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Does Macro Matter? Part 2: Equities

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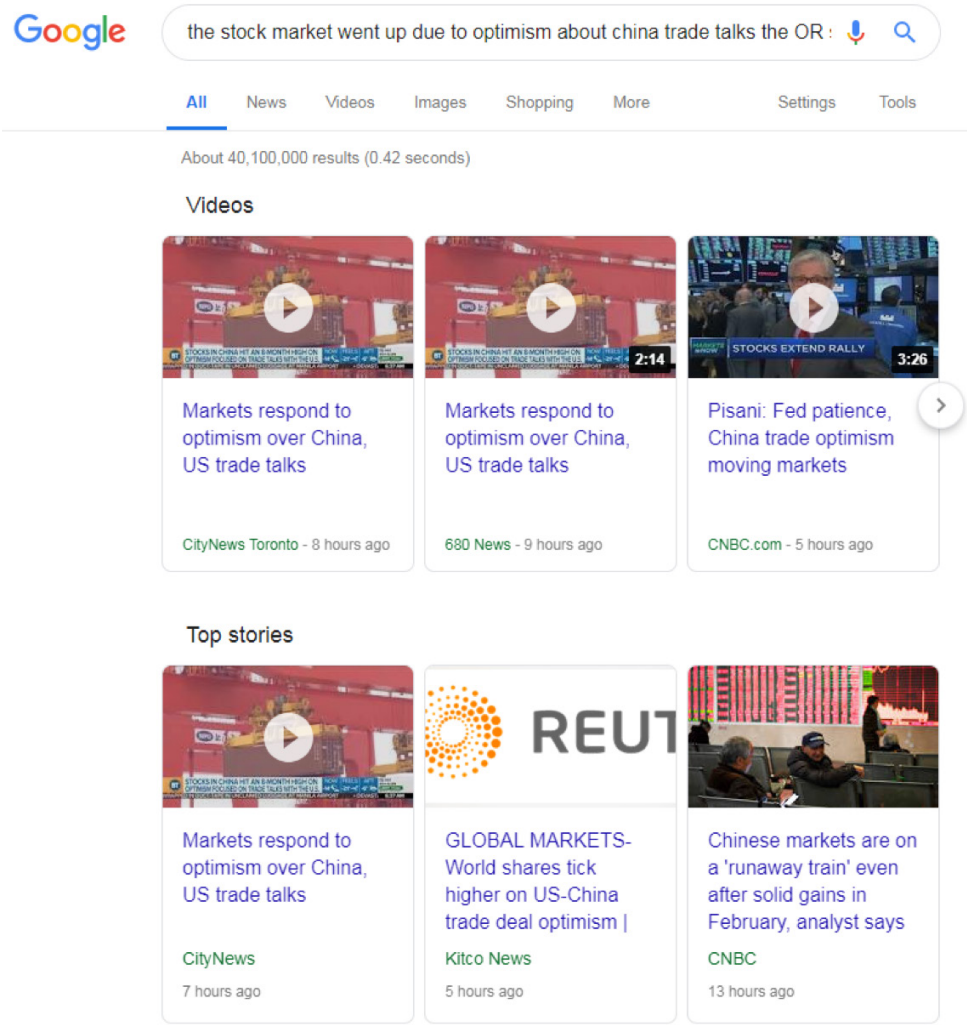
During my ride home from work, I listen to Bloomberg Radio. Every 15 minutes there is a market update where the presenter attempts to explain the day's market activity: "The stock market went up/down because of X". Invariably it is some short-term macro input. Investors want to know why, and the media responds with a narrative.

One of the primary narratives of the past year has been trade tensions between the United States and China. A search for "the stock market went down due to pessimism about China trade talks" using Google found about 7.2 million results. The inverse search, substituting up for down and optimism for pessimism resulted in about 40.1 million results.



