April 22nd, 2019

At the point where the data needs to catch up to the equity rally…

The three major U.S. equity market indices (the Dow, S&P 500, and Nasdaq) have pulled off quite a feat over the last four months as they've surged back to their all-time highs and completely unwound the dramatic sell-off in Q4. I, for one, have been surprised by the move – not that I didn't think things were overdone to the downside in late December and that the negativity back then presented a solid set-up for a meaningful rally, but I'd be lying if I said I thought we'd be back to flirting with all-time highs by the end of April. Perhaps I lack imagination or an open mind, but this also has been a rather rare occurrence in history where after a -15% waterfall decline in the S&P 500, the index didn't go back and at least retest those lows. I have been in the retest camp, and while I haven't completely given up on this being a possibility, it's important as an investor to adjust and adapt to what is actually happening rather than what one thinks should be happening.

The fact of the matter is that the forward outlook looks even murkier today than it did back in Q4. What made sense about the equity market selloff in Q4 was that the fundamental data and price action in the capital markets (both stock and bonds) moved in a manner that made financial sense. Unless an unexpected catalyst were to emerge in the next several quarters, it looks fairly certain that a broad swath of the U.S. economic data and growth momentum peaked in Q2 2018. So as Q4 got underway and financial conditions tightened as a result of the Fed hiking interest rates and draining liquidity, incoming data began to confirm the peak of the cycle was in and capital markets moved swiftly (too swiftly, in my opinion) to price in this loss of momentum. The economic data and corporate earnings started to soften which provided some fundamental confirmation for the sell-off in the equity market and corresponding rally in the bond market. Market prices and fundamentals were interacting in a logical and historically consistent fashion.

With the stock market crying 'uncle', the Fed realized the lagged impacts of its monetary tightening were starting to bite and in early January they pivoted in quick fashion to make it clear that they were going to execute "patience" with any further moves in 2019. Couple the Fed pivot with policy makers in China capitulating and injecting massive stimulus into their economy, and these two developments were enough to instill some confidence into investors that policy makers were willing to step in and take action to stave off any further pain.

So, while these actions have succeeded in resurrecting the optimism in the equity markets, the verdict is much more mixed on the actual hard data front. Investors are notorious for shooting first and asking questions later, so it's not too much of a surprise to see equity prices rip higher in anticipation of a recovery in the underlying fundamentals as confirmation for where prices have already moved to. But here's the rub (and I'm going to highlight this in the data below): we are reaching the point where the data needs to start picking up to justify the current price levels of the 'hope' trade.

While the major averages are hugging the all-time highs, when you look at other parts of the market, they are no longer coming along for the ride. Since February 21st, the KBW Bank Index (BKX) is down -1.28% and the Russell 2000 is down -1.68%. Banks and small caps are two very cyclically sensitive areas of the economy and these two segments of the stock market led the gains coming out of the December lows, so seeing their momentum wane for over two months now is worth monitoring. Speaking of the small cap space, the USA Today ran with a story just this morning titled "*Small Firms' Dip Could Be Signal of Recession*". Forget the dramatic title, it's the survey of 30,500 small firms by Invoice2go that caught my attention where they show revenues in Q1 were down -3.4% YoY. They go on to say that the downturn follows a slowdown in revenue growth from 14% in 2017 to about 3% in 2018 and it has now slipped into an outright contraction at present. This corroborates with what we've recently seen from the March NFIB index (National Federation of Independent Business) that 27% of participants stated that sales were lower in the past three months, up from an average of 19% in the second half of 2018.

On Friday, we're going to get the initial release of Q1 GDP with consensus forecasts ranging from +1.0% to +2.9%, with the median estimate at a +2.0% annual rate after last week's better-than-expected retail sales reports. Even the research arms of the various regional central banks are having a difficult time finding a middle ground on forecasting this number with the Atlanta Fed at +2.8%, the St. Louis Fed at +1.9%, and the New York Fed model forecasting +1.4%. Let's assume that the number comes in at the median estimate of +2.0% – this would mark the third consecutive quarter of slowing growth.

