June 10th, 2019

Sequencing the path, almost as important as the destination…

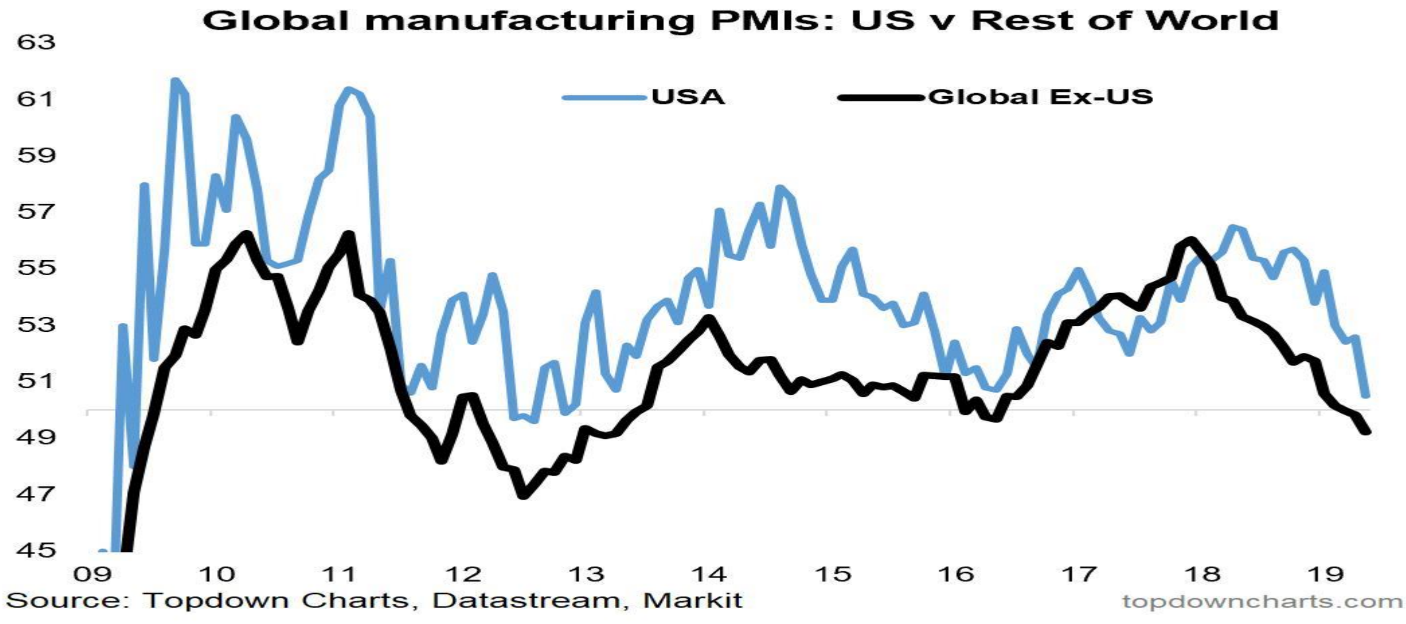
U.S. equities ripped higher last week with the Dow gaining nearly 1,170 points in just five trading sessions which lifted the blue-chip index +4.7% and put it within roughly 3% of its all-time high. The gains were widespread with the S&P 500 up +4.4% on the week, the Nasdaq is now only 2.5% from its all-time highs, and the Wilshire 5000 saw its market cap swell by $1.2 trillion in one week. Getting a bounce off of what were deeply oversold levels and extremely negative sentiment readings to close out the month of May (a month that ended on a -7% drawdown from the highs) shouldn't come as a surprise, but the amplitude of this move surely has been. That the Dow and the S&P 500 managed to rally +1% on Friday following what was one of the weakest employment reports of this cycle is a perfect illustration that economic fundamentals are not what's driving the price action in the equity market at this time. No, what matters at the current juncture is Fed policy expectations and the prospect of lower rates ahead for the foreseeable future.

