
**January 7th, 2019**

## Cognitive Dissonance…

U.S. equity markets have taken quite a turn for the better following what was the worst pre-Christmas showing on record and the worst December since 1931. Moreover, the steep sell-off since the late-September highs was the sharpest decline since the 2008 Global Financial Crisis. The question is – and this is a question a rather astute client has pointed out to me – what now? Given the heightened level of volatility and daily average moves in the Dow approximating +/-500 points, it wasn't much of a stretch to suggest that we were due for some sort of a bounce. After all, the Merrill Lynch ‘Bull & Bear’ gauge of market sentiment had fallen to 1.8, which is an ‘extremely bearish’ reading for this metric, and as such triggered a short-term buy signal. This was just one of many sentiment readings that indicated markets became very oversold at the Christmas Eve trough – for the first time since February 2016, the Investors Intelligence bull/bear ratio fell below 1.0x.

In addition to bombed out short-term sentiment readings, you had investors taking action to reflect this increase in fear with $100 billion-plus flowing out of U.S. equity based mutual funds and ETF’s in the three weeks just prior to the post-Christmas day rally. In fact, over the past nine weeks equity outflows have totaled roughly $175 billion and, in perhaps a short-term indication that we’ve seen some level of capitulation, money market funds saw a net inflow of $8.5 billion in the week to January 2nd.  I can't say this level of reactionary impulse is all that surprising given the swings we've been seeing in the stock market.  Consider that December is typically an extremely favorable time of year from a seasonality standpoint and the trading week that encapsulates Christmas is historically bullish, yet the four days leading up to Christmas saw nearly 1,900 points come off the Dow.  The fact that the day after Christmas saw one of the biggest point rises in history (1,086) still left investors underwater from where they stood just a couple of days earlier.  Then we rolled into 2019 with the Dow plunging 660 points last Thursday followed by a 747-point surge on Friday.

This isn't the type of investment environment that engenders confidence and comfort, but rather epitomizes what happens in bear markets.  As a reminder, the top 10 largest daily point advances for the S&P 500 all occurred during official bear markets. What I'm getting at is for those investors breathing a sigh of relief, thinking that all the damage that has been done since the September 20th highs is behind us, may want to stress test that conclusion before proclaiming that an ascent back to (and above) the all-time highs is underway in what has already been the 2nd longest bull market in history. I'm not saying that such a scenario is an impossibility, but rather a low probability scenario. Given the low in the S&P 500 of 2,346 reached on December 26th, the charts suggest a move back up to the 50-day moving average at 2,645 would fill an open gap and still not violate the downward pattern in the major averages. Other technical frameworks, including Fibonacci retracement levels, suggest the S&P 500 will run into a plethora of resistance levels before then, with a cluster of levels suggesting this rally will peak sometime this week around 2,565 – 2,575.

So, my advice is to treat the current environment as just that, a bear market bounce, until it proves otherwise. The first step of disproving this thesis will be for the S&P 500 to move and hold above the 2,600 to 2,650 area and at that point it would warrant a reassessment. Technicals aside, my bigger picture fundamental view remains relatively consistent with where we left off 2018. A quick recap on that front, in that our work suggested 2018 would represent a peak in the economic cycle and as such the equity market would work its way through a topping process. With what we've seen play out on both fronts (of which I'll provide some updates to this effect in this missive), I have no reason to alter this view. Refine and evolve the view, yes, but there is nothing that has happened over the past six months that has caused me to change our base case scenario. That base case scenario entails a material slowing in U.S. economic activity in 2019, a slowing that will put the U.S. economy at risk of sliding into a recession perhaps as early as the second half of the year, and even if we don't slip into a recession, it's likely to feel like one in regards to asset prices.

First, I want to share some comments on some recent events that have assisted in the latest rip higher in the equity market following what I already noted earlier as an unsurprising oversold bounce that began the day after Christmas. In particular, just last Friday when we got a confluence of news, all of which was understandably digested in a bullish fashion. Early Friday morning it was announced that the PBoC (People's Bank of China) was going to cut reserve requirements again and on top of that they were going to pour a net $117 billion of liquidity into the financial system. This elicited an enthusiastic response on the part of investors where they viewed that the government was stepping in to fight any further slowing in the Chinese economy. I'm not questioning the reaction by investors, but I am questioning their presumption that this support by the PBoC will end up differently than the four times they took similar steps in 2018, yet the economy still slowed to its slowest pace of growth in decades and the stock market declined by 25%.

Then we got the December employment report which showed the U.S. economy virtually doubled consensus expectations by creating 312k jobs. In addition to the strong job gains we saw wage gains pick up to a cycle high reading of 3.2% YoY and the Labor Force Participation Rate tick up to 63.1% – its highest reading since 2013 and an encouraging sign that individuals continue to reenter the workforce.  I don't want to spill too much ink over this report other than to say I don't think it was nearly as rosy as the weekend papers made it out to be.  For one, the corresponding Household survey showed only 142k jobs created in December and this was the weakest gain since August of last year.  Not to mention the 25 – 54 age group (prime working age) showed a loss of -11k jobs in December.  And lastly, for all the cheerleaders praising this report, I wonder if they've even considered what it means to have the aggregate hours worked index increasing at a 2.4% annual rate in Q4, and yet Q4 GDP estimates are tracking right around 2.0%.  This implies that productivity is in the toilet (more workers for only a marginal improvement in output) and hence what one would expect when you see 146k of the 142k job gains in the household survey occurred among the 18 and 19-year olds (yes, this means there were net job losses in other age cohorts). Come on, really? This is what passes as a great jobs report today? I have no issues with youth employment as any young adult just needs a chance to get his/her life on the right path, but the jobs these individuals fill in society aren't exactly high-skilled roles on the cutting edge of advancing structural economic change.