- Q2 2018 real GDP growth: +4.2%
- Q3 2018 real GDP growth: +3.4%
- Q4 2018 real GDP growth: +2.2%
- ** Q1 2019 real GDP growth: +2.0% (estimate)

The NY Fed model is estimating Q2 2019 real GDP to come in at +1.9%, and should this end up being the case, then I think it's pretty fair to assume the fiscal stimulus from the tax cuts and deficit spending was nothing more than a two quarter bump which now puts the economy back into the +1.5% to +2.5% muddle through environment that has persisted for the bulk of this recovery. Not that this has been terrible a backdrop for risk assets, but keep in mind that up until October of 2014 the Fed was consistently implementing rolling renditions of QE, and then in 2015 the BoJ and ECB stepped up to flood the world with central bank created liquidity. So, we know that a sluggish growth environment which engenders low interest rates and central banks expanding their balance sheets is a utopian set-up for risk assets, but does such a utopian state exist if we only have sluggish growth and no QE? My guess is that eventually the central banks will revert back to these money creation policies, but I'm also of the view that they won't revert back to such policies until things breakdown in a more meaningful way for them to justify such an action.

How about the consumer, and last week's March retail sales report that got everyone so excited because it showed a whopper +1.6% jump and smashed consensus expectations of +1.0%? I don't want to get into the minutia of this report, not because it wasn't solid, but rather because the seasonal adjustment to this report (given the late timing of the Easter holiday this year) may be materially distorting this data point. This doesn't mean we're not going to take a look at retail sales, but let's do so with a longer timeline than one month and see if all the hoopla over the strength of the consumer is justified. Smoothing out the monthly retail sales into quarterly data points at an annualized rate (similar to the GDP data above) shows a pretty clear deceleration is underway:

- Q2 2018 +6.1%
- Q3 2018 +4.3%
- Q4 2018 +1.0%
- Q1 2019 +0.2%

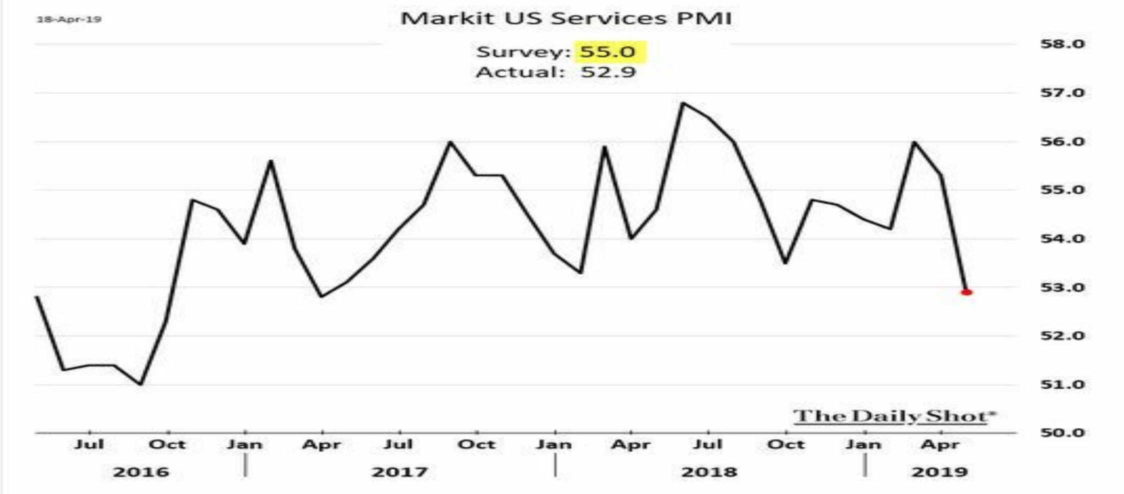
Keep in mind the quarterly retail sales figures above are on a nominal basis (so they include price increases), but the data series below are strictly on a volume basis (annualized growth rates):

- Q2 2018 +3.9%
- Q3 2018 +2.3%
- Q4 2018 -0.5%
- Q1 2019 -0.7%

Yes, you are seeing that right – on a real volume basis (meaning removing the inflation impact), retail sales have contracted for two consecutive quarters which last happened in the first half of 2009 at the tail end of the Global Financial Crisis. Don't look now, but there is another squeeze on the consumer's pocket book coming with gasoline prices having surged +71% in just the last 80 days.

