April 8th, 2019

Data remains mixed as hopes run high…

The about face in U.S. equity markets is nearing completion, and who would have thought that the S&P 500 would be knocking on the door of all-time highs less than four months after markets and the global economy seemed to be falling apart in mid-December? The fact that we are back here in such short order is a testament to just how powerful the central banks are today and how quickly things can change in global capital markets. Since the turn of the year, not only has the Fed pivoted back to an extremely accommodative monetary policy stance, but so too has the

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ECB, the BOJ, Royal Bank of Australia, Bank of Canada, and the Reserve Bank of New Zealand. Not to mention China is stimulating their economy like a madman through both fiscal and monetary aggregates.

At the end of the day, it all comes back to the Fed (who have become the central bank of the entire globe, whether they care to admit it or not) where their pivot since the December rate hike has managed to remove two pledged rate hikes out of the markets. As a result, interest rates are lower everywhere, yield curves have flattened (inverted in some parts), and financial conditions have moved back near their lowest levels in history. All of these developments filter their way through the capital markets in a constructive manner, resulting in a dramatic improvement in liquidity and thereby propelling the 'risk-on' investment mentality.

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I get a chuckle whenever I hear or read market commentary professing about how strong the economic or fundamental backdrop is, when in fact it's the stock market that is strong despite weakening fundamental underpinnings. I came across the following chart from Jim Bianco of Bianco Research which perhaps best encapsulates the weakening economic growth trends across Emerging Markets, the U.S., and other developed economies. The data incorporated into this chart from Jim is updated through April 1st, so we're not talking about stale data that is several months old.

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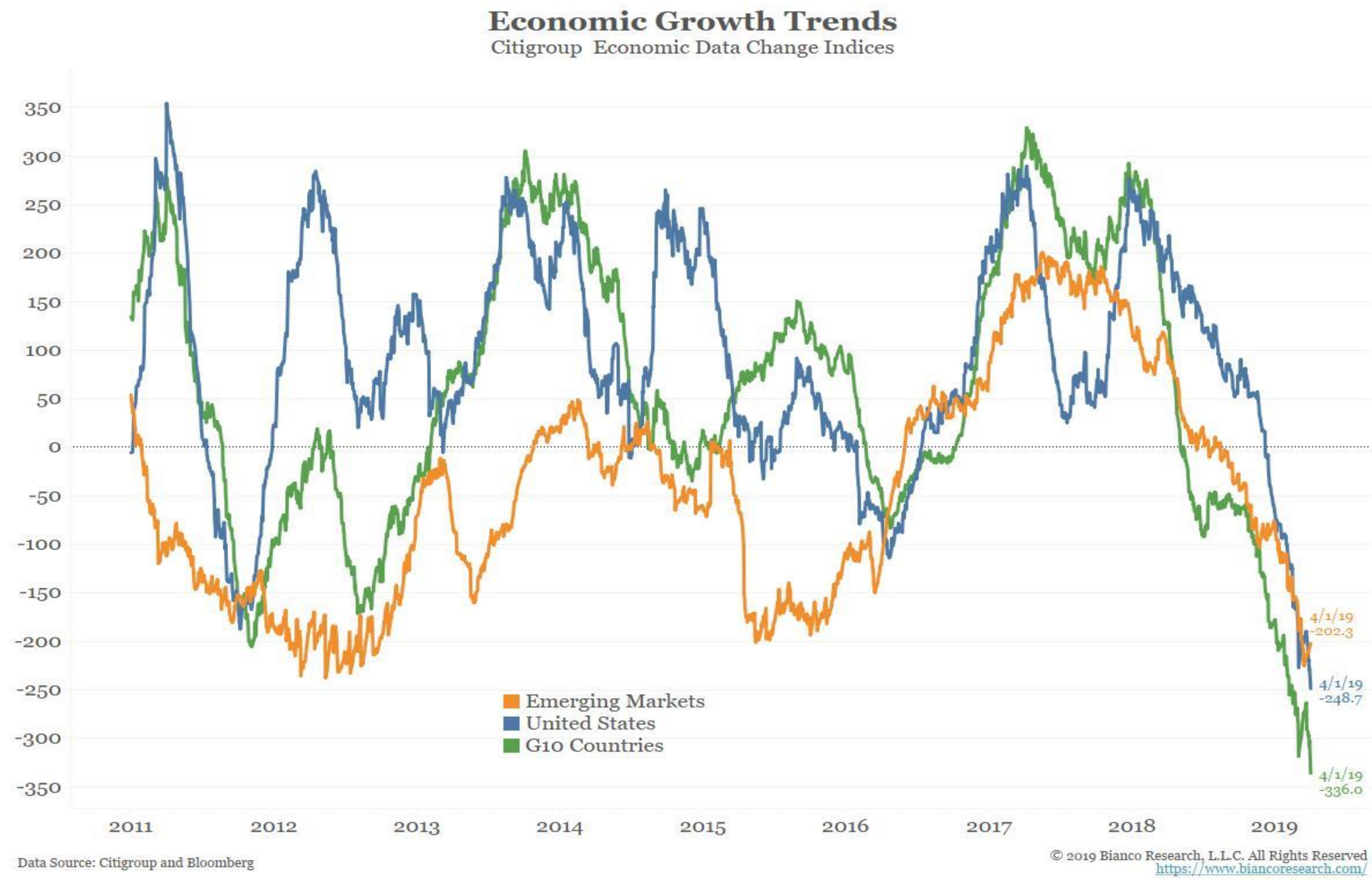

