February 19th, 2019

Confused? Yup, I must admit to feeling this way…

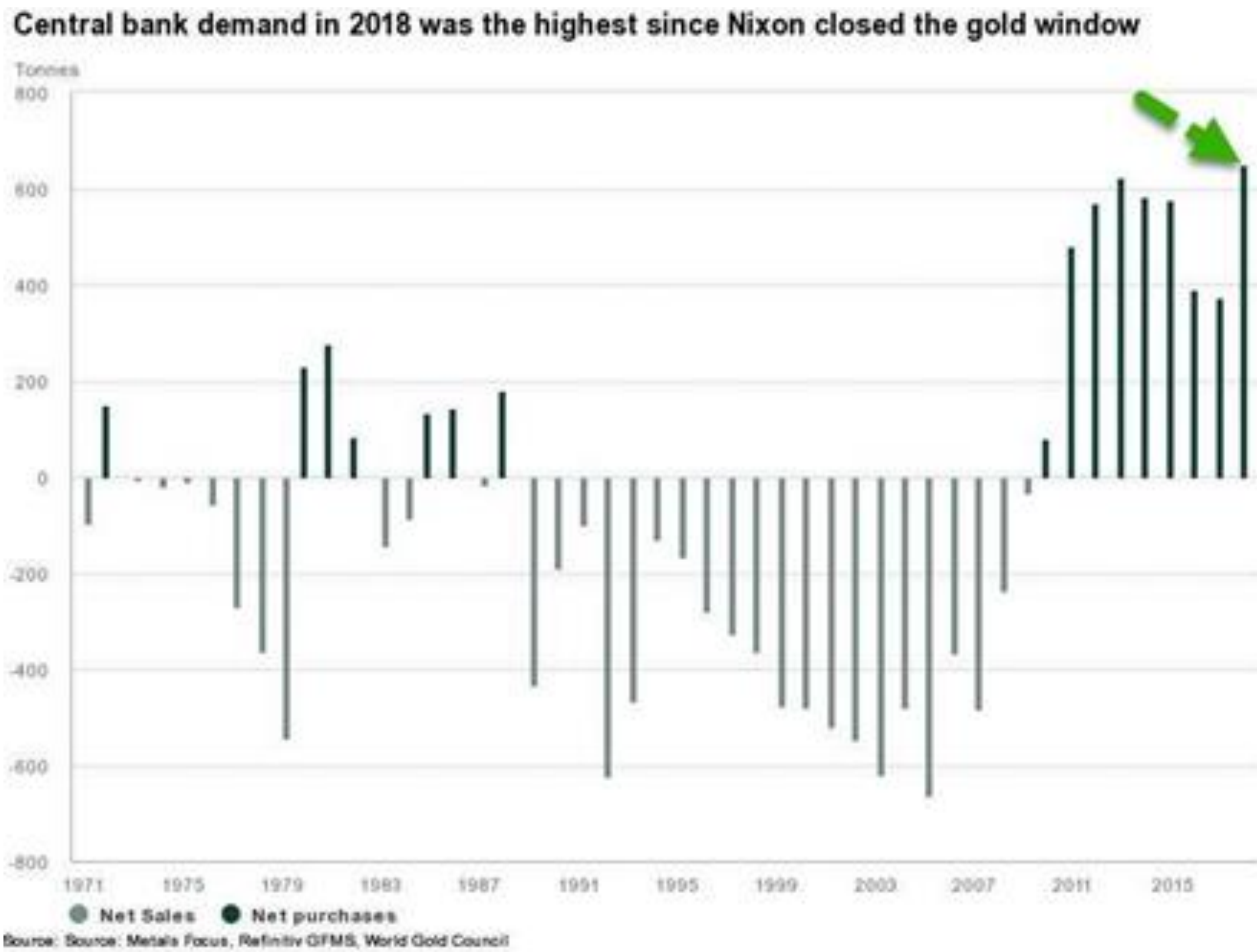
Without question, this eight-week win streak for the major U.S. equity indices has been a surprise and has far surpassed my expectations. It's been one heck of a run for risk assets across the globe, where it was just 45 days ago that the Nasdaq was in the throes of a bear market, yet not even two months hence and we're looking at the same index having rallied 20%. The S&P 500 and the Dow Jones Industrial Average are up 18% and 19% respectively from their December lows, with the Russell 2000 Small Cap Index surpassing them all by having rallied some 24% since December 24th. So here we are, not even two months into the year with the S&P 500 up 11% YTD, a full 2% above the average annual gain of 9%. Not only did the stock market record the best January performance since 1987, but it's also off to one of the best starts since 1931. Hopefully the full year results turn out much better than those two years, where in 1987 the stock market rolled over hard to end the year down 13% after being up as much as 18% in the first two months, and in 1931 – after an early year surge – the S&P 500 went on to decline by 58% into the end of the year. The lesson here is to not become complacent about annualizing early year gains, and 2018 is the most recent example of just how quickly things can change.