The last event I want to hit on is the pivot by Chairman Powell on Friday morning at his speaking event in Atlanta, and this followed similar shifts from several of his lieutenants that were making the rounds on the speaking circuit. What markets welcomed most from Powell's comments on Friday was that they (the Fed) would be 'flexible' with their tightening process going forward. He did say that he doesn't believe that Quantitative

Tightening is having much of an impact at all on financial markets and that the winding down of the Fed's balance sheet is not "an important part of the story", but what the market really liked and all bullish investors heard was he "wouldn't hesitate to change balance sheet policy if needed". That's a long way from saying a change is imminent, but it's also a big step from his comments following the December FOMC meeting where he indicated the balance sheet roll-off was on auto-pilot. These comments on Friday morning from Powell followed a material shift from Cleveland Fed President Mester (voter this year) where she sees no urgency to raise rates now given inflation levels. Dallas Fed President Robert Kaplan in a Bloomberg Television interview last Thursday said, "we should not take any further action on interest rates until these issues are resolved for better or worse." This is a far cry from Kaplan's view back on October 19th when he said, “another two to three interest rate increases from the Federal Reserve will likely put U.S. borrowing costs in “neutral” territory where it is neither stimulating nor restricting economic growth.  Now we have comments from Atlanta Fed President Bostic hitting the wire as I type that he envisions only one rate hike this year – a step down from his recent view that two hikes would be appropriate in 2019.

So what gives?  In a matter of three months (October through December) we’ve seen a material shift in Fed language from crowing about how strong the economy is and guiding towards 3 – 4 more rate hikes through 2019, to the Fed Funds futures market now pricing in a 30% chance that the Fed cuts rates before year-end.  Well for one, we have seen a material degradation of the global economic data.  Putting aside the strong jobs report from last Friday (which it must be acknowledged that employment data is a quintessential lagging indicator), but we saw a steep 5-point slide in the national ISM manufacturing index last week.  This was the largest one-month slide since Lehman Brothers failed in September 2008.  The internals were as weak as the headline suggested with only 61% of the industries reporting growth in December, the worst breadth in two years.  And it wasn't just the National ISM, but all the regional ISM indices (NY Empire, Philly Fed, Kansas City, Richmond and Dallas) showed material weakness in December.

It's only just recently that we've seen the U.S economic data start to deteriorate, but the data across the rest of the globe has been pretty dismal for the better part of a year now.  What caught my attention more than almost any data point last week was the contractionary readings in the PMI new orders component across the globe (keep in mind any reading below 50 is a contractionary reading – not just slower growth, but outright decline):

- China 49.8 – first time in contraction since June 2016
- Malaysia 44.6 – third consecutive month of contraction
- Taiwan 45.2 – lowest reading since September 2015 and 4th straight month of contraction
- South Korea 49.8 – two straight months of contraction
- Turkey 45.2 – nine straight months of contraction
- Germany 47.4 – lowest level since November 2014, and third straight month of contraction

- France 46.5 – lowest level since August 2016, and 2nd straight month of contraction
- Italy 47.8 – five straight months of contraction
- Poland 44.5 – lowest level since June 2009, and 2nd straight month of contraction

