March 11th, 2019

Running in place…

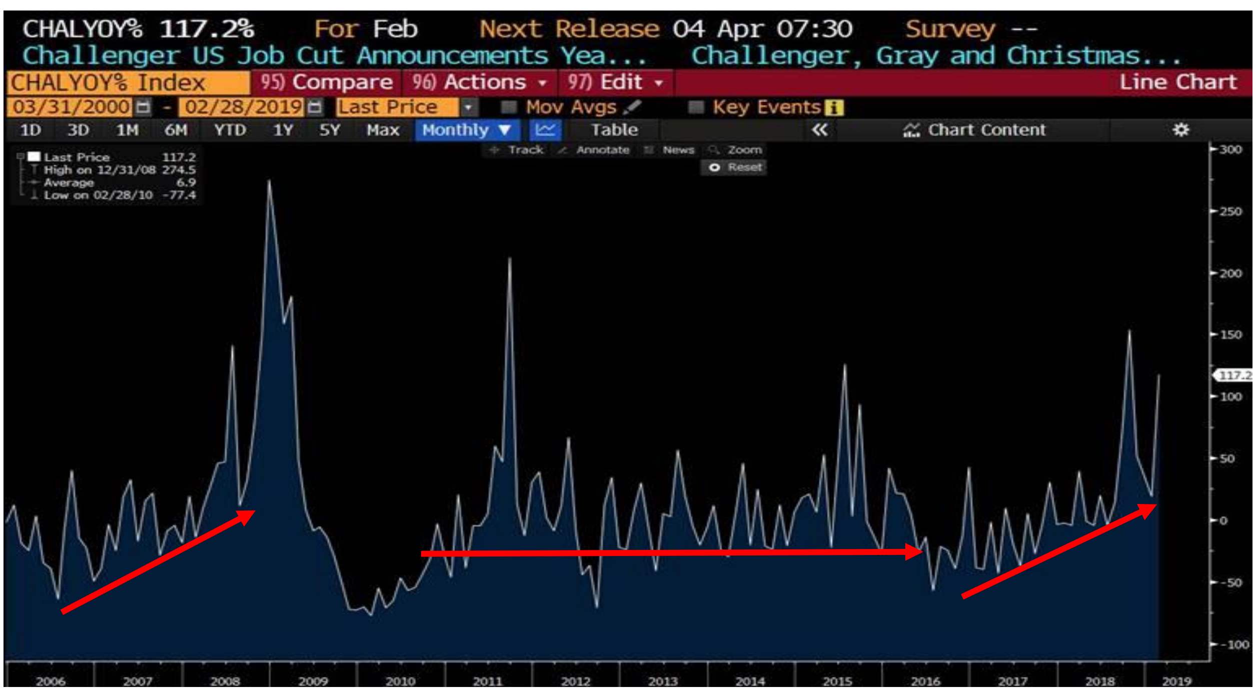
Last week, the U.S. equity markets registered their worst weekly decline of the year with a 2.5% retreat, as the S&P 500 was unable to hold above 2,800 for a fourth time since the index peaked at all-time highs on September 20th of last year. Nevertheless, as with most other capital market signals at the current time, it's hard to make too much of the price action so far this year. The simplest and perhaps most objective inference anyone can make is that investors drastically overreacted to pricing in an imminent recession at the lows in December, and since that panic selloff they have made a course adjustment to rally the major averages back to levels just a couple of percentage points below the 2018 highs, as we all take a page out of the Fed's playbook in exercising some "patience" as it pertains to what comes next.

