March 18th, 2019

Divergences to watch…

U.S. equity markets were in rally mode last week with the major averages having now registered gains in 10 of the past 12 weeks, and as a result the S&P 500 is back to the levels it traded at in early October. It appears retail investors have lost their patience in waiting for a pullback as U.S. based stock funds were on the receiving end of nearly $30 billion of inflows (one of the largest weekly inflows in the past year). I've lost my appetite for attempting to explain through fundamentals and logic the short-term gyrations in equity prices – in my opinion the algos, buybacks, and momentum trading strategies have become so large and systematic that they are driving prices to extremes in both directions, irrespective of whether it aligns with economic fundamentals or bottom-up security analysis.

To anyone cataloging and tracking the economic data over the last six months, it's become obvious that the U.S. economy has hit a severe soft patch (the weakness is even more pronounced overseas), but while the data is saying one thing, the investment narrative has taken on a life of its own. It is the narrative that is proving to be the much more powerful force at the current time, and this narrative can be summarized down to two common beliefs:

1. After a brief spell at attempting to normalize and tighten monetary policy via higher interest rates and shrinking its

balance sheet, the Fed has reverted back to the position of backstopping asset prices and protecting investors at all costs.

2. The current bout of economic weakness is just another temporary soft patch (the likes of which we've seen before back in 2011 and then again in late 2015/2016) that in time will reaccelerate and prolong what is close to becoming the longest expansion in U.S. history.

Regarding the Fed, I don't disagree whatsoever that the maelstrom in the equity markets late last year frightened them and as a result they've gone out of their way (starting with Jay Powell's mea culpa on a panel with Janet Yellen on January 4th) to make sure everyone understood that the Fed was going to remain "patient" with their normalization path going forward. The Dow Jones Industrial

Average gained nearly 750 points on January 4th and the S&P 500 surged by more than 3%, and neither average has looked back since.

As for the prevailing view that we are just in a temporary bought of economic weakness, I remain in a wait and see mode. I get it, and I can see how/why investors want to latch on to this being the case given previous such experiences this cycle. However, when I look at the data today I see an economic backdrop where GDP growth appears to have peaked in Q2 2018, inflation peaked in Q2/Q3 2018 (depending on the metric you're looking at), real sales peaked in November, the unemployment rate troughed in November, industrial production peaked in December, real weekly wages peaked in January, and aggregate hours worked also peaked in January.

Not to mention jobless claims (one of the timeliest leading indicators) which have started on a noticeable upward trend over the last several months. Don't get me wrong, the latest reading of 229k in jobless claims is still extremely low on an absolute and historical basis, but it's the rate of change that is relevant and worth watching going forward. The four-week moving average smooths out the weekly volatility of this metric and since the lows late last year, the four-week moving average on jobless claims has increased 18k. Historically when this metric increases by 69k from its cycle trough, the U.S. economy is at the front end of a recession. As you can see, there is still more room to go on this metric before alarm bells start going off, but what this subtle increase is signaling is that economic momentum is waning at the margin. This is yet another data point of many conveying a similar message – the soft patch hasn’t abated yet and recession risks are on the rise, as can be seen from the February update to the NY Fed recession model which ticked up to 25% odds (an 11-year high, and a normalized basis suggests the probability of recession is around 70%).

Having said all that, I think there are a couple of things investors need to keep in mind, and it doesn’t matter whether you’re a bull or a bear. First and foremost, an economy that is losing momentum with both growth and inflation slowing does not guarantee a recession, and while I’m of the view that the complacency in the equity market at the current time drastically underestimates such risks, that doesn’t mean portfolio positioning should be reflective of recession odds at 100%. I think the incoming data in April and May will shed some light on whether the Q1 weakness was just an aberration and investors were right to look through it, or if recession concerns should be taken much more seriously. As an aside, we are seeing some signs of 'green shoots' in European economic data and stabilization in some Asian data, but I think it's worth pointing out that these signs of stability are coming from very depressed levels. So we're going to need to see more than just stability to get excited, but it's a start.