Clearly all you need to know is what the outcome will be. How important are the Chinese trade talks to the U.S. economy? According to the U.S. Census Bureau, the U.S. exported $120 billion of goods to China in 2018. They peaked in March at $12.4 billion in anticipation of U.S. tariffs. U.S. Nominal GDP was around $20.5 trillion in 2018, making the exports around 0.6% of U.S. GDP. The decline in exports from 2017 to 2018 was $9.7 billion, 0.05% of Nominal GDP. The loss of exports due to the trade war is insignificant to overall GDP, but it is very meaningful for some key exports, primarily in agricultural products, aircraft, motor vehicles and energy. The impact on earnings for the majority of S&P 500 companies is insignificant.

While the media narrative is around trade talks, the reality is Chinese growth is slowing. The economic data available to the west can be somewhat unreliable, but there is a trail in the media that suggests that the Chinese economy might even be contracting.

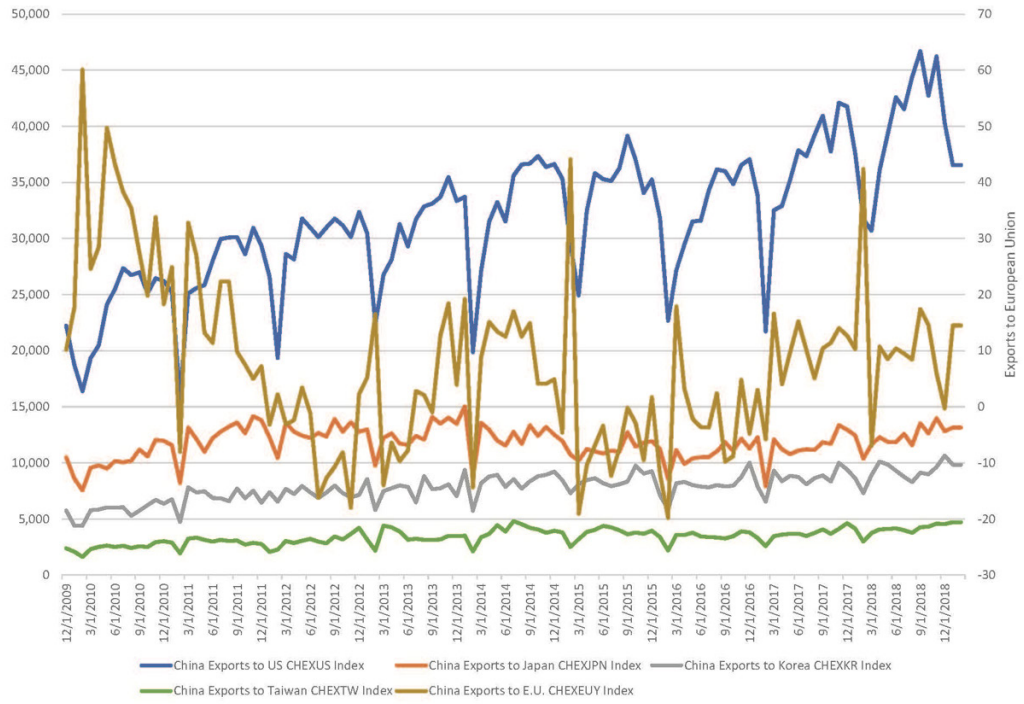
Rich Farr, the Global Economic Strategist at Merion Capital wrote a recent note that looked at a series of news reports suggesting that China's economy may be contracting. Here are examples of some of the headlines[1] from his report:

- Ford's China JV to lay off 'thousands' of workers -New York Times
- Chinese Factories Cut Prices, Lay Off Workers in Trade War: UBS
- China experiences a sharp slump in Apple iPhone sales
- China's tech giants are "optimizing" people as the economy slows
- China's IT sector saw massive layoffs in 2018: state media
- Tech layoffs threaten middle-class China dream
- Chinese Regime Warns of 'Severe Risks and Challenges'

The macro that matters for the stock market is all around the waves of economic growth. China is the number two economy and the number one consumer of natural resources. A material slowdown in China is negative for producers of raw materials: emerging markets, Canada and Australia. Chinese growth has been largely debt fueled and the slowdown was generated by a Chinese leadership desire to gently reduce leverage in their economy.