Whether one is inclined to lean in the direction of being cautious / bearish or optimistic / bullish, there is no "there" there that either side can latch on to with a high level of conviction. Last week's employment report is a perfect example, where the U.S. economy gained 20k new jobs in February (coming in materially below consensus expectations for a print of +180k) and if the headline number was all anyone looked at, then they would have inaccurately concluded that this was a very poor jobs report. Underlying the weak headline print was an unemployment rate that ticked down to 3.8% from 4.0% and a record-breaking decline in the broad U-6 measure to 7.3% from 8.1%. Additionally, the blowout number of +304k new jobs in January was revised upwards by +7k and December's initial print of +222k was boosted to +227k. In summary, this February report was the exact opposite of the January report, in which the January headline number was strong but the internals were poor, whereas in February the headline job creation number was weak but the internals were strong.

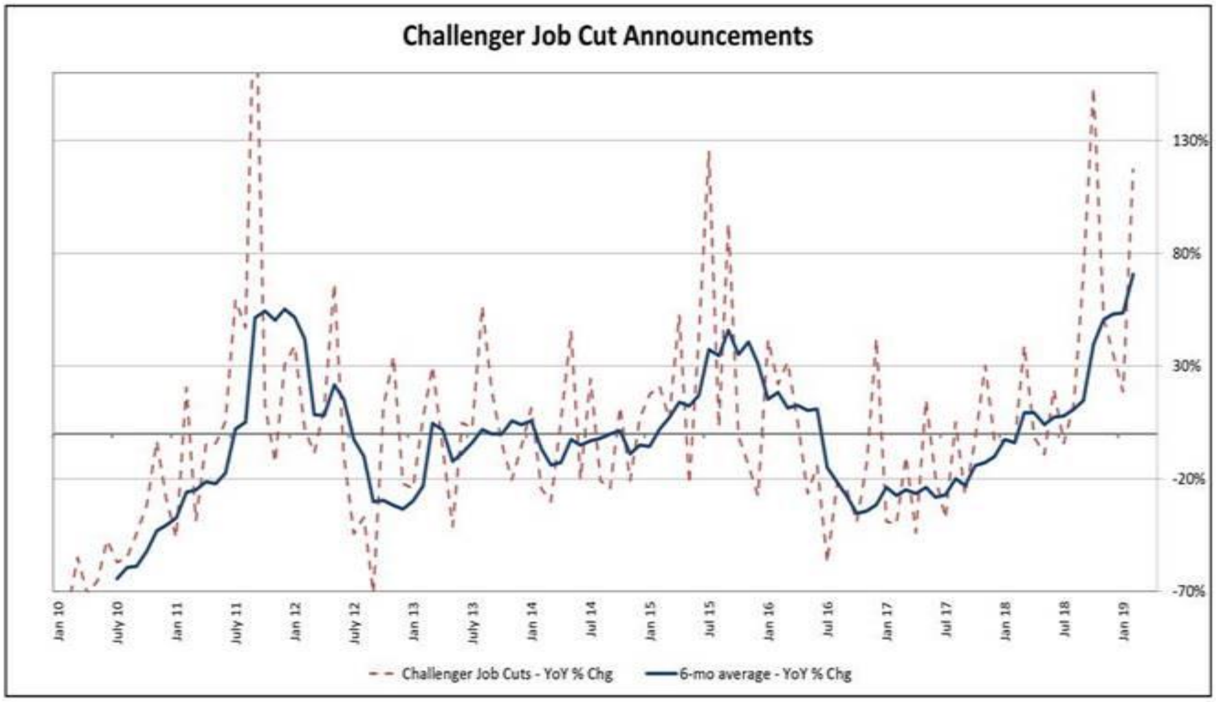
Whether it's the adverse weather conditions or the government shutdown that is having some distortive impacts on incoming data makes no nevermind in the sense that what we've seen over the last several months in terms of gauging the strength or weakness as it relates to the U.S. economy is inconclusive. The same degree of inconsistency we've seen in the employment reports is playing out in the recent ISM manufacturing and non-manufacturing surveys, where the manufacturing report for February was the weakest print (54.2) in the last twelve months while the services index came in near its highest reading (59.7) in the last twelve months.

