Casilio Leitch Investments
A Private Wealth Management Company

Capital Market Musings & Commentary

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Don't lose sight of the big picture…

Global equity markets have staged quite a rally over the last several weeks with the S&P 500 up almost 11% from its December 26th intraday low. I'm going to spare you the bean counting of going through various markets to detail just how much they've each rallied off their recent lows, because I think there are more important and insightful factors that investors should be focused on at the moment – namely that the degradation and deceleration in the global economic data hasn't abated even remotely over the last several months. In fact, in many respects the data has weakened further, and given that we haven't seen even a modicum of positive inflection in a host of economic metrics from the largest economies in the world, it makes me question the staying power of this rally in global equity markets.

Now to be fair, a relevant question any objective investor should always be asking themselves is "how much of what we already know is priced in?" The answer to such a question is never definitive, so you're on your own on this account, and I must admit that I've been a bit surprised over the last week at the market's ability to ignore a host of worrying data prints. The fact that the markets haven't sold off more in the aftermath of these reports has me wondering if maybe there is more negativity priced in than I'm giving markets credit for?

What data am I referring to?

- Over the last month there have been no fewer than 14 bellwether companies who have issued warnings or missed their quarterly sales and profit estimates. It was the retailers last week with Macy's, Kohl's, and L Brands announcing weaker than expected comp sales and this really undermined the integrity of Target's CEO's comments last fall that he's never seen a better consumer environment in his entire career. I get that all CEO's are salesmen first and foremost, but perhaps a bit of humility would ground you from making such a bellicose statement – don't forget that even the mighty Amazon lowered guidance in its last quarterly conference call. These retail warnings coincided with trimmed profit guidance from American Airlines last week as well, and it wasn't all that long ago that this lower guidance train got started with FedEx and Apple. It's hard to find a company more integrated into global activity than FedEx, so when you see them expressing caution over global demand, it's not an indicator you just brush aside.

  What we have seen is the analyst community get their hatchets out and chop away at their Q4 EPS estimates, taking growth forecasts down to +11% from +17% just three months ago – still positive for sure, but the momentum has clearly subsided. Now I see today, markets are taking Citigroup's earnings miss in stride as they rally the stock, and I don't have as big an issue with this reaction as the financial sector (while cyclical) isn't the poster child of excess this cycle as they were during the last. This segment of the market actually may turn out to be fertile shopping ground in the event volatility returns to the capital markets over the ensuing couple of months and quarters.

- The economic data we've been seeing out of China and Europe over the last several weeks has been downright putrid (apologies, as I don't want to come off as a hypocrite in calling out Target CEO Brian Cornell as being a sensationalist, and then turn around with my own overly dramatic assessment, but I think the data speaks for itself in this regard). Over the last week, we've received three separate pieces of data from China on inflation, exports and imports, and defaults:
    - Consumer prices were flat in December after declining 0.3% in November, and the key non-food inflation rate slowed to 1.7% YoY from 2.1%. We also learned that the year-over-year trend in producer prices fell to 1.6% from 2.7% and this metric was running at +5.5% as recently as June. All of this strongly suggests that Chinese demand growth is fading in a material way.
    - Credit insurer Euler Holmes was cited in the FT last week referencing estimates that insolvencies in China are poised to surge 20% this year. In 2018, corporate debt defaults in China amounted to $23.3 billion which exceeded the cumulative volume total over the prior four years. In case you didn't know, China is now home to the world's third largest bond market and if these estimates about future default levels are even in the ballpark of reality, it's no wonder why Beijing is back in policy accommodation mode.
    - Lastly, we learned this morning that China's exports for December fell 4.4% from year ago levels (far worse than consensus estimates for +2.0%), and imports contracted 7.6% (once again nowhere near consensus estimates of +4.5%). Both of these readings were the softest in about two years and come on the back of China PMI results that fell to the lowest level since 2016.

  As for Europe, Germany published recession-like industrial production numbers last week that caved 1.9% sequentially in November with October revised down to -0.8% from the initial estimate of -0.5%. This was the third straight decline in German production and took the YoY trend to -4.7%, which is the worst level since the nadir of the GFC a decade ago. Keep in mind, folks, Germany is the largest economy in Europe and the fourth largest economy in the world, and by the looks of it they may already be in recession. France, the second largest economy in Europe, isn't helping the situation much, as it reported a 1.3% month-over-month slump in industrial production for November which took the YoY trend to -2.1%.

  I count 8 major countries whose latest GDP prints had a negative sign in front of them – five of these countries are in Europe. This may come as a relief to U.S. centric-minded investors, but I caution any complacency that this may render in that if the 2008 GFC taught us anything, it is that there is no decoupling when it comes to the global economy. The global financial system in particular is as integrated as it's ever been, and while it may be a relative game of better or worse, we're all tied at the hip when it comes to problems with the big boys – I'm talking about the economies of the U.S., China, and the EU. The system is stable and secure enough to handle isolated negative outcomes in smaller, less significant systemic regions, but material weakening in any of the top four economies is sure to have an impact on everyone. At the moment we're seeing a material weakening in two of the four (Germany and China) and don't overlook the fact that Europe's weakness isn't isolated to just Germany – which will be sure to rattle the entire globe given that the total output of the EU is larger than that of the U.S.