It’s not seeing equities rally from what were extreme oversold levels in late December that’s been surprising (decisive reversals/bounces in the throes of a bear market are typical), it’s that this rally continues uninterrupted in the face of what has been some very weak incoming economic data, both in the U.S. and abroad. Not only has the data been weak, but fund flows have shown retail and professional investors have been net sellers over this time period, and both investing segments are overweight cash to an extent we have not seen in a decade. Whether it’s just machines and algos, short-covering, or stock buybacks driving this levitation over the last couple of weeks is an open question, but it definitely creates an investment backdrop that challenges one’s analytic rigor and confidence.

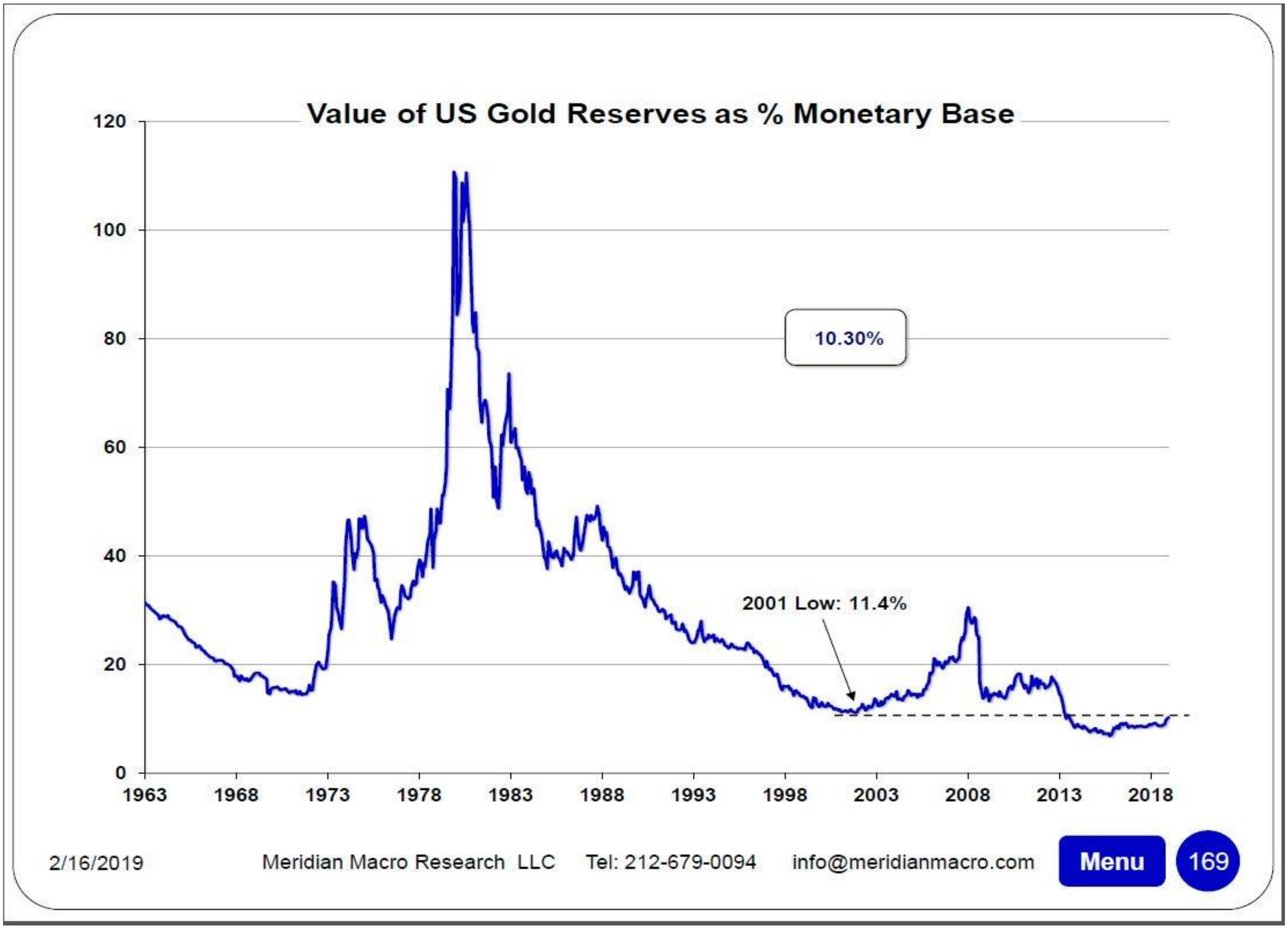
With that being said, there have been times in my career when I had to admit to myself that things are occurring that I just don’t understand in the moment, and it’s at these infrequent junctures when it’s best to play the role of spectator rather than participant. It’s at these moments of confusion that I’ve learned it’s best to take a step back and assess the backdrop rather than forcing a poor decision – taking such an action sacrifices short-term potential, but allows you the ability to refocus on the more important long-term horizon.