However, China is still an export driven economy. There is little evidence in the export data that China has experienced a material slowdown.

Chinese Exports to Major Trading Partners



Source: Bloomberg L.P.; CI Investments

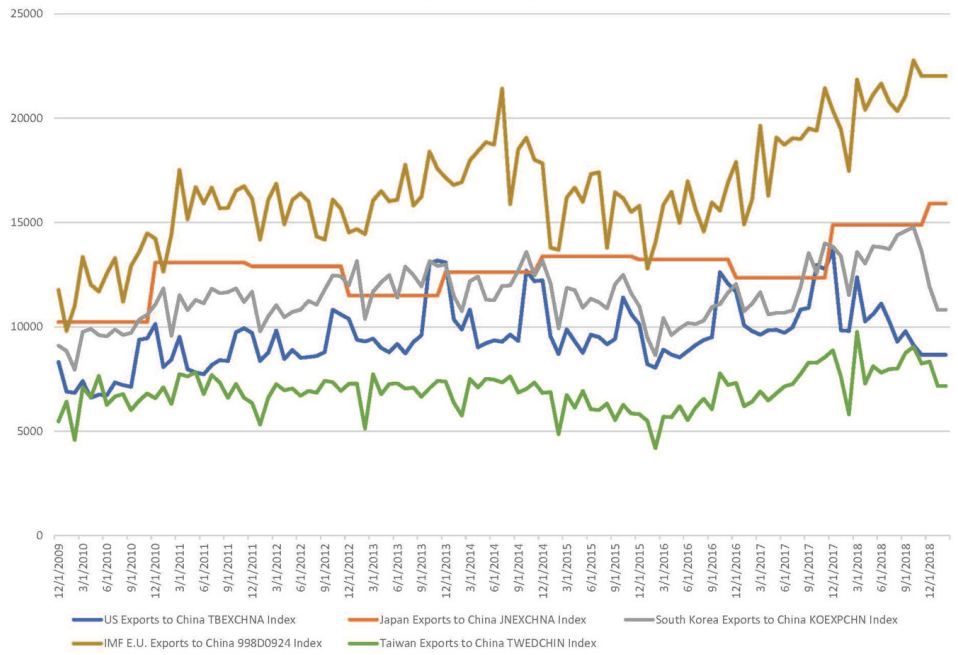
As of February 2019

Indeed, when you look at exports to the U.S. there is little evidence that the "trade war" is negatively affecting China's exports, 2018 was a record year.

[1]Links to the listed articles can be found on the last page of this document.

However, when you look at exports to China it is a different narrative. U.S. exports to China have dropped sharply. Their key exports are civilian aircraft (no duties), soybeans (duties levied), oil (duties levied), electronic integrated circuits (no duties) and motor vehicles (duties levied). The Chinese purchase of soybeans has collapsed. They were by far the major customer for the commodity with more than a 60% share of U.S. soybean exports previously (St. Louis Federal Reserve). However, in response to duties, they have stopped purchasing from the U.S., and as a result, soybean prices have declined by over 20%. At the same time, duties have led to exports of oil declining to zero.

Major Trading Partners' Exports to China



Source: Bloomberg L.P.; CI Investments As of February 2019

Soybean futures: Before and after imposition of a 25% duty by China

Source: Bloomberg L.P. As of March 5, 2019

The October 25, 2018 issue of Forbes magazine noted that U.S. car exports to China had declined by 56%. The major victim of the decline was the BMW plant in Spartanburg, South Carolina. BMW responded by moving production to China. In many cases, the communities that are most affected by the Chinese trade retaliation are communities that supported the Republican Party in 2016.