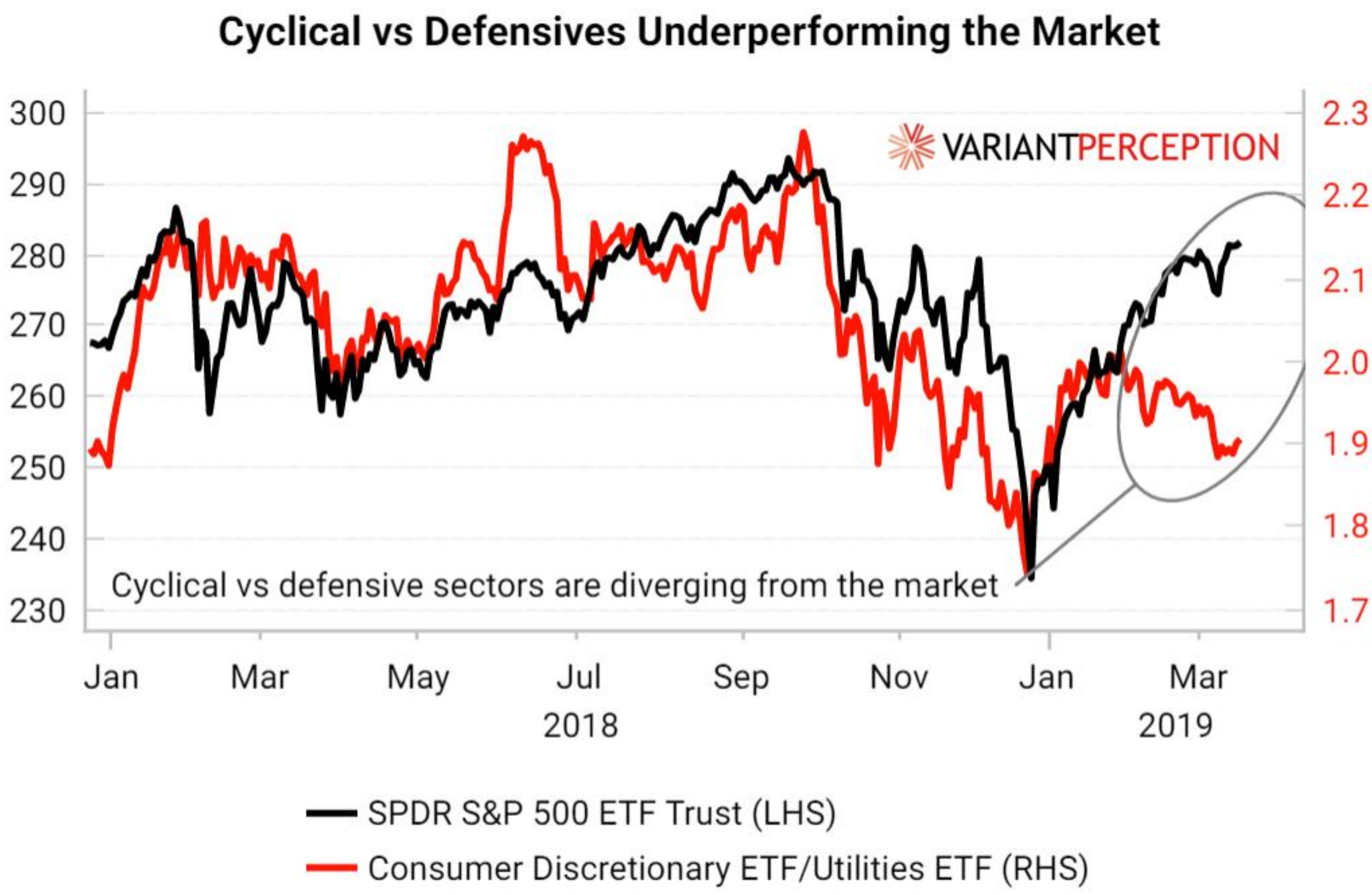
The other item I think warrants some thought is about Fed policy. There is no doubt in my mind that the Fed is going to step in and try to rescue the economy and risk asset prices from going into a prolonged downturn. This has been their modus operandi going back to the late 1980's (with Alan Greenspan originating the 'Fed Put') and the most recent policy maneuvers implemented since the GFC (by Bernanke, Yellen and now it's Powell's turn) have pushed the boundaries of conventional and unconventional monetary policy tools that could be used to achieve their Congressional mandates. The question is, will it work? The Fed started cutting interest rates prior to the start of the last three recessions, but on each of these occasions it turned out to be too little too late. History is pretty clear on this file in that when the Fed starts cutting interest rates after a prolonged tightening cycle, it's not an event that has been kind to equity markets twelve months out (while on most occasions it is a celebrated development when the move is made).

