June 25th, 2018

Opportunities in the defensive sectors of the market…

Call it a state of no man's land, and that description applies to both the U.S. economy and financial markets. The stock market bulls label it as a period of consolidation before the broad averages make their next push higher, the optimistic economist community highlight how strong the U.S. economy is growing relative to the rest of the world in Q2, while on the other hand the stock market bears see a Dow Jones Industrial Average that is nearly 2,500 points off its January 26th high, an S&P 500 trading at the same level that is was on

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January 3rd, and a growing number of Emerging Market Indices falling into bear market declines (greater than 20% off their highs). Furthermore, the skeptical economists see a bevy of global economic data points rolling over in a meaningful way (Global PMI's and World trade at 10- and 6-month lows, respectively) while evidence mounts that Q2 GDP growth in the U.S. could represent peak activity.

As for my two cents, as many of you loyal readers know I've been skeptical on the sustainability of this expansion for going on a year and a half now, but that didn't mean there wasn't a window from mid-last year into the beginning of the second quarter of this year that favored leaning in a more bullish direction. Well that constructive lean is no longer, and on the margin based on the data flow, investor sentiment and positioning,

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government policy, geopolitics, and most importantly – central bank policy, I think there is plenty of evidence to suggest investors should be reigning in their risk exposure.

Let's peel back this onion one layer at a time to give you some perspective from my vantage point. Keep in mind that as I'm penning this, most of the major U.S. indices are flirting with some key technical levels that should we trade through them to the downside, then there is a strong possibility we revisit the early February lows (2,532 on the S&P 500). The levels to watch on the S&P 500 are right around 2,700 and then after that would be 2,665. It also should be stated that the major averages still remain mired in a muddling trading range that has persisted since the January highs. So, there is nothing to get too excited about in one direction or the other at this point even if we

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were to test the lows – it's not until we break them that potential trap doors would open.

Starting with the capital markets and stocks in particular, it has been and remains my view that ever since the S&P 500 made a new all-time high on January 26th that the overall stock market has entered into a classic topping pattern. It's been more than 100 days since the S&P 500 hit its January high with each rally (and there have been several) failing to be able to threaten that 2,872 level. What has been playing out is a series of lower highs with each subsequent rally and this is a pattern that is very consistent with how things played out at the end of the 1989, 2000, and 2007 bull market cycles. One of the most concerning elements of this lack of upward momentum for the S&P 500 is the fact that it is coinciding with blowout operating earnings. Here we are coming off +25% year-over-year earnings

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growth in Q1 and analyst estimates for Q2 have ratcheted up to +20% YoY (the top two quarterly performances in the last seven years), yet the best the stock market could do was violently trade sideways.   Not exactly the price action the bullishly inclined would like to see.

Investors are getting a front row seat to witness the degree to which the multiple one is willing to pay on a profit stream is much more important than the profit stream itself. Don't misinterpret this math, as they are both key variables, but here we are in a year where S&P 500 profits are set to increase on a full year basis by nearly 20% (a growth rate typically realized coming out of a recession) and yet the index performance is roughly flat because the P/E multiple has declined by a full two points. Moreover, those investors naval gazing at the averages have likely overlooked

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the fact that nearly half of the companies in the S&P 500 are in correction mode (down more than 10% from their recent highs), the financial sector is off nearly 12% from its January high (Goldman Sachs -13% ytd, Citigroup -11%, and while JP Morgan is only down 2% ytd, it's down nearly 13% from its February high), the industrial sector is off more than 11%, and homebuilders are down more than 20% – these are all highly cyclically sensitive parts of the economy that are acting anything but bullish. And to think these were sectors that all the cheerleaders on bubblevision were raving about earlier this year.

