December 17th, 2018

You can't have it both ways…

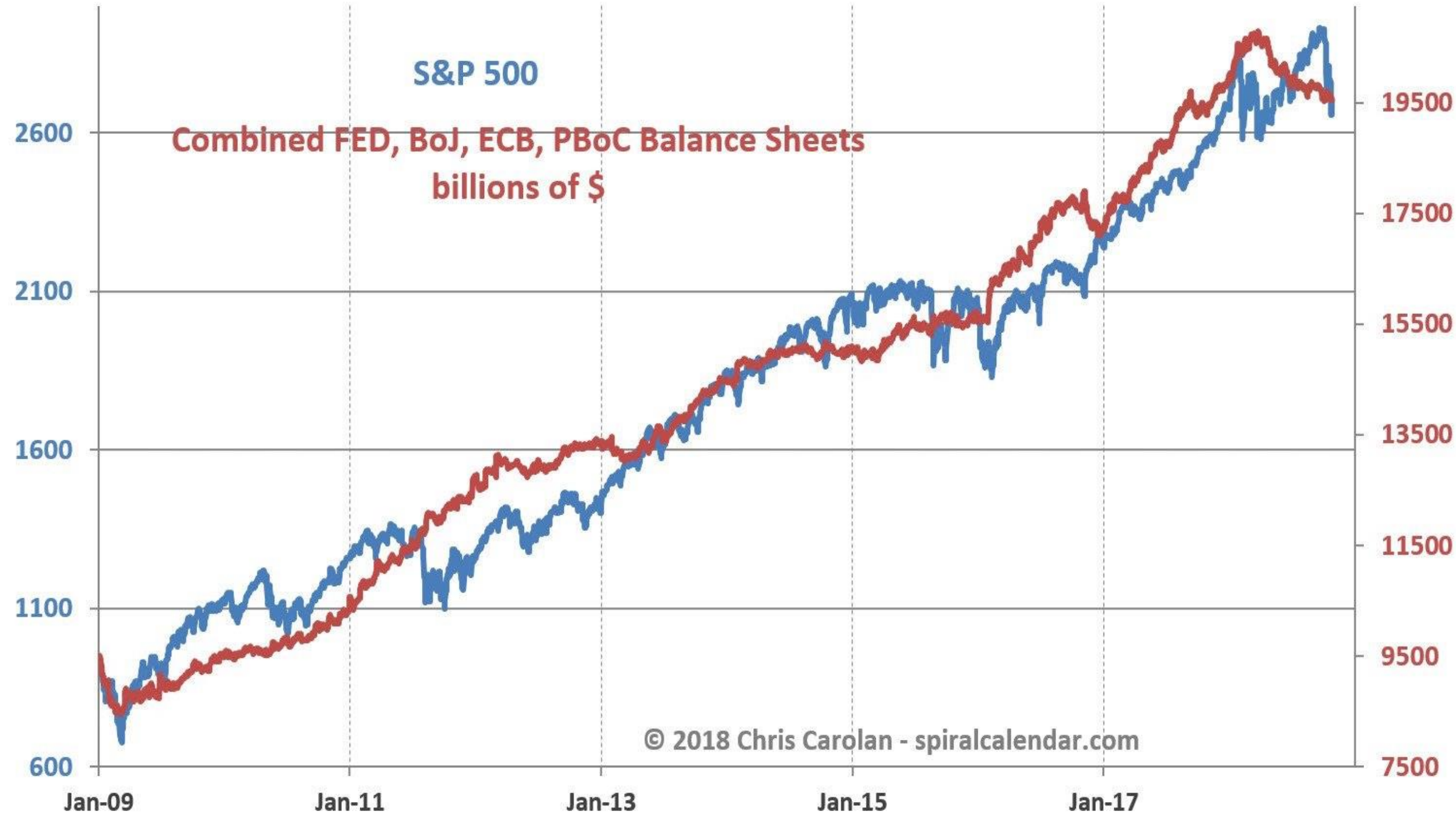
It truly is a disturbing state of affairs when the most bullish catalyst I hear on bubblevision or read in mainstream business periodicals is predicated on the Fed pausing or outright stopping its interest rate hiking cycle. Look, I can understand the rationale and thought process behind how such a shift could be interpreted as a near-term relief for asset prices, but then the next thought that runs through my mind is a sense of agitation in that this is what present day financial analysis has come to – pleading for central banks to revert back to propping up asset prices, as has been the case throughout the entirety of this nearly decade-long bull market.