As for what is catching my attention in the here and now as it relates to this strong move we've seen in the stock market through the first three months of year, in a word: divergences. Recently I've been wondering if I'm even looking at the same market as so many of the talking heads on bubblevision. If one's reference point is the lows put in by the major averages in December, then I understand the unbridled excitement and optimism about where the S&P 500 is trading today. But, let's also recognize that while the S&P 500 is once again pushing above 2,800, it first reached this level back in January 2018. So we're talking about a roller coaster ride over the last fourteen months, but I'd argue that we're getting back to this level with a much weaker hand.

For one, we don't have as constructive of an economic setup, and we've already benefitted from the fiscal goodies of tax cuts and an aggressive government spending bill. Additionally, the technicals on a breadth basis are measurably weaker. The first time the S&P 500 hit 2,800 in January 2018, the average S&P 500 stock was just 5% from making a new high – compare this to today where even in the face of all of the Fed led euphoria, the average stock is still some 13% from its highs. At the first move through 2,800, 25% of the stocks were making new 52-week highs versus just 9 % of constituents today. Looking at the number of companies in the S&P 500 trading above their 200-day moving averages: 82% back in January 2018, compared to 58% at present. You can see what I'm getting at…yup, the internals aren't nearly as strong.

The below chart from Sven Henrich of Northman Trader is interesting in that he's drawing a comparison between the all-time high in the S&P 500 back in September which occurred on a divergence in the Relative Strength Index (RSI), and how it's eerily similar to today where the S&P 500 is once again making a high for this post-holiday rally on another RSI divergence. However, it's worth noting that today the Fed has meaningfully pivoted their policy stance compared to back at the September high where they were full steam ahead on tightening policy. Depending on one's perspective, this could be interpreted as a policy bullet that's already been expended, or the headwind on this file is nonexistent today compared to back then.

Another divergence being born out of the price signals in the equity market is the outperformance of the defensive areas of the market versus the cyclicals. Variant Perception, a highly respected institutional research provider, put out the below chart in one of their recent pieces arguing that a healthy market rally would not have cyclical sectors lagging as much as they are today.



The WSJ published an interesting article last week illustrating how the gains in the equity market are inconsistent with what one would expect given the expectations about future earnings. For example, the Technology sector is leading the sector scoreboard this year with a gain of 18%, but when you look at the lower section of the Bloomberg Earnings Estimates table below you see that analysts are penciling in negative EPS growth for the first three quarters of 2019. For full year 2019, EPS growth for the Tech sector is estimated to slow to +2% from +14% in 2018, which, given the rise in share prices, implies that the forward P/E multiple for this sector has increased to 18x – about one-point shy of the peak for the sector that was set back in January 2018.