It's this erratic nature of the recent data that has provided the fodder for the bulls to readily dismiss any negative piece of data while laying praise to any incoming positive data as being the reality. And while I don't think this way of rationalizing is wrong in the short-term, I think it is extremely myopic and narrow minded in terms of the big picture and where we are in the waning stages of this business cycle. Take a look at the below chart, put out last week following the jobs report by Tommy Thornton (who does some of the best Demark work in the business) which puts into context what an unemployment rate of 3.8% looks like in the context of several business cycles.

What I see is a data point that is comforting at the time when it's reaching its cyclical trough, but doesn't provide a whole lot of comfort for what typically transpires over the months and quarters thereafter. One data point that hasn't been garnering too much attention over the last several months (but is a leading indicator for the labor market) is the inflection higher in the Challenger, Gray, & Christmas layoff announcements which are up 117% year-over-year.

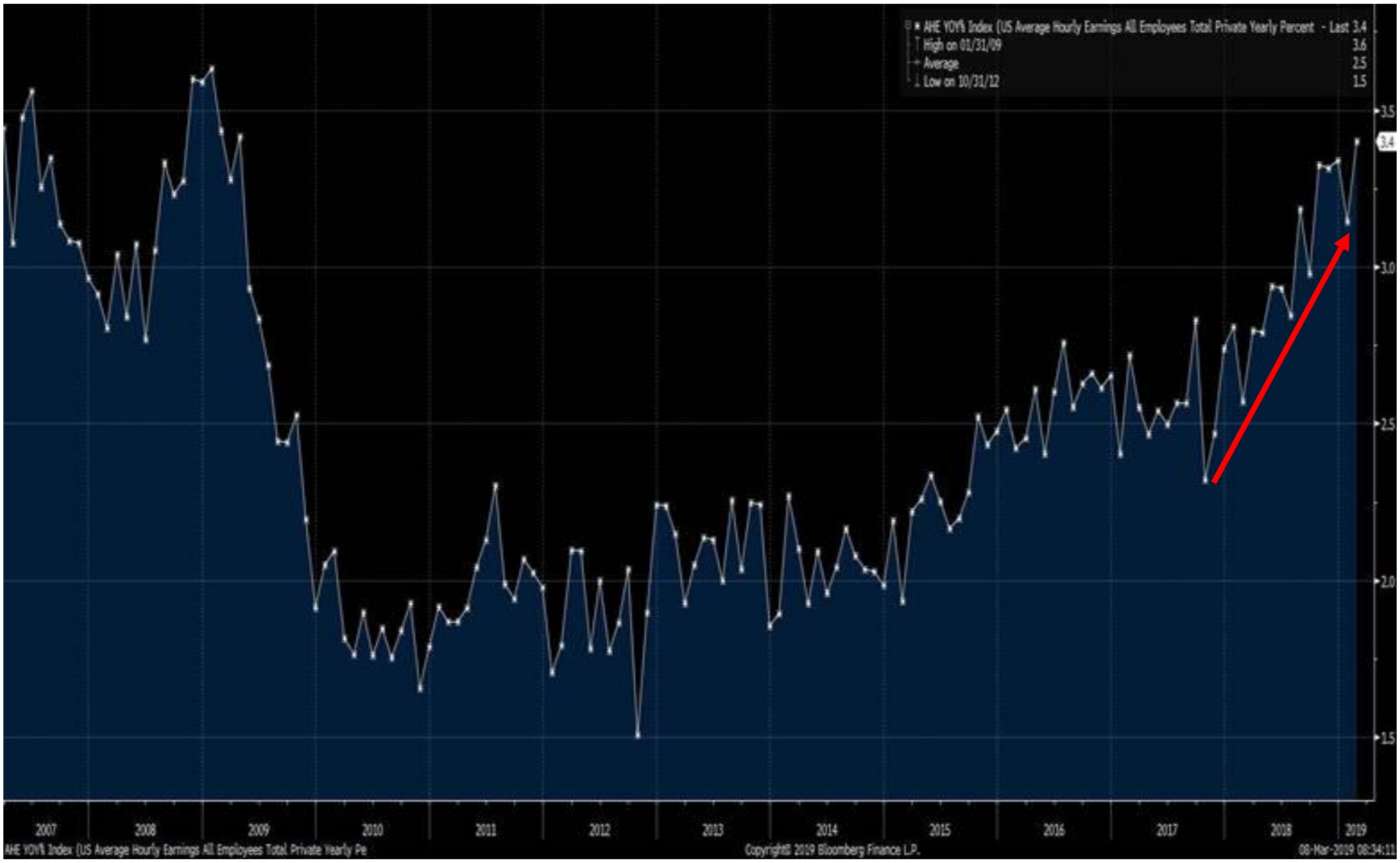


It's these gradual and methodic shifts higher late in an economic cycle (as was the case on the above chart from 2006 to 2008) that flash an amber warning signal that a change is afoot within the labor market. The below chart hones in on the time series of this data over this cycle where you can see the 6-month average YoY % change (blue line) has recently moved above the highs we saw back in late 2015/2016 and are currently at the highest reading for this cycle.



This is one of the many data points that restrains me from buying into the notion that the current soft patch is just like what we saw in early 2016, when back then it was Yellen acting as Chair of a Fed that pivoted to a prolonged pause in hiking interest rates, and central banks around the world went into full monetary policy accommodation mode. Similar to what we're seeing today, but other than prices of risk assets moving higher (a conditioned response mechanism that has been beaten into investors by central banker's fixation on asset prices), we've yet to see any carry over into a reacceleration in global growth. The OECD recently revised lower its global growth projections, U.S. Q1 GDP estimates are being taken down to sub 1%, the Brookings Institute just released a report showing that the Chinese economy may actually be 12% smaller than official numbers portray, and just last week the ECB slashed its growth and inflation forecasts for the EU. Oh, did I forget to mention that Turkey just slipped into recession for the first time in a decade, joining Italy as the other major economy currently in a recession?