Take last week's employment report as yet another example of how something could look solid on the surface, but once you take a look under the hood you see why so many lights are flashing on the vehicle's dashboard. I'm not suggesting that this report was a total dud or that it was all that weak, after all +196k jobs created in March is a solid number and we also had +12k in positive revisions to the previous two months. But it's the various

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components among the subsectors that provided confirmation that a slowdown in jobs growth is underway.

- Over the last three months (through March) job growth has averaged +180k which is materially less than the +233k level it was at in December.

- In the household survey we saw a net decline of -201k jobs, and this metric is negative in two out of the past three months. I found the commentary around this fact fascinating as this was the part of the February report that everyone was anchoring to last month when the establishment survey showed a disappointing +20k jobs created, which was much less than the +255k in the household survey. Now here we are this month with a strong establishment survey

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print and everyone forgets to mention the weak household number. What's most interesting about the household survey is that full-time positions (an important component of income and confidence for the real economy) declined -190k last month, and the folks who got part-time jobs (individuals looking for full-time work but had to settle for part-time positions) increased by +189k.

- The subcomponents of where the jobs were being created or destroyed was interesting as well, where 60% of the job gains in March were from government, healthcare, education, and leisure/hospitality services – these aren't your cyclically oriented sectors geared towards the economy. Nope, the areas linked to the contours of the business cycle were actually weak: air/rail/ground

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transports -2k, durable goods manufacturing -7k, retail fell -12k (on top of a -20k slide in February), and factory overtime hours declined -1.9%, which doesn't exactly jive with the "strongest economy ever" narrative.

- We also saw temp agency employment (a leading indicator) fall by -5k, and this sector is down in two of the past three months (it is flat over the last six months).

- What was most striking about this report (and it's exerted a heavy influence on job growth so far this year) is the "birth/death" model which the BLS uses to estimate how many positions were created by new business formations throughout the month. The "birth/death" model added +78k jobs in March to the headline total, and in the first quarter of 2019 this model has

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accounted for more than half of the total +541k jobs created for the year.