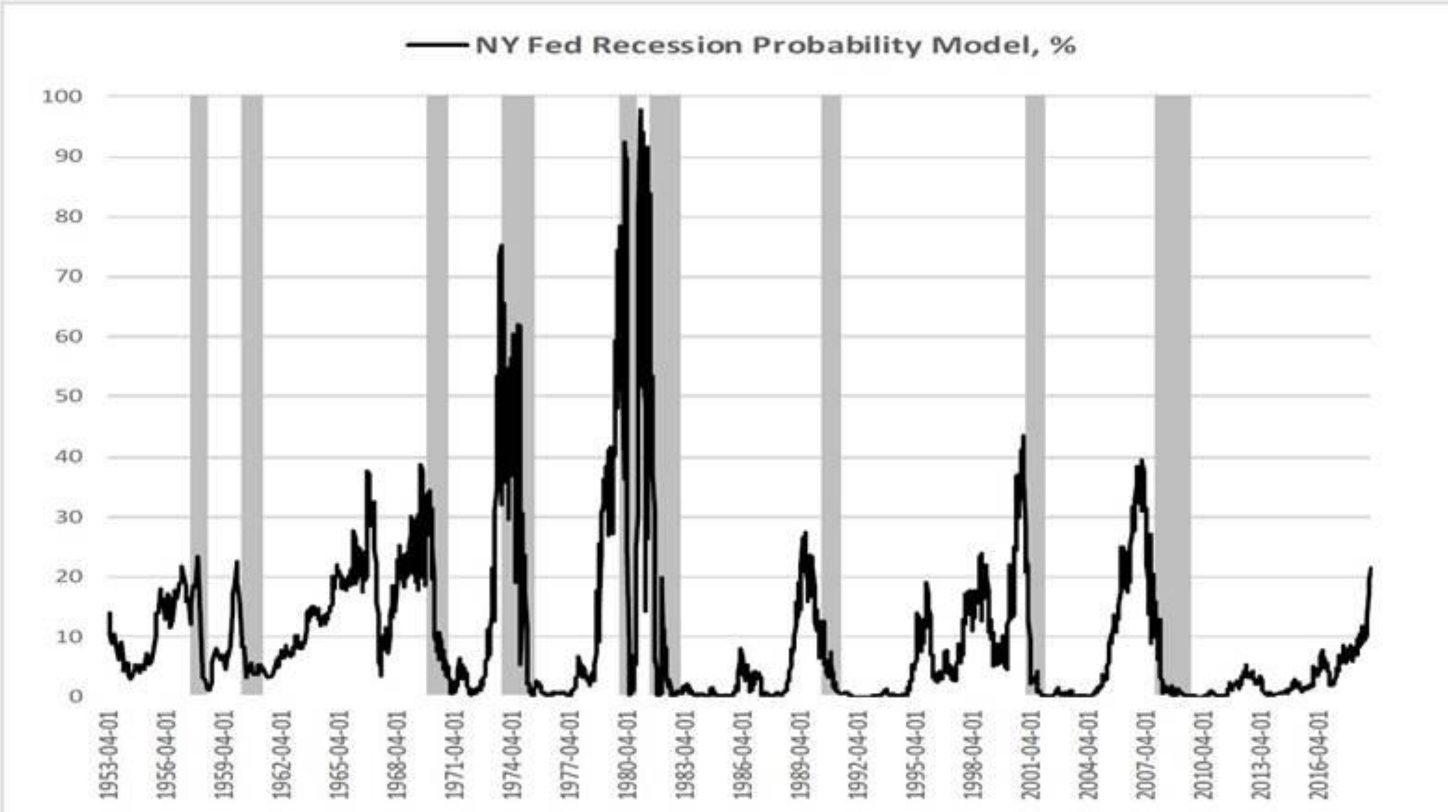
Also, we have jobless claims in the U.S., while still at a historically low level of 231k, but are well north of the low they hit back in September of 202k.  On the job front we also saw last week's Challenger data that layoff announcements are up 35% in December from year ago levels, and what was most striking in this report was that the pink slips were most intense in the cyclically-sensitive sectors: transportation services, real estate, autos, media, and electronics.

For the folks who have been paying attention to what the leading indicators have been signaling (and yes, the capital markets are a leading indicator), this decline in the economic data is not a surprise. The stock market has been suggesting such a transition was afoot as far back as the fundamental high on January 26th 2018, and the bond market has been hammering this point home since interest rates peaked along various parts of the yield curve in October and November. Consider that over the last month you've seen the likes of FedEx, Apple, and Delta all come out and lower both their earnings and revenue forecasts. Think about that, a worldwide shipping and logistics company, a company that was at one point the largest company in the world and sells a product that generated(s) roughly $50 billion dollars' worth of revenue per quarter, and a global airline – all preannouncing weaker results that they didn't see only a few months ago. Commodity markets are no different and are telling a similar story to anyone willing to pay attention. Oil plunged 40% almost in a straight line from its early October high, copper prices are in a bear market, and lumber futures have collapsed 50% since peaking on May 17th to end 2018 with a 26% annual decline.

The Economic Cycle Research Institute (ECRI) smoothed index had been in a steady decline for almost a year now and just last week fell to -5.3 (its weakest level since January 2012). If you recall, back then the Fed was implementing QE2 versus today where Chairman Powell is hinting at being more "flexible". The FIBER leading index is indicative of an even more sanguine economic reality with it falling to -7.00% on December 28th, its poorest reading since April 2009. As an aside (and please don't shoot the messenger), but this is the same level the FIBER index was sitting at in December 2000 and December 1990. For anyone who doesn't remember, a recession started just three months following that December 2000 reading and the U.S. economy was midway through the 90-91 recession when the FIBER index was at this level during that period.

I know, anyone of us can look at each one of these data points in isolation and come up with a cogent and logical explanation: be it Apple's guidance because their pricing was too aggressive for a commoditized product in a mature and saturated market, oil's fall is on the back of abundant supply, Delta's issues can be excused by the trade war and fears over international travel. But to undertake such an exercise risks missing the bigger picture and that is that when you take all of these variables together, it is conveying a fairly consistent and transparent message: global growth is decelerating and monetary policy tightening from around the world is doing what it is expected to do – slow things down and dampen inflationary forces. After all, that is why they tighten policy.