And you know what, with over $11 trillion worth of bonds around the world, or 20% of the global fixed income market, back trading with a negative yield (the German 10-year bund at a record low -0.26% on Friday) it's not difficult to fathom why investors are flocking to equities. However, the flip side of this low rate environment should warrant some thought about just how much firepower the central banks will have at their disposal to fight the next recession? Take the U.S. for example – at the peak of the last cycle the Fed Funds rate peaked at 5.25% and was cut all the way to 0% to combat the Global Financial Crisis. Before that at the height of the Tech Bubble, the Fed Funds rate peaked at 6.50% and was taken all the way down to 1.0%. Debt levels today are higher (both on an absolute and relative to GDP basis) than they were at the end of each of those cycles, which will make it interesting to see what unconventional policies the current brass at the Fed comes up with to combat a period of contractionary activity. In early May we got a glimpse of their possible ideas from Lael Brainard when she discussed the potential use of capping interest rates at the long end of the Treasury curve – a policy that was implemented from 1941 through 1952 when the U.S. government committed to paying down the Federal debt it built up after WWII.

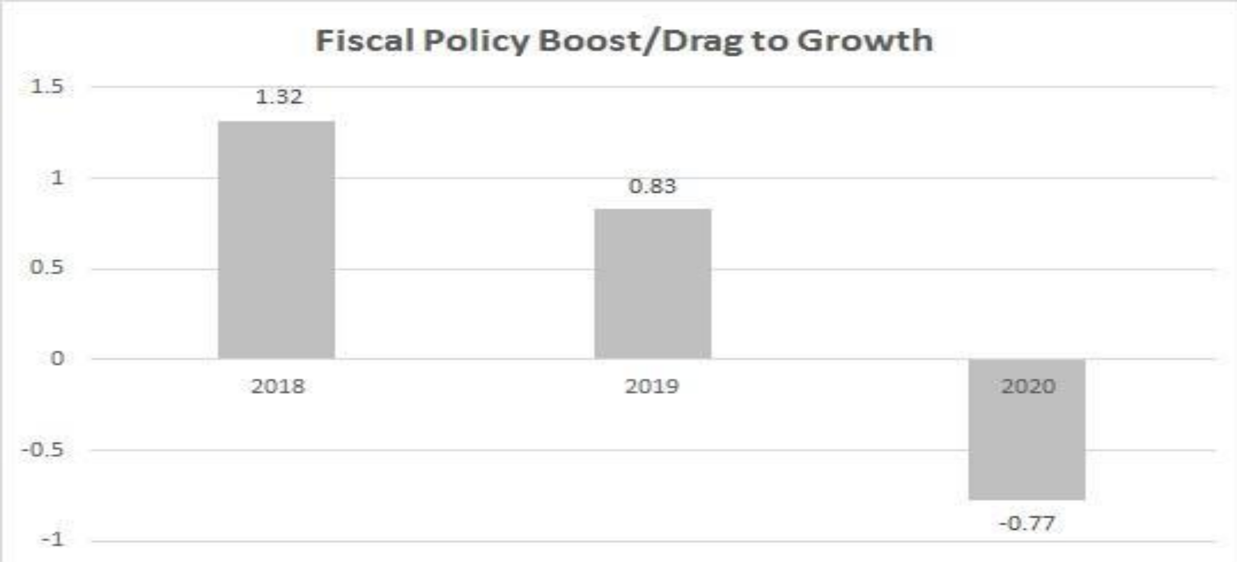
More than anything, ideas and discussions coming out of central banks at the moment about the use of additional unconventional monetary policy tools must be considered and contemplated by all investors, and such thought exercises must be entertained with an open mind and no lack of imagination. For example, that period back in the early 1940's to early 1950's when the Fed capped rates wasn't kind at all to fixed income investors – they got their money back in full, but on a real inflation adjusted basis the return profile paled in comparison to equites and real assets. The one item the Fed has focused on over the last six months has been inflation and their repeated failure this cycle in being able to generate sustained inflation above their 2% stated objective. Anyone living month to month may vehemently disagree with the objective of the Fed that a minimum 2% annual increase in prices is appropriate, but that debate is a waste of time and energy because it's the FOMC that is driving this ship and they are the ones implementing the policies to achieve that end.

