August 27th, 2018

Stocks just want to go up…

Could it really be that simple? Stocks just want to go up: Trade talks with China = market rally. Trade talks with China end with little progress = market rally. Fed to continue hiking rates and draining liquidity = bullish. Fed considering pausing rate hikes by year end = bullish. Strong Q2 economic data = bullish. Weak economic data to kick off Q3 = bullish. Rising U.S. dollar = bullish. Falling U.S. dollar = bullish. Globally synchronized growth at the start of the year = bullish. Weakening global growth and spreading emerging market contagion risks = bullish.

North Korean denuclearization = bullish. North Korea not dismantling nuclear capabilities = bullish… You get the point, and at this moment I'm of the opinion that the explanations for why it's happening take a distant second place to the actual reality of what is happening – and that is a U.S. equity market that continues to just yawn at any element of risk that presents itself.

Acknowledging and accepting the reality that U.S. equities are caught in a vortex of upward price momentum as money managers chase prices higher with FOMO (Fear Of Missing Out) on full display, does not excuse prudent investors from abandoning discipline and exercising objective due diligence. U.S. equities made a new all-time high last week and that is not fake news, but I do think it is noteworthy to evaluate the fundamental underpinnings today versus the highs made back on January 26th, and how much things have changed in just seven months.

At the start of the year, investor optimism was centered around globally synchronized growth taking shape for the first time since the Global Financial Crisis. As it turns out, January looks to have been the peak in this coordinated growth with China having turned down in a decisive way, Europe rolling over, and many emerging market economies starting to feel the negative impacts on growth from a strengthening U.S. dollar and rising interest rates. The best illustration of this global divergence in economic strength is relative performance of the MSCI World Index vs. the MSCI World Index ex U.S. where a 10% performance divergence has opened up following what was a very tightly correlated relationship since late 2015.

MSCI WORLD/MSCI WORLD EX US

The other large variable driving both economic and investor optimism at the start of the year was the passage of tax cuts by the Trump administration and then the passage of the omnibus spending bill in March that added an additional $300 billion in government spending to what was already a bloated budget. Add these two things together and we're talking about the most aggressive fiscal stimulus package in over three decades. But here is the rub, and this is what I encourage investors to think through: In January, these items acted as a carrot that fostered optimism that drove increased estimates for forward looking forecasters and investors. Here we are mid-way through Q3 with the tax cuts and increased government spending in hand, a stock market making new all-time highs, but no catalyst nearly as large as what we had to look forward to back at the end of January.

A large beneficiary of the tax cuts has been corporate America with S&P 500 profits surging higher with two successive quarters of nearly 25% EPS growth. This profit windfall has done wonders to what was a rather expensively valued equity market coming into the year with forward P/E multiples having compressed by more than 2 full points. At this time the S&P 500 trades at a P/E multiple of 16.6x on forward earnings which is still 2 handles above its historical average, so it remains a stretch to conclude that stocks are cheap on this metric. On other metrics like Price-to-Sales, Shiller P/E, and the Buffet Indicator (stock market cap / Nominal GDP), the equity market is near its most expansive valuations in history, but keep in mind valuations are an inferior market timing tool. Where valuations are most useful is in informing an investor about the margin of safety they have in any particular investment.

But looking at the earnings setup today versus the highs in January is also an interesting observation in that we have two +20% EPS growth quarters in the books and analysts are penciling in another +20% print in Q3, but after that, the numbers really start to fall-off in a material way: +17.5% for Q4, +7.3% for Q1

2019, and +7.8% for Q2 2019 (numbers according to FactSet). Food for thought for those thinking that +20% EPS growth can go on indefinitely. As an aside, some analyst's models that I follow that do a lot of thorough work on this front indicate that organic EPS growth (outside of the benefit from the tax cuts) is running closer to 10% – just some context and goes to show just how rare +20% EPS growth is outside of one-time accounting adjustments.

The U.S. economy is also in a much more peculiar spot today than where we were at the start of the year. Perhaps the most obvious illustration can be viewed through the ECRI's U.S. Weekly Leading Index (WLI) growth rate which decreased last week to 0.0% – a 126-week low.

