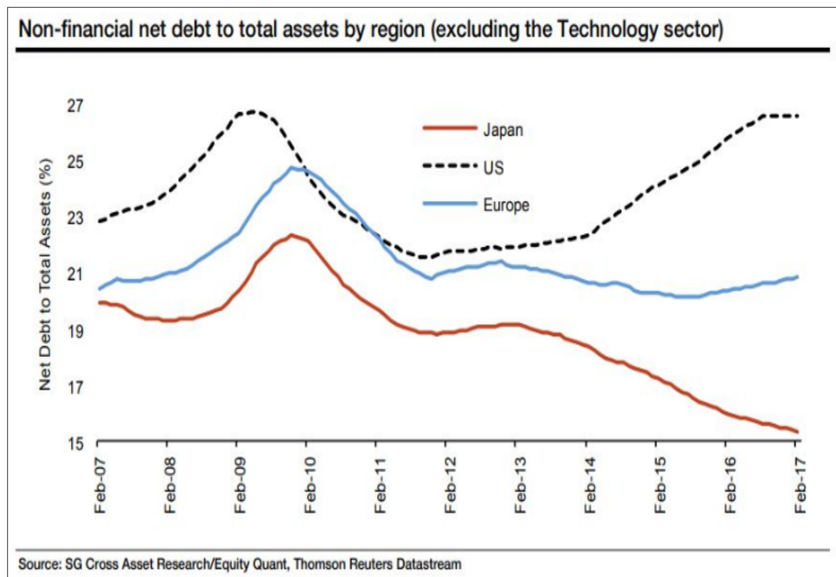
The Long & Short of It
Quarterly Newsletter
Third Quarter 2018

Crosscurrents
At 110 months, this economic cycle is the longest since the 120-month expansion of March 1991 to March 2001. With the S&P 500 up 10.6% through September 2018 and volatility hovering near record lows, the stock market appears relatively tranquil. Depending on how one measures bull markets, we are now in the longest or second-longest bull market in history. It is too early to say that either the economic expansion or the bull market is at an end, but signs continue to surface.

Lurking beneath the surface are tariff discussions, rising long-term interest rates, an end to the swift rise in earnings, and the upcoming election. With unemployment now under 4%, it is low enough to potentially bring rising labor costs, further aggravate inflation and require more aggressive monetary policy disruptive to financial markets.

A stable, slow-growth economy that produces a debt cycle longer and eventually deeper than average seems certain. One cannot help but wonder when the party will end. Two items are particularly worth watching: 1) debt creation, to understand and estimate the size of this bubble and to monitor the inevitable decline in credit quality that will accompany this bubble; and 2) manifestations of inflation, to understand and estimate when and how the Federal Reserve will be forced to tighten monetary policy enough to produce a bear market, not just a correction.

Debt Creation Kicks Up a Notch
The debt expansion that drives late-cycle economic growth is finally picking up steam. Policymakers have attempted to regulate away a possible repeat of the excesses of the last credit cycle, so this time will be a little different. History will not repeat, though most expect it will rhyme.



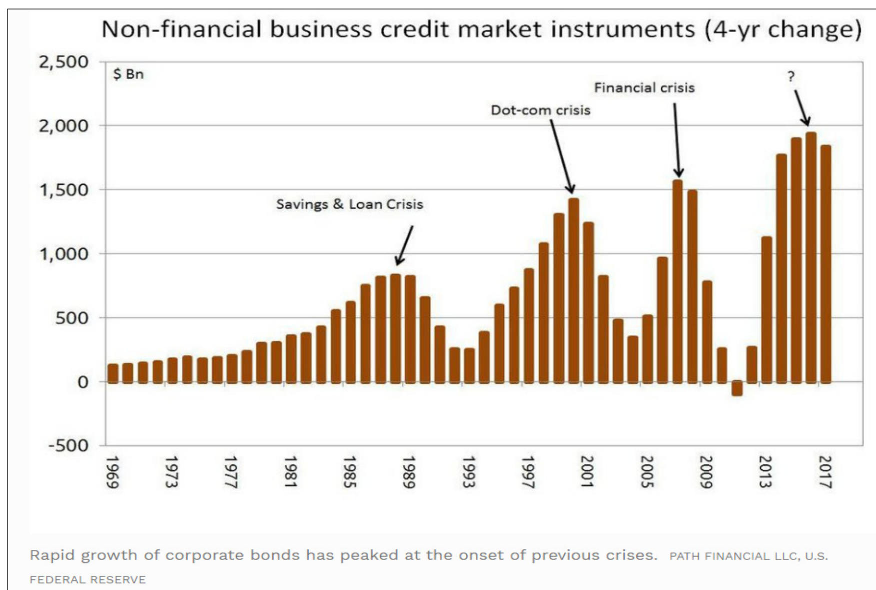
Source: SG Cross Asset Research/Equity Quant, Thomson Reuters Datastream

Recently, François Villeroy de Galhau, the governor of the central bank of France, observed that in 2001, corporate and household debt was 190% of worldwide gross domestic product (GDP). By 2007, it had risen to 210%. Today, this same ratio is closer to 240% of worldwide GDP and while Mr. de Galhau does not see an imminent crisis, he did confirm that rising debt brings increased risk.

