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Sifting through the noise…

Plainly speaking, there was nothing fun about the price action in the equity markets last week which saw the Dow Jones Industrial Average lose over 1,400 points, the S&P 500 declined nearly 6%, the Tech heavy Nasdaq plunged by 6.5%, and every one of the 11 major S&P sectors finished in the red. Overseas markets were much the same and didn't provide any semblance of respite: the MSCI EAFE index declined 3.6%, Emerging Markets were off a little more than 4.5%, German DAX down more than 4%, China's main indices down close to 7%, Hong Kong down 4.5%, India slid nearly 3%... I think you get the point. Even the safe haven defensive areas of the stock market like Utilities (-2.6%), Healthcare (-6.7%), and Consumer Staples (-4.5%) didn't provide much relief from the carnage.

What was again a bit troubling was seeing the lack of a meaningful offset from Treasury Bonds getting a bid with the yield on the 10-year Treasury managing to decline a measly 3 basis points on the week. It really is something when you consider the two bouts of corrective stock market action since the end of January and the best the 10-year T-note yield could do was fall 14 basis points from the interim high. It wasn't too long ago that prior episodes of stock market angst and volatility like we have seen of late would have sent the yield on the 10-year T-note down anywhere from 50 – 100 basis points.

Interestingly, the Energy sector was the best performing equity sector last week, down a little less than 1%, but this near-term support likely has more to do with the appointment of John Bolton as National Security Advisor than it does about underlying fundamentals. The 'Bolton Premium' as some are dubbing it sent oil prices higher with WTI pushing above $65 per barrel (Brent is north of $70/bbl) and is a strong indication that the Iran nuclear deal is in trouble. There are some other constructive variables supporting oil prices: Saudi Arabia hinting output cuts could be extended through 2019, overall inventory levels continuing to decline (U.S. inventories recently slipped below their five year average for the first time since 2014), and the demand for crude continues to be firm – all of this in tandem with U.S. crude production hitting a record high of 10.4 mbd last week.

Another area that stood out last week as a port in the storm was Gold which rallied nearly 2.5% as it climbed to its highest level ($1,351/oz) in over a month. Some may suggest that gold has been boring so far this year as it ebbs and flows within a trading range of $1,300 and $1,360, but others may just appreciate its stability at a time when so much else seems to be in a state of heightened uncertainty. There is a lot to like about gold for those who care to take a long-term view, but it needs to break out and hold above this $1,360 - $1,370 level that has acted as a ceiling for almost two years now before investors start getting too excited about a lot more potential upside. Within the precious metals space, Silver may just be a bit more interesting at the moment especially with net speculative positioning in the most recent

Commitment of Traders (COT) report reaching its lowest level on record.

The gold/silver ratio recently ticked back over 80 (prices for gold are more than 80 times those of silver) which in the past represented an extremely compelling opportunity for the future potential price move in silver relative to gold.

Another interpretation of this rare divergence in price between these two precious metals is that it is foreshadowing a weak global economic profile. The industrial use for silver accounts for about 55% of the demand for silver (according to the Silver Institute) and hence investors tend to favor gold and discard silver when they fear slower global growth will crimp future demand for the metal that has characteristics of both a precious and industrial metal. There just may be something to this latter point as the rest of the base metals complex is signaling anything but global economic growth accelerating: Copper is down 9% on the year and at three month lows as it sits below $3 per pound, Iron Ore has plunged 10% in just the last month alone, the Baltic Dry global shipping index is off 35% from its December peak (-18% so far this year), and the cyclically sensitive Aussie dollar is down 5% from its recent highs.

Whether these are just indications of an expected weaker growth profile from China or a more ominous indication that the highly touted 'synchronized global growth' narrative is rolling over bares close evaluation going forward. The most important question is whether this is yet another iteration of this 'stop and start' rolling recovery that has epitomized this expansion since the Global Financial Crisis. Or, have we just experienced the last thrust of upside momentum that the global economy can muster in unison? Sure, we can all look at the various regions of the world and conclude that they are in different phases of their economic expansions: the U.S. is late cycle, Europe is in the middle of their cycle, China and the Asia-Pacific region are in various stages of early cycle recoveries – but for an eighteen month stretch dating back to September 2016, the major economic regions around the world were all expanding in unison.