S&P 500 Index													BBG Estimates			
SALES GROWTH (%)	CQ1 16	CQ2 16*	CQ3 16	CQ4 16	CQ1 17	CQ2 17	CQ3 17	CQ4 17	CQ1 18	CQ2 18	CQ3 18	CQ4 18*	CQ1 19	CQ2 19	CQ3 19	CQ4 19
S&P 500 Aggregate	-1.9%	-0.3%	2.4%	4.9%	7.8%	5.3%	5.3%	8.3%	8.2%	9.5%	8.0%	6.0%	6.2%	4.7%	5.3%	4.9%
Energy	-29.3%	-24.2%	-14.2%	4.2%	34.1%	15.8%	17.9%	22.5%	12.8%	21.7%	19.6%	11.2%	1.3%	-1.0%	0.4%	-3.3%
Materials	-8.8%	-7.3%	-2.4%	2.7%	9.1%	7.2%	8.6%	13.6%	11.7%	16.3%	10.7%	2.7%	-0.5%	0.6%	2.0%	4.0%
Industrials	-2.0%	-1.3%	2.2%	2.6%	4.2%	4.8%	6.6%	8.4%	10.4%	9.5%	6.8%	6.7%	3.8%	3.9%	4.2%	4.4%
Consumer Discretionary	6.3%	8.5%	8.2%	7.8%	8.4%	3.8%	3.0%	7.7%	7.3%	9.0%	8.1%	5.6%	4.1%	4.3%	6.2%	5.5%
Consumer Staples	1.2%	0.7%	1.7%	2.7%	2.1%	2.5%	4.5%	5.1%	5.4%	5.4%	2.6%	1.8%	7.3%	2.7%	3.8%	4.1%
Health Care	9.2%	8.8%	7.0%	5.4%	5.7%	4.0%	4.5%	6.8%	7.7%	7.7%	7.2%	9.0%	13.0%	12.5%	12.7%	10.3%
Financials	-1.7%	0.7%	5.6%	5.5%	9.3%	4.5%	1.7%	3.3%	3.4%	5.9%	4.6%	3.9%	2.9%	2.7%	3.7%	5.5%
Information Technology	-6.8%	-5.9%	-2.2%	0.6%	7.7%	8.2%	6.9%	11.6%	13.2%	12.4%	10.6%	1.3%	3.1%	-0.1%	1.1%	4.3%
Communication Services	11.2%	15.0%	10.1%	4.5%	8.2%	4.6%	4.3%	7.5%	9.8%	9.8%	12.1%	13.4%	11.6%	11.7%	8.5%	5.4%
Utilities	-10.5%	-2.4%	3.5%	8.1%	7.2%	6.4%	-2.7%	3.4%	3.4%	0.4%	1.7%	2.1%	4.1%	4.8%	6.3%	0.3%
Real Estate	11.4%	7.4%	7.5%	3.7%	4.5%	7.3%	5.2%	8.2%	14.6%	13.5%	13.1%	12.8%	3.6%	3.7%	4.2%	3.2%
EPS GROWTH (%)	CQ1 16	CQ2 16*	CQ3 16	CQ4 16	CQ1 17	CQ2 17	CQ3 17	CQ4 17	CQ1 18	CQ2 18	CQ3 18	CQ4 18*	CQ1 19	CQ2 19	CQ3 19	CQ4 19
S&P 500 Aggregate	-8.0%	-3.9%	3.2%	6.4%	14.6%	10.0%	7.1%	12.5%	22.6%	24.5%	24.2%	12.3%	1.2%	1.0%	1.8%	8.0%
Energy	-109.6%	-81.6%	-63.7%	-1.5%	690.1%	210.0%	138.0%	53.9%	61.2%	98.8%	98.6%	99.9%	-16.3%	-8.4%	-16.3%	-12.1%
Materials	-16.0%	-9.1%	3.2%	-1.1%	19.6%	7.4%	10.7%	41.9%	31.9%	43.8%	28.3%	1.4%	-15.7%	-7.0%	-0.8%	7.6%
Industrials	-7.3%	-1.9%	-1.5%	-5.3%	1.5%	6.6%	0.3%	5.4%	24.9%	17.5%	17.1%	18.6%	1.5%	7.1%	9.7%	10.9%
Consumer Discretionary	17.8%	10.3%	6.5%	4.7%	7.0%	1.9%	1.8%	9.6%	14.1%	20.0%	22.7%	15.5%	-5.5%	4.0%	8.7%	12.6%
Consumer Staples	1.2%	0.0%	4.4%	4.0%	2.9%	4.1%	3.1%	7.3%	10.1%	10.8%	9.1%	3.6%	41.8%	0.2%	2.1%	4.5%
Health Care	8.1%	4.8%	5.9%	4.8%	5.4%	6.6%	7.1%	8.9%	14.2%	13.1%	14.5%	11.1%	3.2%	4.1%	4.6%	9.2%
Financials	-14.2%	-7.0%	12.8%	6.6%	17.9%	9.5%	-8.9%	1.0%	26.6%	22.7%	30.6%	2.7%	0.2%	5.1%	3.9%	16.7%
Information Technology	-7.4%	-7.3%	3.9%	4.2%	20.8%	19.2%	19.8%	20.8%	28.4%	32.1%	24.8%	5.8%	-4.9%	-7.6%	-3.7%	6.4%
Communication Services	16.1%	19.7%	14.3%	11.2%	16.7%	3.5%	16.8%	19.8%	23.3%	37.6%	27.5%	21.7%	2.7%	4.5%	1.6%	3.4%
Utilities	-1.9%	8.9%	12.6%	110.6%	3.5%	5.1%	-3.5%	18.9%	15.6%	11.7%	14.8%	-0.1%	3.7%	0.6%	3.4%	18.2%
Real Estate	8.3%	7.1%	8.7%	3.1%	6.5%	7.1%	7.6%	10.2%	8.2%	6.7%	8.8%	10.1%	2.8%	3.2%	3.4%	1.5%
Data Source: BBG	*Start of Tech/ComServ Breakout (all previous periods represent legacy Telecom)											*497/500 Reported				

