April 29th, 2019

What to believe?

There is no better place to start this week's missive than with the S&P 500 hitting a new all-time high last week, especially considering this was not in my crystal ball. Frankly, I don't know of too many individuals that saw this in the cards, notwithstanding the eternally bullish, and I'd venture a guess that the fact that we've reached new highs within only four months from the severe slide in Q4 is a surprise to them as well. Nevertheless, we're here now and as such I find myself asking the question of what should or should not be believed?

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- Was the Q4 equity market sell-off just a "glitch", or perhaps a one-off erratic downside spasm due to liquidity constraints brought about by overly aggressive monetary tightening by the Fed? Well, given the quick and decisive about face away from "additional tightening coming in 2019" to a more "patient" policy stance by Chairman Powell and other FOMC members in the wake of the Q4 bloodbath, it's a reasonable assertion and a constructive development for investors that the Fed has reverted back to being a tailwind for risk assets. After all, this cycle has been dominated by global central bank policies and the actions they have taken to back stop and support asset prices have mattered more than any other fundamental data point this cycle. There is no better

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illustration of this power than the mere fact that this still remains the weakest economic expansion in the post-WWII era, but that hasn't prevented the occurrence of one of the strongest and longest bull markets in history.

To me, it's no longer a question of whether or not the Fed sees asset prices as systemically important to the overall health of the economy – after ten years of implementing policy tools geared towards creating a wealth effect, and seeing the swiftness with which they backed off of their tightening campaign following last year's rapid -20% decline in the stock market is confirmation of this reality. But here is the question, and none of us (not even the Fed) will know the answer to this at the current time: Did they already tighten monetary policy too much? Below

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are a couple of data points that suggest this could be the case:

- Various parts of the yield curve inverted late last year and into earlier this year. It's worth noting that some of these inversions have reversed, others weren't inverted for longer than several days, and only a few still remain inverted today. But historically speaking, this has been a precarious signal in terms of the markets indicating that the Fed has over-tightened, with the damage already being done regardless of the yield curve moving back into a normal position.

- Fed Funds Futures are pricing in nearly 70% odds that the next move by the Fed is a rate cut by early 2020, not a

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rate hike. Historically, when the Fed starts cutting rates after a pause it hasn't been a welcome development for the economy or asset prices. There are exceptions that also should be noted, like the rate cuts in '87, '95, and '98 that helped prolong and extend those cycles.

Which brings me to the "what to believe?" question. Do investors still have enough confidence and faith in the Fed that they extend this cycle even further? Given what we've seen so far in Q1, with U.S. equity prices pushing to new all-time highs and credit spreads compressing back near cycle lows, I believe the answer to this question is a definitive YES. However, you have to ask yourself just how strong can the economy be if it can't handle the Fed hiking short-term rates

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above 2.50%? Another question that arises are the laws of diminishing returns in terms of cheap money and ample liquidity to meet the desired objectives. Recent developments out of China may be (I stress *may be*) a canary in the coal mine on this front, given they provided nearly $1 trillion in monetary and fiscal stimulus in Q1 where the initial response has been extremely beneficial to its stock market (up over 25% at its high for the year). However, as of this morning the Shanghai Composite is down nearly -7% from its recent high and it's yet to be determined whether this is just profit taking, or if in a highly indebted economy like China's, all you get for $1 trillion in short-term stimulus is a multi-month jolt that ends up fading?

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- Now what about that blowout Q1 GDP report that showed the economy grew by 3.2%, well beyond the 2.3% consensus estimates, and up from 2.2% in Q4? I'm not going to challenge the headline print, as it is what it is and for many investors that's the only number that matters. But I will say that this is one report where the real information content lies below the headline and that looking under the hood revealed some disconcerting trends. I've read several economists' take on the number, with many highlighting the weakness of the headline beat given that the combined impacts of inventory builds (+0.65% contribution to the headline number), net exports (+1.03%), and government spending (+0.41%) added up to over 2% of the 3.2% headline print. The argument is that inventory stockpiling occurred for the third straight quarter in

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anticipation of more tariff hikes, and as a result, inventory levels are near their highest levels of the cycle which will cause production to fall in the quarters ahead as companies look to reduce this inventory overhang. The big jump in the net export contribution was a result of a sharp fall in imports which has some wondering whether fewer imports is a result of falling demand.

