Lions and Tigers and…Bears…

By: Dave Lavigne

For this column, I generally try to address a macro type issue that I think is of some current relevance that may in some manner effect our favorite (financial) topic; stocks, and more specifically microcap stocks. Admittedly, in some ways, that notion (the macro picture) is a bit counterintuitive to our focus. Fundamentally, if you are a stock picker, you are at lease on some level suggesting that the broader environment does not impact *everything* equally. That is, stock pickers often pick stocks in part because they believe that they can find companies with extraordinary characteristics that will make them work *regardless of where the broader markets are headed*. My experience has been that there is some truth to that notion. I have certainly seen stocks perform very well on the heels of strong fundamental inflections in otherwise poor equity environments. On the other hand, you will never hear me say the macro doesn't matter. Again, anyone who has looked at these columns in the past can attest, I pay great attention to the big picture, because I certainly think it matters…sooner or later. That brings me to a few big picture things to consider.

I submit, the markets have experienced considerable volatility over the past several weeks, and certainly some of that has occurred because of macro components, FED policy, impending trade wars, impending military conflict, and a host of others. However, being the macro "chicken little" I have tended to be (especially since the central banks "cured" the Great Recessions with piles of cash), I continue to be surprised by how little some of these seemingly telling macro events have actually impacted the markets. Here are a few of the recent macro narratives that I find chilling, but the markets have managed to shrug off or at least minimize.

Oil Prices. I have been wrong about oil prices. Recall, about a year or so ago, I wrote in this column, that I did not see how OPEC was going to hold its coalition together and enforce/adhere to their reduced production quotas. They have done a much better job of that than I thought. Although, the reasons for that might be different than some envisioned from the start. While Saudi remains the biggest contributor to the reductions, Venezuela has also been a large contributor, but not because they are a team player. As it turns out, in January, Venezuela reflected its lowest production number in 30 years, *which was down 20% from the same period last year*. Venezuela's economy is declining at an alarming pace, and one of the casualties of that decline is the country's oil production infrastructure. Keep in mind, Venezuela holds more crude than any country in the world (it started OPEC back in the day) and oil makes up 95% of its exports. The demise of Venezuela's oil infrastructure is not insignificant.

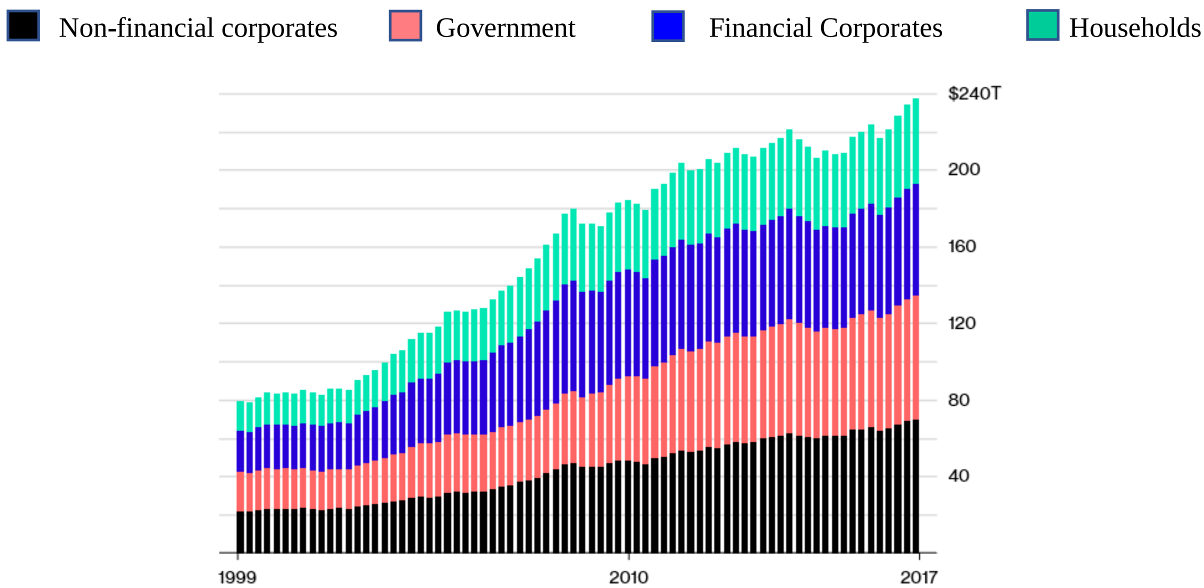
In retrospect, while I have not been right about the path of oil, I was right about a couple of things. First, as I suggested domestic oil producers are filling the gaps in declining international supplies (by design or demise), and from what we can gather they continue to drive their own costs down, making them formidable global competitors. Higher prices in the face of growing domestic production is a panacea for domestic producers. The other thing I was right about was one of my caveats to lower oil prices, which was that unstable oil producers like Venezuela, some of the African producers and others, might experience marked production declines as they fail to invest in maintaining infrastructure. We are certainly seeing some of that albeit much more quickly than I thought. What is particularly strange about recent oil prices and the financial markets is that higher oil prices used to be viewed as a net negative for global growth and by extension equity prices, because of oil's considerable position as an input of production. Airline profits are a good example. Apparently, the markets take a different view of rising oil prices than they used to.