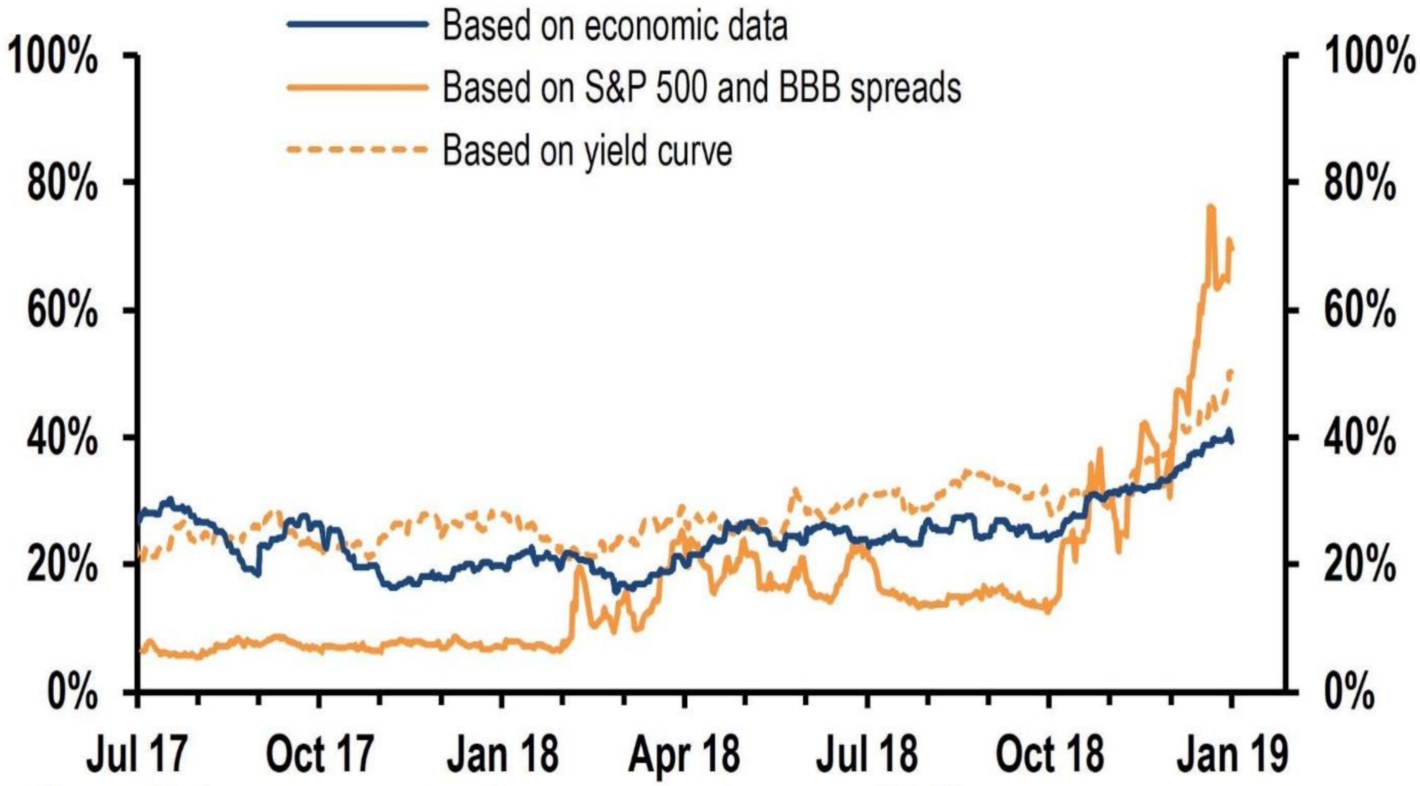
There have been thirteen tightening cycles in the post-WWII era with 10 of the 13 landing the economy in a recession. So, the probabilities are on your side that if the Fed is tightening policy it's likely that at some point this will tip the economy into a recession as has been the case 77% of the time since 1950. It would be irresponsible as a prudent steward of other people's capital not to consider such a possibility, especially with mounting signs that the probabilities are rising. The NY Fed Recession Probability Model is just north of 20%, its highest level in 10 years, and pegs the odds we enter a recession in next twelve months at a 50/50 coin flip.




*Source: NY Fed; Bloomberg*

This comports with the following chart J.P. Morgan put out last week quantifying the probability of recession based upon various capital market signals. Based upon the economic data, we are at a 40% chance of recession, the yield curve (which is inverted from the 1- year Treasury out to the 7-year maturity) pegs recession odds at a little over 50%, while the S&P 500 and BBB credit spreads are signaling the highest probabilities of just over 70%.

**Figure 1: Probability of recession beginning within one year**




Source: Various government and non-government sources, J.P. Morgan

I know it's blasphemy to even mention the word recession, but for the sake of thoroughness let's assume that a recession is not a fictional character like Godzilla, but rather just part and parcel of the business cycle. On average, with fundamental bear markets that coincide with a recession, you see the stock market decline 10 – 15% in advance of the recession even starting. Then in the recession it's typical to see the stock market decline an additional 15 – 25%. On a technical basis the stock market doesn't typically bottom until we get, on average, at least a 50% Fibonacci retracement of the entire bull market move – which would target a level around 1,800 on the S&P 500. More often than not, the low is not in until the S&P 500 reaches the fourth order Fibonacci sequence at 61.8% – this targets a market bottom around 1,550 on the S&P 500.

Keep in mind, these estimates assume that the S&P 500 peak was in fact the 2,940 level reached on September 21st, and an economic recession occurs. This is a scenario analysis in order to provide you with some context to formulate a plan, similar to an exercise we undertake routinely, to preclude us/me from making irrational and emotional decisions in what are the most erratic and chaotic market environments. Off this scenario analysis you can/should assign probabilistic outcomes and formulate your roadmap – what I'm simply trying to provide is some context and historical references.