- Speaking of the U.S., it seems as though in the commotion of the government shutdown, the trade negotiations with China, and the recent pivot by the Fed towards a less restrictive monetary policy path, investors have stopped looking at the actual economic data being released. But, even if actual analysis has been rendered obsolete because the Fed is back to having investors' backs, you would think the decline we continue to see in two separate series of leading indicator indices might give investors some pause about buying hook, line, and sinker into the 'Fed Put' at this moment. The ECRI leading economic indicator growth rate fell again in the week ending January 4th to -6.5% from -5.7%. This is the weakest reading on this metric since January 20th, 2012 and if you recall back then, the Fed responded by implementing "Operation Twist" later that year.

We also got updated data on the FIBER leading index which also weakened from -6.9% to -7.2%, and you have to go all the way back to April 24th, 2009 to find the last time this metric was at such a negative level (and you know what the Fed was doing back then to resurrect economic activity). It's important to keep in mind that these are 'leading indicators' and are much more important reference points to gauge what may materialize in the economic data over the next several months than a lagging payroll report that is subject to countless revisions. I don't mean to insinuate that the payroll report isn't a useful data point with reams of information, but it has a terrible track record at front-running critical turning points in a business cycle.

If one is inclined to overlook or dismiss the cautionary tone these leading economic indices are portraying because you'd rather hear directly from the horse's mouth, have a look at the just released Duke CFO Global Business Outlook survey ended December 7th, where nearly half (48.6%) of U.S. CFO's believe that the U.S. will be in recession by the end of 2019, and 82% believe that a recession will have begun by the end of 2020. These are the people charged with allocating capital for the largest globally reaching companies in the world, and I'd be hard pressed to imagine that they'll be looking to take on a major project (you know, the kind that move the needle in a $20 trillion economy…) with an outlook like they have today. Here is what John Graham, a finance professor at Duke's Fuqua School of Business and director of the survey, had to say:

> *"The end is near for the near-decade-long burst of global economic growth,…The U.S. outlook has declined, and moreover the outlook is even worse in many other parts of the world, which will lead to softer demand for U.S. goods."*

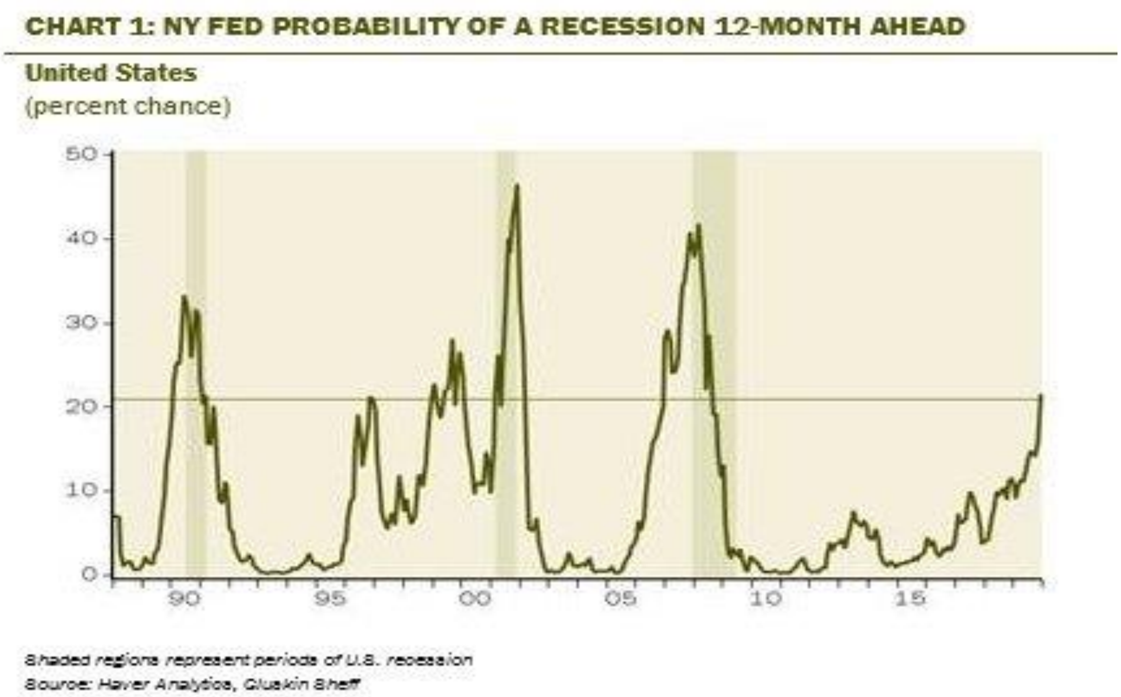
Within the context of this rally in risk assets, I implore you to not lose sight of the big picture, and that is that the global economy continues to weaken with little to no signs as of yet that things are bottoming. Yes, the near bear market decline in the S&P 500 off the September highs was enough to cause the Fed to take notice and back off their pre-determined path of tightening, and don't get me wrong – this is a big deal, and a net positive for the markets in the short-term. But I fundamentally believe that micro-managing a $20 trillion economy based upon the vacillations of the equity market is the precursor to a gigantic policy error. It's a dangerous road and one we are all familiar with given the excesses created in the past two financial asset bubbles – the Tech Bubble in 2000 and Real Estate Bubble in 2007.