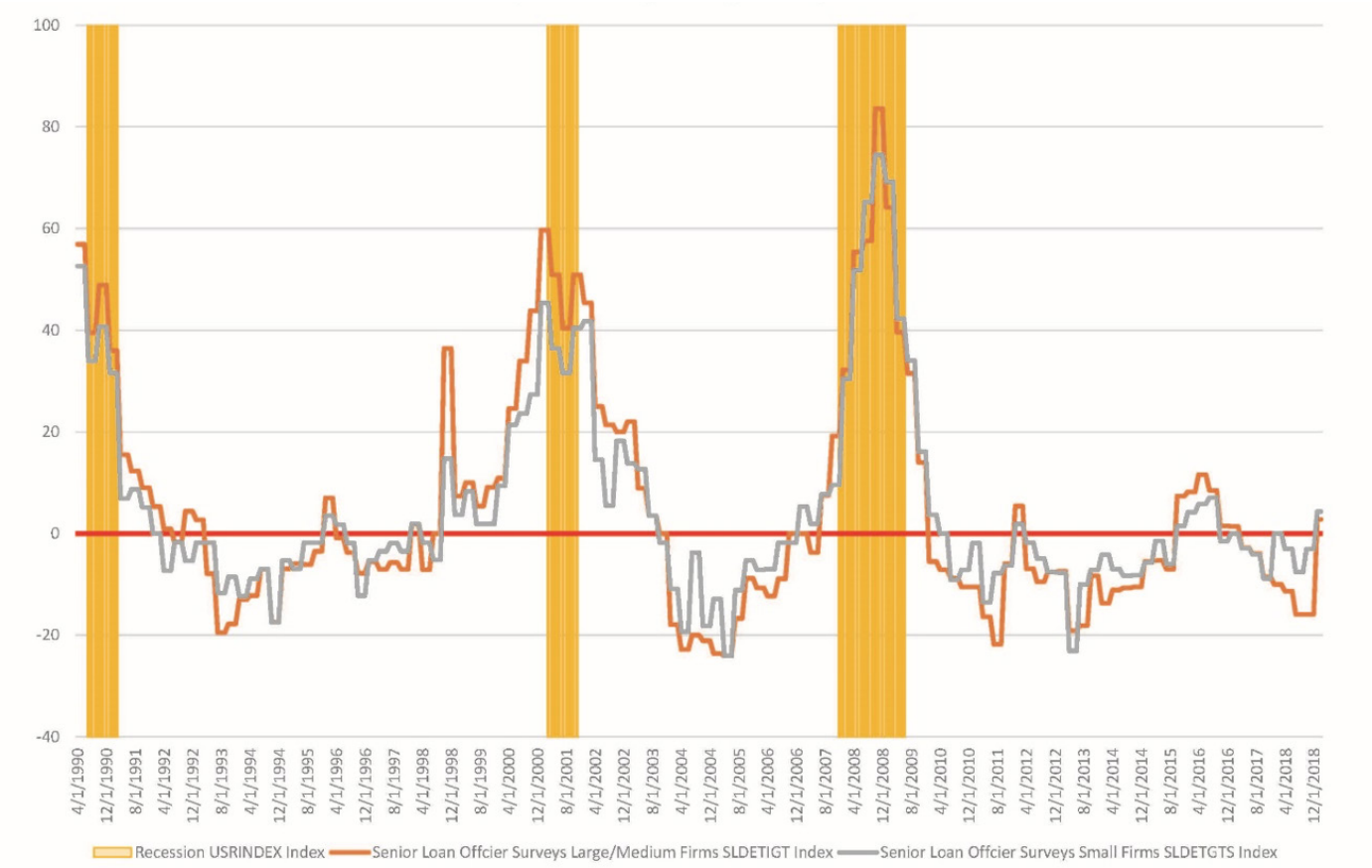
It looks like the U.S. may need a trade solution more than China does.