On average, in the post-WWII era, the S&P 500 does not hit its low until 11 months after the very first Fed easing. Additionally, it's typically not until four months after the last rate cut that the S&P 500 bottoms. So, yes, the Fed does play a roll, but we're a long way from any of these destinations at this point and it does take time for the monetary lags to kick in.

Simply based upon price levels reached in full bear and bull market cycles, on a median basis the bear market ends once the S&P 500 just undercuts the peak of the prior bull market – typically a 7% slice below the prior high which would target roughly 1,460 on the S&P 500. On an average basis, a bear market sees the low coming at 16% above the previous peak – that would target a level around 1,820 on the S&P 500 based upon this scenario.

As for P/E multiples and earnings, in a classic deflationary recession it's typical to see corporate profits cut by 20% and a trough P/E multiple on trailing earnings hit 12x, or a trough multiple on forward earnings fall to 10x. If you assume that 2018 S&P 500 earnings per share come in around $170 / share and that represents the peak for this cycle, in which this number gets cut 20% as a result of a recession, then we're talking about

S&P 500 EPS falling to $136 – put a 12x P/E multiple to that and we looking at target price for the S&P 500 around 1,632.

What you come up with is a confluence of targets between the 1,500 and 1,800 level on the S&P 500 for a potential trough, if in fact we slip into a recession and the historical averages have some relevance for this period. With the S&P 500 currently trading around 2,550, that implies another 30 – 40% downside from here and roughly a 50% decline from the September peak. Not an unreasonable expectation considering the last two bear market recessions saw the S&P 500 decline 49% and 56%.

As for the Fed and all the jubilation following Powell's comments on Friday, while it's a welcome sign to see the Fed hint at stepping back from its tightening path, perhaps taking a pause, and assessing the impact of the tightening that's already in the system, it very well may be too little too late. It's my opinion that that the Fed has already gone too far, and the global economic system hasn't even fully experienced the lagged impacts from the tightening in financial conditions that has occurred in the second half of 2018. Chairman Powell acknowledged this at his speech in New York on November 28th, stating "*We also know that the economic effects of our gradual rate increases are uncertain, and may take a year or more to be fully realized.*"

Rack a history book or spend some time combing through the archives of prior Fed tightening cycles, and you'll learn that the last rate hike is just the beginning of the end, not the end of the end. Just look at the last two rate hiking cycles as an example. The Fed pressed the pause button in June 2006, began cutting rates in September 2007, but this didn't stop the recession from starting in December 2007. At the end of the Tech Bubble the Fed stopped hiking rates in May of 2000, began easing in January 2001, but this didn't stop the recession from starting in March 2001.

As the saying goes, a picture is worth a thousand words, and in my view the following chart encapsulates why I think the Fed (even with a Fed Funds rate of only 2.50%) has already tightened too much. Overlaid on this chart is the S&P 500 against the long-term downtrend line in the Fed Funds rate – this picture indicates that the last two times the Fed Funds rate has pushed up against this downtrend line from below, the equity market was in its topping process and a reversal of monetary policy was just around the corner.

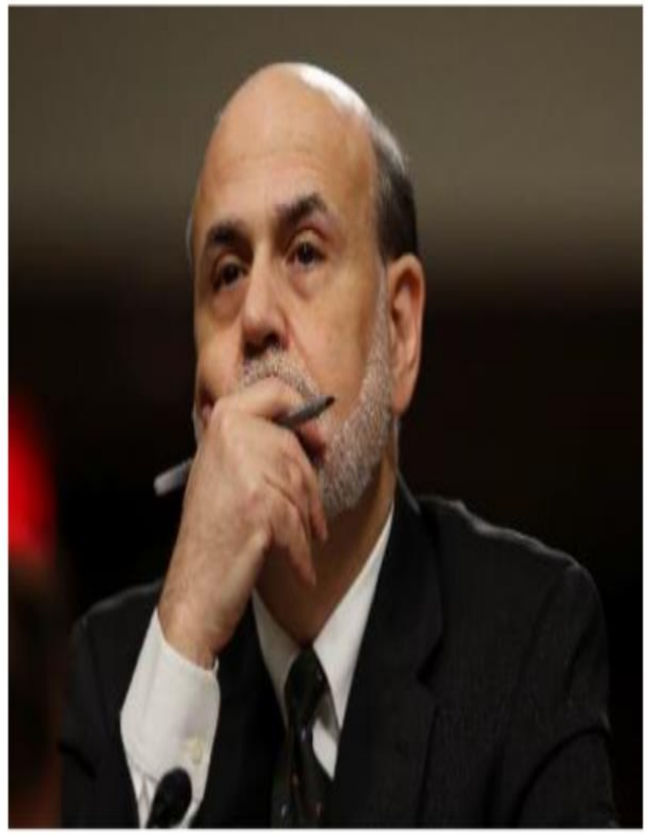

Now I understand and have seen and heard a lot of opinions on how this could turn out to be like early 2016 where the Fed paused after having hiked in December 2015 for the first time in nine years, and global risk assets ripped. But what also occurred at that time is that China implemented its largest fiscal and monetary stimulus package since the GFC, the

ECB upped its QE program and the BOJ instituted negative interest rates.  I've done the work in comparing and contrasting the two time periods (then and now), and reached the conclusion that there are just too many differences between the two to have a high level of confidence or conviction that a similar script could play out this time.  The biggest difference being that no major central bank in the world today is conducting asset purchases or QE.