Then there's the bond market, where even the most ardent growth bulls would have to acknowledge how incongruent it is for the growth/hopium story that the yield on the 5-year T-note (2.41%) is a full 10bps below that of the 1-year T-bill (2.51%). I hear the argument all the time on bubblevision about how there is no risk of recession until the 10s-2s curve inverts (it's at +15bps today), and that even from the point of inversion you still have more than a year before the recession starts. I don't refute their historical findings, but I think it's become way too convenient to anchor on this one metric when everyone and their sister is aware of it and thinking the same way. We have been in an abnormally low interest rate environment since the GFC, where global central banks have kept interest rates nailed to the floor. In such an environment, both Europe and Japan experienced recessions without their yield curves inverting out to the 10-year maturity. With that being said, why would anyone want to rely solely on this metric to make their investment decisions while ignoring that the U.S. yield curve is inverted from the 1-year out to the 7-year maturity?

Nevertheless, not much has changed over the last several weeks to alter my view – growth and inflation or slowing, the economy is entering a widow of vulnerability, recession risks are on the rise, and the risk/reward setup in the equity market remains skewed more towards risk than reward. I don't think it's mandatory for investors to have a recession forecast as their base case, and nor is that ours at this point, but part of investing is managing risk and not just solely focusing on returns. With that being said, prudent risk management requires making adjustments when there is a material shift in probabilities – with the chance of a recession three times higher today than where it was a year ago and six times higher than where it was two years ago, if your capital is allocated the same way today as it was a year or two ago, then you're not doing it right.

This doesn't mean that you go full bore into a "canned goods, butter, and ammo" investment strategy, but rather be a bit more discerning in your security selection, exercise patience, and pick your spots to take advantage of opportunities that the market provides. I do look at the next 12-18 months as potentially providing some very fruitful and fertile investment opportunities, but you won't be able to take advantage of such opportunities if you're chasing every momentum-based rally into a weakening fundamental backdrop.

Corey Casilio
Partner, Portfolio Manager

101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215