So why am I so focused on this? Because the Fed has been the dominant variable in driving asset prices since the GFC ended in the spring of 2009 after they announced the implementation of QE1. The first QE was supposed to be a one-time thing to shore up the banking system and forestall calamity in the financial system. Fast forward ten years, and after only 15 months of the Fed unwinding its balance sheet (they started in October 2017) did we learn in January of this year that the Fed would end the balance sheet roll-off in September 2019. While it's not an admission of failure, it's an obvious miscalculation that once such policies are implemented and the financial system becomes dependent upon them that they can never be removed.

What I'm getting at is that we are now reaching another window of vulnerability in the global economy that will force the Fed to once again take action. The below chart plots the global PMI's Ex-US (black line) which peaked and started to rollover at the start of 2018 vs. the U.S. (blue line) which peaked shortly thereafter, but didn't really start to rollover in a definitive way until the end of last year. Based on some of our economic work, there is an increasing probability that the U.S. manufacturing PMI data takes another leg lower in the next couple of months and should this index break below 49.5 (last reading was 52.1), historically the Fed has always become more accommodative.

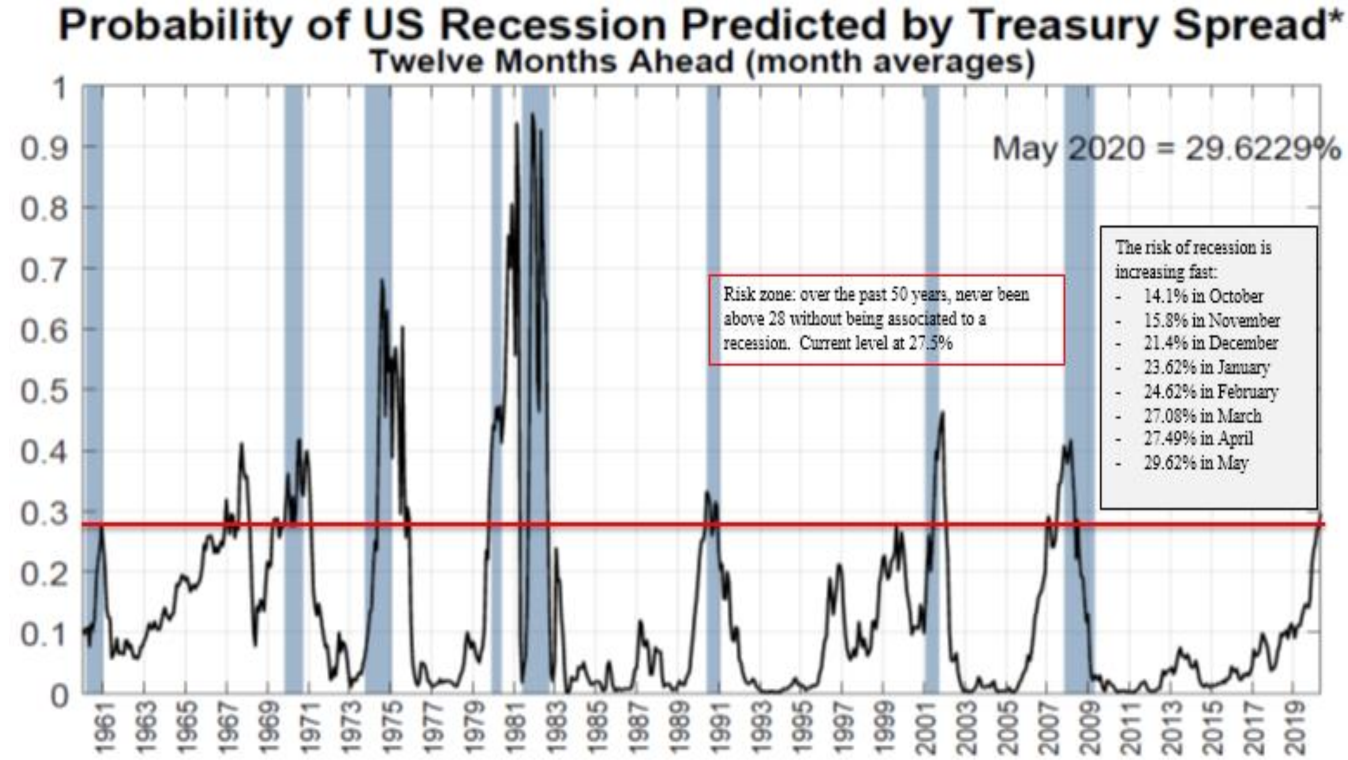


Another factor the caused the pace of growth in the U.S. to outpace that of the rest of the world was the fiscal boost from tax cuts, deregulation, and a bloated Federal budget. However, as is depicted in the chart below, fiscal policy (which acted as a boost to growth by as much as 1.32% in 2018) has already started to fade by only adding an estimated 0.83% to growth in 2019, and will become an outright drag by an estimated -0.77% in 2020. These estimates are fraught with assumptions and are static in nature, but don't allow those shortcomings to distract from the big picture perspective, and that is that keeping all things constant, the U.S. economy is setting up to have a meaningful growth lever shift to becoming a drag on growth.



