February 11th, 2019

In a holding pattern…

The U.S. equity markets have become a bit lethargic over the last week and a half with the S&P 500 trading this morning (2,705) at the same level it closed at on January 31st (2,704). Sure, there've been some ups and downs along the way, but having since worked their way back from what in hindsight was a bit of an overreaction to the downside in Q4, the major equity market averages appear to have taken on a 'wait and see' approach. And there's no shortage of issues around the globe that are causing investor indecision and uncertainty at the moment.

First off, we're flirting with the increasing possibility of the U.S. government shutting down again at the end of the week if a compromise can't be reached between the White House and the Democrats on funding for a border wall. Irrespective of one's view on this particular issue, two thoughts sit front and center in my mind. The first is that some of the estimates I've seen coming out of the economist community indicate that another shutdown at this time will have even deeper negative implications for the U.S. economy than the first did. This would be a very unwelcomed development as it would coincide with a growth backdrop that was already decelerating quite meaningfully in Q4 (granted, from what was a fairly robust pace in Q2 and Q3), but what is most concerning is that the data flow so far this year has yet to stabilize even at a lower level, but rather continues to weaken. And the second thought that runs through my mind is in regards to the dark cloud the prevailing level of rancor and discourse among elected officials casts over any incrementally positive fiscal policy initiatives getting passed over the next two years.

Beyond the U.S. government shutdown uncertainty, we have the Brexit negotiations that don't seem to be going anywhere. Since the turn of the year, pockets of optimism have arisen at times under the presumption that the EU was going to give Theresa May some new wiggle room to cobble together a deal she could get Parliament to sign on to – but so far that has been a complete false dawn.

Then we have the U.S. – China trade deal with chatter coming out of the White House (almost on a daily basis) of just how well the negotiations are progressing, but only to have these lip service sound bites be undermined by one of the major U.S. enforcement agencies charging a Chinese tech firm with some form of IP theft or fraud. It's hard to know the real intent of such actions at this time, whether it's to create some negotiating leverage or other motivations, but I don't imagine it encourages compromise from the Chinese delegation. Look, my two cents on this whole issue is that it is well beyond the intelligence and pay grade of most any of us outside that small circle of officials that eat, sleep, and breathe this issue at the moment. With that being said, I don't think there is much edge any investor can have in trying to game an outcome on this file – it's one of those variables you're better off reacting to rather than trying to front-run and predict. But it does appear as though the markets are pricing in some form of an extension of the March 1st tariff deadline, in particular off of the news that Presidents Trump and Xi won't be meeting before month's end. In my opinion, this was always the more likely outcome with Trump being set up to blink, as he has been prone to do, and Xi doing his best to wait out this administration with the hopes that something changes at the 2020 elections.

And then there is the global economy, where in the past week we've had the likes of the Royal Bank of Australia (RBA), the Bank of England (BOE), and the European Commission all cut their growth forecasts – and these weren't just tiny cuts. The economic data coming out of Europe undoubtedly makes one wonder not if the EU slides into a recession, but rather when? Making matters worse is the fact that short-term interest rates in Germany and France are still in negative territory, and as a percentage of GDP the size of the ECB's balance sheet is almost double the size of the Fed's. Now what concoction of monetary policy medicine can ECB officials possible dream up to step in and stimulate economic activity, when current policies have monetary accommodation already nailed to the floor? At some point these central bank officials (Draghi, Bernanke, Yellen, Powell, Carney, Kuroda…) are going to have to face the music and admit to the limits, if not outright failure, of these policies. Don't hold your breath on this outcome, but with each passing day the reality grows more obvious.

As for Australia – and this ties in closely with the weakness we're seeing in global trade activity and general economic activity out of Asia – the yield on 10-year sovereign debt slipped to near historic lows of 2.06% this morning. Pay attention folks, because the fall in interest rates around the globe is sending a rather loud non-confirmation message to the stock market bulls with the yield on German 10-year Bunds sitting at 0.11%, the 10-year U.S. Treasury yields 2.65% (down nearly 70 basis points from its high last fall), and 10-year JGB's slipped back below 0.0%. Here in the U.S. we have 5-year inflation breakeven levels falling to 1.7% from 2.08% late last year, which is a worrying sign for what this may imply about pricing power and future revenue growth. Everyone is so fixated on the stock market that the non-validation message from the bond market is being ignored.

