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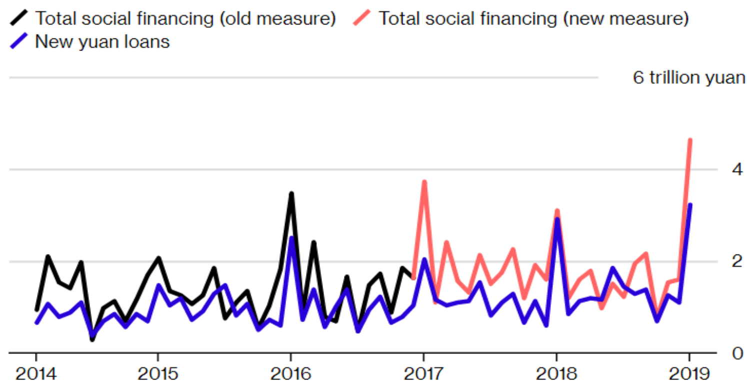
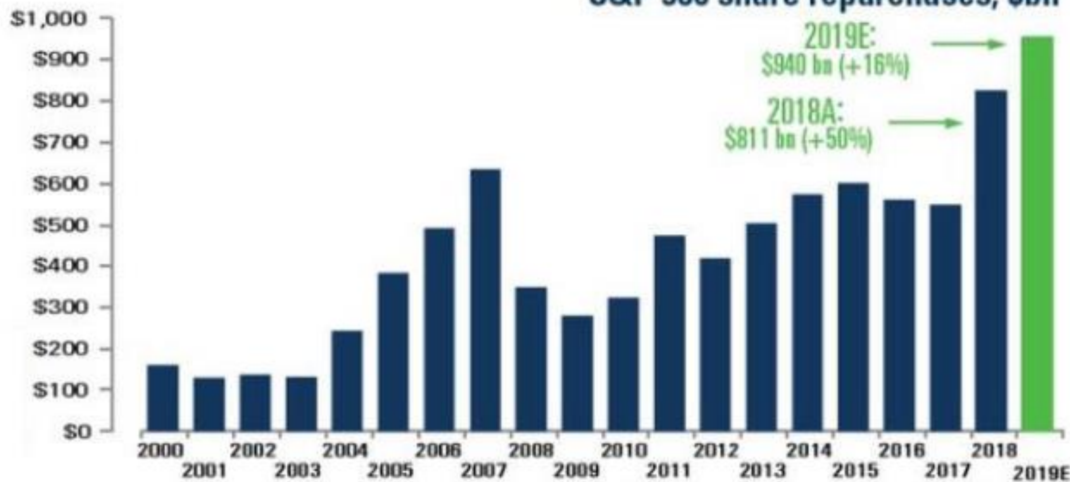
Market Review

Following a tumultuous end to 2018, stocks, bonds and virtually every other asset class rebounded this year, recovering most of the losses in the process. Positive remarks from Federal Reserve Chairman Powell regarding rate hike expectations eased markets concerns about a contracting monetary policy and spurred a broad rally across world markets. Concurrently, a record $900 billion was injected into the Chinese economy by the PBOC (People's Bank of China) to stimulate real estate and manufacturing activity while offsetting trade constrictions brought on by U.S. tariffs.



Seen in the chart to the left is a recent history of China's monthly credit injection into its economy. Specifically of note is the record amount of stimulus that was deployed immediately following the rout in world equities in the second half of 2018. China's economy has grown extremely dependent on continual credit injections to maintain growth.

In addition, there was yet another form of stimulus that was also working behind the scenes throughout 2018, this was in the form of a record $811 billion in stock buybacks. Seen below is a history of yearly corporate expenditures spent on buying back shares of firms in the S&P 500 index. Inconceivably, it is now projected that almost $1 trillion will be spent in 2019 buying back and retiring company shares from the open market.