In a nut shell, this employment report (like the last several) corroborates the growing evidence that the business cycle is slowing and the labor market is becoming more fatigued. This should be a surprise to no one in that it would be an unreasonable expectation to think that the labor market would accelerate with an unemployment rate that has been hovering around 4% for over a year now. The recent trends in the Challenger, Gray, & Christmas Job Cuts report is just another piece of evidence highlighting the decaying underbelly of the labor market in that job cuts totaled 190,410 in Q1 2019, which is a +10% increase from Q4 2018 and a +35% increase from Q1 2018. Ladies and Gentlemen, unlike the BLS employment report which is a coincident to lagging

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indicator, the Challenger survey is a leading indicator in that it is looking through the windshield as opposed to the rearview mirror.

Another U.S. economic data point that didn't appear to get too much attention last week was the ISM non-manufacturing index which showed material signs of losing momentum as the first quarter drew to a close. The index came in at 56.1 (well below consensus expectations of 58.1) and was a sharp decline from the 59.7 level it was at in February. This was the lowest print since August 2017, and what really caught my eye within the report was the sharp -7.3 point slide in the business activity index. This was the sharpest one month decline since the depths of the recession back in November 2008. It's worth pointing out that a reading in the mid-50's on any ISM survey is still solid, but it's the rate of change that is important to watch and on

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this front we're looking at a metric that is down meaningfully from three consecutive readings above 60 in September, October, and November.

So not only has the global economy gone from a 'globally synchronized recovery' back in January 2018 to a 'globally synchronized slowing' at present, we have a U.S. economy that is finally catching down to the rest of the world where GDP growth has decelerated for three straight quarters, and in Q4 National Accounts Profits actually contracted on a sequential QoQ basis. If you want to understand just how detached stock prices have become relative to fundamentals, look no further than the fact that should estimates for earnings to decline -4% in Q1 prove to be correct, then this will be the first time in recorded history that the S&P 500 would have

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rallied +13% in the same quarter as this level of earnings degradation.

With the rally we've experienced this year, we're talking about a trailing P/E multiple on the S&P 500 that has expanded by 3.4 points in just the past three months to 18.9x. This is close to the multiple we got to at the peak of the S&P 500 in September of last year, and back at that time we didn't know the degree to which economic growth would be slowing and the degree to which earnings estimates would be coming under the knife. The multiple on forward estimates has also increased back to its September 2018 peak levels at 16.7x – a widening of 2.3 points since the start of the year. Look, we can argue over the degree of overvaluation these levels are at relative to history and/or how multiples may deserve to be higher in this low interest rate environment,

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but please don’t try and make the claim that the market is cheap. It’s NOT.

There are any number of narratives investors and the talking heads could concoct to explain this bifurcation between stock prices and fundamentals, but the one that seems most plausible to me is good old-fashioned hope – and a sprinkle of hindsight bias. The current position the broad markets are taking is that the recent soft patch will prove to be fleeting, the earnings decline will be a one-quarter wonder, and that economic growth is set to reaccelerate in the back half of the year. I can see why and how investors are buying into this line of thinking – that the Fed rode to the rescue at every point of economic weakness over the last decade, they are doing it once again, and once again they will be successful. I can’t say I agree with this line of thinking at this juncture (for reasons I’ll lay out below),

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but there is a legitimate basis for this way of thinking given the unprecedented nature of this recovery, so one would be wise to not just ignore this possibility.

- The biggest variable driving my doubt that the Fed can reflate the financial system once more this cycle is global debt. At the peak of the last economic cycle in 2007, the world was saddled with $165 trillion of debt (sovereign, corporate, and household) and global GDP that backstopped that level of debt totaled $60 trillion. Fast forward to today, where global debt outstanding tallies $244 trillion compared to global GDP clocking in at $80 trillion. Think about that for a moment – total outstanding debt has increased by nearly $80 trillion relative to an increase of $20 trillion in GDP (income) to service this debt – debt has surged at four times the pace of GDP since

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the peak of the last cycle. So, one of the solutions to counteract the credit bubble that popped back in 2008 and set off the GFC was to create an even larger debt bubble. This is the reason the Fed (or any central bank for that matter) can't raise interest rates any further than they already have – the debt markets would seize up, as was the case back in late November and December when credit markets virtually shut down.