Look I get it, as it's in the back of my mind (like I imagine it's in the back of most investors' minds) and that is the notion that the Fed has capitulated on normalizing monetary policy, and as a result there is no need to fear the headwind of tighter policy going forward. But where that assessment doesn't quite pass the smell test for me is filling in the pieces of the puzzle that would compel them to make such a drastic 180° pivot in such short order. Or why is it that just last week we saw the central bank of India cut interest rates in what was an unexpected move, and this is from one of the strongest economies on the planet. I'm going to save you the time and effort in this week's missive of cataloging the further degradation of some of the key economic data points over the last week, but these shifts by central banks around the globe back towards accommodation are occurring for a reason. And it's not because the global growth backdrop has improved, it's because they see things unfolding in a manner that worries them and they are trying to get in front of it. The question investors have to ask themselves is, will such measures work given where we are in the business cycle? As for the

Fed, they've only engineered three soft landings in the last thirteen rate hiking cycles – 10 of the 13 have ended in recessions. You can do the math, but the odds are drastically skewed in the direction of a bad outcome.

As highlighted with the title of this missive, my current view is that markets are in a state of stasis at the moment. The steep sell-off in the equity market in Q4 was too far too fast, and since then stocks have followed the path of a typical technical bounce that for the fourth time since last September's peak has taken the S&P 500 back to its 200-day moving average. This is a critical level and a sustained move in either direction off of this level should be respected. What has me leaning in the direction of the bears (in addition to my concerns on the macro front) is that I don't think there is that much pent up energy left to push this move much higher.

As of now we already have 80% of the S&P 500 members trading above their 50-day trendlines, which to some is a form of breadth confirmation, but this is also a very similar set-up that prevailed in late January 2018 just before it underwent a meaningful correction into April. Contrast this with the set-up at the Christmas Eve lows where less than 1% of the index was trading above these 50-day trendlines. That was a buy signal back then, and we are at the other end of the spectrum today.

I've also heard the argument made that the sell-off last year was just front-running the weakness we are now seeing in the economic and earnings data. Well, that sounds good and has a certain logical ring to it, but where I believe it falls short is that we haven't seen any form of positive inflection in any of the incoming data. Just look at the trend in analyst's earnings estimates and you have a crystal-clear roadmap indicating that downward adjustments remain a work in progress. Just three months ago the bottom-up consensus estimates were penciling in 2019 EPS growth of nearly 9%, and at the current time this estimate has now almost been cut in half to 5%. As of the end of September, analysts were estimating Q1 earnings growth of 6.7% YoY. By the end of 2018 that had come down to +3.3%, and as of last week that estimate now sits at -1.7% (that's a delta of 5% in a matter of six weeks).

We'll all have to wait and see how the rest of the year progresses, but if global growth continues to sputter, it's difficult to make the case that earnings in the back half of the year don't come down as well. If that's the case then the 16x forward P/E multiple that the bulls are mentioning as cheap is going to look pretty foolish, when in reality – it isn't cheap enough.

Yes, the talking heads were oozing over the January jobs report, but go back and look at what the headline prints for job growth were leading up to the last several recessions:

- December 2007: Non-farm payrolls +110k – no recession in sight, right? It started that very same month.
- December 2000: NFP +152k. The recession didn't start until March 2001, so there was a full three-month lead time on this print.
- May 1990: NFP +151k. This was two months before the recession began in July.
- June 1981: Payrolls +194k. The recession began in July – the very next month.

- January 1980: New jobs created +128k. The recession began that very same month.

You get the point – employment is a lagging indicator and provides investors with very little useful information about what the future holds, in particular at possible inflection points. My point with bringing attention to this data set is not to make a recession call, but more so to highlight just how important it is to not rely on any one data point to defend or support an opinion.

At the current time, I think investors have plenty of information at their fingertips to conclude that they need to be on the lookout and be preparing for the increasing probability of a more sustained turndown in both the economy and equity markets. How severe the downturn, the duration, and whether it's accompanied by a recession will only be known after the fact.

The point I'm trying to make is that, in my opinion, a lot of unknowns and uncertainties that currently have the capital markets in a holding pattern have to fall the right way to justify/support what is already priced in. While we could get a positive announcement on any one of the geopolitical issues clouding the outlook today (and my guess is that will provide investors with a sigh of relief), but as for the fundamental items – economic growth, global trade activity, earnings… it's going to take months if not quarters to re-ignite the level of confidence and energy that pushes the S&P 500 to new highs. However, if these items don't fall the way of the optimists, then we're looking at an investing backdrop that is vulnerable to the downside. Mr. Market has given investors yet another opportunity to cleanse your portfolio and shift to a more defensive and income-oriented posture. Those who didn’t take advantage of similar set-ups in the April and September rebounds have another opportunity – don’t make the same mistake a third time. I get it, there is little excitement over taking this course of action, just as it’s hard to look at a 2-year T-note yielding 2.5% as all that rewarding, but it’s a way to get paid with complete optionality to use this capital for another use should other opportunities arise.

It’s a time to be patient and not force anything at the moment.

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