But is that enough to drive U.S. stock market volatility? I am not aware of any listed companies producing soybeans and direct auto manufacturing is 37 basis points of index weight. So, was it really trade fears that served as the catalyst for the market's decline in Q4 of 2018?

The macro that really matters for the stock market is the ebb and flow of the credit cycle: are banks expanding or shrinking the availability of credit to the U.S. community. I did a Google search on "% of senior loans officers reporting tighter lending standards" and it returned 6.9 million hits.

The ones on the first pages of the search referred to a recent increase in senior loans officers reporting tighter lending standards in the Federal Reserve's regular survey. The February survey showed a mild uptick in officers reporting tighter lending standards, from a very low base for large and medium firms and a very minor uptick for small firms. Leading into recession there is an established uptrend in officers reporting tighter lending standards. The February prints are barely above the zero line. Credit is available.

Federal Reserve Senior Loans Officers Survey:
Net % of domestic respondents tightening lending standards for C&I loans



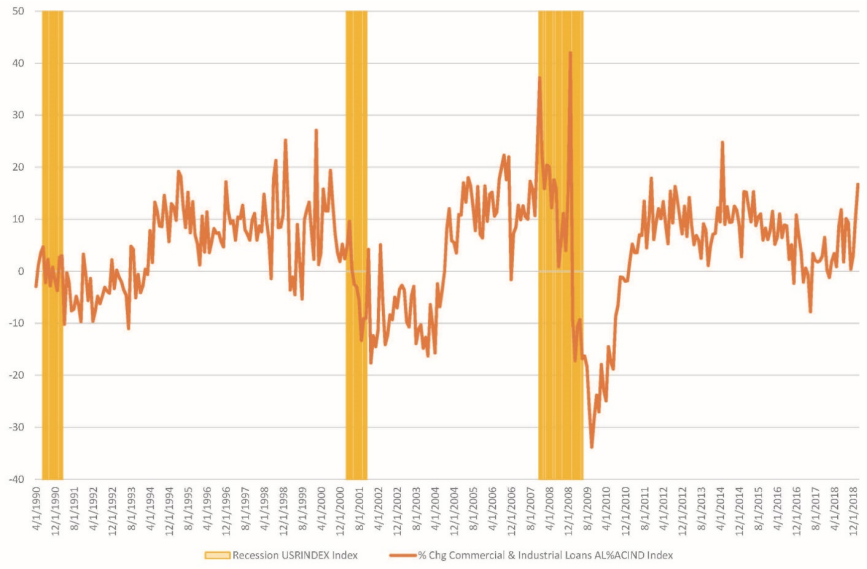
Source: Bloomberg L.P.; CI Investments

As of February 2019

Tightening lending standards lead to declines in the commercial banks loan books. The modest increase in standards in 2016 led to a decline in originations and a modest decline in the loan book in 2017. There is always a lag, with the trough in growth rates for Commercial & Industrial loans and leases appearing post-recession.

The most recent data shows loan growth at healthy levels. It also shows extremely low delinquency rates on loans and leases after an increase in delinquencies form mid-2015 into 2017.