It’s not that there haven’t been some constructive catalysts to elicit this reflexive bounce, but these catalysts are more of the cosmetic variety than anything substantive. Yes, the Fed has definitely shifted to a more supportive posture from where it was in October, where they are not only on an extended pause in terms of interest rate hikes, but now the big talk coming out of the governing body lately has been their intent to end QT (balance sheet reduction) by as early as the end of 2019. This is a big deal in that it is nearly a year-and-a-half earlier than the previous expectations that it would end sometime around the second-half of 2020 or early 2021. In addition to the Fed pivot, we have the ECB following suit with a shift in its own policy guidance with ECB board member Benoit Coeure openly suggesting that the TLTRO (Targeted Long-Term Refinancing Operation) is soon to be revived. This is a facility where the ECB will provide cheap multi-year loans to the banks to deal with their funding challenges. Yeah, I know – it continues to defy logic that the best solution these policy makers can come up with is to extend more debt to a banking system that is choking on the debt it already has on the books.

In addition to the Fed and the ECB, we have the BoJ's Kuroda hinting at more accommodation over in Japan. And why not? I mean, the BoJ already owns 40% of Japanese Government Bonds. I remain firmly of the view that this era of central bank alchemy will see a very ugly ending, but there is no way of knowing when that moment will occur. In the meantime, we are back to $11 trillion of bonds around the world trading with a negative yield. According to the WSJ, 22.6% of all global debt has a negative yield and this is up from 18.9% in October. No wonder gold has been on a tear, having risen from $1,190/oz on October 1st to $1,340/oz today. This is a +12.6% gain over the last four-and-a-half months and compares very favorably to the S&P 500 which is down -5% over this same interval. I've been a staunch advocate for investors to have some exposure to gold for well over a year now, and the rationale for holding this shiny yellow rock runs much deeper than one's view on inflation/deflation, the direction of the U.S. dollar, or interest rates (while all of these variables impact the price level of gold), but in its simplest form I view it as a type of insurance against central bank credibility. I could go on for pages on this subject, but I'll leave you with one final thought to consider in relation to gold. If, as some suggest, gold is just a pet rock that doesn't pay any interest, has little industrial use, and can't be used in society as a form of commerce…then why is it that global central banks have been stockpiling this precious metal on their balance sheets for the last eight years, and total central bank purchases in 2018 were the highest since the suspension of dollar convertibility into gold in 1971? Kevin Muir's Macro Tourist Blog penned a very thought-provoking piece on this subject last week that I would encourage everyone to read: [Link to: The Macro Tourist Blog: Guess Who's Buying?]