That is the irony of this entire complex situation we find ourselves in today – the cognitive dissonance of the global central banks to praise the benefits and positive impacts of expanding their balance sheets and implementing QE over the last decade, and now not being forthright and honest with investors that the removal of such policies will have the opposite impact. Below is a snippet of the Washington Post op-ed penned by former Chairman Ben Bernanke in support of moving forward with QE2, which amounted to a total of $600 billion in asset purchases.

*"Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment.* ***And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending****. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."*

**— November 4, 2010**



Below are comments from Bernanke's testimony to Congress on deciding the size of QE 2:

March 2011,

# HIGHLIGHTS-Bernanke's testimony to Senate Banking Committee

**BERNANKE ON HOW FED DECIDED ON $600 BILLION FOR QE2:**

"We have tried through a number of methods to establish a correspondence between these purchases and what our normal interest rate policies would be.

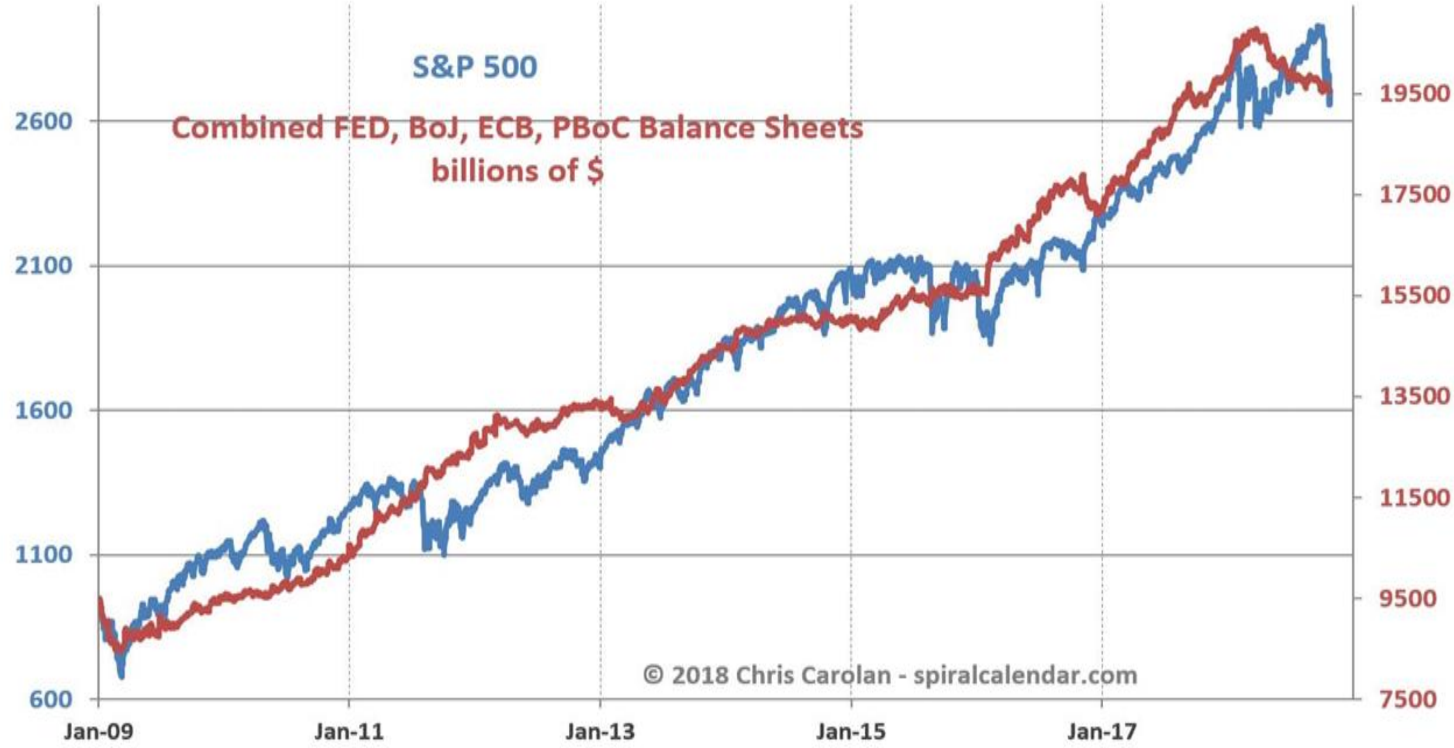
"And a rule of thumb is that $150 to $200 billion in purchases seems to be roughly equivalent to a 25 basis point cut in the federal funds rate in terms of the stimulative power for the economy.

"So $600 billion is roughly a 75 basis point cut in the policy rate in terms of its broad impact.