Moving beyond the arguments for whether this was a strong report or not, my net takeaway is that it provides some confirmation for the bullish rally we've seen in equity markets to kick off this year in that it puts to bed any argument that the large sell-off we saw in Q4 was on the grounds that the U.S. and/or global economy was at risk of an imminent recession. When in all reality, what we've

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seen is an economy that has downshifted from a robust pace of growth in Q2 and Q3 of last year (when the brunt of the tax cuts and fiscal goodies hit) to an economy that at the moment (as in Q1) remains pretty firm.

As for the not so pleasant and troubling part of the GDP print, that was from seeing real consumer spending slow to a 1.2% annual rate in Q1, the weakest performance in a year. The best gauge of the underlying momentum in the economy is the reported figure for real final sales to domestic purchasers, which excludes temporary inventory changes and erratic movements in foreign trade. This metric rose at an annualized rate of 1.4% in Q1 and this was the weakest reading in more than three years (take sales to the government out of this metric and we're

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talking about 1.3% growth – the slowest rate in almost six years). The trend in 'real final sales to domestic producers' is bothersome with Q1 at 1.3%, which is half of the 2.6% rate in Q4, 3.0% in Q3, and 4.3% in Q2 of 2018. Why this is important is because it will be real headline GDP growth that will be converging to this deteriorating trend, not the other way around. This may come as a surprise to some in the Trump administration given it is not what you would expect to see in the "greatest economy ever", and hence many are clamoring for a rate cut (Kudlow) while celebrating the headline reading. This weakening trend is what the bond market saw on Friday as interest rates dropped and interest rate futures markets firmed for a Fed interest rate cut at some point this year.

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Alright, so we're back to this 'what to believe?' theme. Is the economy set to reaccelerate after the growth scare late last year and with the Fed back at the ready to do 'whatever it takes' to extend this cycle? This is what equity markets would have you believe as they've moved in a straight line higher over the last four months to new all-time highs. Or should the bond market garner a little more attention and respect as yields melt back down near their lows of the last 12 months? One other thing to consider in the GDP report is the trend in nominal GDP growth which takes into account both pricing and volumes, which was expanding at an annualized rate of +7.6% in Q2 2018, +4.9% in Q3, +4.1% in Q4, and +3.8% in Q1 2019. Just for some perspective on this metric, this +3.8% reading in Q1 is

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below the +6.2% level in Q2 1990, +4.7% level in Q4 2000, and +4.1% in Q4 2007 – nominal GDP prints in the quarters prior to the last three recessions.

- The last thing I want to hit on is earnings, and I'm going to go in a bit of a different direction than some of my prior musings by not focusing exclusively on the aggregate earnings data. Yes, 77% of companies are beating analysts' estimates, but this is nothing new in that estimates have been dramatically cut coming into reporting season. The fact of the matter is that earnings are still tracking 2% (+/-) in aggregate for Q1 and no matter what, this is below the +6% reading at the start of the year and above the lowest expectation of a decline of -4%. Interpret it how you would like, and keep in mind two other interesting developments: 1) expectations

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for Q2 earnings estimates have slipped into negative territory, and 2) S&P 500 profit margins are clearly starting to roll off the peak – from 12% in Q3 of last year to 11.3% in Q4 to an estimated 10.9% in Q1. Still high for sure and nothing major to worry about, but just some validation that profit margins are coming under some pressure from a subtle rise in interest rates since the Summer of 2017, increasing input costs, and rising wage pressures.

What I think was even more interesting were the earnings reports out of 3M and Intel. Both are cyclical bellwethers and both threw cold water on the hyped-up expectations that a second half growth rebound awaits. 3M could be a unique story of poor execution as several other Industrial companies reported decent results, but 3M is the poster child for the

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industrial heartland and to see its stock plunge -13% in a single day grabs this analyst's attention. Have a look at the chart below via Jesse Felder which plots 3M's revenue growth versus the ISM manufacturing index, and it's easy to see why this company is closely watched by investors as a read on the global economy. If 3M's Q1 results are not just a one off, then investors may want to heed some caution on their rosy forward outlooks.

