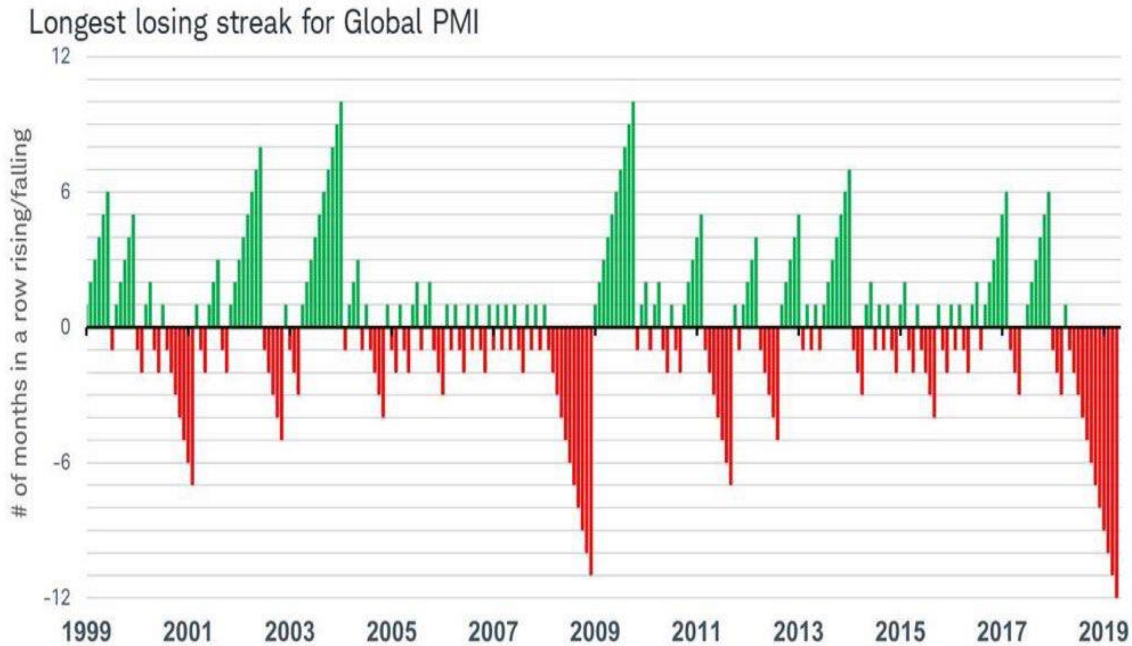
May 6th, 2019

It’s not about the fundamentals…

Equity markets have ripped higher this year with perhaps the most plausible explanation being that the global economy hasn’t slipped into a recession, as was being priced in during the sell-off late last year. I’m sure there are other smart and cogent explanations that sound articulate and make sense, but I continue to disagree with the view that the reason stocks are off to such a great start this year is because the fundamental data is getting better – a more accurate proclamation is that the data is coming in better than beaten down expectations. Let’s take a look:

- Corporate Earnings: The fear coming into the year was that S&P 500 earnings were set to decline almost -4% in Q1, and as results have come in, Q1 earnings are tracking a decline of -0.8% (according to FactSet’s tracking). So better than expected for sure, but we are still looking at an earnings trend that is going in the wrong direction with EPS growth falling from 24.5% in Q2 2018, to 24.2% in Q3 2018, to 12.6% in Q4 2018, to -0.8% in Q1 2019, and estimates for Q2 2019 earnings coming in at -1.3%. With the equity market moving back up to all-time highs last week, it has elevated valuation multiples back near their highs for the cycle. Apple (AAPL) is a great example of what matters to the markets today more than fundamentals in that they reported a second consecutive quarter of revenue and earnings decline, but they announced a $75 billion stock buyback and the shares rallied by more than 7% following the release. As a matter of fact, if you look at all of the members of the FANG constituents, they all reported growth numbers that were the weakest in several years. The flip side of this reality is that while their respective growth rates are slowing (there is an element of the law of large numbers going on here), they’re still growing and that’s much more than what can be said for many other companies in the stock market today. John Authers published an interesting piece on Bloomberg over the weekend where he pointed out that absent the following six U.S. companies (Facebook, Amazon, Apple, Netflix, Google, and Microsoft), the world stock market has gone nowhere for the last 16 months.