One last point on gold before moving on, and that is that investors should view gold through the prism of it being a long-term store of value. Here and now, on a short-term basis gold has come a long way in a short period of time and is registering some overbought technical readings, so any new entrants need to pare back any near-term enthusiasm as this most recent run may be nearing its finality. But those looking to own gold with a long-term investment horizon can do so with the understanding that – on metrics that have historically been used to value gold – it would come as little surprise to me if gold reached $3,000 - $5,000 per oz. at some point over the next decade. In the interim there will be times when its price will oscillate violently in either direction on speculative fervor (in these windows one can chose to increase or decrease their position size) but in my view the big gains will be garnered over the course of an extended period of time. When one considers the extent of money printing and debt accumulation over the course of the last two decades and contrasts this with the current total dollar value of the outstanding gold stock, it provides some context for the potential upside for the price of gold. There is no guarantee or certainty that gold will revert back to an asset that backs the monetary base, but with the current value of US gold reserves as a percentage of monetary base recently reaching one of its lowest levels in history – I personally hold the view that if an investor is ever going to own it, this represents a reasonable entry point to secure your long-term exposure (below chart courtesy of Eric Pomboy).



Getting back to the catalysts that have been pushing this equity market rally, it seems as though it's only a matter of time before an agreement is reached on the U.S. / China trade file. The particulars and depth of the agreement isn't important to markets at the moment, what matters is that there is no further escalation on the tariff front, and hopefully even the removal of the tariffs that have already been put in place. Even the Chinese are joining in on the publicity front indicating that a memorandum on a deal is around the corner. At this point both sides have too much to lose by not finalizing something and it appears that President Xi is following President Trump's lead in having his eye on the rising Chinese stock markets as a local endorsement to get something done. The last political concern that seems to be progressing in the right direction is on the Brexit file where Theresa May is heading off to Brussels for talks with the top brass in the EU.

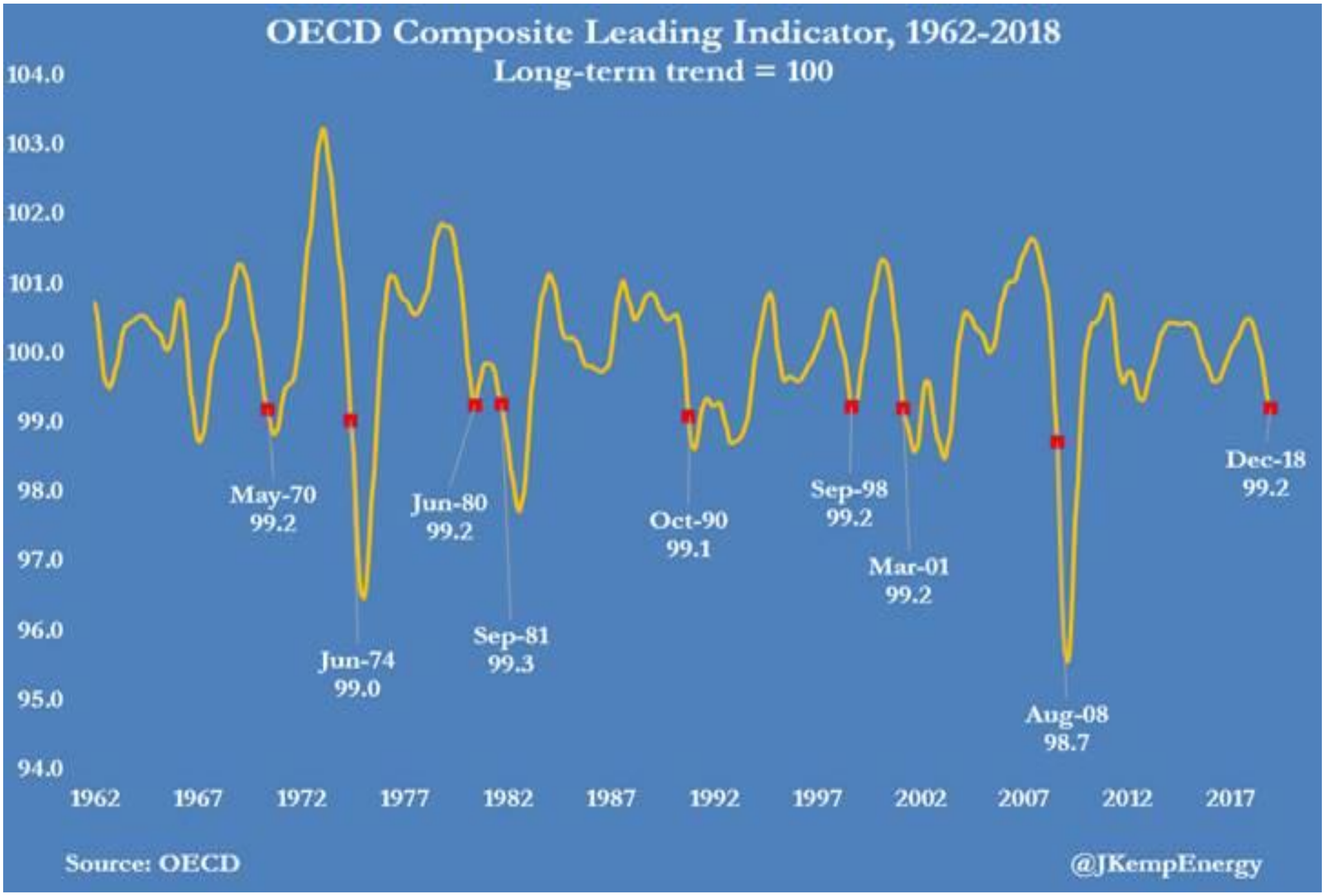
So here we have it where central banks around the globe have pivoted in a market friendly direction, a U.S.-China trade deal is getting priced in, and a soft Brexit is back on the table. It really begs the question about how many times markets can rally on the same piece of news, but as I stated at the outset – this is a market that has been confusing me for several weeks now. The last several weeks have been a clear reminder that there is no piece of economic or earnings data that can stand up to the power of the monetary authorities. This entire post-GFC expansion from 2009 – 2018 epitomizes this relationship in that this still goes down as the weakest economic recovery in the post-WWII era, yet it coincides with one of the most powerful bull markets ever recorded.