Another thing to keep in mind as it relates to the February employment report is the increase in Average-Hourly-Earnings (AHE) up to 3.4% YoY (the highest reading of the cycle). Like many, I welcome this outcome as it is extremely constructive to Main Street and the overall economy (putting aside that the workweek actually fell 0.25%, shrinking for the second consecutive month – less hours with the same wage level mathematically increases AHE), but this is yet another headwind to an already challenging corporate earnings backdrop.



Think of it this way as it pertains to the earnings outlook: top line revenues (sales) are going to come under pressure as global growth slows, profit margins are going to feel the pressure from both higher interest rates and rising wages, and corporate leverage is at all-time highs with a debt maturity wave hitting its highest level in history over the next three calendar years. One theme we have a high conviction level on this year is corporations undergoing a 'debt diet' where operating cash flows that have been free to go into stock buybacks and dividend increases over the last several years are being redirected to improve the quality of the balance sheet and employee retention. These are competing sources for free cash flow that weren't material headwinds the last couple of years, but that is no longer the case going forward.

This is why I think the weekly reading on initial jobless claims and the layoff data are the most important short-term data points to monitor over the next couple months. One worry I have is that companies move more aggressively towards automation and AI so as to weaken the pressure on margins and corporate profits, and while this will benefit the C-suite and shareholders, it will be negative for employees.

Here's another thing worth considering as I close up this week's missive, and this relates to the rather sharp sell-off in global equity markets last week which represented the first real downside price action since the Fed's famed pivot to 'patience'. What I found interesting about it is that this happened in the face of numerous Fed officials hitting the speaking circuit with dovish commentary (Fed Governor Lael Brainard noted "greater downside risks" in her speech) and ECB President Mario Draghi announced that the ECB was going ahead with its TLTRO monetary lending tools. To many astute market observers, this is an incremental step by the ECB towards eventually having to resort back to additional asset purchases to support European Banks and Sovereign Credit, when it was less than three months ago that the ECB ended its QE program.