What stands out most to me when looking at this chart is the peak in this index in February which accurately forecasted the strong 4.1% GDP print we got in Q2. This is a leading indicator and has a strong track record foretelling what lies ahead for the economy, and what it's saying right now is that Q3 isn't shaping up to be nearly as strong as Q2. This doesn't mean the economy is falling off a cliff, but a slowdown already seems pretty apparent. So far this month, nearly three economic indicators have come in below expectations for every one that has beat expectations. Have a look at the diverging view between the NY Fed GDP Nowcast model which is forecasting a Q3 GDP number of +2.0% vs. the Atlanta Fed Nowcast estimate of +4.6% (it has ranged as high as +5.0% to as low as +4.3% in the last month) – it's likely that the final print will come in somewhere in between (we're looking for a number around +2.7%).

Nevertheless, the point I'm getting at in comparing where we were in January versus where we are today in relation to all-time highs in the stock market is that a lot of good news was priced in back at the January high and much of that has actually come to fruition. Perhaps that validates and brings some relief to the most optimistic of bulls out there, but the upside from here will not have the benefit of the tailwinds that existed a short seven months ago.

For starters, we have a Fed that is much deeper into its monetary policy normalization process. They have two rate hikes on the board relative to the start of the year and following Chairman Powell's speech last week at Jackson Hole, futures markets are 96% priced for a third hike in September and 64% priced for a fourth hike this year in December. So, what this implies is that the short-end interest rates have already priced in the September hike and are almost 2/3rds of the way to pricing in the December hike. These hikes work their way through the economic system with a lag and it's a reasonable assertion to think that we are just now experiencing the impacts in the real economy to the tightening in policy we've experienced earlier this year.

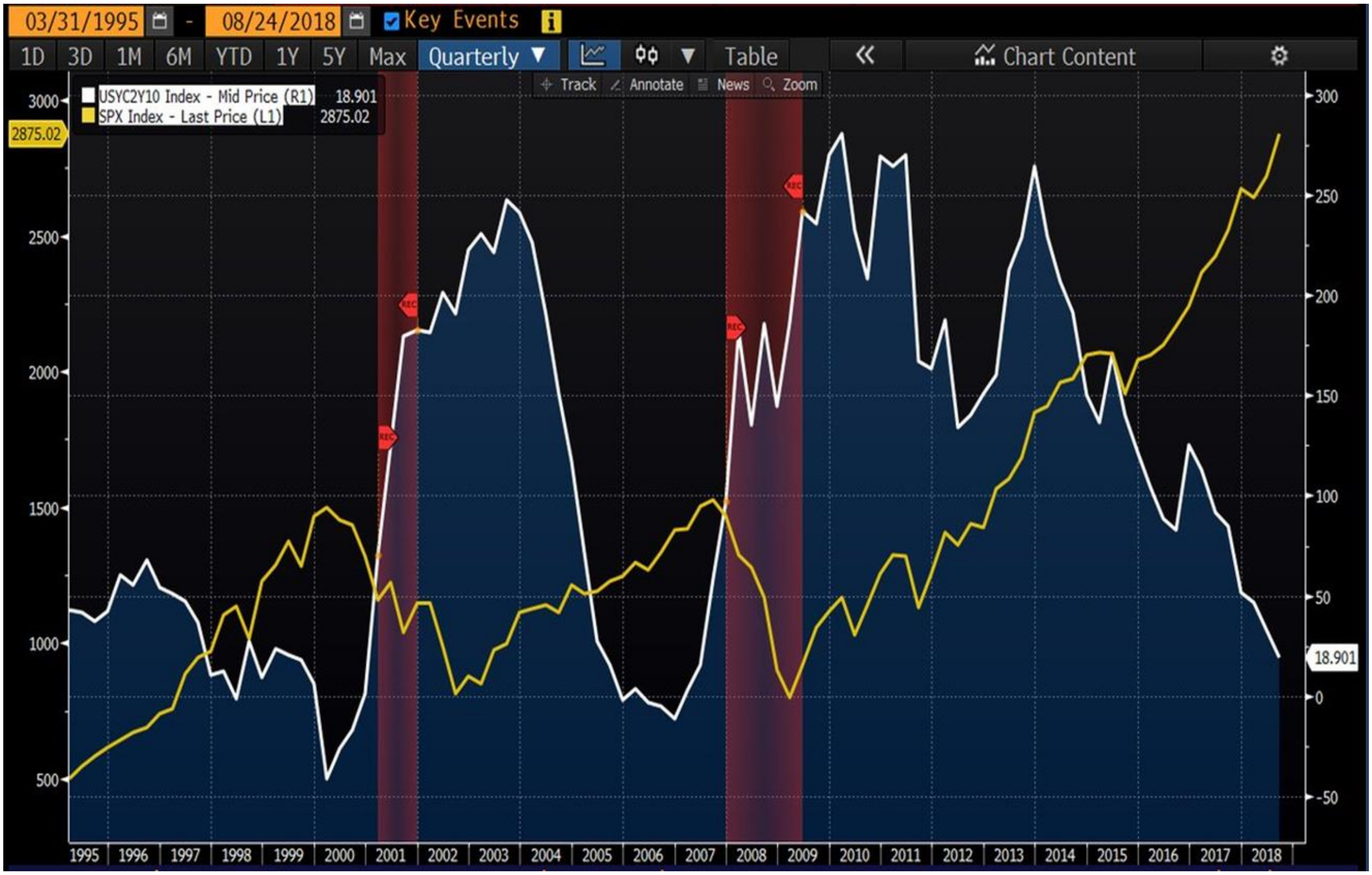
On top of the interest rate hikes, the Fed is nearing the peak of its monthly balance sheet reduction schedule. In January of this year the Fed was allowing its balance sheet to decline by $20 billion per month, which has doubled to $40 billion per month today and is heading to $50 billion per month come October. Liquidity is like oxygen to asset prices and by the end of 2018 or Q1 2019, for the first time in nearly a decade, global central bank balance sheets will be collectively contracting. This compares to a run rate of nearly $100 billion per month being injected into the financial system in December of last year.