Who is Borrowing Now and How?
2007-2008 was noted for a surge in mortgage debt that culminated in a subprime bubble. This cycle is noted by federal government debt created to ease the pain of the last crisis and, more recently, an expansion in corporate debt. Traditional business lending is done by commercial banks. Less traditional business lending, called “Shadow banking” refers to all non-commercial bank financial transactions (lending and financing). Despite its nefarious-sounding name, shadow banking is not illegal and covers everything from corporate debt issuance by non-commercial banks, including investment banks, venture capital & hedge funds, and even loan sharks. For example, Sotheby’s, which has loaned over

$4 billion over the last 25 years to clients to purchase masterpieces, is considered part of the shadow banking sector.

Although it drew great scrutiny from regulators a decade ago, shadow banking continues to flourish. As of 2016 (the most recent period assessed by the Financial Stability Board), total global financial assets amounted to about $340 trillion, non-bank financial assets rose to approximately $99 trillion, and low-quality shadow banking assets grew 7.6% to $45 trillion. The European Systemic Risk Board reported that at the end of 2017, shadow banking accounted for roughly 40% of the European Union's financial system.



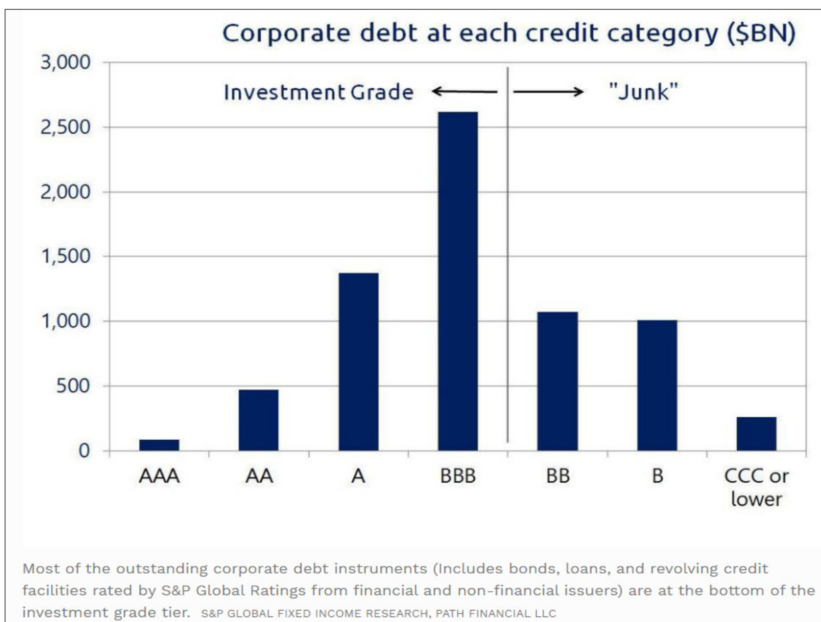
Rapid growth of corporate bonds has peaked at the onset of previous crises. PATH FINANCIAL LLC, U.S. FEDERAL RESERVE

Shadow Banking Meets Leveraged Loans

The more debt is issued to a company, the lower its credit rating goes and the higher interest rate it will have to pay to borrow its next dollar. When debt is issued to a business with a below-investment grade credit rating, it is called a "leveraged loan." A leveraged loan can be transacted with one bank, a syndicate of banks, or even a group of non-bank lenders (venture capitalists, investment banks, etc.). On September 27, 2018, Bloomberg reported: "Investors including mutual funds, insurance companies, hedge funds and banks have snapped up leveraged loans in recent years because the debt produces much better returns than safer assets such as Treasuries."

With interest rates very low by historic standards, and profitability and optimism high, companies are now seeing opportunities to grow. They are unusually eager to take on more debt to fund these pursuits, as debt is the cheapest source of capital available today. The non-bank lenders, flush with optimism from a more business-friendly Washington, are eager to make these loans and are being a bit creative about terms.

The result is a growing number of low credit quality debt instruments issued. There is now an extraordinary concentration of BBB rated debt, the lowest debt rating still considered to be "investment grade." One notch lower at BB and below, the debt is considered to be "junk" and not permitted as part of prudent investment strategies.