Now we’re at a point where industrial production prints are softening in some of the emerging Asia countries, the Citigroup Economic Surprise Index for Europe is at a two-year low, China has transitioned their focus from growth to reigning in debt and excess capacity, and the U.S. growth profile will be constrained by the sheer economic reality that unemployment is already at multi-decade lows, capacity utilization near cycle highs, and the tightening in monetary policy (which notoriously works with a lag) is about to bite.

As for the capital markets, I remain of the view that we are witnessing a paradigm shift before our very eyes. The dramatic rise in volatility this year relative to the past several years is a classic example of the heralding in of this new investment environment, where what has worked previously during this bull market cycle (which has been punctuated by free money, ample liquidity, stable geopolitics, tame inflation, and levitating asset prices) are now all in the rear-view mirror. This doesn't mean the floor falls out from underneath all of these forces, catapulting the economy into a recession and/or pushing asset prices off a cliff. No, not even remotely, but there is a transition afoot and these transitions take time to play out – slowly at first and then they gain momentum.

As all the news continues to focus on tariffs, trade wars, and the President's infidelity (aren't there more important things to cover than an alleged affair that happened over a decade ago? Not condoning the behavior, but is President Trump's character really a gray area anymore?), but this drowns out what are the biggest variables impacting asset prices: Central Banks, liquidity, and interest rates. In order to have a comprehensive understanding around how the shift in monetary policy from Quantitative Easing to Quantitative Tightening is having a profound impact on asset prices, it helps to go back to the origins of why QE was being implemented in the first place.

I've highlighted in previous musings that Bernanke was quite open and frank with the public that one of the main objectives of QE was to target higher asset prices with the expectation that it would repair corporate and household balance sheets and set off a reflexive feedback loop that helped to stimulate economic activity. In hindsight QE proved to be extremely effective at increasing asset prices (just look at the stock and housing markets), but where it was less effective was the impact on the economy with this being the weakest post-WWII economic expansion on record.

What recently caught my eye were comments Chairman Bernanke made back in 2011 during his testimony to the Senate Banking Committee when he was laying out his rationale for how the Fed decided on $600 billion as being the appropriate size for QE2 and the effect he expected it to have on interest rates:

> *"We have tried through a number of methods to establish a correspondence between these purchases and what our normal interest rate policies would be…And a rule of thumb is that $150 billion to $200 billion in purchases seems to be roughly equivalent to a 25-basis point*

cut in the Federal Funds rate in terms of the stimulative power for the economy…

So, $600 billion is a roughly 75 basis point cut in the policy rate in terms of its broad impact…Seventy-five basis points in normal times would be considered a very strong statement, a very powerful move, but not one outside the range of historical experience."

Fast forward to today and we have a Fed led by Jerome Powell who everyone assumes is a clone of his dovish predecessors Bernanke and Yellen, but thus far he has shown himself to be anything but. In the prepared statement from last weeks Fed meeting and in the press conference that followed, Chairmen Powell laid out fairly clearly the prevailing thought of this FOMC: the economic outlook is strengthening, they expect inflation to hit their

2% target, and they lowered their forecast for unemployment to a five-decade low of 3.6%.

Now you can agree or disagree with this view, but that's a completely different debate. Take it for what it is and recall that the Federal Reserve has a duel objective (price stability – which they consider 2% inflation, and full employment – which they estimate is an unemployment rate in the low 4% arena), so based on this report card they have achieved their objectives. This means they are running out of excuses to back off of their interest rate hiking path. The tables are set for them to hike 2-3 more times this year and they are already six months into their balance sheet reduction strategy. It's this reduction of the balance sheet which I think is set to get very interesting as we flip the calendar from March to April. As they have stated previously, the reduction of the balance sheet is on a preset course and they don't want to use the balance sheet going forward as tool for setting interest rates.

Starting in Q4 of last year, the Fed was reducing its balance sheet by $10 billion per month and this monthly reduction would increase by $10 billion per month at the start of each quarter until it reached $50 billion per month starting in Q4 2018. So for this year we are talking about the Fed's balance sheet declining by approximately $400 billion dollars and then by Q4 when it reaches $50 billion per month, that will equate to $600 billion at an annual rate. Let's go back to what Bernanke was saying during his testimony in 2011, in that $600 billion was equivalent to a 75-basis point cut in interest rates – why should we think that a $600 billion reduction in the size of the balances sheet is any different? It's not.