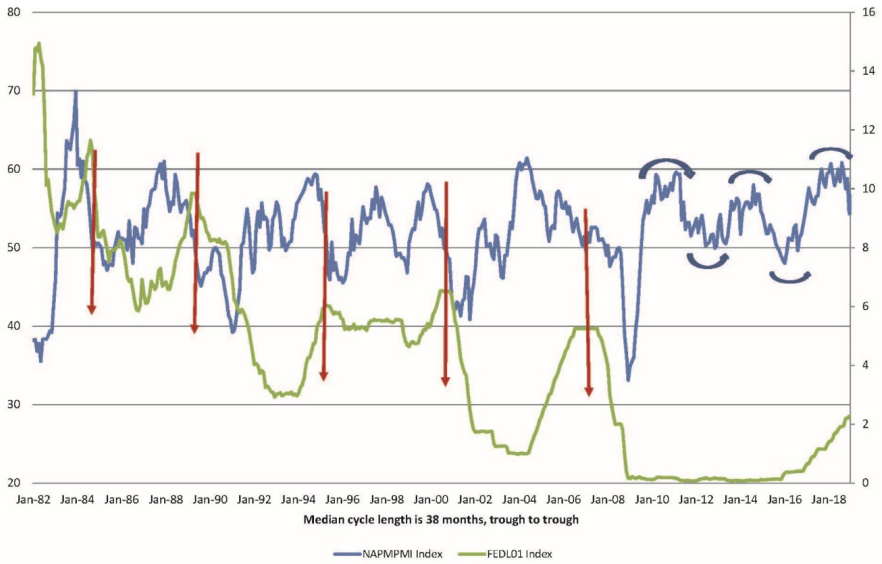
Federal Reserve Senior Loans Officers Survey:
% change for C&I loans seasonally adjusted annual rate



Source: Bloomberg L.P.; CI Investments As of February 2019

It is always worth repeating: credit is the lifeblood of the economy. I have written at length about the differences between a manufacturing cycle and a credit cycle. The current manufacturing cycle started in early 2016 and looks to have peaked in August of 2018. The ISM Manufacturing Index is declining from elevated levels. Tax reform gave a strong stimulus to the economy and the stimulus is wearing off. There is no guarantee that a slowing manufacturing cycle will result in a recession. In the past, when the ISM Manufacturing falls below 50, the tightening cycle is over, and the easing cycle has begun. We will know this year whether we are starting another manufacturing cycle, the fourth of this credit cycle.

Institute for Supply Management:
Manufacturing Purchasing Managers Index



Source: Institute for Supply Management, Bloomberg L.P.; CI Investments As of February 26, 2019

I have inserted red arrows into the ISM Manufacturing chart and added the Fed Funds Rate. The red arrows are placed at the point where the ISM Manufacturing hits 50. Above that is expansionary, below 50 a contraction starts. The mid-cycle slowdowns of 1984, 1995, 1998 were met with Fed easing and a soft landing. The loans officer data from 1990 on, shows that the 1995, 1998 and 2015 slowdowns were also met with easing lending standards. The cycle ending slowdowns of 1989, 2000 and 2007 had the Fed tightening into the declining ISM Manufacturing, together with tightening lending standards. This potential slowdown has benign lending standards and a dovish Federal Reserve. I don't think it is in anyone's interest to have a policy induced recession in the United States.

I did another Google search found 21.2 million hits for "% of economists predicting a 2019 recession". The search displayed 17 pages of articles, most with a gloomy outlook. The early hits were concentrated in December of last year and early this year. In many of the articles the message was that a recession was imminent. This is the macro that terrifies investors and prompts them to take action. In January I wrote an article that looked at the outcomes a year later when you panicked during a rapid market downturn. The panic reflex is almost always wrong.

I'd be very surprised to see headlines screaming out the macro that matters to me: "Coincident tightening of Fed Funds Rate and lending conditions!" A Google search for that exact phrase had zero hits. The words in the search phrase resulted in 803 thousand hits with tightening and Fed Funds Rate being the most common hits. Thirty of the hits were displayed by Google.

Yes, macro matters. The headline macro of "China and U.S. trade disputes" matters in the sense that investors think it is important. It has a short-term impact on market values but little long-term impact on the earnings power of the companies you are investing in. The macro of "cost of capital" matters long-term. Tightening lending standards and rising interest rates put structural stress on consumers of credit. Put them together and you can trigger a recession. Put them together and it takes months for the tightening monetary conditions to really bite. But that makes for lousy headlines. People need to know NOW!