On the flip side of those sectors that are in the midst of breaking down, we are seeing a rotation into those defensive sectors that no one wanted to own as recently as a couple months ago. Consumer Staples are up more

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than 6% from their lows in early May, the Utilities sector is up almost 9% from their February lows (+2.7% last week while the Dow was down -2%), and REIT's are up more than 12% from their February lows. The Wall St. Journal's Daily Shot column put out the following chart last week highlighting just how skewed market positioning has become within the S&P 500 where the market cap of defensive sectors such as Utilities, Telecom, Pharma, and Consumer Staples has been cut in half since 2009 (from 22% to 11%). The last time the market cap of this group was cut in half (from 28% to 14%) was in the late 1990's at the height of the Tech Bubble – an eerily similar coincidence given the Tech sector today (like then) now makes up about 25% of the S&P 500 (it got above 30% during the Tech Bubble) and momentum stocks like Facebook, Amazon, Netflix, Google

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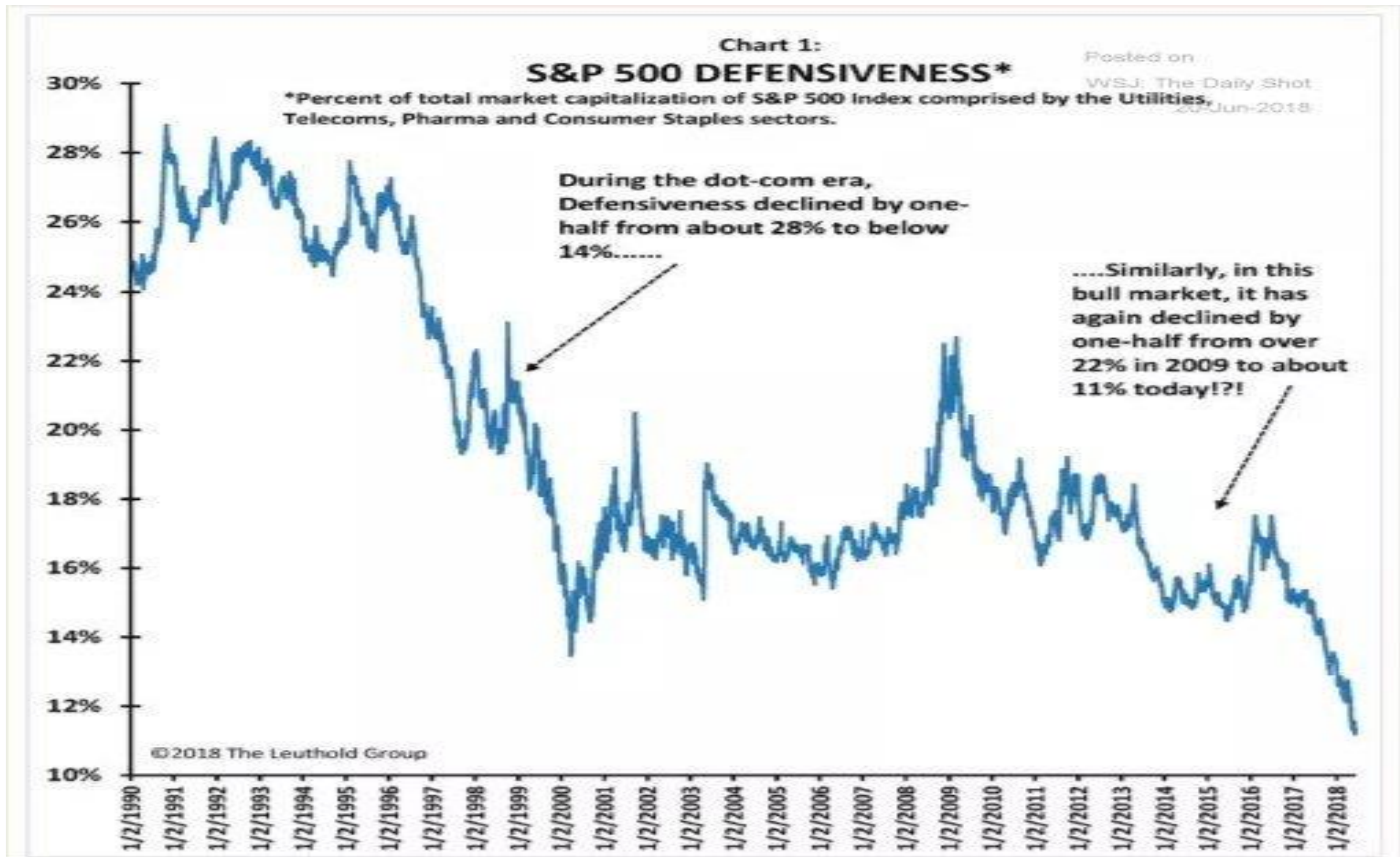
(Alphabet), Microsoft, and Apple now constitute nearly 15% of the S&P 500.