- The ISM manufacturing and non-manufacturing indexes registered disappointing results for April when they reported last week. The manufacturing PMI report fell 2.5 points to 52.8 (well below consensus estimates for a print of 55) and this was the weakest print since October 2016. The weakness back in the fall of 2016 could be blamed on a feeble stock market and election uncertainty, but neither of those are present today, so perhaps a more plausible explanation today is lackluster growth both here and abroad. As for the ISM non-manufacturing PMI survey, it dropped to 55.5 in April from 56.1 in March and 59.7 in February. Don't get me wrong – a print of 55.5 is still a solid level, but this was the lowest reading since August 2017 and the trend in this data series is not comforting: 60.8 in September, 60.0 in October, 60.4 in November, 58.0 in December, 56.7 in January, 59.7 in February, 56.1 in March, and 55.5 in April. The combined composite PMI also declined to 55.2 in April from 56.0 in March, and 59.1 in February. I fail to see in these numbers the consensus narrative that things are reaccelerating as we progress throughout the year, and this isn't unique to just the U.S. economy as the 'green shoots' expectations from the rest of the world just aren't cooperating as of yet. Have a look at the following chart from Jeffrey Kleintop of Charles Schwab showing global PMI readings are now registering their longest streak of declines on record.



Source: Charles Schwab, Factset data as of 5/3/2019 **Past Performance is no guarantee of future results.**
JP Morgan/Markit Global Composite PMI gives an overview of the global manufacturing and services sectors. It is based on non-opinion based monthly surveys of over 16,00 purchasing executives from 32 of the world's top economies, including the U.S., Japan, Germany, France and China which together account for over 85 percent of global GDP. It reflects changes in global output, employment, new business, backlogs and prices. The Global Composite PMI is seasonally adjusted at the national level to control for varying seasonal patterns in each country and is produced by J.P. Morgan and Markit in association with ISM and the International Federation of Purchasing and supply Management (IFPSM).

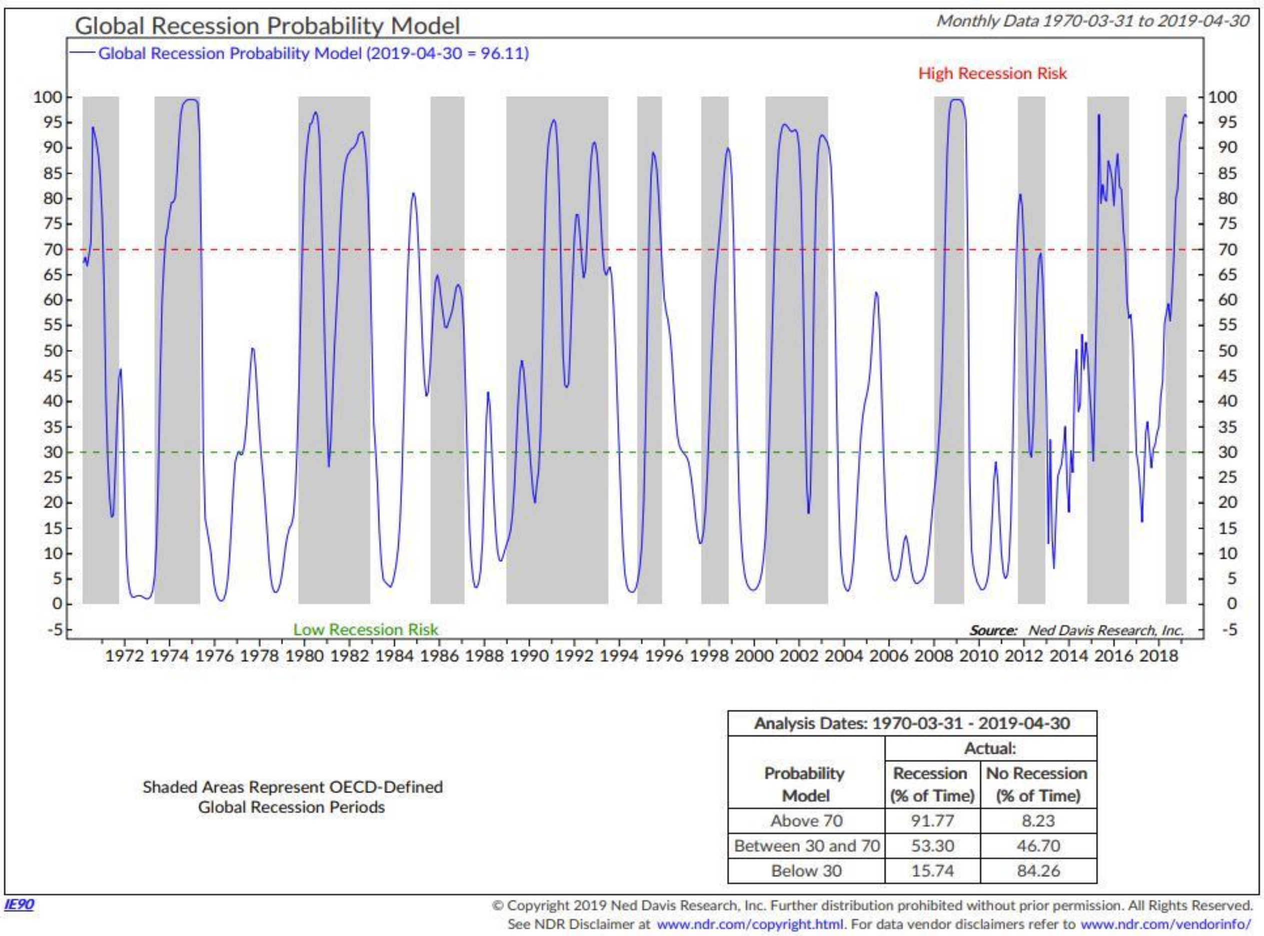
- The employment report that showed the U.S. added +263k jobs in April sure was a pleasant surprise relative to consensus estimates for a print of +190k. I'm not going to besmirch the headline number which is extremely strong this deep into an economic expansion, but I must admit that I still have some reservations on the overall health of the jobs market when digging through the details of the report. I understand the attention paid to the headline print, and the unemployment rate falling to a 50-year low of 3.6% speaks for itself. However, where my skepticism comes from is seeing the corresponding Household Survey show employment declined by -103k in April. This survey uses a different methodology than the Establishment Survey, but it has been around since 1948 and tends to have a better history at tracing inflection points in the business cycle. The Household Survey has reported actual job losses in three of the past four months for a cumulative total of -300k. So, let's call it mixed and inconsistent when it comes to validating either the strength or weakness between the two surveys which over time tend to converge on each other – the question being which way does the convergence occur?