Trade Wars. I also touched on this issue in a prior letter where I paralleled the POTUS with a prior occupant of the White House Herbert Hoover. Recall, one of those parallels was protectionist trade policy. In Hoover's day, that manifested itself in the Smoot-Hawley tariffs, which some blame on exacerbating the Great Depression. I certainly don't pretend to understand all of the nuances to "free trade" around the globe, and I certainly wouldn't disagree that something needs to be done about China's lack of respect for things like the protection of IP, and, it shouldn't surprise anyone that China manipulates trade policy in their favor. BUT, outside of Trump using tariffs and such to compel negotiations to a better environment with respect to these other Chinese digressions, it's hard to embrace barriers to free trade and in fact, a trade war is likely to be very bad for the world economy. I actually think that could be one thing that most economists *might* actually agree on. Granted, the trade thing has negatively impacted the markets, but much of that negative impact was quickly mitigated by sanguine responses from Chinese President Xi Jinping. I suppose the question is, are we all starting to become submissive of Trump's threats (tweets) or did China actually blink? The answer to **that** question may decide the direction of many issues roiling around the globe, for instance the potential for escalating conflict in Syria. I have to say, there was a day when the idea of Russia and the U.S. engaging in some sort of military conflict would have created far more consternation for the markets, which brings us back to the original notion that it seems like many are beginning to view Trump's rhetoric as…well… just rhetoric. On the other hand, the one thing the POTUS has managed to accomplish was tax reform, which has seemingly created another issue that I am frankly shocked that the market appears to have simply ignored altogether…the federal deficit.

Federal Deficits. The Congressional Budget Office just recently projected that the *"annual US budget deficits will cross the trillion-dollar mark in 2020, two years sooner than what the agency was projecting just 10 months ago"* Further, as CNN Money recently noted, *"A trillion-dollar deficit is especially striking given that there is no recession or financial crisis driving the country to spend so much more than what it takes in"*. The CBO also projected that the deficit could reach over $2 trillion by 2028 and they noted *"As deficits accumulate, the nation's debt will rise from 78 percent of GDP, or $16 trillion, at the end of 2018 to 96 percent of GDP, or $29 trillion, by 2028…That percentage would be the largest since 1946 and well more than twice the average over the past five decades. Such high and rising debt would have serious negative consequences for the budget and for the nation".* That just seems staggering and (perhaps sooner rather than later), untenable to me. Why do I feel like I (and maybe Paul Ryan) am only person that seems to think that this budget thing feels like standing on the tracks when the train is coming? I suppose the answer is that the market today doesn't need to be concerned about what happens two years from now. On the other hand, the market does seem to be moved by Fed policy, which this deficit thing may complicate, but even the impact of Fed policy seems to be short lived. Clearly, I just don't get this new math…

The Federal Reserve. The minutes from the Fed's March meeting clearly point to more rate hikes, higher inflation expectations and growing concerns about U.S. policies (see above). Those minutes also reflected concerns by some members that central banks might need to raise rates at a faster rate than they are currently anticipating (read: uncertainty). Here again, there was a time when that sort of mantra would have driven equity markets considerably lower. Granted, they did not react to that information well following the meeting, as the equity market spent the next couple of weeks stepping lower. However, they have managed to get back a considerable portion of that decline even though the situation hasn't changed. Make no mistake increasing interest rates carries some potentially draconian consequences including declining liquidity (pressure on financial asset prices), higher debt service (tampering economic growth) and a host of other negative attributes. I also talked about stagflation in one of these prior articles, which is of one of the worst-case scenario economic environments, but one that I don't think can be dismissed. I recognize that tax cuts and other such stimuli have bolstered the prospects for better economic growth through the balance of 2018, which should extend to better earnings results in this current and perhaps remaining quarters of 2018, but it sure feels like the market is willing to apply greater premiums to good news than it is discounts to bad. I am not suggesting the Fed *can't* necessarily finesse its ways through unwinding its bloated balance sheet, keeping inflation in check **and** maintaining economic growth, but I am suggesting it is a tall order, taller perhaps than the markets are assuming. Moreover, we are in unprecedented territory in terms of the levels of debt that central banks and the world in general have taken on.

International Debt. This may be the scariest one I have heard lately but it too seemed to hit the financial pages and pass without much attention, which makes me conclude that either it's not as scary as I think, or the market just doesn't let things like this bother it. The Institute of International Finance ("IIF") recently reported that *"global debt rose to a record $237 trillion in the fourth quarter of 2017, more than $70 trillion higher from a decade earlier"*. They further note, *"Among mature markets, household debt as a percentage of GDP hit all-time highs in Belgium, Canada, France, Luxembourg, Norway, Sweden and Switzerland"*. The good news may be that apparently since 3Q16, the ratio of global debt to GDP has fallen due to improved economic growth (higher GDP). The graph below from the IIF provides a good illustration:



https://www.bloomberg.com/news/articles/2018-04-10/global-debt-jumped-to-record-237-trillion-last-year

Given this backdrop, I can understand why many believe the central banks simply *cannot* systematically raise rates, even though that seems to be the policy they are pursuing these days. From that perspective, its easy to see why many are watching inflation so closely. Mounting inflation pressures may force central banks into tighter policy, but even absent that variable, it is hard to imagine where the capital required to drive better economic growth will come from when debt is already at unprecedented levels. Moreover, as I have suggested many times, maybe one of the reasons the flood of liquidity from central banks has not lead to classic inflation is because most of the liquidity has gone into financial assets that, contrary to historic correlations, have (as a result) marched higher *in lockstep* over the past few years. That being the case, it seems intuitive to me that if loose monetary policy has led to extraordinary gains in financial assets, tighter policy should lead the opposite. I think new highs in the broad equity indices are going to be much more difficult to come by, and that may apply well into the future. If that is the case, stock picking may become fashionable again.