December 11th, 2018

Live to fight another day…

Live to fight another day – this has been an investment theme of ours that has gained in prominence and conviction over the last six months. At the root of this theme is focusing investment portfolios towards a "return of capital" objective rather than a "return on capital" objective. There will be a time and place to reverse this position, but it is not here and now. If 2018 has taught objective market observers anything, it is that this has been the year to let the market be the teacher and for us practitioners to take on the role of the student. Letting the market dictate the terms and reacting to its lesson has been the most prudent approach, and I am of the opinion that this process will remain relevant as we transition into 2019.

With the heightened level of volatility, the flattening of the yield curve, and equity market leadership transitioning from cyclicals to defensives, the capital markets appear to be laying down enough bread crumbs for investors to get the hint that the bull market that started in March 2009 is nearing its expiration date. Daily trading ranges of 500 points on the Dow (which seem to have become the norm) are not the hallmark of bull market activity – this is classic bear market price action. So far in 2018 the S&P 500 has experienced three sessions of 3% declines or more with zero sessions of gains greater than 3% – this is something that hasn't occurred since 1936. Sure, on a short-term basis mood, sentiment, and over-sold conditions suggest a bounce in equities could occur, but I find it laughable hearing the talking heads proclaiming that 2,600-and-change is going to mark the bottom of this bear market cycle, which to me looks to be just getting started.

JP Morgan just put out a piece which included some very interesting data indicating that based upon macro data alone the odds of a recession are at 35%, based upon the contours of the yield curve there is 41% chance of recession, and 42% odds based upon other market-based information. The numbers, calculations, and mechanics are different but whether one wants to look at the NY Fed recession model at 15.8% (same as where it was in November 2008), the St. Louis FRB recession model sitting at the same level it reached in September 2007 (and the same level as June 2000), the Federal Reserve's 'excess bond premium' model with recession odds hitting 20% (same level it reached in September 2007 and January 2000), or the JP Morgan model – they are all conveying a similar message and that is that recession odds are on the rise. Sure, things could change over ensuing days, weeks, and months that could alter these negative trends, but until they do change in a more favorable direction, it's prudent for investors to respect these signals that in the past have proven to be prescient.

Even the sectors in the U.S. equity markets most sensitive to domestic economic activity are acting in a manner that suggests they are sniffing out rising odds of a U.S. recession next year, not 2020 or 2021 where the consensus currently resides. Since September 20th, the Consumer Discretionary sector has declined by 12.5%, Transports are off 14%, Small Caps have fallen by 16%, and the Regional Banks have retreated by 17.5%. At this point we have an S&P 500 that after being up close to 10% on the year at its September peak is now down more than 1% on the year. The index just recently experienced a ‘death cross’ where its 50-day-moving-average has crossed below its 200-day-moving-average and the median sector is down nearly 5% for the year. Look, I’m not trying to pile on here, but the ‘buy the dip’ strategy that has served investors so well earlier in this bull market is no longer working and the uptrend in the S&P 500 that has been in place since 2016 has been violated over the course of the last two months.

The Leuthold Group put out the below score card today which is a nice summary of just how much damage has been done in global equity markets from their various peaks reached in 2018.

Keeping Score

		Date Of Peak	Loss Through Dec. 6
U.S.	S&P 500	September 20, 2018	-8.0 %
	Dow Jones Industrials	October 3, 2018	-7.0
	Dow Jones Transports	September 14, 2018	-10.5
	Dow Jones Utilities	November 14, 2017	-3.2
	NASDAQ Composite	August 29, 2018	-11.4
	Russell 2000	August 31, 2018	-15.1
	NYSE Financials	January 26, 2018	-14.8
	Value Line Arithmetic	August 29, 2018	-11.4
	S&P High Beta Index	January 26, 2018	-15.7
	S&P Low Volatility Index	December 3, 2018	-1.4
World (in USD)	Global Dow	January 26, 2018	-14.0 %
	S&P Global 100	January 26, 2018	-9.4
	NYSE World Leaders	January 26, 2018	-11.8
	ACWI	January 26, 2018	-12.9
	ACWI Equal Wgt	January 29, 2018	-17.9
	MSCI World Index	January 26, 2018	-11.5
	MSCI World Small Caps	January 26, 2018	-13.8
World Ex US (in USD)	ACWI Ex USA	January 26, 2018	-20.2 %
	ACWI Ex USA Small Cap	January 26, 2018	-22.3
	MSCI World Ex USA	January 25, 2018	-19.3
	MSCI EAFE	January 25, 2018	-19.6
	MSCI Emerging Markets	January 26, 2018	-23.1
	MSCI BRIC Index	January 26, 2018	-23.3
	MSCI Frontier Markets	January 22, 2018	-21.1