Most investors' primary focus is on central bankers and what the Fed is going to do with interest rates and liquidity at Wednesday's meeting. It's bothersome that fundamental drivers like revenue growth, profit margins, valuations, business life cycle, competitive advantage, fund flows, sentiment, and market positioning have become secondary considerations when it comes to investment decision making. Or perhaps these variables have become a byproduct of the ultra-loose monetary policy in what has become a prolonged economic expansion – an expansion that likely wouldn't have lasted this long if not for the unprecedented and unconstrained policies implemented by the world's central banks.

I have little interest in going off on a tirade about how misplaced and misguided central bank actions have become in disrupting the efficient allocation of capital among businesses and markets (which is the primary and most important function of capital markets), let alone virtually eliminating the price signaling mechanics of market prices, because such a tirade would be a colossal waste of your time. What is done is done, and there is no use trying to rewrite the history books, but rather look ahead and attempt to navigate what looks to be a fairly tricky and challenging road ahead.

At different points in time throughout a market cycle, certain fundamental, valuation, or capital market variables will take on a dominant role in dictating the prices and trends in various markets. At the current time, and as has been the case throughout this year, that dominant variable is the liquidity (or the recent syphoning of liquidity by central banks around the world) that is causing the elevated weakness and volatility in capital markets. As of now, we have the cumulative impacts of the G-4 central banks (Fed, ECB, BoJ, and BoE) shrinking their balance sheets at a 1% YoY rate. The Fed alone – which is set to reduce its balance sheet by $600 billion over the next twelve months – has already seen its balance sheet contract by nearly 8% from year ago levels. The ECB is stopping its QE program at the end of this year, the BoE stopped years ago, and the BoJ is doing less nowadays to focus its efforts on controlling interest rates along certain parts of its yield curve. Why am I and why should everyone be focused on this item? Because as the chart below clearly illustrates, the correlation between central bank balance sheets (Fed, BoJ, ECB, and

PBoC) and the S&P 500 since the GFC is north of 90%.



