October 15th, 2018

A very unforgiving market…

U.S. equity markets took it on the chin last week with the Dow Jones Industrial Average plunging by 1,100 points (down 4.2% on the week), the S&P 500 gave back nearly 120 points (or 4.1%), the Nasdaq Composite receded by 285 points (or 3.7%), and the Russell 2000 Small Cap Index (the supposed segment of the stock market most insulated from trade wars) fell 5.3%. While the weekly decline in the Small Cap index was wicked, it accentuates a downtrend that has been underway since August 31st over which time the Russell 2000 has declined more than -11% and given back its entire gain for 2018.

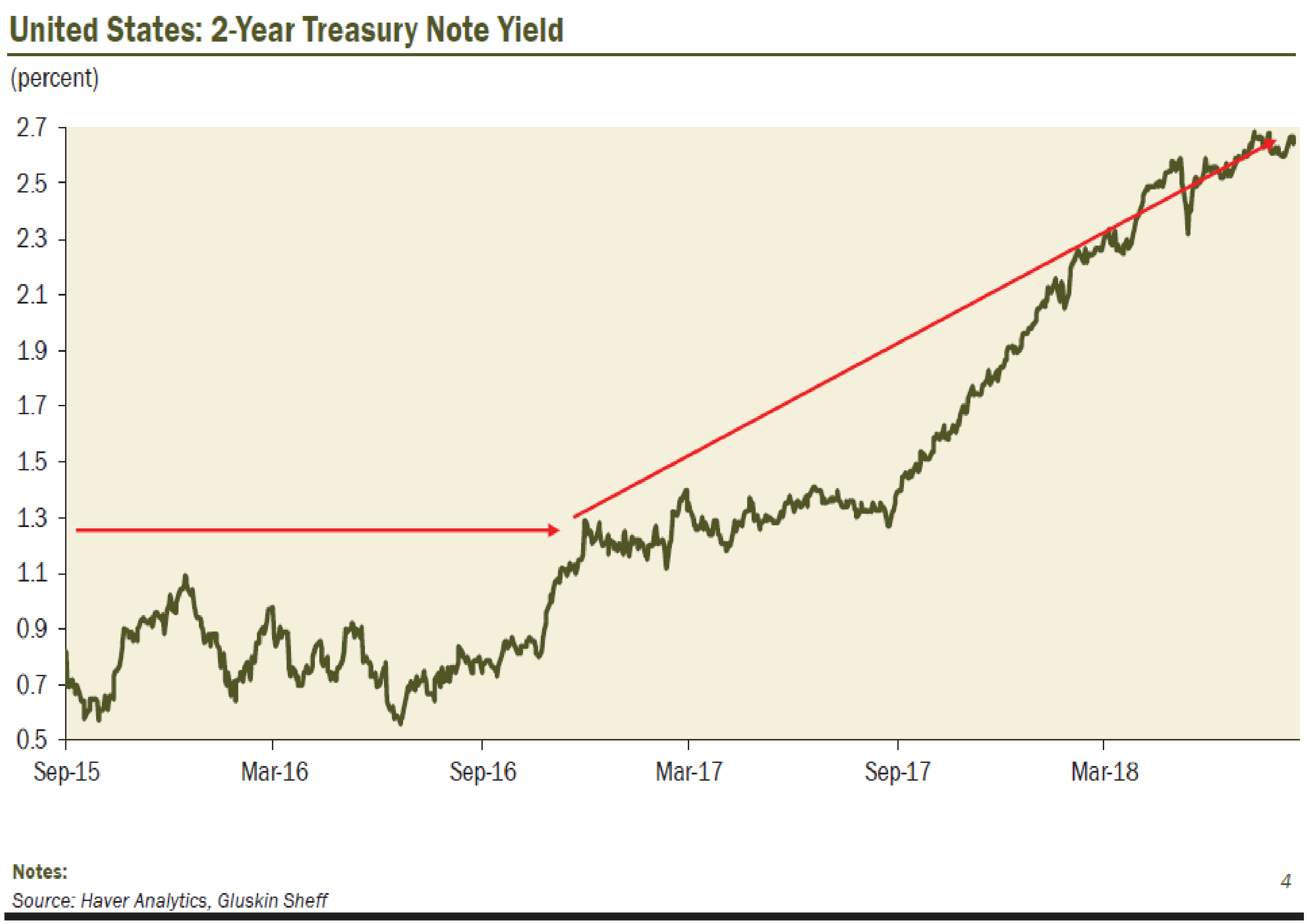
The selloff was widespread with foreign equity markets experiencing a similar fate: MSCI EAFE index -3.85%, MSCI Eurozone -4%, Japan -4%, but the Emerging Markets Index showed a bit of resilience declining only 1.47% on the week. I'll leave the scorekeeping at that, as recapping what has already happened doesn't really constitute much in the way of insightful analysis.