Remember, the role of the media is to sell advertising. The best way to retain your audience is to keep them in a state of low-grade anxiety. They will constantly return to find out "what happened". We have just passed the tenth anniversary of the 2008-2009 financial crisis. On Monday March 9, 2009, I sent an email to the executive team at Sentry Investments about a market letter from Hayman Advisors that had been circulated over that weekend. I replied in detail and with a little emotion, below are some excerpts from that email with my current comments in italics:

> "In reading it today ***(Hayman letter of March 2, 2009)*** I was grimly amused to see many of the same themes I ranted on this morning: equity is worthless if debt cannot be refinanced, over leverage at all levels of society and the long-term risk in fiat currencies. I sent the comments copied below in an email last Friday to John Stackhouse, editor of the Report on Business:
>
> As the bear market progresses and the credit crisis deepens, I thought it might be worthwhile to take a deeper look at the roots of the problem. Is there a societal issue re debt that has led to this outcome? As you know I favoured the Income Trust structure because it allowed me to accomplish in a publicly listed security a very similar outcome as to a private equity or LBO structure. The subordinated debt allowed income to be removed from the company prior to taxation. This led me to the following thought:
>
> Our tax code favours term capital (debt) over permanent capital (equity). Interest payments are deductible for tax purposes while dividends were until very recently subject to punitive taxation. Indeed, during a period of weak corporate profits, in Canada we even went to the extent of imposing a tax on permanent capital. Rational behaviour would suggest that businesses should be structured to maximize the benefits allowed under the tax code. This has led to a wholesale replacement of permanent capital with term capital. ***(record share repurchases in recent years are a debt for equity swap)***
>
> There is nothing in the economic statistics that suggest the time has come to play offence. If I have a fault it is that I am an optimist at heart. Indeed, I have trouble dealing with pessimism. I cannot recall ever being in as gloomy a frame of mind as I am in now. Hopefully I am in some way representative of the broad market and am showing that we are entering the capitulation phase of this down-turn. In the February/March down phase the volumes have been markedly higher that we saw at the bottom in November and much more biased to the downside. There have been no upside spikes in volume such as were seen post the November low. Technical structure has deteriorated as well. In talking to desks and reading market emails the comments are that even long-term fundamental type accounts are liquidating positions while the short players are pressing. ***(March 9, 2009 was a capitulation bottom for the market; a generational low)."***

The issues from 2009 have not gone away, but the narrative has moved on. A Google search for "we must balance the federal budget" yielded 9,510 hits dating primarily from a decade ago. If you had invested using the macro inputs from the Hayman letter you would have invested to an outlying outcome. I was given very good advice in my early years as a portfolio manager: have a primary outcome and invest for that to be realized. Be aware of outlying risks, regularly review them and when a risk becomes the new primary outcome, change your investment portfolio accordingly.

When tightening credit conditions coincided with a rising Fed Funds Rate in 2006-2007, we actively changed the credit composition of our equity portfolios at Sentry. Our primary call was for continued economic expansion, our primary risk was that tightening financial conditions would stress the economy and result in recession. We wanted to participate in potential market appreciation while minimizing liquidity risk in the companies that we were invested in: we stress tested them. You could make exactly the same comment today. My primary call is for continued economic expansion and our primary risk is that tightening financial conditions will stress the economy and result in recession. Stress test your portfolios. But please, never trade on "macro headlines". They don't matter.

Footnote article links from Page 2: Ford's China JV to lay off 'thousands' of workers - New York Times: https://is.gd/Vce9Gs , Chinese Factories Cut Prices, Lay Off Workers in Trade War: UBS: https://is.gd/FUTRJH, China experiences a sharp slump in Apple iPhone sales: https://is.gd/wBeW7a, China's tech giants are "optimizing" people as the economy slows: https://is.gd/x9jPRk, China's IT sector saw massive layoffs in 2018: state media: https://tinyurl.com/y6xrctof, Tech layoffs threaten middle-class China dream: https://is.gd/V2Kc1T, Chinese Regime Warns of 'Severe Risks and Challenges': https://is.gd/8jU5b3

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