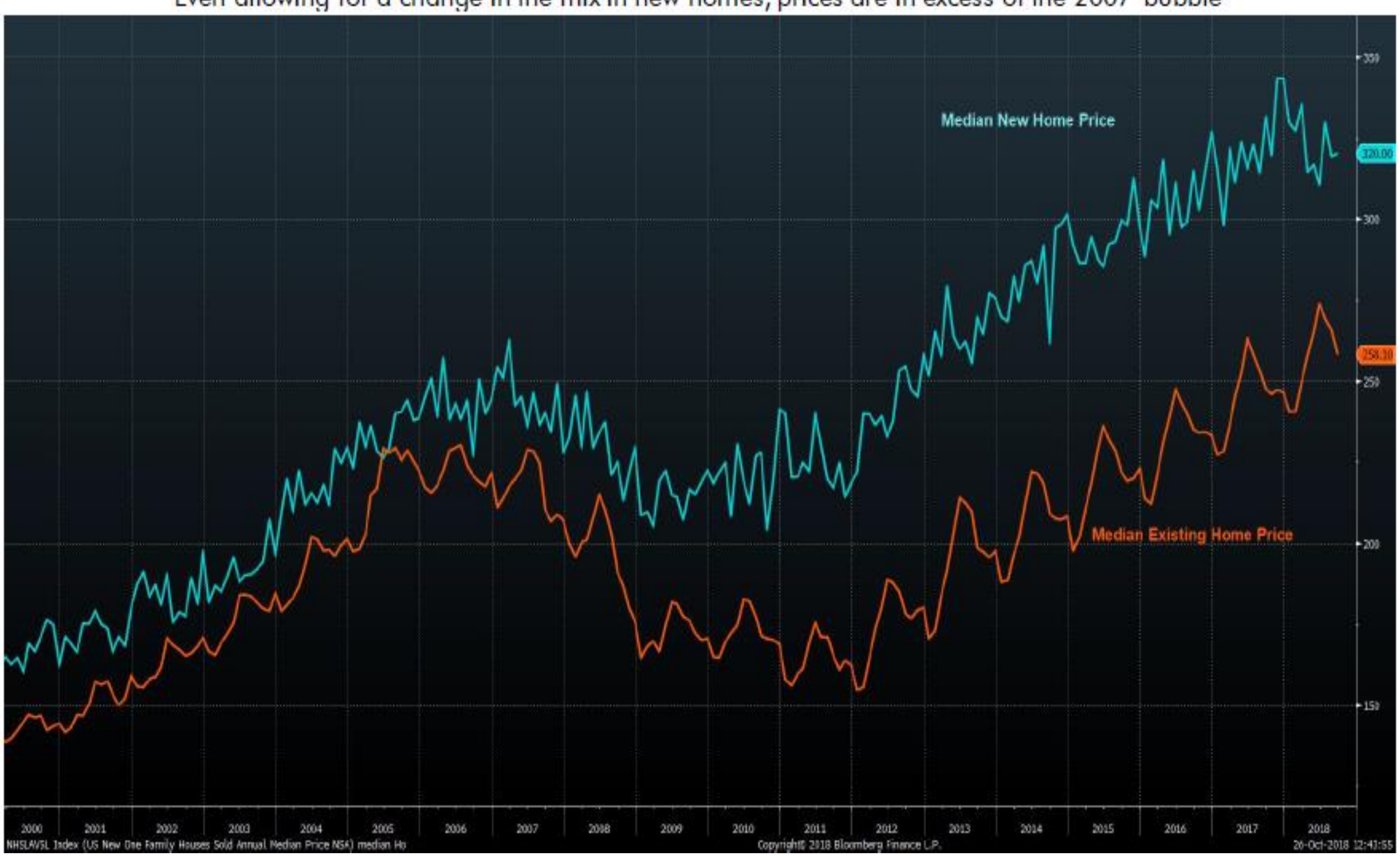
You can make the argument all you'd like that this is one of many possible drivers for the performance of the S&P 500 over the last decade, and I'll concede the point that there have been other factors complimenting the positive liquidity backdrop. But it's hard to argue that liquidity isn't the most important variable in markets when in calendar year 2018, S&P 500 earnings growth is set to come in north of 20%, real GDP growth is near 3%, and the unemployment rate is sitting at five-decade lows, yet the S&P 500 is approaching a 5% year-to-date decline with two weeks left to go in the year.

I find quite a bit of irony in this currently perverse set-up, where investors are begging the Fed to bail them out by backing down on its tightening campaign with the hope that it will breathe new life back into this bull market cycle: the U.S. has an unemployment rate at 3.7% (a five decade low), real GDP is tracking 3%, and core inflation is at 2.2% (hitting the Fed's 2% arbitrary objective) and virtually everyone from President Trump, other members of his cabinet, big-money investors like Stanley Drunkenmiller and Kevin Warsh (have a look at the op-ed they penned in today's WSJ), and well informed individual investors clamoring for the Fed to pause.

Which begs the question: if the Fed cannot tighten policy in this environment – then when can they?