Most of the outstanding corporate debt instruments (Includes bonds, loans, and revolving credit facilities rated by S&P Global Ratings from financial and non-financial issuers) are at the bottom of the investment grade tier. S&P GLOBAL FIXED INCOME RESEARCH, PATH FINANCIAL LLC

Our concern is that these non-bank entities inherently have weaker balance sheets backing their loans than regulated banks because they

are not subject to bank regulations like capital ratios, reserve requirements, and asset quality tests. The lack of bank regulatory oversight can often lead these institutions to extend riskier loans. If done in sufficient size, defaults on these loans could be disruptive to the broader financial system. Warnings are being published frequently and bear watching.

In its third quarter review, the Bank for International Settlements—a cooperative financial institution and bank for 60 central banks—warned that “investors’ continuing willingness to accept weaker protection against deterioration in borrowers’ repayment capacity” is leading to growth in leveraged loans and “investors are not necessarily being compensated for this risk.”

While these debt levels rise, further economic growth becomes more difficult to achieve. Added profitability will also be harder to come by. Most of these loans do not have a fixed interest rate, but one that floats. The Federal Reserve discussed its concerns about this problem in a November 2017 publication titled “*The Potential Increase in Corporate Debt Interest Rate Payments from Changes in the Federal Funds Rate*” in which they state that 85% of corporate loans have floating rates. As the business cycle matures and interest rates rise, the floating rate feature of leveraged loans will make these loans more expensive, reducing earnings, damaging debt coverage ratios, and potentially triggering defaults.

Disturbingly, these leveraged loans are often being pooled together with other similar leveraged loans into a device called a collateralized loan obligation (CLO). Now would be a good time to say “déjà vu” as CLOs are a bit like the syndicated mortgages or collateralized mortgage obligations (CMOs) that contributed to the 2008 credit crisis.

In an environment where the federal government is fully leveraged and corporations continue to take on more debt, the consumer remains cautious. As healing proceeds, they too might join the party. The critical question is when inflation will force the Fed to stop the healing and force a serious credit contraction.

So, When Does it End? Watch Inflation and Rising Labor Costs

Even though borrowing has increased, the economy appears quite healthy today. The velocity of money (the rate at which money circulates to purchase goods and services) has begun to improve for the first time since 2010. Businesses and consumers are spending or investing cash rather than hoarding it. Better yet, this is all taking place without the Fed promoting risk taking through quantitative easing or a zero-percent interest rate policy. Manufacturing activity has picked up. GDP growth is solid. Banks seem well capitalized. Consumers are less indebted than before the 2008 credit crisis. Inflation has merely risen to match or slightly exceed the Fed’s targeted level of 2% after years of being very low.

If long-term rates rise a bit and cause a short-term market correction, it should be healthy for the market. Valuations are a bit rich and an increase in the ten-year Treasury interest rate makes them more so. Yet, the Fed is pretty good at what they do and they will not be forced to cut off the credit expansion until inflation begins to violate their mandate. For a better understanding of where the Fed stands on these issues, we must look to their leaders.

The New Captain and Crew

On August 24, 2018, Federal Reserve Chairman Jerome Powell noted that inflation sometimes shows up in financial markets before it surfaces in the overall level of prices. More importantly, he added that history has shown that "doing too little comes with higher costs than doing too much" when trying to control inflation. Less than a month later, Fed board member Lael Brainard elaborated: "The past few times unemployment fell to levels as low as those projected over the next year, signs of overheating showed up in financial-sector imbalances rather than in accelerating inflation.” Brainard also noted that leveraged lending is rising as underwriting standards ease, saying stock market valuations are "elevated which might be expected after a long period of economic expansion and very low interest rates."

A new Fed chairman can usher in new policies. The last chairman to begin his term late in an economic expansion was Ben Bernanke. Despite his nickname ("Helicopter Ben"), Bernanke worked hard to show that he was not a bubble-blower like Alan Greenspan. Some argue that Bernanke's behind-the-scenes tightening and eventual reluctance to lower interest rates exacerbated the 2008 credit crisis. As this economic cycle ages, we will learn important things about the evolution of the Fed's thinking, as well as Chairman Powell's leadership. When Powell answers the call in the moment of the next financial stress, as inevitably he will, investors may discover additional uncertainty about Federal Reserve policy. Today, it seems this uncertainty has yet to be priced into the stock market.

Portfolio Positioned for Turbulence

Valuations on stocks were cheap to reasonable from 2008 to 2017. In the last year, according to our research, valuations have moved above long-term sustainable levels, especially if interest rates rise from here (ten-year treasury rate currently at 3.06%). Future increases in stock market prices, though entirely possible, will be driven by even more debt and speculation and subsequently valuations would have to return to more reasonable levels.

As we close out the year and head into 2019, we will maintain an aggressively defensive posture in our security selection. We will continue to closely analyze credit risks associated with each investment, rotating away from holdings in companies compromising their balance sheets. The party is not over, but it might be time to stock up on the Alka-Seltzer.

Wishing you a festive holiday season.

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