  Beyond the number of jobs created, what really stood out in the report was seeing the workweek contracted by 0.3% in April to 34.4 hours. This metric has declined or stagnated in three of the last four months, and why this is so important is that hours typically tend to lead bodies. Add the decline in the workweek with the tepid increase in wages and we actually saw average weekly earnings decline in April to 2.9% Y/Y from 3.2% in March, and 3.5% back in January. Ladies and gentlemen, average weekly earnings is the mother's milk for work based compensation and a decline in this metric raises some concern about the ongoing strength of the consumer. It's this last data point that got the market's attention on Friday which caused interest rates to fall, the dollar to sell-off, and provided a bid to commodities.

  The other economic data that was released last week that didn't get much attention (and probably because it wasn't a good report) was the auto sales data. The strong print of 5.3% growth in March of 17.45 million units (annualized) looks to be a one-off given that sales in April sank 6.1% to 16.39

million units and this is the lowest level since October 2014. Sales have now declined in three of the past four months, and the -4.3% Y/Y is the weakest it has been in the past eight years.

Over the weekend, President Trump issued a tweet threatening to move to 25% tariffs on $200 billion in imports from China starting on Friday, presumably in an effort to get both sides over the final hurdles to finalize a trade deal. It's anybody's guess whether this is just a negotiation tactic or a signal that trade talks are breaking down. We're all along for the ride on this issue with the most prudent course of action being to wait, watch, and react to anything tangible that manifests. I think it's a reasonable presumption to assume a deal gets inked, which makes the risk skewed to the downside should things escalate from here and the threatened increased tariffs go into effect come Friday. The chart below from Ned Davis Research speaks for itself with the April reading of the NDR Global Recession Probability Model coming in at 96.11 – a level that rarely gets met without a global recession occurring.

