May 30th, 2017 | Scott Carmack (Portfolio Manager)

IS THE CONSUMER BLINKING?

LABOR DATA IS STILL STRONG

Last year we viewed the markets in the context of excessive pessimism due to geo-political risk against the backdrop of a strengthening U.S. consumer. The commodity crash, Brexit, as well as the upcoming election had resulted in palpable risk asset volatility and valuations that we viewed as attractive. Much has changed over the last twelve months, most notably valuations and investor sentiment. Top-line macroeconomic data has not changed over the last year--at least on the surface. The unemployment rate is still probing post-Recession lows, job openings are at their highs, and payroll data continues to be robust. When viewed in the context of consumer leverage and interest coverage, the consumer looks to be well-positioned.

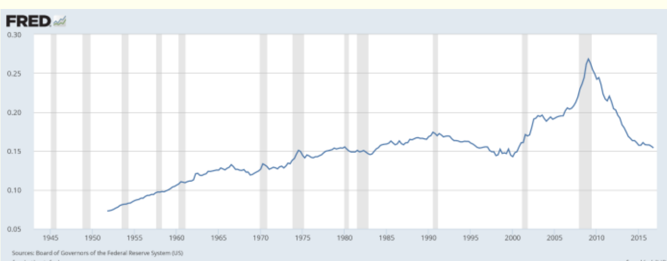

Figure 1 - Consumer Debt to Net Worth is at 20 year lows

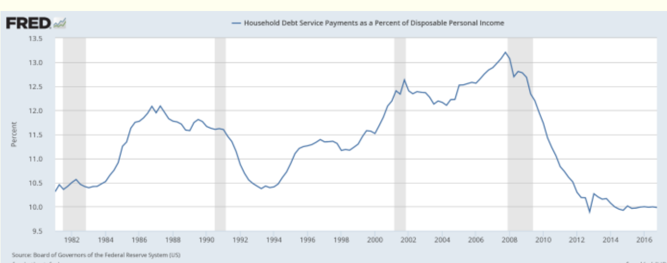

Figure 2 - Consumer Debt Service ratios are at all-time lows

Anecdotally, I cannot walk into a store on the streets of Portland without seeing a "Help Wanted" sign. The signs point to a tightening labor market, but cracks are starting to emerge, and given the substantial shift in sentiment, they warrant extreme caution.

THE CRACKS

Much of the data that economists use to create their economic forecasts is aggregated. Gross Domestic Income, for example, includes not only salaries, wages, and benefits, but it also includes proprietors' income, rental income and corporate profits. In fact, these categories account for almost 25% of GDI. Much of the salary data is driven by the top 5% of wage earners. Because the aggregated data (including the debt-to-net worth and debt service ratio) is primarily powered by those at the top of the income spectrum, it makes sense that this data could remain strong, even as cracks in the health of the consumer emerge—especially given the income inequality that has emerged over the last twenty years. As a result, the importance of monitoring the lower rungs of the income spectrum become increasingly important when monitoring economic inflection points, and this data is weakening.

One data series that has turned, is the real hourly earnings of production and non-supervisory employees. In fact, it has recently turned negative, indicating substantial stress on the lower cohort of income earners.

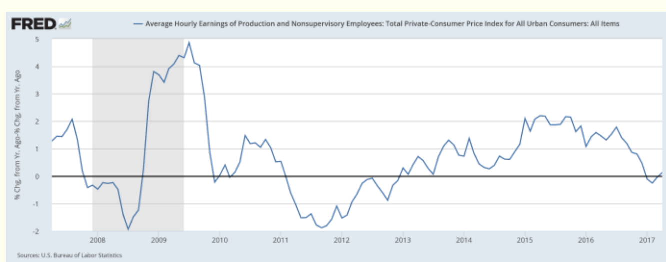

Figure 3 - Real Wages have turned negative

While aggregate income data continues to point to growth, there is something pernicious happening. Confirmation of this trend can be found in the increasing savings rate in the

U.S. Lower income cohorts tend to have a high marginal propensity to consume. That is, their paychecks get spent, and are often leveraged as they have more access to credit. Meanwhile, marginal savings rates are loftier for high wage earners. The aggregated personal savings rate has increased from 4.5% at the end of 2016 to 5.3% in April. This is still within the post-Recession range, however, the recent uptick merits attention.

More concerning is the recent upturn in delinquencies. The consumer is no different than any other industry. In 2015, the weakest E&P companies were the first to exhibit weakness. In 2016, it was the retailers. Subprime auto loans have garnered the most attention of late. However, delinquency rates have likely bottomed across the board. And while they are at still low levels, increased borrowing costs may already be taking their toll. It is a common theme in first quarter earnings reports. In April, Capital One Financial announced a write-off rate of 5.02%, the highest in six years. And that theme has been echoed by several large firms.

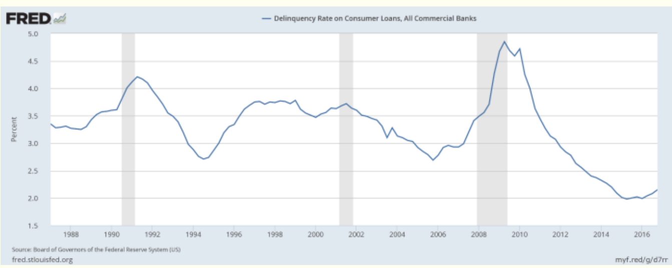

Figure 4 - Delinquency Rates Have Bottomed

Delinquency rates typically bottom one-to-two years prior to a recession. If the second quarter of 2015 does indeed mark a bottom, the economic expansion may be on borrowed time—it's worth considering.

CONCLUSION

Much of our bullish thesis for risk-assets has been predicated on negative sentiment and improving consumer trends. Our year-end newsletter indicated that negative sentiment had likely run its course, and that multiple expansion from these levels was becoming less and less likely. With consumer data starting to show early signs of stress, we think caution is the most prudent modus operandi for investors. The market has shown incredible resilience in the face of geo-political risk, but we doubt in could do so in the face of a weakening U.S. consumer.