What continues to be most bothersome to me is the fact that during the two deep sell-offs in the U.S. equity markets this year (early February and last week) U.S. Treasuries barely rallied. Take a look below at various fixed income ETF's that are widely held by investors, and how they performed last week during a steep equity market sell-off:

- iShares 3-7 Year Treasury Bond ETF (IEI): +0.29%
- iShares 7-10 Year Treasury Bond ETF (IEF): +0.57%
- iShares 20+ Year Treasury Bond ETF (TLT): +1.26%
- iShares iBoxx Investment Grade Corp. Bond (LQD): +0.37%
- Vanguard Intermediate Term Corp. Bond (VCIT): +0.19%
- Vanguard Total Bond Market Index (BND): +0.33%
- iShares iBoxx High Yield Corp. Bond (HYG): -0.18%

Sure, by and large, they were flat to up modestly and as a result they didn't contribute any further to a deep decline that investors experienced on their equity holdings, but the diversification benefit from this asset class was rather disappointing. This modest flight to safety bid in the bond market is rather informative nonetheless and highlights a conundrum investors face going forward after what has been a decade of global central banks keeping interest rates nailed to the floor and risk asset prices nailed to the ceiling. Last week the yield on the 10-year T-Note retreated by a modest 8 basis points (when yields fall, bond prices rise) to 3.15%, which is a distinct contrast to prior episodes of downside equity volatility this cycle where on average the decline in yield ranged from 25 – 50 basis points. This type of price action is what one would expect in a moderate stagflationary environment which is looking more and more like the backdrop that is at play today with cost-push inflationary effects from higher tariffs and the fiscal induced surge in bond supply.

Thus, the rise in Treasury yields – which has seen the 2-year yield (a proxy for the price of money) triple since September 2016 – is starting to have a meaningful impact on the pricing of assets.



This is why 2018 has been such a frustrating environment for the paint-by-numbers asset allocators given diversification has actually detracted from portfolio performance. Take for example the following asset allocation ETF portfolios from Blackrock iShares:

ETF Name	Symbol	Stock Allocation	Bond Allocation	2018 Performance
iShares Core Conservative Allocation ETF	AOK	30.00%	70.00%	-3.93%
iShares Core Moderate Allocation ETF	AOM	40.00%	60.00%	-3.60%
iShares Core Growth Allocation ETF	AOR	60.00%	40.00%	-3.67%
iShares Core Aggressive Growth Allocation ETF	AOA	80.00%	20.00%	-3.58%

This year it doesn't matter much how an investor divided up their exposure to the two largest capital market asset classes there are (stocks and bonds), the results are virtually identical and that's because outside of a highly concentrated portfolio in a select few Large Cap U.S. equity holdings and short-term Treasury Bonds, most every other asset around the globe is lower than where it began the year.

Rare is the occurrence nowadays that I agree with President Trump when it comes to the capital markets or the economy, but the material rise in interest rates and the mechanical nature in which the Fed intends to raise interest rates going forward is one place where I do share a similar view. Suggesting that they are “crazy” as the President did last week is a bit dramatic, but the Commander-in-Chief is anything but soft spoken. But what did he expect would happen with an economic backdrop that he proclaims is one of the strongest ever, an unemployment rate that has been below the Fed’s full employment threshold of 4.5% for 18 months now and every inflation estimate out there at 2% or higher (the level the Fed views as price stability). This economic backdrop epitomizes what the Fed would want to see in order to move the Federal Funds rate to what their models suggest is a neutral level.

Yes, the Fed will bear the responsibility / blame for over-tightening and tipping the economy into a recession, and their actions over the past decade make them well deserving of receiving this accountability. However, they are not alone as elected officials in both this administration and the last have been all too content in enabling the current imbalances by deferring any difficult decision that needed to be made over the last decade to get the U.S. economy onto a more sustainable path. The mere fact that the most dynamic and innovative economy in the world (the U.S.) may not be able to handle the Federal Funds rate rising to 3% is in-and-of-itself rather disheartening.

Look, I don't mean to be talking out of both sides of my mouth here, so let me try and express my view in as simple and concise a manner as I can. There is no easy way out from where the economy, interest rates, and capital markets are at this point. We are at the point in the Fed's tightening cycle where things start to break, but unfortunately the destruction is only occurring in emerging and international markets at this point. The fact is that the U.S. economy is juiced up on fiscal stimulus while the tightening in financial conditions has only just started to show up over the last couple weeks. But unless things start to break-down in a more material way in the U.S., then the Fed will continue to push forward on hiking interest rates and withdrawing liquidity. This is what makes the investment backdrop today so extremely challenging in that both stocks and bonds are at risk of decline until the Fed relents.