Tom Lee, Founder of Fundstrat, also put together an interesting graphic focused on the Consumer Staples sector highlighting how the sector's P/E multiple has compressed from a 15% premium to the S&P 500 to a 13% discount. Over this time the entire 11-year outperformance of the Consumers Staples

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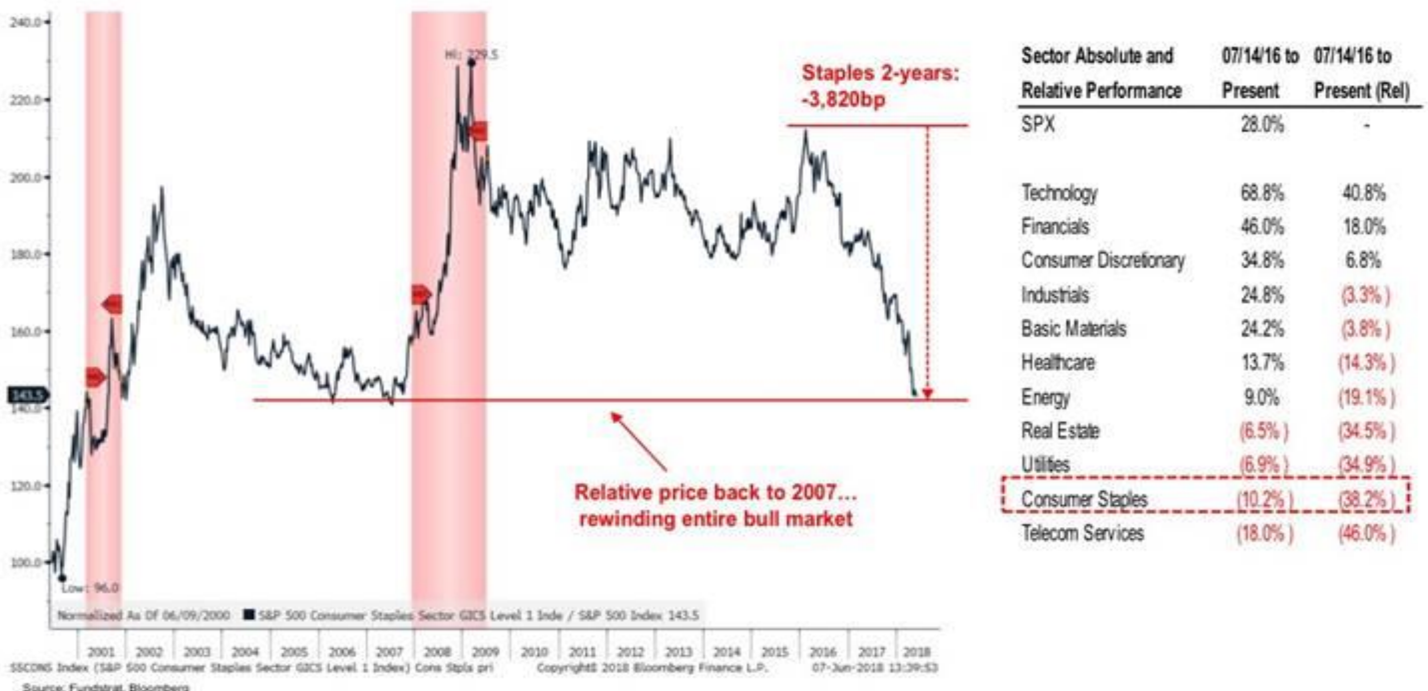
sector relative to the S&P 500 has been unwound. It will be interesting to watch how this sector performs relative to the S&P 500 over the next several months, should the recent outperformance persist then it may be less of a reflection of a dead cat bounce from a beaten-up sector and more about investors positioning for a much weaker economic and stock market backdrop going forward (have a look at how the line spikes higher during the last recession implying the degree to which Staples outperformed the S&P 500).