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As for Intel, this other bellwether company reported disappointing results which took its stock down -7% the following day. The reason investors should pay attention to Intel and the semi-conductor space in general is because almost everything that is manufactured today has a semi-conductor chip in it – communications equipment, PCs, autos, smartphones… and this is a sector that typically leads the stock market. The weakness in Intel wasn't unique as Samsung, Xilinx, and Texas Instruments all guided down with Texas Instruments (2nd largest Semi company) reporting revenue declined -5% in Q1 and guiding to a -10% year-over-year revenue decline in Q2.

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So once again, I come back to the 'what to believe?' question. The Semiconductor Index was up 50% in 4 months heading into last week's earnings disappointments despite a bevy of indicators flashing warning signals that a global chip slowdown was underway, and now we know that domestic chip sales have declined -23% Y/Y to the lowest level in two years and global chip sales declined -11% with most companies throwing cold water on the second half recovery story. But the sell-off in the group has been relatively modest (-5%) given the 50% rise, which indicates that investors remain partial to the second half recovery story even though the executives running these companies suggesting this is 'fake news'.

A similar discrepancy is at play with 3M, not only as it relates to the strength of the

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U.S. economy, but also the hype and hope about a meaningful positive turn in the Chinese economy. See the snip-its below, pulled from the 3M earnings call (hat tip to Teddy Vallee who brought this to my attention):

Please note, additional business group performance details can be found in the appendix of this presentation. As mentioned earlier, throughout the quarter, we continued to see soft end market trends in China, automotive, and electronics, along with channel inventory adjustments. These trends primarily impacted our Industrial, Safety and Graphics, and Electronics and Energy businesses. Our Industrial business saw a broad-based slowdown across most of its portfolio, posting an organic sales decline of 2.8% to start the year.

More on China from later in the call:

enthusiasm in places like China, given increased stimulus and/or tax cuts that could help markets like China auto or electronics. So have you seen any improvement in any of your short-cycle businesses over the last few weeks or a month or two?

Michael Roman, 'Chief Executive Officer'

Yeah Andy, certainly as we went through first quarter, we talked a bit about the slowing that we saw as we went through the quarter and that continued right through the end of the quarter and really led by those markets China, automotive, electronics, so those are all the ones we've been talking about. There is -- I think the outlook is, that gets better when you listen to the projections, the economic projections in those areas.

We haven't seen that. Our April is basically on track with what we're laying out for our total year guidance. But seeing a market improvement in those markets, I think we'll see -- we'll get an answer as we move further into the quarter, into the second quarter.

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China, continued:

Laurence Alexander

Right. Did you see -- have you seen any sort of actual turnings in order patterns or is it a really just more just everybody's forecasting the back-half therefore?

Michael Roman, 'Chief Executive Officer'

Well, I would say, we haven't seen a sharp turn in these softened markets.

We're in line as we go into April with our expectations. I would say, maybe we see the inventory adjustments slowing down. I mean those tend to be -- those don't tend to be fourth quarter unless there's another macro kind of event that drives it. Those will adapt pretty quickly.

That -- and we're seeing maybe some signs of that as we go forward. But it we certainly don't see what these particular markets, automotive, electronics, they're forecasting a stronger second half and we don't see the early indication of that yet. I think it makes sense to a degree what they're talking about, but not early days of April have we seen that.

So, if I can summarize and synthesize this week's missive, it would be that anyone brave enough to have aggressively played this incredible rally in 2019 should look for opportunities to lock in some of the gains that almost nobody saw coming. For those like myself that didn't participate to the degree that we would have liked, I'd encourage you to fight the urge to chase at this point. There is a legitimate case to be made that we could very

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well go into full bore melt-up mode, and it's for this reason that investors should maintain some exposure to the equity market even in the face of conflicting fundamentals (perhaps even add some exposure in a disciplined and prudent manner over time). Such a melt-up would be painful for those under-allocated to equities at the moment, but don't forget that markets do correct and last year we had two doozies that provided opportunities for the willing and able.