Between the U.S. Federal Reserve guidance, U.S. corporate buybacks, and continued monetary support from the world's central banks, including China's, the near-term outlook for global risk assets remains positive.

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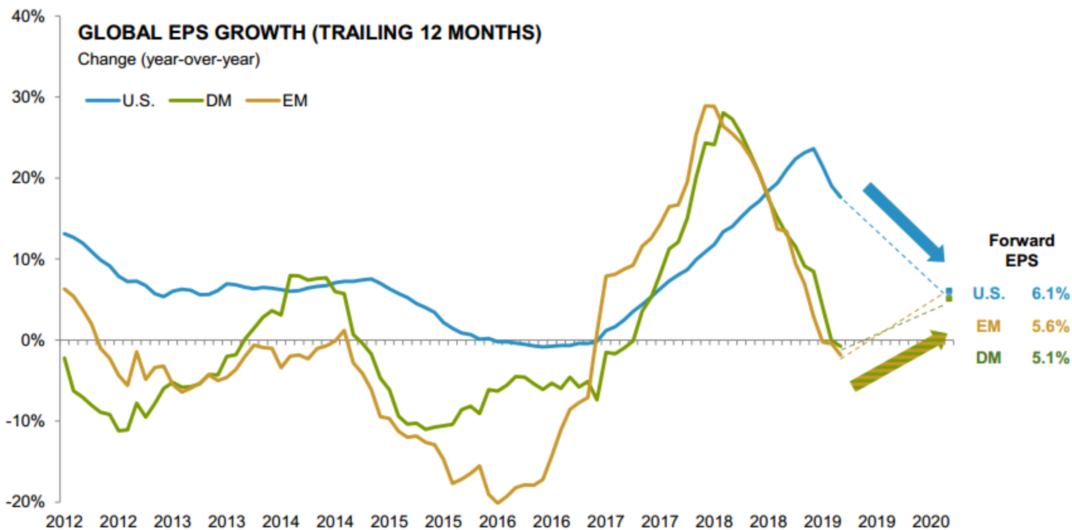
Broad Look

The general consensus amongst investment professionals is that on balance, the world economy is still doing well and continued economic growth is a fair expectation over the next 12 months and beyond. Forecasters from major financial institutions point to expected continued growth in corporate earnings as well as emerging market economies, such as China.

Expectations for Global Earnings-Growth Convergence

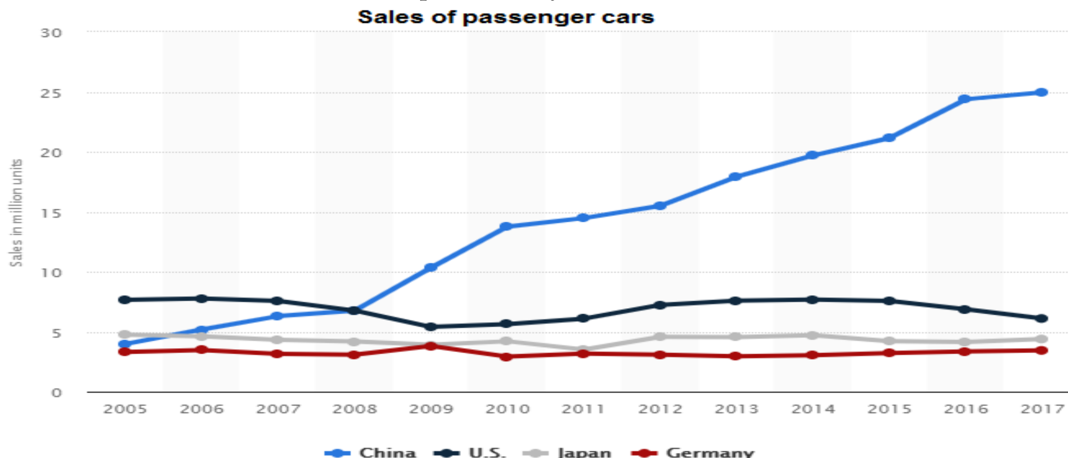
Forward estimates point to market expectations for a convergence of global profit growth in the mid-single-digit range over the next 12 months.