- The other variables that I believe will challenge the reflation narrative over the next several quarters are the rising costs of labor, debt service costs, and input costs. Wage growth (while it ticked down in the U.S.) is at its peak rate of growth for this cycle, and over the last year the lack of skilled workers has been near the top of the complaint list for businesses. The

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following chart measures the percentage of small businesses seeing cost of labor as the "single most important problem", which hit a record high of 10 in February (white line). Also plotted on this chart (in yellow) is the year-over-year change in GDP, which you'll notice that anytime the white line pushes above 8 (circled in blue on the chart) GDP growth turned down and on average a recession followed within 12 – 18 months.

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In addition to wage growth, we have interest expenses that are set to increase on the nearly $1.5 trillion in corporate debt that needs to be refinanced over the next two years. Sure, the Fed has stopped hiking and interest rates have stopped rising, but that doesn't change the fact that interest rates are still higher than they were at any point over the last three years. In order to avoid a credit downgrade, corporations are going on a debt diet starting this year and this will divert precious free cash flow from stock buybacks, capex investment, and potentially new hiring.

- The last variable that heightens my caution is the level of the U.S. dollar relative to other currencies. A strong dollar isn't good for anyone except the U.S. consumer

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as it keeps a lid on inflation. The writing may be on the wall of a walking back and breaking down of the four-decade trend towards globalization, but we aren't there yet and as a result we still have nearly 50% of corporate profits for S&P 500 companies derived from overseas. That being said, the U.S. dollar index has been holding near cycle highs for about six months and is threating to breakout above a stiff resistance level around 98. Just holding around these levels is going to be a headwind on earnings growth, but a push above 98 would (in my opinion) act as a global wrecking ball not only for U.S. corporate profits, but even more so for emerging market debt denominated in U.S. dollars.

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Conversely, if the dollar were to break down from here and begin a meaningful and prolonged down trend, then I think this breathes a big breath of fresh air into the reflation thesis and a plethora of risk-on investment setups come to the fore.

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So, where does that leave me in terms of thoughts on where and how to invest? I'm still of the view that investors can generate positive returns through a barbell approach of short-term, high-quality fixed income on one side and high-quality, non-cyclical dividend paying stocks on the other hand. As the calendar rolls over into Q2, the economic work we track suggests that U.S. economic growth should continue to slow and the decline in inflation should start to reverse later in the quarter. Such a backdrop favors secular growers – think of your disruptors and companies that don't need the tailwind of economic growth to drive their top line: energy, real estate and biotech within the healthcare sector are areas that screen well in such a backdrop. There are some signs of stability (albeit at low levels) in foreign economies and some emerging markets – Mexico and Taiwan are two markets that look

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relatively favorable at the moment and looking forward. The question with emerging markets and foreign markets in general is whether this is just a brief pause in the data before it rolls back over again or can these 'green shoots' gain some momentum?

I still think investors should monitor the rise in recession probabilities over the next twelve months (the NY Fed's model just ticked up again in March to 27.08 – recall that when this metric gets into the 30's it's a big problem…), but outside of an exogenous shock, it's unlikely that the U.S. economy loses enough momentum in Q2 to trigger a recession.