Global asset classes (both stock and bond markets) have had a tough go at it this year with no major asset class registering a return of 5% or more – an event that has not occurred since 1972 and a rare environment were diversification didn’t work. The last time both the equity and bond market returns were both negative in the same calendar year (which they are at this point, but we’ll see how the whole year ends up) was in 1969, and since 1928 this condition has happened less than 5% of the time. One area that has worked and continues to work (as short-term interest rates continue to hold near their highest levels since the summer of 2008) is the T-bill market which has returned 1.7% this year. Not record breaking to say the least, but a positive return nonetheless and an asset with a lot of optionality that holds its value and can be swapped into other assets should the opportunity present itself.

One of the few near-term constructive signposts I can find at the moment is that the S&P 500 appears to have turned in a triple bottom around the 2,600 – 2,620 area. As long as this holds then I think the algos and short-term traders will continue to have a field day playing what appears to be a defined range of 2,600 – 2,800 on the S&P 500. However, a breakdown below the 2,600 floor of this range opens up the floodgates for additional damage with some scenarios taking this index all the way down to 2,400 and then the 2,200 – 2,100 level in the most extreme iteration. Alternatively, a breakout of the 2,800 ceiling level of this range would be constructive for the index to make an assault on its all-time highs, but I wouldn't put too much stock in this scenario given the fact that we're looking at a year where S&P 500 EPS growth is set to come in at 20% and calendar year GDP growth is likely to be a little under 3%, and yet the S&P 500 is in negative territory with two weeks left in the year.

Keep in mind that it's the U.S. economy that is just now beginning to decelerate as it catches down to a weakening economic growth backdrop throughout most of the rest of the world. In contrast to this time last year when everyone was cooing about synchronized global growth, the OECD leading indicator just came out for October and fell 1/10th of a point to 99.5, which represented the eleventh consecutive month of decline and puts this metric at its lowest level since the fall of 2012. Over 80% of the countries in the index are seeing their economic growth prospects decelerating in what one can only interpret as a globally synchronized slowdown.

A lot of attention gets paid to the trade war impacts and rightfully so, but it is unfair to place the blame of the slowdown in global growth squarely at the feet of this development. I'm not saying it hasn't and won't continue to have an impact, but global growth (including the U.S.) was already set to slow from a hot pace in the latter part of this year. However, when you add the rising uncertainty from geopolitics around the world to an embedded global economic growth slowdown, it widens out the risk paradigm and forces markets to account for increased possibilities of worse case outcomes. These geopolitical events I'm talking about are the yellow vest protests in France that are spreading to other European countries (Netherlands, Hungary, and Belgium), the weakening banking system and fiscal instability in Italy, political changeover in Germany with Merkel losing governing prominence, and a U.K. Brexit where it is becoming impossible to handicap an outcome given the daily gyrations. A 'no' vote on PM May's Brexit plan is all but assured and a new referendum vote appears to be gaining momentum among the masses.

That brings us to "Tariff Man" and the showdown with China on the trade front. These two global powers can float trial balloons through the media all they want, but this is more than just a trade war. I've said it before, and it's worth repeating: investors should brace themselves for a prolonged economic showdown and how it plays out is highly uncertain. This situation is a variable that has to be accounted for in everyone's investment process, yet it's a variable where no investor can have an investing 'edge' or know the 'odds' to structure a favorable payout structure because it's such an unknown. Each side has different objectives of what success would entail. Each side has different cultural biases to appease. Each side comes at the confrontation from a different perspective: the U.S. viewed both internally and externally as the world's sole super power, and the Chinese as the budding super power that wants respect on the global stage. That's a complex set-up for an equitable resolution to be reached.