Put aside the manic whipsawing on the trade front (don't get me wrong – these trade war spats are important and impactful on many fronts, but they are truly difficult to handicap from day to day…) and focus on what is playing out in real-time with the underlying fundamental underpinnings of the economy and corporate America. Q2 GDP estimates from the NY Fed just got reduced last week from +1.5% to +1.0% and the Atlanta Fed's estimate is at +1.4% (both are below the most recently updated Bloomberg Consensus estimate of +1.97%). S&P 500 EPS estimates for second quarter earnings have receded from +4% at the start of the year to -2.3% currently which is yet another deceleration in earnings growth from +24.2% in Q3 2018, to +12.6% in Q4, to +1.52% in the first quarter. Add to this the very disappointing jobs data we got last week from both the ADP release and the BLS. I don't want to spill too much ink over just one report as it's best to wait another month to see if June corroborates just how weak this report was. Nevertheless, the rate of change of monthly job growth already confirms that the labor market is slowing with the three-month average job gains at +151k, the six-month average of +175k, and the twelve-month average at +196k. This is a classic end of cycle pattern. Not to mention the latest Challenger job cut announcements which soared +85.9% YoY in May with the total of 289k job cuts announced year-to-date up +39% from the comparable period last year.

This slowdown in growth and falling inflation is why the bond market has moved aggressively over the last month to invert the 3m/10yr yield curve to its deepest level since the summer of 2007. The NY Fed's recession probability model (which is driven by this curve relationship) increased again in May to its highest level in 12 years at 29%, up from just 11% last year and 8% two years ago. Have a look at the chart below – the historical record for this model has never gotten above 30% without a recession following shortly thereafter.



Why I'm walking through all of this is because while all investors should have a plan and a process with an endpoint in mind, it's extremely important to evaluate the potential sequencing of events that could ultimately lead up to that end point being reached. It goes without saying that all good plans should allow for adjustments and necessary adaptions along the way. Let me lay out my thoughts for how I see the sequencing of events playing out in the months ahead.