Past performance is no guarantee of future results. DM: Developed Markets. EM: Emerging Markets. EPS: Earnings per share. Forward EPS: Next 12 months expectations. Source: MSCI, FactSet, Fidelity Investments (AART), as of 3/31/19.

1 For investment professional use only.

One of the key themes often discussed is the emerging and rapidly expanding middle class, especially in China. And it's true that the level of gargantuan expansion of China's infrastructure and middle class is completely unprecedented. For example, China poured more concrete between 2011 – 2013 than the U.S. poured in all of the 20th century. This includes the massive amount of concrete needed to construct the Hoover Dam, the highway system, the Empire State building and all of America's skyscrapers over the last 100 years. In essence, China built a United States in 3 years. This would have made for a good investment in sand, a key ingredient in concrete, which saw its prices more than double over the last 20 years. In addition to infrastructure activity, China also leads the world in vehicles sold. For example, China sold more cars in 2017 than the U.S. did in the previous 4 years.



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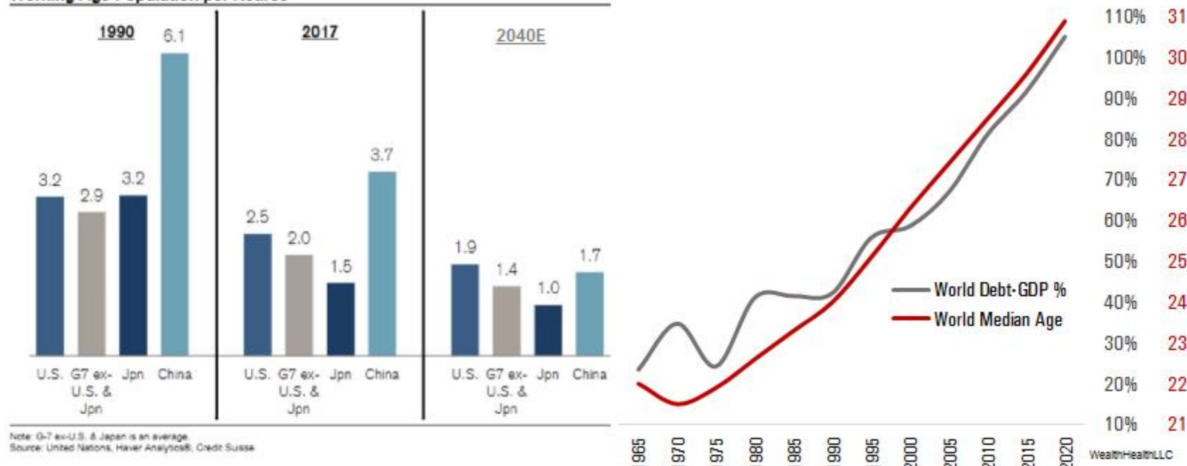
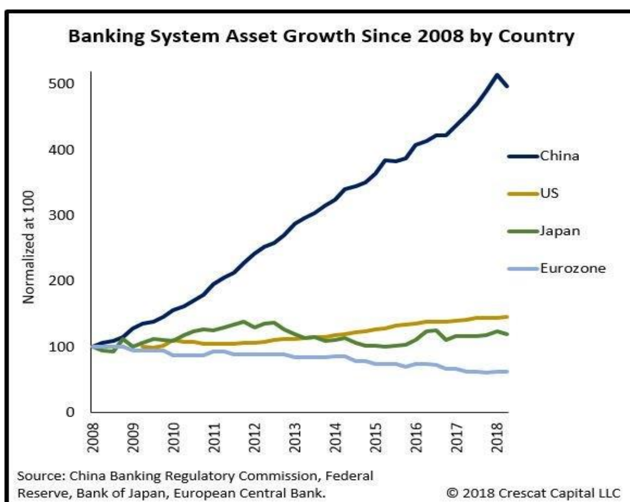
Middle-class growth in China is also truly without precedent. From 1980 – 2020, China will manage to increase its middle class from 200 million to approximately 800 million people. Urbanizing 600 million people in the process, almost twice the entire population of the U.S. in 40 years. This explosive growth in China is a boon for both emerging markets and broader advanced economies. These powerful demographic and economic trends are impossible to ignore, hence the upbeat and positive forecasts from mainstream prognosticators.