Sector Absolute and Relative Performance	07/14/16 to Present	07/14/16 to Present (Rel)
SPX	28.0%	-
Technology	68.8%	40.8%
Financials	46.0%	18.0%
Consumer Discretionary	34.8%	6.8%
Industrials	24.8%	(3.3%)
Basic Materials	24.2%	(3.8%)
Healthcare	13.7%	(14.3%)
Energy	9.0%	(19.1%)
Real Estate	(6.5%)	(34.5%)
Utilities	(6.9%)	(34.9%)
Consumer Staples	(10.2%)	(38.2%)
Telecom Services	(18.0%)	(46.0%)

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By the way, while we're on the topic of disconcerting price action, the Shanghai composite just crossed over into bear market territory as it dipped more than 20% from its recent highs. Ladies and gentlemen, putting aside the trade tensions (what this implies about who's winning and who's losing) this is the second largest economy in the world and should it stumble it will have ripple effects across the globe (both economic and financial). How anyone can reframe this as a bullish development is beyond my comprehension and the fact that this stumble is occurring amidst the Beijing leadership's actions to ease credit policy via lowering the reserve requirement ratio by 50 basis points is an indication that all is not well.

Meanwhile in the bond market, I must admit that it's been a bit disconcerting to see bond

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prices react as lethargically as they have. It's a bit of a complex analysis rifling through all the machinations taking shape in the yield curve with short-term interest rates on the rise while the intermediate and long-end of the yield curve have flat-lined or declined marginally. What this has done is compressed the yield curve to its flattest level (35 basis points on the 10's – 2's differential) since before the GFC and this is a rather bright amber flag signaling a cautionary view on the future trajectory of economic growth from the fixed income community. What's also troubling is that with global interest rates having hit their 5,000-year lows in July 2016 there really wasn't any other direction for them to go but up. This doesn't mean they'd be screaming higher, but since September of last year we've seen a fairly substantial move upwards in rates which has pushed bond prices lower. This puts diversified investors

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with portfolio exposure to both stocks and bonds into a bit of a perplexing situation where the stock market is roughly flat on the year, yet the bond market is in the red (High Yield -2%, Investment Grade Corporates -6%, Barclays Aggregate Bond Index -3%, 10-year Treasury's -3%, and 30-year Treasuries -4.5%).

One of the few vestiges of safety and security where investors in the bond market could hide this year has been in the short-end of the Treasury market where you need to be willing to roll short-term T-bills with rising interest rates. The 3-month T-bill is up to 1.9% from 1.3% six months ago. The 2-year T-note is up to 2.6% from 1.8% six months ago. Another development that has made this part of the bond market more compelling over the last six months is that the dividend yield on the S&P 500 is unchanged at 1.9% over this period.

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So, R.I.P to the T.I.N.A (There is No Alternative) investment thesis the bulls have used in the past as a rallying cry for the stock market because investors can now get a higher income payout with little to no capital risk.

Before moving on, I have to comment on the oddity playing out at the current time in the bond market where the high yield (junk bonds) segment of the corporate bond market is outperforming investment grade credit by a factor of 3. Sure, this could speak to the structure of the corporate bond market, liquidity, and/or investor preference but what makes less sense is that over the last four months investment grade credit spreads have widened by more than 90 basis points to their highest levels since April 2017, yet high yield spreads have compressed by nearly 40 basis points over the same time interval. To state this more plainly to the novices among us –

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investors are demanding additional compensation for the risk in the investment grade market while at the same time demanding less compensation from junk bonds. I must tell you, it's getting harder and harder to rationalize the irrational that has taken shape this cycle.

Moving on to the economy, and this is where things get a little counterintuitive as it relates to the health and strength of the economy versus what's playing out in the stock market. Economists across the board have been upping their estimates for Q2 GDP growth with the majority falling in the 3.5 – 4.0% camp. Without question this is setting up to be a solid number and I see no point in belittling it, but I will share some views on why I think it will end up being a one-off. Part of it is a catch-up from the weakness the U.S. economy experienced in Q1 and some of it stems from

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organic activity that took hold in the 2nd half of last year. However, a good chunk of it is a result of fiscal spending coming out of the budget bill passed earlier in the year, with the bulk of that government spending occurring in Q2. As we move into Q3, this level of spending will taper off with a marginal amount spilling over into Q4, and then as we move through 2019 the economy is setting itself up for a 'Wiley E. Coyote' moment in that fiscal stimulus will fall off a cliff.