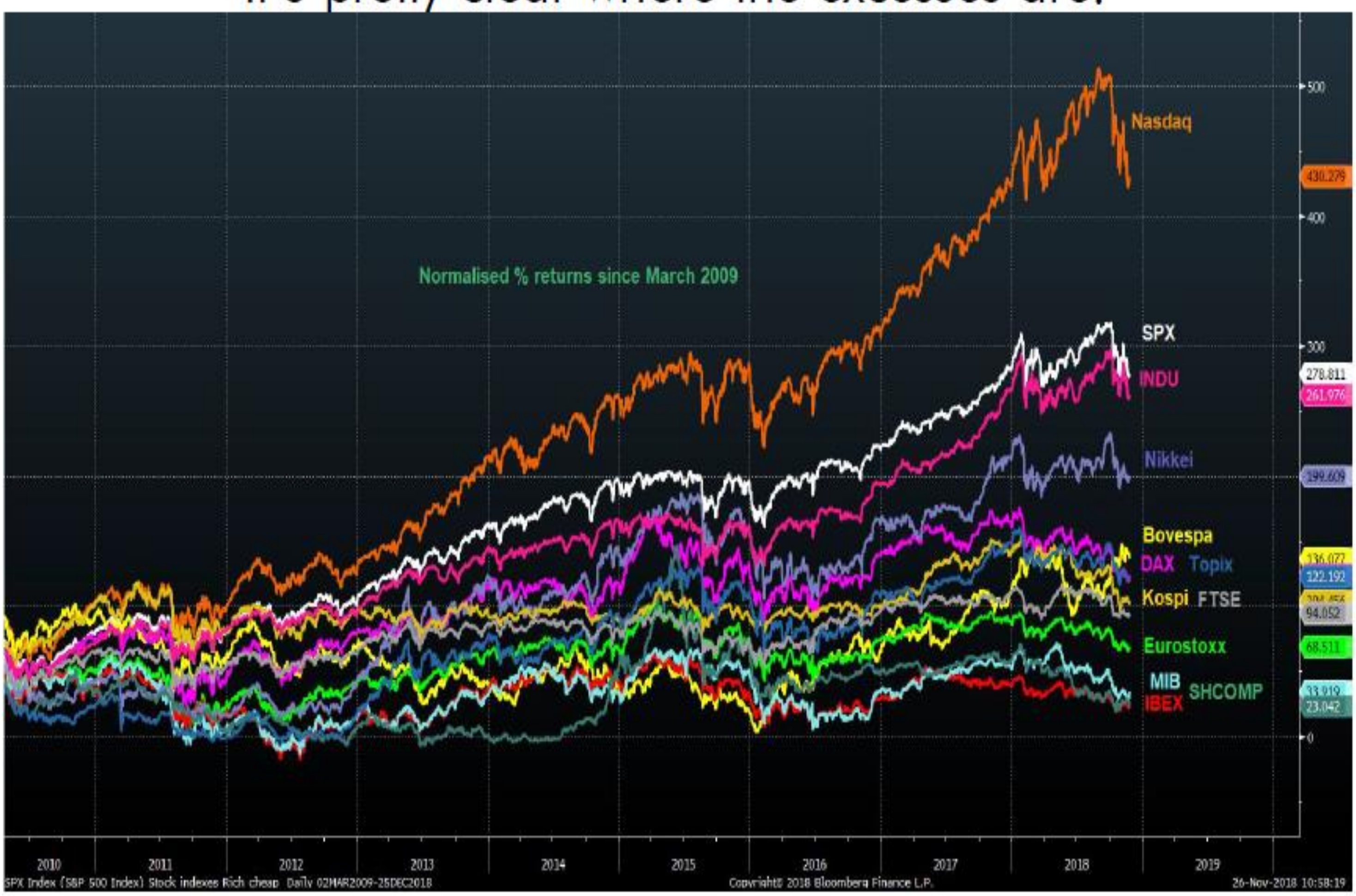
It's a question I am asking myself, and I assure you that I don't have the answer. But what's more telling to me is realizing just how backed into a corner central bankers are with monetary policy that remained way too accommodative for way too long, and these policies had the unintended (or intended) consequence of nailing asset prices to the ceiling while compelling the owners of these assets to believe that they fundamentally belonged there. Almost any financial or economic book worth its salt identifies the excesses of the last two business cycles as technology stocks in the lead up to the Dotcom Bubble in 2000 and mortgage debt and bank credit in the lead up to the Housing Bubble in '06 –'07. This doesn't imply that everything was distorted, but these two areas moved beyond price levels that could be sustained for an extended period of time, so when the music stopped, they were the areas that hurt the most in the ensuing downturn. It doesn’t take a rocket scientist to look at the charts below, where in the first chart you see that housing prices (both on existing homes and newly constructed homes) are above the peak levels they reached in ’05 – ’06.