At the moment, the market is filled with contradicting signals and non-confirmations, but as has been the case with this bull market run (especially in the last three years), none of these cautionary signals matter until they all matter and matter in a big way. I concede that more than at any other point in this cycle, many of the relationships between the stock market and economy, fundamentals and

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security prices, security selection and market beta… have broken down relative to historical norms and passed the price discovery baton to the machines, liquidity, and central banks. At the current time, these latter variables are pushing risk assets higher irrespective of fundamentals, hence the breakdowns in relationships that have been reliable leading indicators even as recent as last year:

> Top panel is the correlation between the Citigroup Economic Surprise Index and the S&P 500 from 2015 – 2017, where the two data series moved almost in unison. The bottom panel plots this relationship from 2018 – 2019, where the correlation between the two sets of data actually move inversely.

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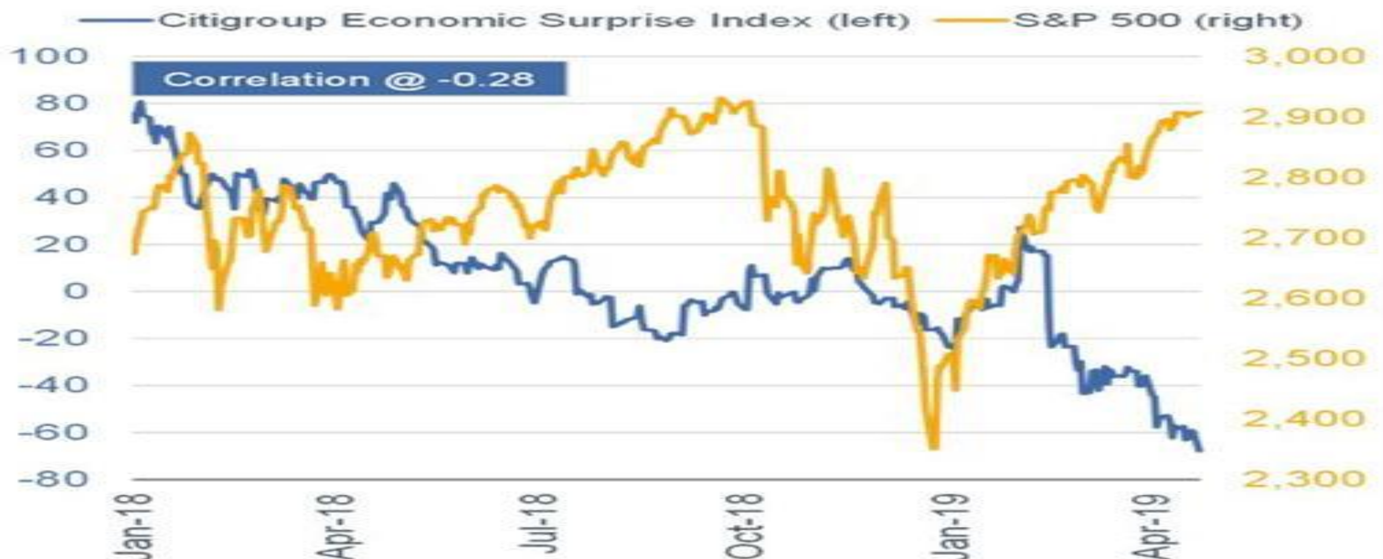
CESI vs. S&P 500 (2015-2017)

As of 4/22/19. Source: Charles Schwab, Bloomberg.

CESI vs. S&P 500 (2018-2019)



A similar dichotomy has occurred between lumber prices and the S&P 500, with lumber prices falling back down to the lows they touched in early Q4 (when

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they led the slide in the S&P 500 by a couple of months), but the S&P 500 could care less at this time as it moves back to all-time highs.

There is no guarantee that these relationships (among many others) ever converge back to their historical norms no matter how much any investor may prefer they do. There is a plausible claim to be made that stocks have become commoditized with the indexation of

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the market, algorithmic trading, a shrinking float where half as many companies trade publicly relative to two decades ago, and the financialization of the U.S. economy – if such an environment were to be maintained, then irrespective of fundamentals, all investors should have some exposure.

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