This moderation in fiscal stimulus will be coinciding with a global economy where a slowdown is underway, a domestic economy that will be contending with the lagged impacts of Fed tightening (higher interest rates, a stronger dollar, and reduced liquidity), and a corporate and household sector that appears to be less willing to take on any more debt for unnecessary activities. Add in the

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uncertainty from a global trade war as we are already seeing tangible impacts from the steel and aluminum tariffs (the WSJ reported that washing machine prices have risen by 17% over the last 3 months) and homebuilders indicating that the lumber tariffs have increased the cost of building a home by roughly $9,000. Look, none of us know how this brewing trade war plays out, if the bark is bigger than the bite, and/or who bears the bulk of the costs versus who accrues the benefits. What I am confident about is that in the short-term no one wins and should this prove to be a full-scale reshuffling of the four-decade trend towards globalization – then the unwinding of such an interconnected global system will bring about some pain and investors should consider this in how they are allocating their capital.

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One last point on the economy and that is that while I think we are reaching the 'as good as it gets' moment here in Q2, it is my expectation that the slowing from this point will take some time to play out. In other words, there are very few indicators or economic metrics that suggest an elevated risk of recession in the next quarter or two. However, don't let this create a false sense of security or complacency in how you're investing. After all, it's economic strength that will ultimately prove to be the death nail to this cycle. Recall me mentioning earlier how this would seem counterintuitive in that a strong economy with rising inflation will keep the Fed on its tightening path. Therefore, this cycle is setting up to play out similarly to 10 of the last 13 where the Fed eventually tightened policy too much and tipped the economy into a recession.

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Right now what we are seeing play out in the capital markets – Emerging markets down more than 15% from their peak, the cyclical sectors of the U.S. equity market falling into double digit declines from their peaks, defensive sectors rallying, the dollar rallying against most foreign currencies, and money flows concentrating into a narrow group of companies who continue to rally – these are all examples of the market telling the Fed to be careful with how much further and/or aggressively the Fed tightens financial conditions.

However, it was Sir Isaac Newton that taught us that every action has an equal and opposite reaction. If we are to believe former Fed Chairman Bernanke's explanation for why the Fed instituted Quantitative Easing (asset purchases) back during the nadir of the GFC – and that was to create a wealth effect on the

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back of rising asset prices – well then why would unwinding these asset purchases (or Quantitative Tightening) not have the opposite impact? Here we are about to flip the calendar into July where the Fed's monthly balance sheet reduction schedule kicks up from $30 billion per month to $40 billion. Is it really a mystery any longer that this is a material event for asset prices? Now not only do we have the Fed's QT draining liquidity from the system, but we have the ECB which announced they will be done with QE by the end of the year (reducing it to $15 billion/month from $30 billion/month in September) and the BOJ has been forced to reduce QE as well.

Couple this with seven rate hikes by the Fed since December 2015, with guidance for another two over the rest of this year and three more next year, and a Treasury Department that has an issuance calendar that averages

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roughly $100 billion/month going forward and we're talking about a heck of a lot of liquidity being drained from the financial system. As a matter of fact, should the G4 central banks carry out their guidance for asset purchases, then by the first quarter global central bank liquidity begins to actually contract. This will be the first-time investors have experienced an environment like this since prior to the GFC. Think about that for a moment – that means all the algorithms, high frequency traders, and momentum strategies are going to have to figure out how to price risk without the world's monetary authorities acting as price insensitive buyers.

All of this argues for a higher risk premium being applied to asset prices and explains why stocks are experiencing multiple compression in the face of stellar earnings. In such an environment cash is an attractive investment

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especially when it pays you more than the dividend yield of the market. Should the Fed relent and back off its tightening course then that will buy some more time for this cycle to be extended, risk assets will catch some relief, but markets are already signaling to Chairman Powell that he needs to back off soon before natural economic forces take us down the path of the next recession. The current backdrop is more about watching and observing – it's not the time nor place to be a hero with your capital. There is too much that has changed over the last year to blindly conclude this is just another buy the dip opportunity. Risk has risen, and my advice is to adjust accordingly.

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