But while the price action in the equity market is decisively in favor of the bulls, it remains extremely difficult to just ignore the arguments being made by the bears. Look back at last year, when at the start of the year the consensus view was that the global economy was finally reaching synchronized global growth, and the bears said it wouldn't last – and they were right, as it started to fall apart by the end of January. The bulls were all excited about tax cuts and fiscal stimulus while the bears said it was just a sugar rush and the bump wouldn't be sustained – and the bears were right when you consider that Q2 GDP came in at 4.2%, Q3 GDP came in at 3.5%, and the most recent estimate from the Atlanta Fed GDPNow model has Q4 GDP slowing to 1.5% (keep in mind the Atlanta Fed's estimate was as high as 3.0% in late December). And it doesn't look as though there is going to be any reacceleration heading into Q1 with the latest estimate from the NY Fed expecting Q1 GDP growth of around 1.08%.

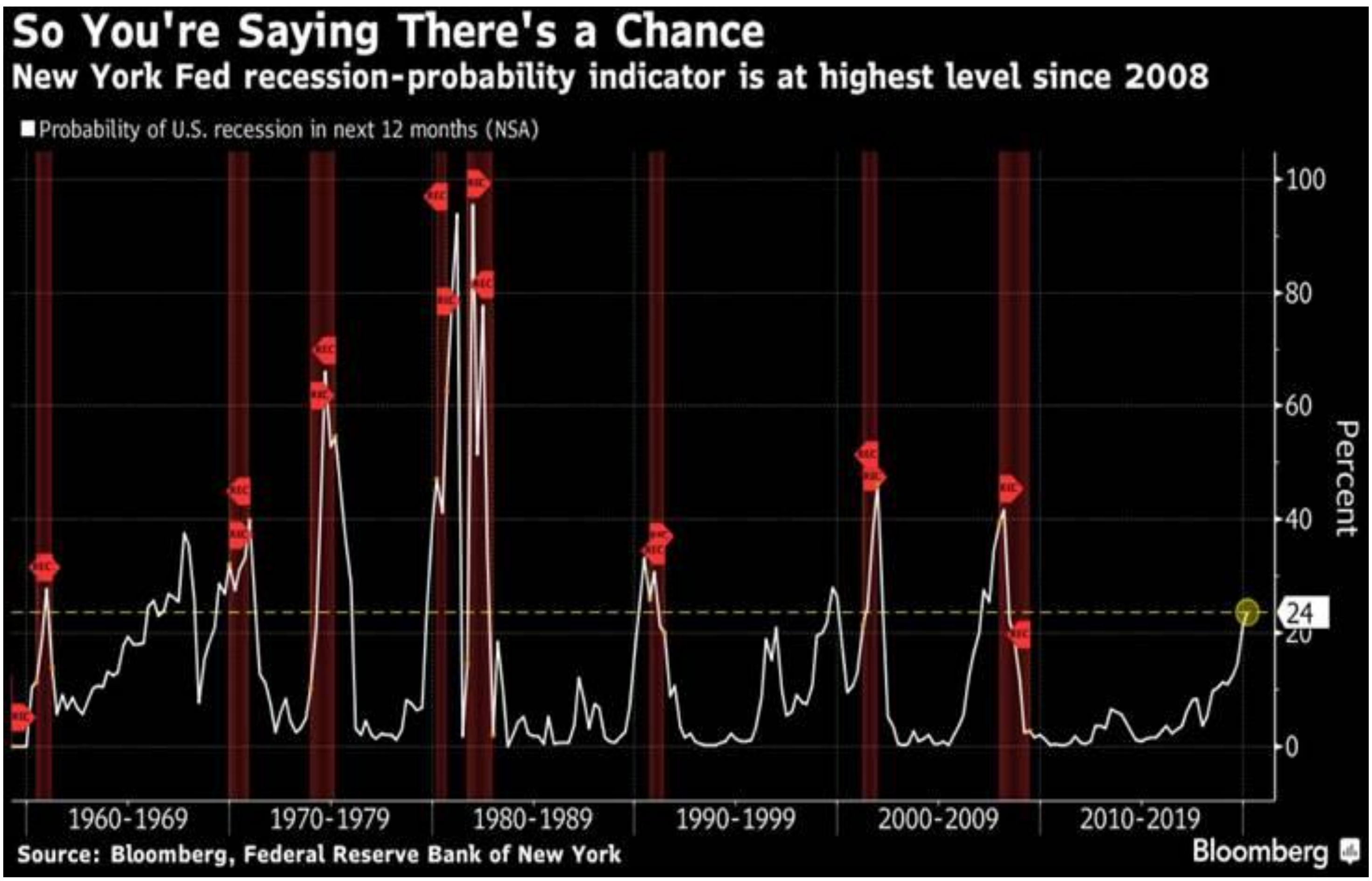
The battle between the bulls and the bears is a bit more balanced in declaring a victor as the bulls did have the benefit of pointing to three consecutive quarters of 20% EPS growth from the S&P 500 from Q1 – Q3 2018. But where the bears can claim some form of validation is in arguing that those levels of EPS growth were in large part driven by tax cuts and the true underlying growth potential was much lower. Well, we're seeing this argument gain some merit in real-time with Q1 EPS growth estimates having been revised down to +0.4%, with Q2 and Q3 not much better at +3.7% and +3.2%, respectively.

You see, it's not as simple as just pointing to the price action in the stock market and claiming that anyone who has retained a cautious or skeptical view has been wrong. Sure, on a price basis the more bullish you've been in regards to the stock market the more right you look, but if you look on a fundamental basis it's hard to even make a cogent argument that incoming data has at all been supportive of the bullish view. I don't think it's an unreasonable assertion to suggest that if you've been buying equities this year, you've been more lucky than good. Another plausible explanation to justify buying stocks this year would be anyone that invested on the premise that central banks around the world would add a new mandate to their objectives, which is to backstop asset prices once again and support risk-oriented market behavior at any cost. These explanations at least offer some form of reality and hubris, but make no mistake – it's hard to defend the assertion that one has been adding risk exposure to their portfolio based on the improving economic backdrop.