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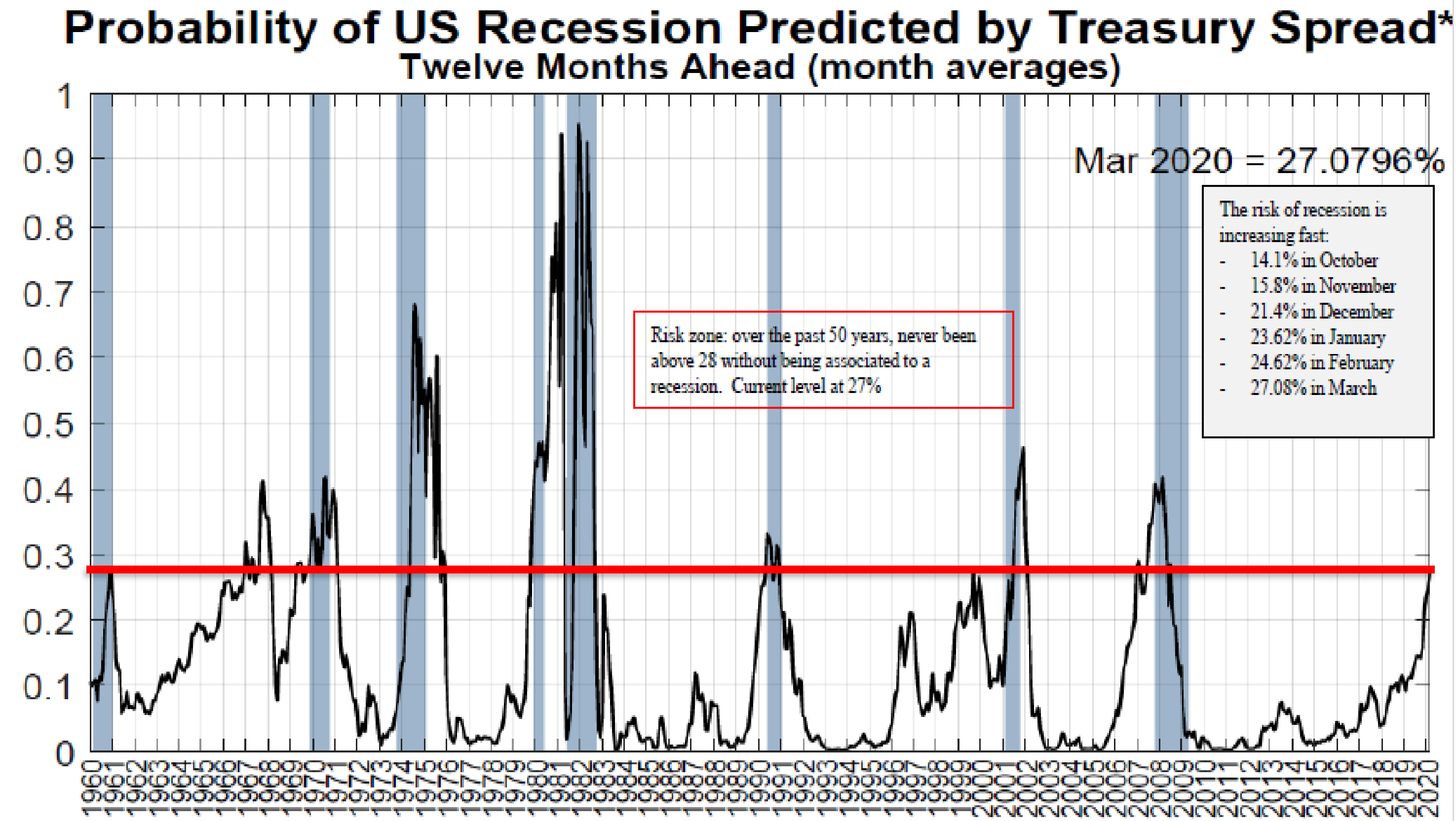

Precious metals should fair okay in an environment where growth is challenged and inflation stabilizes (picks up), not to mention a flight to safety bid from geopolitical risk and tension – if the dollar were to roll-over this would really light a fuse under this sector. I'd be surprised if over the remainder of the year the equity market continued on its one-sided, upwards levitation, but I've already been surprised by the outsized move to the upside to start this year. This is a stock market that

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has gone unchecked since the lows in December and that makes for a pretty tricky technical backdrop should things breakdown, as it would leave a lot of guess work as to where the downside support levels are. In the meantime, I expect the next several weeks will get interesting with Q1 earnings season about to kick off, and the height of the buyback blackout schedule starting next week. Companies have been the biggest purchasers of stock throughout this decade-long expansion, and even more so following the windfall from the recent tax cuts – losing their buying power with so much hope predicated on strong forward guidance could make for some interesting price discovery should results be a disappointment.

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