All I'm getting at is there is a big delta between the underpinnings supporting the economy and capital markets today with U.S. equity markets traversing all-time highs, versus where we were when we reached these levels in late January. The tangible benefits from the administration's aggressive fiscal stimulus package peaked in Q2 and while they are still working themselves through the economy in Q3 and Q4, they will be moderating and then meaningfully stepping down throughout 2019. Furthermore, the U.S. economy in the quarters ahead has to contend with a weaker global economic backdrop, a rising dollar (which is a powerful tourniquet to emerging market growth), higher interest rates, liquidity diminishing around the globe, and a Fed that seems destined to tighten policy until something breaks.

Take this week's missive as nothing more than a cold wet towel on what is becoming a rather frothy equity market environment. These environments can be extremely fun and financially rewarding for those willing to throw caution to the wind, and it's for this reason that even cautious and skeptical investors remain disciplined with their portfolio allocation by retaining exposure to equities. One of the constructive elements I’ve appreciated about the market’s move back to new all-time highs is that it’s actually been some of the defensive sectors that have been leading the charge, like REIT’s, Utilities, Healthcare, and Consumer Staples.

The last thing I want to opine on before signing off on this missive is the decline in the yield curve as measured by the 10s/2s spread which has fallen to its lowest level since 2007. To most investment practitioners the yield curve is the ultimate arbiter of economic truth, and given that it has declined from a spread of roughly 75 basis points earlier in the year to just 19 basis points last week (see chart below compliments of Charlie Bilello), it is as solid as any historical indicator that one could rely upon to forecast what lies ahead. And what this indicator is saying is that the collective wisdom of all the opinions that make up the largest and deepest market in the world (the U.S. Treasury bond market) is that the U.S. economy is late in its business cycle, growth going forward is set to slow, and long-term interest rates are at or close to their highs for this cycle.

This next chart plots the yield curve (white line) against the S&P 500 (yellow line) and collaborates many investors' view that the stock market historically rallies as the yield curve nears inversion. What's important to watch going forward and is born out in this chart is that it's not until the yield curve starts to steepen (short-end rates start to decline and long-term rates stay flat or rise) that investors need to start bracing for an economic recession and likely, a nasty bear market. Also, it's worth considering that this cycle is unique on many fronts, so relying solely on historical analogs in one's analysis may be extremely misguided, as there is no historical reference for central banks ever attempting to unwind the experimental monetary policy that was implemented this cycle.



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