All of this attests to this being an equity market rally for traders to rent, and not for investors to own. And so far, this bear market rally lines up pretty closely with what is typical, where historically the S&P 500 bounces 16% from the nearby lows (up 11% so far in this bounce), and in the process reverses 75% of the peak-to-trough decline. On this latter basis, that would target the S&P 500 getting as high as 2,700 and even if that were the case, this wouldn't by itself invalidate the bear market rally thesis. My two cents is that in order for the S&P 500 to rally up to the 2,700 level it would take a material improvement in the fundamentals (a bottoming out or uptick in some of the cyclically sensitive data) or something from the policy side that is substantial enough to reignite animal spirits and hence boost activity. I don't see a high probability of either of these coming to fruition and that includes a trade deal with China – you know, one that actually has some teeth in it and not an agreement that gives both sides cover to proclaim they actually negotiated something meaningful.

Keep in mind that entering 2019, the economist's community was already penciling in a backdrop where real GDP growth was set to fall back to the +2.0% trend level it averaged during the entirety of this expansion. Now when you account for the detrimental impacts from the government shutdown (latest estimates I've seen suggest it reduces growth by 0.2% to 0.5% at an annualized rate for each week that it goes on), plus the hit to spending via a higher cost of capital and depressed 'wealth effect', and the yet-to-bite lagged impacts of the Fed's last two rate hikes (September and December) and you're looking at perhaps as much as a 1.50% hit to baseline GDP growth in 2019. A -1.50% hit to a 2.0% base-line GDP estimate may not assure a recession according to the NBER's definition, but that backdrop surely isn't reflected in capital market prices today, in my opinion.

The biggest difference in my view of the economy and capital markets in 2019 relative to last year is the increased risk of a recession. My view throughout 2018 was that the U.S. equity market was going through a topping process and upon further reflection I am of the view that the fundamental high in global equity markets occurred in January 2018 with the U.S. equity market putting in a new price high in September. I find myself somewhat perplexed at the level of complacency (or perhaps it's denial) regarding the possibility of a recession / bear market materializing in 2019. It's by no means a sure thing and such an event is always hard to predict, but given the deceleration in global growth, the steep slide in cyclical parts of the U.S. equity market, the U.S. expansion approaching its 10-year anniversary, the unemployment rate near 5-decade lows (meaning it doesn't get much better than this), the Fed deep into its monetary policy campaign (remember, 10 of the last 13 tightening cycles ended with recession), credit spreads widening off their cycle troughs, and parts of the yield curve having already inverted – it should come as little surprise to see recession probability estimates increasing.

David Rosenberg of Gluskin Sheff posted the following chart today regarding the NY Fed Recession Probability model increasing to 21.4% in December from 15.8% in November and 14.2% in October. The odds have doubled over the past year, and as you can see from the chart, the increase to 20% is a meaningful level in that 3 of the last 4 times this occurred a U.S. recession wasn't too far down the line. The one false positive was in the mid-90's when the Fed backed off tightening monetary policy any further after a meaningful sell-off in both the debt and equity markets.



Some investors are holding tightly to the view that the pivot by the Fed over the last two weeks may engender an outcome similar to what transpired with the 'Fed Pause' in 2016 and the mid-90's before that. I'm not of that view, but it is a possibility. I'll leave you with one final reference point in relation to evaluating the ability of the consensus to proactively get in front of a recession: In December 2007, recession odds (according to the NY Fed) were double what they are today (40% – but keep in mind every time it's been above this level, the U.S. was in or about to enter recession), real GDP estimates for 2008 were +2.2%, Wall St. strategists were penciling in 10% gains for the S&P 500 and EPS growth, and the Fed was already done with its policy tightening having hiked interest rates for the last time in June 2006 and initiating its first rate cut in September 2007. A recession started in December 2007.

Compare this with today where real GDP growth estimates are between +2.0 and +2.5% for 2019, recession odds are around 20% to 25%, analysts are estimating EPS growth of 10%, equity strategists are forecasting 12% gains for the S&P 500, and it's expected that the Fed may not hike interest rates again. Only time will tell what comes next, and my only reason for laying out this comparison is to compel investors to think, execute some diligence and rigor via their own analysis, pay attention to the world around you at the current time, and to not get overly complacent about the future. There is no such thing as a sure fire, tell-all indicator, and looking for or relying on a single variable / one factor model opens an investor up to significant risk if it's not that particular variable or factor that is relevant. Capital markets and economies are highly complex and dynamic ecosystems that include unpredictable, emotional, and irrational human beings as input factors. Hence, the best any investor can do is to try and tilt the odds ever so slightly in their favor so as to gain an edge in handicapping the risk / reward of future outcomes.

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