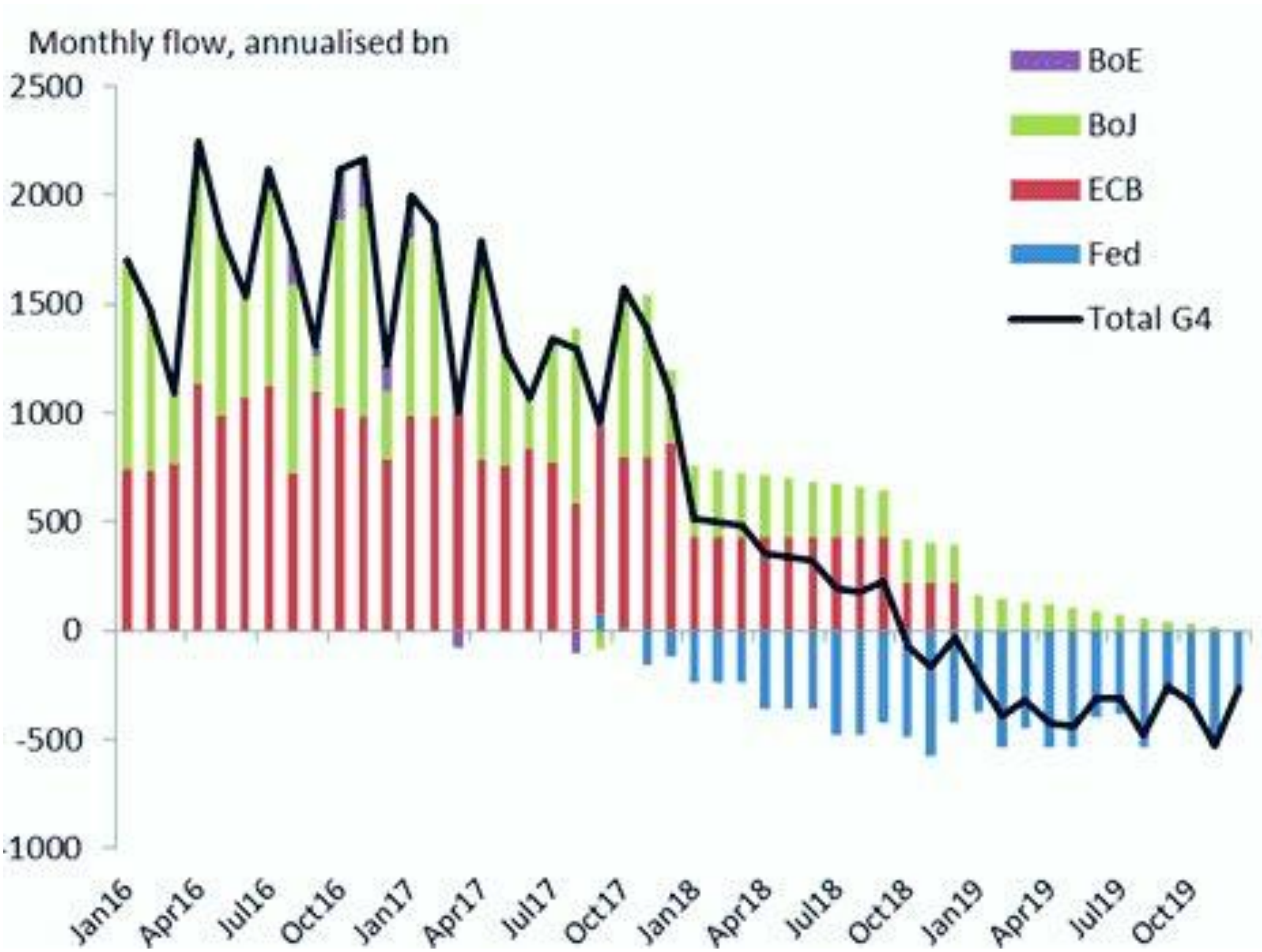
"Seventy-five basis points in normal times would be considered a very strong statement, a very powerful move, but not one outside the range of historical experience.

"It would be one taken, that would be at a period of concern, and then we would observe the effect. So that was roughly the analysis that we did."