What about corporate profits, surely they are supporting the move in the S&P 500 back to its all-time highs? Q1 earnings are underway and the cat's already out of the bag in terms of expectations being handily marked down following the slowdown in economic growth and fall in the stock market late last year, so I don't think there is much information to be gleaned about whether Q1 earnings growth comes in at +3.0%, flat, or -3.0% – anything in this range would be consistent with market expectations. Thus far we've had 79 companies in the S&P 500 report for Q1 with revenue growth coming in at +2.6% and EPS growth at +0.50%, but this week is the big week for earnings and especially from the heavyweights in the Tech space (Amazon, Facebook, Twitter, and Microsoft). The earnings numbers that I think are more important to follow at this point are estimates for Q2 and later in the year as these are the ones that will be adjusted to what the corporate managers are saying on their Q1 conference calls. On October 1st of last year, the consensus EPS estimates for Q2 S&P 500 earnings growth was +9.2%; at the start of this year those estimates were already revised down to +6.5%, and as of this morning those estimates now stand at +2.1%.

The decelerating trends are at play in the housing market as well. Housing starts for March were released on Friday and showed a year-over-year decline of -14.2%, and permits have contracted for three consecutive months. Keep in mind, this degradation in the housing data is coming at a time when mortgage rates are declining. For Q1 as a whole, single family starts are down -4.6% YoY and building permits by -6.2%. The last data point worth mentioning was last week's preliminary PMI data from Markit, which showed the manufacturing sector stuck in the low 50's at 52.4 while consensus was looking for an increase to 52.8. The big surprise came from services which had been holding steady until now, as the index slumped to 52.9 from 55.3 in March (expectations were for a print of 55.0). The below chart from The Daily Shot are pretty clear at depicting the slowing in activity that started in the second quarter of last year and is consistent with all of the other data points referenced earlier in this commentary.



But here's the point I'm trying to make, and what's important for investors to understand: we're back to a market and environment where fundamentals don't matter. I know it doesn't make any sense, and deep down I remain of the view that over the long-term fundamentals, valuation, and sentiment do matter, but the current economic expansion is a perfect illustration of this premise where we have experienced the weakest post-WWII economic growth recovery by GDP metrics, yet we've had the second strongest and longest bull market in history. Equity valuations have been elevated to some of their richest readings in history and profit margins have failed to mean revert from all-time highs for several years, but none of this has mattered for longer than a quarter or two this cycle because of unabashed faith in central banks coming to the rescue.

At some point it will matter, but neither you nor I know when that point will be. Could it be next quarter or later this year? Sure, one could surmise that by looking at the current data where at best it shows fundamentals stabilizing at much lower levels that don't argue very strongly for high expected returns going forward, and at worst shows a legitimate risk of a deeper or more protracted slowdown in the event that things don't reaccelerate in the next several months. And that's the point. The equity market has been willing for several months now to look through the early part of this year as nothing more than a short-term anomaly, where in the second half of the year global synchronized growth reasserts itself and global equity markets can break out of this 15-month consolidation pattern that they've been in. Admittedly there are some overseas regions that are showing indications that global growth may have bottomed in Q1, and that is an important development for capital markets. However, things just becoming less bad overseas is not enough. Not only do we need to see some continuation in the green shoots in other parts of the world, we also need to see the data in the U.S. stop decelerating, and in short order. Alternatively, if the data isn't going to show up to support the jubilant investor mood, then the Fed needs to take action by being proactive and cutting rates and then expanding their balance sheet. This isn't to say that I agree with this course of action by the Fed, but this is the animal they've created and what we learned last December is that economic growth and asset appreciation can't handle a material reversal in central bank morphine. If we get neither a believable improvement in the data and/or further central bank easing, then the below chart showing a potential triple-top in the S&P 500, or a head and shoulders pattern – whatever you want to call it – is going to be confirmed because stocks won't break to new all-time highs without one of these catalysts.

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