Coming back to the U.S. economy and the Fed, where investors for a brief respite rejoiced in the belief that the Fed may be nearing the end of this tightening cycle with next week's FOMC meeting perhaps being the last hike of this cycle. Whether it is or it isn't is the wrong thing to be focusing on. What's already baked into the setup going into next year suggests that if we don't have a U.S. recession, it's sure going to feel like one from an investment standpoint. Furthermore, monetary policy works with a lag, where the tightening that has already taken place via past hikes and further balance sheet reduction will have a negative impact on the economy next year. And while I'm of the view at the moment that the upcoming recession (be it 2019 or

2020) will likely not be that severe on the economy (the impact on asset prices is another story), it will be a very difficult situation to climb out of since we have very little ammunition via fiscal or monetary policy stimulus. Historically the Fed has slashed rates by 500 basis points to counteract prior recessions, but that can't be done if the fed funds rate peaks out at 2.75 – 3.0%. Additionally, fiscal policy typically kicks in with some form of government spending/tax cuts that expands the budget deficit by 3% of GDP, but doing so at this time with budget-deficits/GDP set to tick up to nearly 4% next year makes this challenging.

Federal Funds Rate from Start of Fed Rate Cuts to End of Fed Rate Cuts and Respective Delta:

		Federal Funds Rate (%)		
Start	End	Start Level	End Level	Delta
Oct-57	May-58	3.50	0.57	-2.93
May-60	Jul-61	3.83	1.18	-2.65
Nov-66	Jul-67	5.74	3.79	-1.95
Feb-70	Feb-71	8.95	6.03	-2.92
Sep-71	Feb-72	5.53	3.30	-2.23
Jul-74	May-75	12.91	5.22	-7.69
Apr-80	Jul-80	17.43	9.01	-8.42
Jul-81	Dec-81	19.10	12.44	-6.66
Aug-84	Dec-84	11.50	8.13	-3.38
May-89	Sep-92	9.81	3.00	-6.81
Dec-00	Jun-03	6.50	1.00	-5.50
Aug-07	Dec-08	5.25	0.13	-5.13
Average		9.17	4.48	-4.69
Median		7.73	3.55	-4.25

Source: Gluskin Sheff, David Rosenberg Chief Economist & Strategist

Deficit-to-GDP % at Cycle Peak vs. Year Following Recession and Respective Delta:

Cycle Peak	Deficit-to-GDP (%)	Year Following Recession	Deficit-to-GDP (%)	Delta (%)
1948	4.5	1950	-1.1	-5.6
1953	-1.7	1955	-0.7	1.0
1957	0.7	1959	-2.5	-3.2
1960	0.1	1962	-1.2	-1.3
1969	0.3	1971	-2.1	-2.4
1973	-1.1	1976	-4.1	-3.0
1980	-2.6	1983	-5.9	-3.3
1990	-3.7	1992	-4.5	-0.8
2001	1.2	2002	-1.5	-2.7
2007	-1.1	2010	-8.7	-7.6
Average	-0.3		-3.2	-2.9
Median	-0.5		-2.3	-2.9

Source: Gluskin Sheff, David Rosenberg Chief Economist & Strategist

Let me sign off on this week's missive in a similar vein that I started – we are in a different environment today relative to the easy compounding backdrop that existed from 2009 – 2017. Sure, there were scares along the way during this period: European Credit Crisis in 2011, growth slowdown in late-2012/early-2013, and global recessionary risks in late-2015/early 2016, but on each of those occasions, investors could fall back on global central banks stepping in to backstop asset prices. This central bank backstop doesn't exist to the same degree today as it has in the past (this isn't to say it doesn't exist at all) and should they need to act in the near future, they lack the potency in their policies given how little progress they've made in their tightening campaign so far.

Borrowing from an investment mantra first echoed several years ago by Howard Marks, "move forward, but with caution" is the most practical and proficient advice I could offer anyone at this point.

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