Getting back to last week's action in the capital markets, it's understandable to see everyone looking around asking, "what happened that caused such a meltdown?" Unfortunately, the reality is that when it comes to financial markets there isn't always a rhyme or reason, but to anyone digging beneath the surface of the economic and capital market data, it shouldn't come as a surprise that there are some deep-rooted imbalances and risks that have built up. Except of course for all those technical traders that can draw a line on a chart as if they obviously saw this coming (I say this sarcastically as I've never seen technical analysis embraced to the extent it is today, with actual financial analysis becoming an extinct science – the talking heads on bubblevision were in rare form last week redrawing those lines on the charts to refit their narratives).

I’ve said it before and I’ll say it again, nothing matters until we reach a point where it all matters. Whether we’re reaching that point now is yet to be determined, but I think the warning signals are piling up that should suggest to investors that Mr. Market is not going to be nearly as forgiving going forward as he’s been in the last several years of this bull market. There has been a lot of technical damage done to the stock market over the last month where we now have a situation where 2/3rds of the companies in the S&P 500 are in an official correction of down 10% or more. That is a broadly-based decline, one that the bulls cannot simply dismiss as an immaterial event.

A couple of things caught my eye last week with the negative action in the Financials validating the overall equity market weakness after some of the big guys reported earnings on Friday. JP Morgan reported earnings 33% above year ago levels (4% above analyst's estimates) and after an initial pop in the stock, the shares ended up reversing and closing out the day with a 1.1% loss. Citigroup results showed earnings grew 22% (3% above estimates) and the initial 4% rally in the stock ended up rolling over to only a 2% gain by the end of the day. The scenario played out with Wells Fargo on Friday and we got Bank of America results this morning with the stock experiencing an initial rally after they reported solid results, but as I type the stock is down almost 2% on the day.

What stood out most in the earnings numbers from the big banks isn't the solid results but rather the large jump in credit card growth that propelled the earnings. After all, supposedly we're in one of the greatest economic booms in some time with an unemployment rate that is at 40-year lows, wage growth picking up, and yet credit card growth is the driving force behind bank earnings? Not only that, but mortgage growth slowed a whole bunch which isn't all that surprising with the 30-year mortgage rate jumping back above 5% last week. At this point the Financial Sector is down -5.1% on the year and this fact alone should serve as a canary in the coal mine to investors – especially since this is one group that should have been benefitting from rising interest rates.

Another thing that caught my eye last week was the material move higher in gold – a commodity I view as a long-term necessity in investor portfolios given the geopolitical and monetary policy risks apparent today. However, it has been a humbling investment this year and an investment that has forced patience among those having exposure to the barbarous relic. Gold did act as a decent portfolio hedge last week, decisively breaking out of the $1,200 level that has acted as a magnet for the better part of the summer/fall. On the week the yellow metal gained 1.2% as the Gold Miners index popped nearly 6%, and this left for dead segment of the stock market has really firmed since the announced merger between Barrick Gold and Randgold in late September.   Should the yellow metal be able to push above the $1,245 level (it's at $1,230 today) then investors could see one heck of a counter-trend rally as shorts are forced to cover what has become the largest short exposure on the COMEX futures market in 17 years.

Beyond the capital markets and the global economy, but very closely linked, what has grabbed my attention more than any other item over the last two weeks was the speech delivered by Vice President Pence at the Hudson Institute, "The Administration's Policy Toward China" [Link to YouTube for Vice President Pence's Remarks]. I came across a piece of research written by an analyst I have the utmost respect for, Russell Napier, which encouraged me to take the time to listen to the 43 minutes it took to deliver this message. I, like Mr. Napier, conclude that this speech has the 'potential' to change the world as we know it (I lack the conviction to say – "will change" but that is my true opinion). The tone and tenor of the message is delivered with precise intent and in my opinion puts to rest the view that an amicable compromise can be met between what this administration wants from China versus what China is willing to give.

For those unable to find 43 minutes to watch the speech, the below excerpts provide some indication of the extent to which the United States of America now sees itself in conflict with the People's Republic of China:

> *The dream of freedom remains distant for the Chinese people. And while Beijing still pays lip service to "reform and opening," Deng Xiaoping's famous policy now* rings *hollow.*
>
> *China now spends as much on its military as the rest of Asia combined, and Beijing has prioritized capabilities to erode America' s military advantages on land, at sea, in the air, and in space. China wants nothing less than to push the United States of America from the Western Pacific and attempt to prevent us from coming to the aid of our allies. But they will fail.*

America had hoped that economic liberalization would bring China into a greater partnership with us and with the world. Instead, China has chosen economic aggression, which has in turn emboldened its growing military.