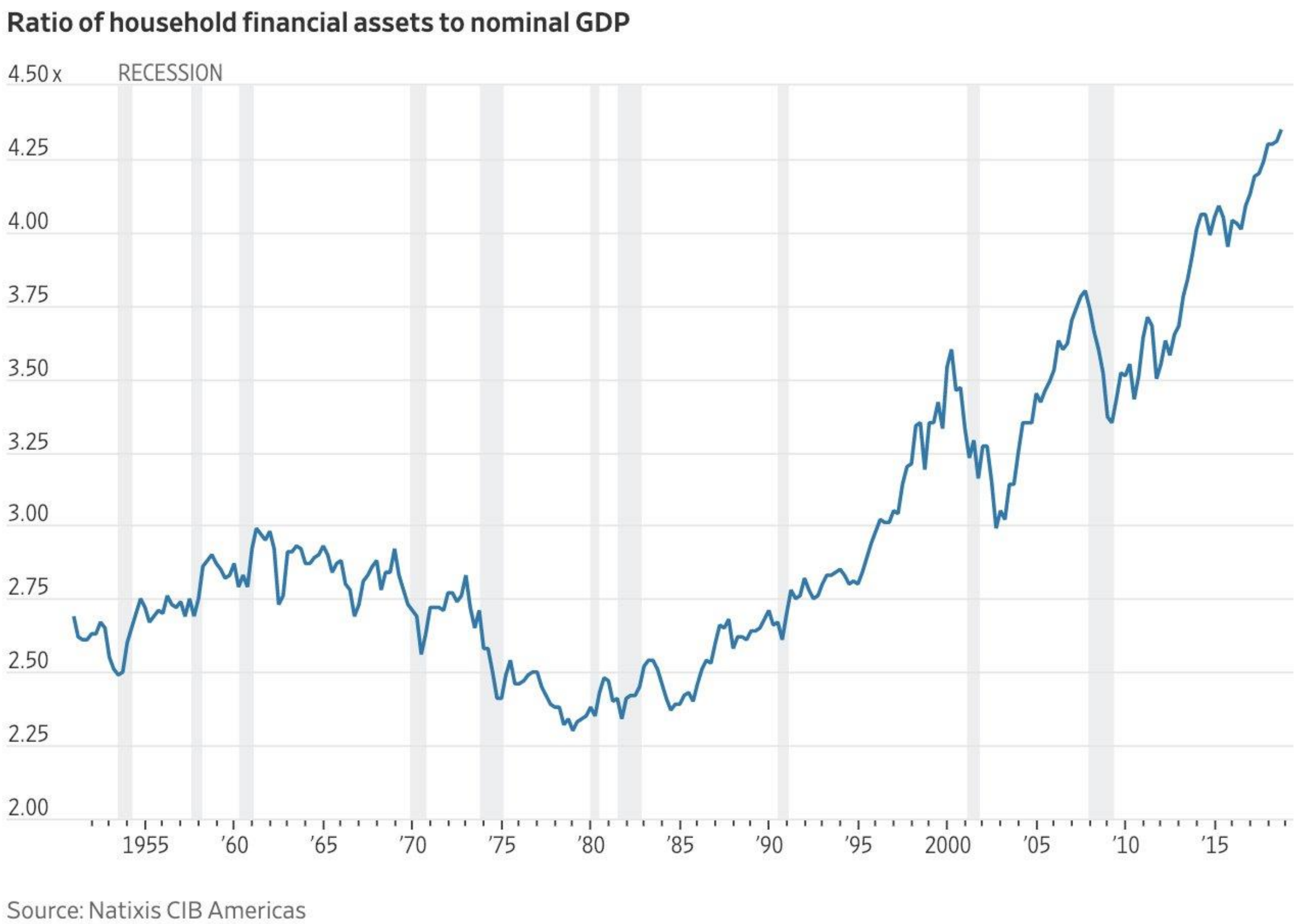
As a reminder, the Federal Reserve's balance sheet reduction schedule is set at $50 billion per month in 2019, and should it go on for the full year, that equates to $600 billion. This is the same size as QE2 and equivalent (according to Bernanke's math) to 75 basis points of additional Fed tightening. So even if the Fed doesn't hike rates at all this year, they will be tightening policy each and every month as the balance sheet contracts. Once again, this is what has the cheerleaders on bubblevision salivating over the last couple of days of this rally – the fact that Powell suggested, if forced by the markets, the Fed would consider slowing down or stopping the balance sheet roll-off. And yes, on this metric the bulls have reason to celebrate because if history is a guide, asset purchases by central banks are extremely important to financial assets. Most readers of this missive have seen this chart before (below chart from Chris Carolan plotting the balance sheets of the Fed, BOJ, and ECB against the S&P 500), so pardon the redundancy, but it's important enough to show again for anyone seeing for the first time.




Now have a look at the following chart that shows the rapid decline in the balance sheets of these G4 central banks, which has taken the annualized pace of asset purchases from over $1 trillion in December 2017 to almost zero at the start of this year. The big step down came in October of last year when the ECB lowered its asset purchases from $30 billion per month to $15 billion and the Fed's balance sheet reduction stepped up to $50 billion per month versus $40 billion. Think it's a coincidence that the S&P 500 peaked in late September? I don't.




The most difficult thing both investors and the Fed are going to have to navigate on the road ahead is how to untangle an economy that has become dependent on appreciating asset prices.  A recent article in the FT included the following chart highlighting the ratio of household financial assets to nominal GDP – which has moved well beyond the levels we saw at the peaks of the last two economic expansions and bull markets.  Keep in mind this is a ratio (financial assets / GDP) so it's scaled and accounts for the growth of the economy.  Couple this with global debt levels that are nearly 50% above where they were back at the height of the global financial crisis, and what we have on our hands is a real mess.




As for the Fed and the start of them capitulating to the message of the markets, keep in mind that actions speak louder than words.  So far, the Fed has done nothing but indicate that they are willing to be flexible.  It's not until they actually alter their balance sheet reduction path and/or start cutting rates that we'll actually be making meaningful progress at starting to look for signs of a definitive bottom in both economic activity and the stock market. We are a long way from that moment at the current juncture, but as an investor you should always be looking ahead.

Furthermore, they aren't the only game in town. Corporate earnings will start to be reported in the next couple of weeks, and it will be important to listen to what managers are saying about their ability to navigate increasing costs, higher interest rates, rising wages, and slowing end demand. 2019 sets up to be an extremely interesting year on many fronts, including what unfolds on the political front (the Mueller investigation is wrapping up and I have no edge or insight on what it will entail, but I am of the view that the markets have no idea how to price in anything other than the status quo). Not to mention there is a whole host of geopolitical events tabled for this calendar year: Brexit, anticipation of a new ECB Chair, global trade agreements… The one word I say to myself every morning, as I think it will be especially pertinent and relevant this year, is “patience”, and that comes from the perspective of already having capital positioned in a defensive and capital preservation orientation. I look forward and welcome the potential opportunities to come, but given my thesis and playbook, it requires letting some of these chips fall where they may before taking decisive action.

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