aggressively. I give that no better than a 20% chance of playing out, as an aside. Ten years into this thing, it's time for the power of mean reversion to take hold. And don't forget that along with capex, another casualty this year as cash flows get diverted to debt service as 'fallen angel' prevention plans dominate the landscape, will be share buybacks. These were a powerful force behind the 2009-2018 bull market, as the S&P 500 share count plunged to an 18-year low.

So we get a typical 35% decline in the stock market during the entire recessionary bear market phase — though that doesn't mean there are absolutely no places to hide at all. Even in the Great Recession, Walmart, Family Dollar and Ross Stores — all low-end and trade-down retailers — made you money. Non-cyclicals like these, or Utilities or say, Health Care REITS or select Consumer Staples, may not be bad places to be even in a recession. The key is to focus on strong balance sheets, minimal cyclicality and a step up in quality across the entire capital structure.

But the overall index, or passive investing, are a no-no. I realize the bulls are all excited about this 13% rally off the lows, but it is purely a short squeeze from oversold technical levels late last year. Consider how long it took to go down that first 20% in 2008…a full nine months. Or how long it took to go down 20% for the S&P 500 during the 2000-01 tech wreck…try six months. We did it this time in three months — so naturally the market fell too far, too fast. In past periods of this initial leg down, it was completely normal to see as much as a 75% reversal — so this is all technical.

Remember what Stan Weinsten has told us that is the only thing that is important — the peak was put in last Fall. Everything else is just backing and filling. The stock market is still well off its highs, and what happens normally is that it declines 10% ahead of the recession — that down payment is then followed by another 25% down to the lows that tend to occur three months before the recession ends. I should add that the yield on the 10-year T-note drops an average 160 basis points peak-to-trough in recessions, so a test of 1.7% is a good bet.

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CHART 16: S&P 500 BEAR MARKETS

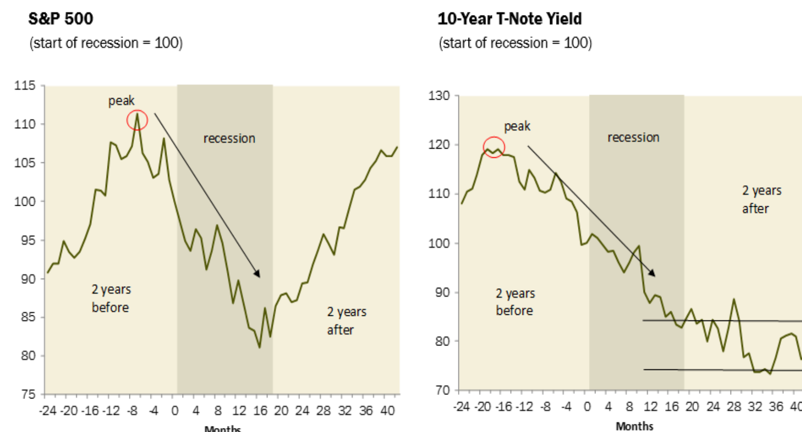
United States

Bear Market			S&P 500			
Start	**End**	**No. of Days**	**Peak**	**Trough**	**% Decline**	**Recession?**
Jun-48	Jun-49	363	17.06	13.55	-20.6%	Y
Jul-57	Oct-57	99	49.13	38.98	-20.7%	Y
Dec-61	Jun-62	196	72.64	52.32	-28.0%	N
Feb-66	Oct-66	240	94.06	73.2	-22.2%	N
Nov-68	May-70	543	108.37	69.29	-36.1%	Y
Jan-73	Oct-74	630	120.24	62.28	-48.2%	Y
Nov-80	Aug-82	622	140.52	102.42	-27.1%	Y
Aug-87	Dec-87	101	336.77	223.92	-33.5%	N
Jul-90	Oct-90	87	368.95	295.46	-19.9%	Y
Mar-00	Oct-02	929	1527.46	776.76	-49.1%	Y
Oct-07	Mar-09	517	1565.15	676.53	-56.8%	Y
Average (Total)		**393**			**-32.9%**	
Average (Recession)		**474**			**-34.8%**	
Average (Non-Recession)		**179**			**-27.9%**	
Median (Total)		**363**			**-28.0%**	
Median (Recession)		**530**			**-31.6%**	
Median (Non-Recession)		**196**			**-28.0%**	