None of the information I highlighted above is unknown to most market players or the Fed. One's interpretation of these data points may differ, but the raw data, the rate of change, and the underlying deterioration is well known. The Fed is well aware of the tight spot they're in with a bond market that is screaming at them to cut (the Fed Funds futures market has priced in 3 to 4 rate cuts before 2020) and an equity market that is salivating over the idea of easy Fed policy coming to the rescue to save the day once again. Furthermore, the Fed is very aware that with the Fed Funds rate at only 2.375% they don't have a whole lot of ammunition in the chamber to offset a material downturn in the economy. One of the key phrases that has been uttered on several occasions by Chair Powell, Vice Chair Clarida, and others is that the Fed will act to "extend this expansion" which could imply that they may be preemptive in acting before things get any weaker. However with a stock market just shy of record highs, an unemployment rate still at 3.6% (while everyone knows – including the Fed – this is one of the most lagging of lagging indicators), corporate credit markets not showing high levels of stress, and inflation not too far below their mandate – it makes it very challenging for the Fed to justify a cut.

Think back over the last several years to how the Fed acted and what events drove those actions. In December of 2015 the Fed hiked interest rates for the first time this cycle with expectations to hike four more times in 2016. Not as a result of that one hike, but global growth was at risk of sliding into a shallow contraction by the spring of 2016: The S&P 500 was down almost -12% to start the year, global equity markets were in even worse shape, and oil prices were collapsing into the mid $20's/bbl. The Fed quickly pivoted to walking back any additional Fed hikes in 2016. Then there was the Q4 2018 bloodbath in the U.S. equity market which really went into a tailspin following the Fed's last rate hike in December, guidance for 2-3 more hikes in 2019, and Powell's comments that balance sheet reduction was on "autopilot", but by January 3rd (after a -20% decline in the S&P 500) the Fed was walking back its tightening plans.

What I'm getting at is that the table is set for the Fed to take action: the fundamental data is weakening and at risk of weakening further, the bond market is giving the Fed cover by already pricing in cuts, but we don't yet have the go-ahead from the stock market. I have my doubts that the Fed will act until the equity market is at a level that such action will have a positive impact. If the Fed were to come out and cut next week at its June meeting with the stock market at the level it's at currently, I think it's more likely that the stock market sells off on fears that the Fed is acknowledging the fragile economic underpinnings. In that hypothetical situation, the Fed has used up one of the precious few bullets in its chamber for no incremental positive benefit.

So oddly enough, if you're an equity market bull (which I'm chomping at the bit to become, in due time and at the right price) awaiting the latest fix from the Fed, I'm of the view that you may be disappointed until stocks undergo some pain to the downside. There are obvious holes to my hypotheticals, but one of the variables that concerns me most is that the Fed steps in to rescue the slide and their actions have no positive impact. An example of this is what we are seeing play out in the housing market with mortgage rates down almost a full point from their highs, but we are seeing little in the way of incremental demand increases because of lower borrowing costs. Should the Fed be unable to halt a slide in asset prices, then I think the likelihood of the U.S. slipping into a recession becomes an almost certainty. If we're being honest with the market cap of the U.S. stock market at over 160% of GDP (the second highest reading in history outside of the top of the 2000 Tech Bubble), the stock market has become the U.S. economy. Unfortunately, with the policies pursued by the Fed since the GFC, corporate executive decision making has become dependent on what the stock price is doing, consumer spending has become highly correlated with the level of the stock market (have a look at the retail sales data in December), and even sovereign leaders are constructing policy around values of their respective equity markets.

Like it or not, this is what it's become until this whole charade ends. However, understanding the sequencing of events that could/would/should play out before getting to your end point is an important part of a prudent investment process. My guess is the next several months will be highly interesting with plenty of noise on the trade front (there is the G20 meeting at the end of the month, with a lot of hope that talks can at least restart between the U.S. and China…), Q2 earnings begin in mid-July where the biggest question is "Have estimates been cut enough?", the slate of economic data for June (set to be released in July) will provide color on whether May was a one-off or if the slowdown is deepening, and of course Fed action – which could come at any one of the next several Fed meetings.

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