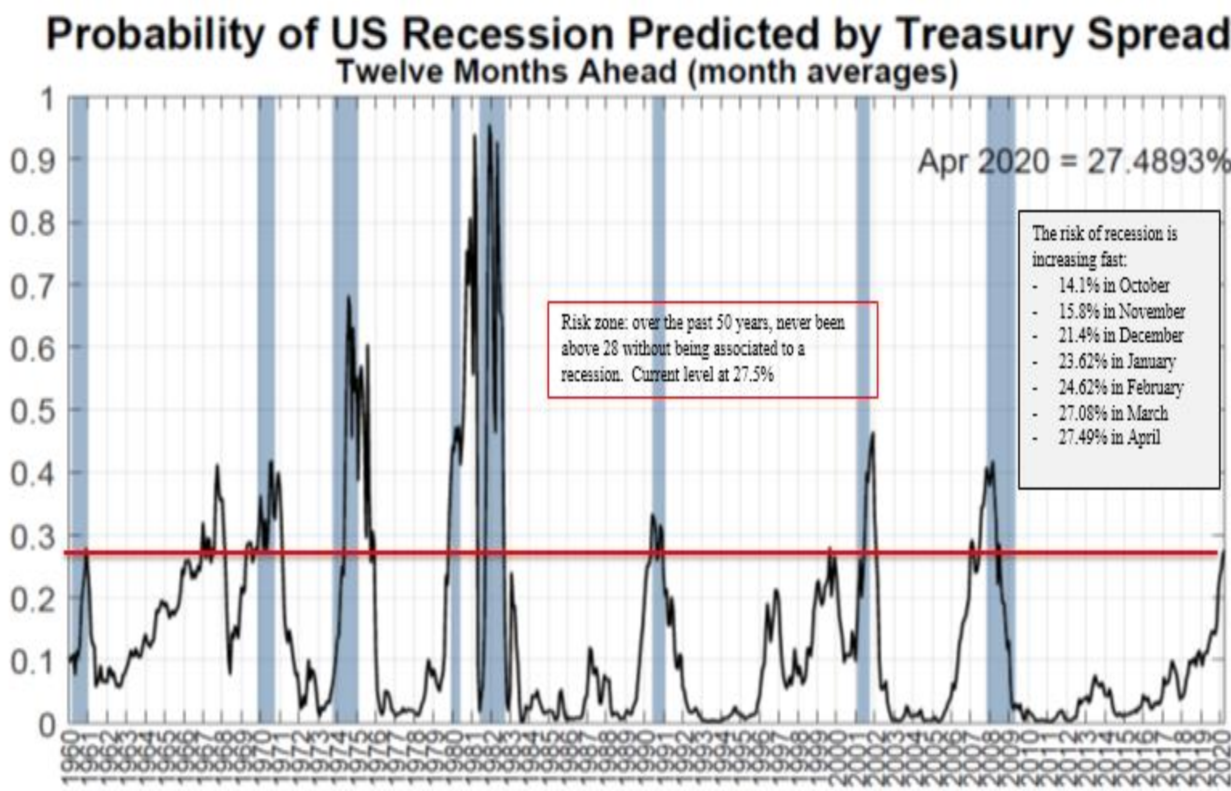


Analysis Dates: 1970-03-31 - 2019-04-30		
	Actual:	
Probability Model	Recession (% of Time)	No Recession (% of Time)
Above 70	91.77	8.23
Between 30 and 70	53.30	46.70
Below 30	15.74	84.26

It's the fragile state of the global economy (which has been showing some signs of stability over the last several weeks) that adds heightened attention to the outcome of this trade skirmish between the U.S. and China. Many people may look at this chart and wonder how U.S. equities could be back at all-time highs in the face of such elevated risk, and such a reaction isn't unfounded. But on the other side of this risk is the Fed and global central banks, which have gone out of their way this cycle to be a backstop for risk assets when things breakdown in a material way. It's the Federal Reserve that has been the most dominant player in this equation and U.S. asset prices that have become the world's safe haven. Hence anytime there is weakness anywhere in the world, there is a perpetual bid for both U.S. equities and bonds.

You may not like this reality (nor do I) – and I remain of the view that when this game ends, it will end badly – but the reality is that the U.S. stock market has become the U.S. economy. In the past it's been the economy that has driven the stock market, but that script has shifted this cycle after a decade long period of cheap credit and ample liquidity. The pivot by the Fed late last year from tightening monetary policy to leaning towards a loosening in policy is a testament to just how correlated the global economy is to the U.S. stock market. Think of it this way – the U.S. economy is the largest economy in the world at roughly $20 trillion in annual GDP, which is roughly 24% of the total $84 trillion in world GDP. According to data from The World Bank, as of the end of 2018 the total market cap of the global equity market was a little over $65 trillion, with the U.S. equity market totaling about $34 trillion (or a little over 50%). Given the extent to which the U.S. economy has become financialized (the stock market cap of $34 trillion is more than 150% larger than the size of the economy), the Fed – by targeting asset prices in this recovery – has tied policy to the whims of the stock market.

It is because of this reality that I don't disagree with the calls from various members of the administration for the Fed to cut interest rates. Whether I take issue with the U.S. being in this position and whether I think this is right or wrong is a whole separate question. It is what it is, and when you see data coming directly from the Fed's research department (like the table below indicating that the probability of a U.S. recession materializing in the next 12 months has increased every month this year to its highest level since June 2007), it suggests it's only a matter of time before the Fed is cutting rates. It's my view (and our work suggests) that the U.S. economy just started to weaken in Q4 of last year from what was a robust pace of growth in Q2 and Q3. In order for this momentum to be halted to the downside going forward, the Fed has to loosen policy (cut interest rates and eventually revert back to QE) and quickly before the U.S. catches down to the weakness in the rest of the world.



The fact that equity markets are ignoring weakening data and increasing recession probabilities says one of two things: 1) this time is different and leading indicators like this don't matter, or 2) we've repeated the same mistakes as the last two cycles by creating another asset bubble where prices are drastically divergent from fundamental reality. I've always been fearful of uttering the "this time is different" view, but when the price of money (interest rates) globally hits 5,000-year lows (summer 2016) – it's hard not to acknowledge that investors are in a place we've not been before.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215