As history attests though, a country that oppresses its own people rarely stops there. And Beijing also aims to extend its reach across the wider world.

The American people deserve to know: in response to the strong stand that President Trump has taken, Beijing is pursuing a comprehensive and coordinated campaign to undermine support for the President, our agenda, and our nation's most cherished ideals.

China is also applying this power in more proactive ways than ever before, to exert influence and interfere in the domestic policy and politics of this country.

And worst of all, China has initiated an unprecedented effort to influence American public opinion, the 2018 elections, and the environment leading into the 2020 presidential elections. To put it bluntly, President Trump's leadership is working; and China wants a different American President.

There can be no doubt: China is meddling in America's democracy.

To that end, Beijing has mobilized covert actors, front groups, and propaganda outlets to shift Americans' perception of Chinese policy. As a senior career member *of our intelligence community told me just this week, what the Russians are doing pales in comparison to what China is doing across this country. And the American people deserve to know it.*

Next month, it will be my privilege to represent the United States in Singapore and Papua New Guinea, at ASEAN and APEC. There we will unveil new measures and programs to support a free and open Indo-Pacific. And, on behalf of the President, I will deliver the message that America's commitment to the Indo-Pacific has never been stronger.

More business leaders are thinking beyond the next quarter, and thinking twice before diving into the Chinese market if it means turning over their intellectual property or abetting Beijing's oppression. But more *must follow suit. For example, Google should immediately end development of the "Dragonfly" app that will strengthen Communist Party censorship and compromise the privacy of Chinese customers.*

It's difficult to analyze and assess all the potential impacts from a structural change to the entire globe from a degradation in the U.S. / China relationship of this magnitude. The best I can suggest in attempting to handicap this situation is to not ignore it and account for it as a material unknown in all of your investment calculations. To me it's just another uncertainty (as large or larger than any I account for) that challenges what, prior to last week, was overly complacent investor sentiment.

Let me finish up this missive by yet again echoing a cautious tone. I long for the day when capital appreciation and growth-oriented investment strategies supersede capital preservation and risk management, but the backdrop that supports the former is not present at the current juncture. Instead, what we have today is an environment where the stock market has radically outpaced what the economy has done this cycle to a degree never experienced before. What I'm talking about is a quadrupling in the S&P 500 from the lows back in 2009 which is almost a 15% annualized gain versus an economy that generated just over 2% annualized real GDP growth. This 7.5:1 ratio is nearly double the historical average of a 4:1 ratio over the previous eight economic cycles and handily exceeds the 5.4:1 ratio of the bull market and economic expansion during the 1990's to March of 2000. This completely unprecedented degree to which stock prices eclipsed economic growth was generated by central banks across the globe maintaining unnaturally low interest rates and relentless rounds of global QE.

Now we are at the point where the powers that be are attempting to unwind these unnatural forces, and I for one applaud and welcome the removal of these policies, as it will allow for asset prices to more closely align with their fundamentals. And why wouldn’t any investor want the assets they own to be a reflection of their true intrinsic value, rather than having to account for how much of an impact $20 trillion in global central bank asset purchases has had on the price we see today? The gradual tightening of global monetary policy via higher interest rates and reduced liquidity, in addition to being 10 years into an economic expansion, that even with massive fiscal stimulus is showing material signs of its late cycle nature – these variables alone should be enough to make even the most ardent bull exhibit some restraint before charging ahead.

I didn't even hit on the state of political disarray going on in Europe right now with Angela Merkel's star continuing to fall in Germany with her fragile party suffering another defeat in key state elections. French President Emmanuel Macron's latest poll numbers show his public approval rating all the way down to 33% from 53% at the start of the year, to which I don't think its happenstance that Marine Le Pen is making a resurgence back into the political fold. And just when it seemed that the UK and the EU were coming to terms on a Brexit plan we see more defections from Theresa May's cabinet (9 members at last count) and the negotiations grind to a stand-off. Not to mention the Italian budget showdown with the EU is about to take center stage and this situation is not going to be nearly as easy to paper over as the Greece situation given the size and leverage the Italian government thinks they have in pushing their agenda through.

Sure, some will say "Corey, you worry too much and this is just your customary 'wall of worry' that markets always seem to work through in time." I hope this retort is right, but I also understand that as strong of a positive emotion as hope is, it's not an investment strategy and does not excuse prudent analysts from doing the worrying for others.

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