Negative rates and QE have massively inflated house prices
Even allowing for a change in the mix in new homes, prices are in excess of the 2007 bubble



The second chart tracks the performance of major stock market indices from around the world since this bull market cycle began in 2009. The performance of U.S. based indices stand-out like sore thumb versus other markets from around the world. However, like in the lead up to the Tech Bubble in the late 90's, it's the gains in the Nasdaq that far surpass any other market.

It's pretty clear where the excesses are!



The point I'm trying to make is that investors should expect there to be some payback for years of asset prices being targeted by central banks and artificially elevated by their policies on the premise that it would create a wealth effect that would feed into a self-sustaining economic recovery. One of the consequences of leaving interest rates at the zero-bound for seven years and global central banks expanding their balance sheets to almost $20trillion was that it has re-inflated asset prices in the U.S. to levels that exceeded the heights of the last two asset bubbles.

Well, just as cheap and abundant money helped push asset prices higher on the way up, isn't it only logical to think that a reversal of such policies may have the opposite impact?

Being naïve to the negative implications on asset prices or outright ignoring them can no longer be considered a miscalculation or minor oversight.

This isn't to say that should Fed policy do an about-face at this Wednesday's meeting that investors shouldn't adapt and adjust their view along the way, but even a pause by the Fed at this point may be too little too late. Already we are seeing 2019 EPS estimates coming down (not enough at this point, in my opinion), the slight inversion in the front-end of the yield curve is forecasting that the economy is set to cool as we head into next year, credit spreads in both the investment grade and high yield markets continue to widen, and now even the defensive parts of the equity market (that had been holding up during this correction) are starting to rollover. The Fed pauses in '89, '00, and '06 didn't exactly mark the tops for those respective cycles, but they did foreshadow more difficult and trying times were ahead. As it stands, coming into today the fed funds futures market is only pricing in one hike by the Fed for next year, and this is down from 33% odds of three hikes as recently as early November. What this suggests is that the market has already moved quite a bit in terms of pricing out future hikes by the Fed, and given the 7% decline in the S&P 500 so far here in December, this move by the markets to front-run a dovish pivot by the Fed hasn't done anything to lessen the selling pressure.

The anticipation of markets pricing out future rate hikes by the Fed hasn't been lost on the gold market with the yellow metal pushing up to $1,250 / oz. Gold is up 2% for the month of December and 4.5% in the fourth quarter, which compares very well against an S&P 500 that is down nearly 8% in December and 12.6% for the quarter. Precious metals in general and gold in particular are an asset class fit for an environment where interest rates are no longer going higher, the Fed is flirting with a policy mistake, and geopolitical uncertainty is resonating around the globe.

Moreover, the data from around the rest of the world has only continued to weaken further with retail sales out of China last week falling to their slowest pace in 15 years. Not to mention auto sales in China are set to have their first annual decline in over 20 years. Then you have the likes of Italy, Germany, and Japan seeing an actual contraction in their Q3 GDP readings. As I've mentioned on several occasions over the last few months, there has been a rather disconcerting 11 consecutive months of decline in the OECD leading indicator which is pointing towards a worldwide slowdown next year – something the global stock markets have been pricing in since the summer. The U.S. economy is just in the initial stages of catching down to the reality of what's been taking shape in the rest of the world for almost a year now. I've heard quite a bit on the yield curve over the last several weeks and months and all the prognostications that after the yield curve inverts, investors have anywhere from 8 months to 18 months before they have to worry about a recession. Okay, but please don't rely solely on this sound bite to base your portfolio positioning and risk profile because we've also seen in this cycle that both Europe and Japan slipped into recessions without their yield curves inverting. You can never focus on just one thing – I only wish it was that easy.