However, the exceedingly upbeat consensus outlook may perhaps be glossing over important counter-trends that have been developing of late. Possibly as a result of China's one child policy from the 1970's, China's population is now rapidly aging, following in Japan's footsteps of a rising dependency ratio. In 1990, Japan had six working age adults for every one senior (age over 65). Next year it will be two working age adults for every one senior, by 2040 it will be 1:1. China is following the same trend, as is the rest of the world. An aging demographic increases a nations costs, not just healthcare cost, but opportunity cost as well. Older citizens spend much less on homes, cars, furniture, restaurants, etc. Simply put, a rapidly aging demographic makes it difficult for an economy to continue to expand. This economic reality puts into question China's never-ending, parabolic, growth trend estimates.



Coincidentally, as the world's population ages, there is a commensurate and reflexive increase in debt. China is following the same trend but at an accelerated rate as the median age in China ages six months every one year. As such, in order to overcome the costs associated with an aging demographic while striving for rapid economic growth, China unleashed the largest credit creation spree in history. Seen in the graph to the left is a comparison of the growth of financial complexes across the world. Over the last 10 years, China's banking system growth was unparalleled. Used as a proxy for credit creation and leverage, an overheated financial system can lead to severe and devastating contractions. This is a very important counter-trend going forward, as an increasing amount of credit creation will need to be introduced *just to maintain status-quo.*



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Looking Ahead

While continued economic expansion here in the U.S. and abroad is always welcome news, there is a growing body of evidence that questions the sustainability of this trend. Corporate balance sheets are overleveraged relative to history. This makes it difficult for U.S. firms to continue buying back their own shares as most of that activity is funded through debt issuance. Moreover, as rates continue to rise and corporate indebtedness becomes oversaturated, debt service payments will start to eat into earnings. To maintain profit margins firms will have to either reduce share buybacks or find other ways to cut costs, possibly through headcount reductions. Currently at $10 trillion, U.S. corporate debt is twice that of 2007. At the moment, this debt load seems manageable. However, over the next 3 years almost half of that debt will need to be refinanced as it is nearing maturity. This will place undue strain on corporations as they will be tapping credit markets right when rates are climbing higher, central banks are less accommodative and corporate balance sheets are near their worst relative to history. Presently, corporate debt-to-earnings is at an all-time high and interest coverage ratios are near all-time low's, making it more difficult to obtain funding. While the argument could be made that new debt will be used solely to pay off existing maturing debt (thereby having minimal effect), the cost of issuance will still be higher based on deteriorated financial metrics. Investors will invariably ask for higher yields. In addition, a lot of the maturing debt was taken on when prevailing interest rates were lower. China faces a very similar problem with a similar debt maturity wall and peak maturities in 2020.

The growing indebtedness of the corporate market gave rise to the term "zombie firm", that is, "a firm that is unable to cover debt servicing costs from current profits over an extended period" -BIS (Bank of International Settlements). As it stands right now 12% of public firms across advanced economies are considered zombie firms, up from 2% in 1980. These firms will be part of the cohort tapping credit markets over the next 3 years in an attempt to roll over maturing debt.

In Summary

Analyzing prevailing challenges and weighing the risks and rewards we believe that while the near-term outlook remains positive, we continue to make careful adjustments to reflect economic realities. Interestingly, it seems that other participants are starting to share this view as evidenced by their survey's and search interests.