So not only do capital markets have to digest 2 – 3 more hikes by the Fed this year, they also have this level of tightening yet to come just from the ongoing reduction in the size of the Fed's balance sheet. Me thinks this has a lot to do with why bond prices and stock prices have become positively correlated over the last several months. What I mean by that is that they are both moving up and down together. Coming into this week the S&P 500 was down 3.2% on the year and the intermediate part of the Treasury bond curve (7 to 10-year maturities) was down 2.7%. This is the worst possible outcome for investors who have become complacent to the passive investing view of buying low cost indexed funds to build a balanced portfolio and holding it forever. Without question this has been an extremely successful strategy this cycle and in hindsight for the last 3 ½ decades, but you have to be naïve to think that the current setup offers anything in the vicinity of the same return profile going forward.

What was it that Warren Buffett said, the one thing "we learn from history is that people don't learn from history"? So let's try and learn from history in that even with the juiced up earnings profile on the back of the corporate tax cut, equity valuation levels are still handily above where they traded at the peak of the 2007 market cycle. The CAPE multiple in the U.S. is still at 32.8x (almost double the historical average of 16.8x) and many bulls will argue that low interest rates warrant a higher multiple, but they tend to conveniently leave out the part that interest rates are coming off of 5,000-year lows reached in July 2016 and are now rising.

So here we are at this interesting juncture with the Fed reducing the amount of Treasury and Mortgaged Back Securities they are buying at the same time that we are about to push through a massive $1.3 trillion spending bill that is not paid for and hence, will increase Treasury issuance even further. I'm not sure what to say other than to point out that there is nothing about this bill that suggests fiscal conservatism was even considered. What this administration has done (both the Executive and Legislative branches) is max out everyone's credit card by taking on massive amounts of public debt via tax cuts and government spending and told us that it was income. Even my soon to be four-year-old daughter could understand after about five minutes of explanation that this is not income – it is debt! It's no different than a CEO issuing corporate debt to pay shareholders a dividend – when done repeatedly, these are companies you would want to short.

It will be fascinating to watch how this week's Treasury auctions go seeing as the U.S. is set to sell a record $294 billion of bills and notes. Of particular interest will be to observe the foreign participation in these auctions given the stepped-up rhetoric on the trade front. Should global investors shy away from the onslaught of massive Treasury issuance we have coming down the pike, then Uncle Sam will have to rely on domestic savings being deployed, but that leaves the question of what interest rate level is necessary to entice these savings into Treasury securities? Perhaps this would be the roundabout way of the many within this administration that claimed the tax cuts would pay for themselves – yeah, via interest payments to domestic Treasury investors.

While we're talking about Treasuries, the short end of the T-bill market gets more enticing by the day. It's hard to say that the 'There Is No Alternative (TINA)' investment thesis is still relevant at the present time with every part of the Treasury curve paying a yield that tops the S&P 500 dividend yield. A 1-year T-bill yields 2.03% at present and the 2-year yields 2.27% – these have become a pretty compelling alternative for yield-hungry investors that are subject to some risk (mainly inflation) but do not have capital risk.

What else might investors want to consider in this period of transition, elevated uncertainty, and heightened volatility?

- Raise some cash – mainly on up days as markets going through a regime change tend to have outsized days both to the upside and downside. Pick your spots with any reallocation you're doing – for example there is a reasonable chance the stock market could experience a handsome rally from Friday's close which was right at the 200-day moving average. Given I'm writing this as the stock market is ramping higher suggests that traders will use that level as a stop going forward and a rally on the S&P 500 could take us back up to the 2,750 level before meaningful resistance comes into play.

- Increase quality – this goes for all parts of your portfolio (both stocks and bonds) including pruning your holdings down to best of breed, well capitalized companies with strong balance sheets.
- Precious metals – I'm no gold bug but do have some gold exposure if for no other reason than as an alternative currency

holding to the U.S. dollar. Its price will fluctuate in particular over the near-term as real-yields continue to rise, but should inflation remain stable to moderately higher it's only a matter of time before interest rates reach a point where they put too much pressure on an over-indebted system and can't go any higher. At this point real-yields will peak and gold should have very little encumbrances to the upside. Silver is also interesting as an inflation hedge, but I view it as a subordinate (sometimes a compliment) to a gold position. One other commodity market that I remain a long-term believer in is uranium, although it's experienced some downward pressure in this period of volatility, but the long-term investment case remains firmly intact.

Lastly, have a plan that accentuates patience, prudence, and discipline. There are going to be many twists and turns ahead which will be sure to chop you up at times, but you want to make sure you're positioned to a level of comfort that won't cause you to impulsively react to wild daily and weekly gyrations.

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