Let me try to close up this week's missive with some constructive feedback, and no, this doesn't mean trying to spin what is a very complex, dynamic, and challenging investment backdrop into anything more than the reality that it is. I'm of the opinion that so much information has been and continues to be dismissed or ignored by the forecasting community and as a result there remains way too much complacency among investors. I get it, it's confusing when the President as recently as early October proclaimed that we are in the best economy the U.S. has ever seen, and not too long after that the Chairman of the Fed confirmed as much with a speech of his own. Then not even six weeks later, Chairman Powell adjusts his tune in another speech, all the while you have cabinet member after cabinet member going on TV and re-upping the rhetoric of just how strong the economy is – Peter Navarro was on CNBC this morning talking about the strength of the economy, but in his next breath he says the Fed shouldn't be hiking rates. I just don't get it – you can't have it both ways. Either the economy is too weak to handle additional hikes or the economy is strong and should be able to handle a 25-basis point hike in rates that would only take the Fed funds rate to a range of 2.25% – 2.50%. Something doesn't add up!

If anything, this is the point I'm attempting to make in this missive: asset prices have become so out of step with where fundamentals would justify, that attempting to keep the economy humming at a solid clip while keeping all other variables constant (interest rates, stock prices, housing activity, the U.S. dollar…) just isn't possible. Move one lever, and it has implications on the rest of the economic and financial system. Those investors looking and waiting to see clear indications that a recession is upon us are missing the forest for the trees. In the last cycle the stock market peaked in October 2007 and no one knew at that time that a recession was set to begin only a few months later in December. At the start of this century, the stock market peaked in March of 2000, but the recession didn't start until twelve months later in March 2001. What I'm stressing is for investors that haven't already done so, to take their beer goggles off. This isn't about trying to call or time the market, it's about objectively observing and listening to what the market is telling you as it plays the role of leading indicator.

Historically when homebuilding and financial stocks have closed out a year down double digits, it has foreshadowed a very challenging year lies ahead for equities. Another observation over the last week that I think provides a road map for more to come next year is the action taken by Lowe's to increase its share buyback plan by $10 billion, which got applauded by investors bidding up its shares shortly after the announcement. What some of these investors may have missed was Moody's downgrading Lowe's credit rating following the announcement to Baa1 from A3. This is going to be a big paradigm shift in the years to come where corporate balance sheets – after having been maxed out this cycle in the interest of fueling share buybacks, which has pushed corporate debt ratios to their highest levels in history – will no longer be a tailwind for the equity or debt markets.

I wish I could end this missive on a more positive note, but the reality is that the price action in the capital markets is more emblematic of a bear market than a bull market. The speed and veracity in which it has taken shape has surprised even me, and I've been harping about being defensive and cautious for well over a year now. Nothing has changed with this view on a longer-term basis, but in the near-term I'm of the view that the seeds are being sown for a bear market rally. At the moment, only 25% of the stocks in the S&P 500 are trading above their 200-day moving average and this is nearing the 20% level that typically represents a solid entry point for a bounce. One other item I'll be keeping my eye on as an indicator for a capitulation point is the VIX which closed out today at 24.52 (up 13% on the day) and any push up in this metric to the high 20's or low 30's would be something I'd take comfort in thinking that a short-term low is near. But keep in mind, until proven otherwise, we are still in the part of the cycle where investors should be using rallies as selling opportunities and a chance to right size the risk profile of their portfolio.

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