The fact that markets exhibited weakness in the face of such accommodative commentary suggests to me that (just maybe) investors are turning their attention away from the liquidity spigots and low interest rates and instead are giving a little more attention to the reason why the Fed made such a decisive pivot in such a quick fashion, and that is because of the meaningful erosion in global growth. Over the last several months we've seen the likes of the Fed, PBOC, RBA, BOE, BOC, and the ECB pledging "lower for longer" on interest rates. The degree to which China is attempting to stimulate its economy through increased credit and fiscal spending gives off the impression that they are in panic mode for just how severe the slowdown in the world's second largest economy may be. The regional trade data coming out of Taiwan, South Korea, and Japan as well as the steep slide in the Baltic Dry Index (measure of global shipping rates) confirms the deep slide we're seeing in global trade data. The Dow Transports is yet another confirmation in the U.S. that this downturn is for real as this index declined for the 11th straight day as of Friday's close – that's the first time that has happened since the depths of the Great Recession in 2009.

I continue to lack the excitement that I hear permeating on bubblevision to kick off this year – you'd think the market was making new all-time highs, yet when I fire up my terminal, I see an S&P 500 that is still some 100 points below the levels it was trading at last January. Moreover, we're still looking at a global stock market as measured by the MSCI All-Cap World Index that is 10% below where it was 12 months ago and an S&P 500 that is little changed over the last 14 months. So, while my overall view of the global equity market remains sanguine, it doesn't mean that there aren't opportunities presenting themselves. For one I still think the short-end of the Treasury market (2-year T-Bills) offer a great yielding alternative to cash at 2.50% with the benefit of price appreciation when the Fed shifts from talking dovishly to actually cutting interest rates. Yes, I think the Fed's next move will be an interest rate cut and I continue to believe they have already tightened too much, where I expect the lagged impacts to continue to show through into the fall season. The 2-year T-Bill gives you a higher cash flow than the dividend yield of the U.S. stock market while at the present time still acting as the world's risk-free asset.

Within the stock market, our research indicates that real estate and homebuilders should benefit from interest rates being capped on the upside. Later in the year, there is the potential for inflation metrics to reaccelerate on favorable base effects and should the Fed choose to really step in and try to extend this cycle even further, then there is a slowly rising probability that a stagflationary environment could present itself for the first time since the late 60's / early 70's. In such an environment you want to have as much exposure (as your capacity and willingness to take risk allows) to real assets and that goes for commodity and energy related segments of the economy. We've also recently concluded some in depth work on the long-term secular transition in the Electric Vehicle space where we are on the lookout and tracking companies focused on this area. Along with the battery technology, manufacturers, and commodities going into retrofitting the transportation grid away from combustible engines, you can't help but dig into the energy sources that feed into these power grids.

Yes, I'm still a big fan of nuclear power and uranium, even though this investment theme has been beyond frustrating over the last eight months with uranium being one of the best performing commodities in 2018, yet uranium mining companies have lagged dramatically. This market (including the commodity, miners, and utility contracting) has been in a state of stasis ever since the Department of Commerce (DOC) took up its Section 232 investigation in July 2018 (where they're looking into protecting domestic uranium production under a matter of national security). The deadline for this investigation is coming up in mid-April, so it will be interesting to see what the rest of the year brings once we get by this uncertainty overhang (irrespective of what the DOC concludes). Environmental consciousness continues to the be an area where there is a lot of focus and cooperation around the world, in particular as the global leadership baton passes from one generation to the next. Marcelo Lopez of L2 Captial Partners recently penned a good summary and overview on the uranium market that I'd recommend taking a peek at for anyone interested in this space: [Uranium: The Bull Market is Upon Us].

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