If you are a fiduciary or even consider yourself to be a prudent, fundamentally driven investor, then it has been extremely difficult to dismiss the fact that the OECD's composite leading indicator fell again in December to 99.2. This marks the twelfth consecutive month of decline and in the last 60 years, when the composite indicator has fallen to this level, the U.S. has entered a recession on seven out of eight occasions. The lone exception was 1998 when the economy slowed, but pulled out of the soft patch after the Fed cut interest rates. I see some people making the argument that today is a good parallel with 1998, to which I couldn't disagree more adamantly, but they like to mention that the Fed pausing a rate hiking cycle (as they are doing at present) is the same as a rate cut – well I got news for you, it isn't.



Another data point that causes me to scratch my head (when I hear it so easily dismissed, as if it is irrelevant…) is the steady rise in the NY Fed's "Probability of a Recession in the next 12 Months" model which rose to 23.6% in January from 21.4% in December, 15.8% in November, and 14.1% in October. Notice a trend developing here? Quite often, recessions occur when this measure moves into the 30 – 40% probability range. The last time there was a global growth scare back in 2016, this model was sitting around 5%, a year ago (even with the deregulation wave and tax relief) the odds rose to 10.4%, and as of last month we are now more than double that level.



Whether you are a steward of your own or other people's money, you can't just ignore the significance of these data points as the risk for being wrong on this outcome can be life changing. I don't state that to sound dramatic or extreme, but rather to highlight the reality that if a recession were to materialize in the next 12 months, then it's reasonable to expect at least a 40% peak to trough slide in the stock market. If you're unprepared or not even aware of it being a possibility, then it's likely you'll get caught up in the first 20 – 30% of the slide and by that time it's too late to do anything about it and you're better off staying the course through the duration of its decline. But should you be in a position where you're at or nearing the point of relying on your nest egg to live, then you're talking about a 40% drawdown where you need a 67% gain to just get back to even. That's without taking into account any outflows you have coming out of the portfolio to live on.

So the way I see it, it's not a matter of whether or not a recession is the base case scenario in your analysis, but any prudent fiduciary has to account for the fact that there is an increasing chance of an economic contraction going forward. Relative to where these probabilities were over the last two years, how investors position capital should be realigned to account for this increased risk. If your portfolio today looks like it did a year ago when recession probabilities were less than half where they are currently, you are not doing a very effective job at managing risk.

There is nothing in the recent slate of economic or earnings data that indicates the U.S. economy (or global economy, for that matter) has stabilized and is about to reaccelerate. Hedgeye's tracking of January Composite PMI data shows 76% of the 38 economies they track across the globe decelerating, which is up from the December reading of 71% decelerating. Even the most recently updated ECRI U.S. Weekly Leading Index growth rate ticked down to -4.3% after experiencing a multi-week period of increase. Last week's release of December retail sales declining -1.2% was truly awful and there was nothing within the report that suggested otherwise. Everyone is so desperate to grasp onto the positive spin of the blowout +304k January jobs report that they fail to acknowledge that the Household Survey showed job losses totaling -251k. The negative print in the household report makes more sense given the steady rise we are seeing in jobless claims where the four-week moving average is up to its highest level in 54 weeks. Folks, jobless claims are a leading indicator while the monthly employment report is a coincident-to-lagging economic indicator. Seeing auto sales collapse by 5% in January (haven't seen many people talking about this, have you?) gives some validity to the softness we are seeing on the spending side of the economy and December's weak retail sales report. All of this flies in face of the chorus of talking heads I hear on CNBC suggesting that the recent weak data flow is not to be trusted and that this soft patch in the economy is just transitory – i.e. related to the government shutdown or the effects of the Polar Vortex. Well, we'll see, and given the way the stock market has been ripping, it seems as though it's more than just a small contingent of investors that are thinking this way. But it highlights just how little thought is being given to the prospect that the slowdown is more permanent in nature – be it a hangover from the large injection of fiscal stimulus in 2018 that won't repeat in 2019, the lagged impacts from the Fed's tightening cycle, and/or the slowdown in economic activity from abroad.

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