Source: Haver Analytics, Gluskin Sheff

CHART 17: STOCKS AND BONDS THROUGH THE CYCLE

United States



Source: Haver Analytics, Gluskin Sheff

That is the problem. Timing the recession is only a matter of whether it is a second, third, or maybe a fourth quarter story — but it's out there. The issue will be once it starts, when will it end? We simply do not have the policy firepower to fight recessions like we used to. The bright lights in Washington decided to spend their fiscal bullets at the peak of the economic expansion instead of saving dry powder to fight the next

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recession. Heads will roll in the 2020 election because of this lack of preparation and foresight. And the Fed is out of ammunition as well. When I mentioned how the central bank has tightened more than 300 basis points this cycle, keep in mind that meant taking the 'shadow' (balance sheet-adjusted) funds rate from -5.1% to -1.9%. Imagine that the rates and economic cycle ended with a de facto negative funds rate. The economy and the stock market has cried uncle over the lowest peak ever in the Federal funds rate, and that reflects the vagaries of trying to normalize policy in a completely abnormal economic expansion. An expansion that saw little in the way of capital deepening and productivity enhancement but saw much in the way of financial engineering, rampant asset inflation and a swelling in the number of marginal companies who managed to access credit only because of the long interventionist arm of the central bank.

Historically, the Fed cuts rates 500 basis points to fight a recession. In the last cycle the Fed realized, though when it was too late, that it needed to cut 700 bps — but the peak in the funds rate was 5¼%. Hence the move to QE to generate a synthetic 'negative' policy rate. If the Fed needs to cut a traditional 500 basis points again, it will have to go back to zero on the nominal funds rate and re-engage QE afterwards. The Fed, being classically incremental, is now bracing the markets for no more rate hikes and for an early end to QT…again, too late, but better late than never. And when Powell and crew make the shift back to an easing stance, rest assured that history shows this reversal to be quick and dramatic. Even so, can there really be any positive shock effect? The Fed taking the funds rate down to 1% in 2003 did act as a huge shock and positive force. Who had ever seen that in their lifetime? The Fed going to zero and then doing QE repeatedly — who even knew what QE was before 2009? What is the rabbit out of the hat going to be this time around? One thing is certain and has been the pattern since the asset boom-bust cycles began under Alan Greenspan in the late 1980s — the Fed has had to become increasingly more aggressive each time to end the recession. Even then, the aftershocks generated extremely subdued recoveries, which saw the output gap continue to widen and deflationary forces follow suit.

Everything I am talking about is on the Fed's mind. Jay Powell tried everything he could to get the funds rate as high as possible this cycle. As close to his definition of neutral as possible. December 19th was the grand finale. But he now realizes the rates cycle is finished and so do all the hawks on the FOMC who have done a 180 degree shift in view in just the past month.

Go back to the July 31st/August 1st FOMC minutes and it starts off with something you rarely see published: a special presentation to policymakers titled *Monetary Policy Options at the Effective Lower Bound*. The Fed already has the recession on its mind even though it

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has yet to form its base-case forecast and is telling us that the first thing it is going to do is bring the policy rate back to zero, then re-engage in QE (with no certainty that will have a decisive impact). But all anyone needs to know is that if, indeed, we go back to the zero bound at the very front end, yields out the curve are going to melt and I can see a situation where the long bond goes all the way down to 2%. Great news for high-quality, long duration fixed-income product and if you need to be exposed to equities, best to stick with rate-sensitives that also possess defensive characteristics. SIRP again will rule the roost under this plausible scenario — 'Safety and Income at a Reasonable Price'.

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Gluskin Sheff at a Glance

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OVERVIEW

As of December 31, 2018, the Firm managed assets of $8.2 billion.

Gluskin Sheff is a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) and is 17% owned by its senior management and employees. We have public company accountability and governance with a private company commitment to innovation and service.

LEADING

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INNOVATIVE

Throughout our history we have consistently pursued innovative approaches to wealth management for our clients. Today, we offer a diverse platform of investment strategies, including Canadian, U.S. and international equity strategies, alternative strategies and fixed income strategies.

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ALIGNED

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$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately $6.6 million[2] on September 30, 2018 versus $3.2 million for the S&P/TSX Total Return Index[3] over the same period.

For further information, please contact: research@gluskinsheff.com

Notes:

1. Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.
2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.
3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

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