June 3rd, 2019

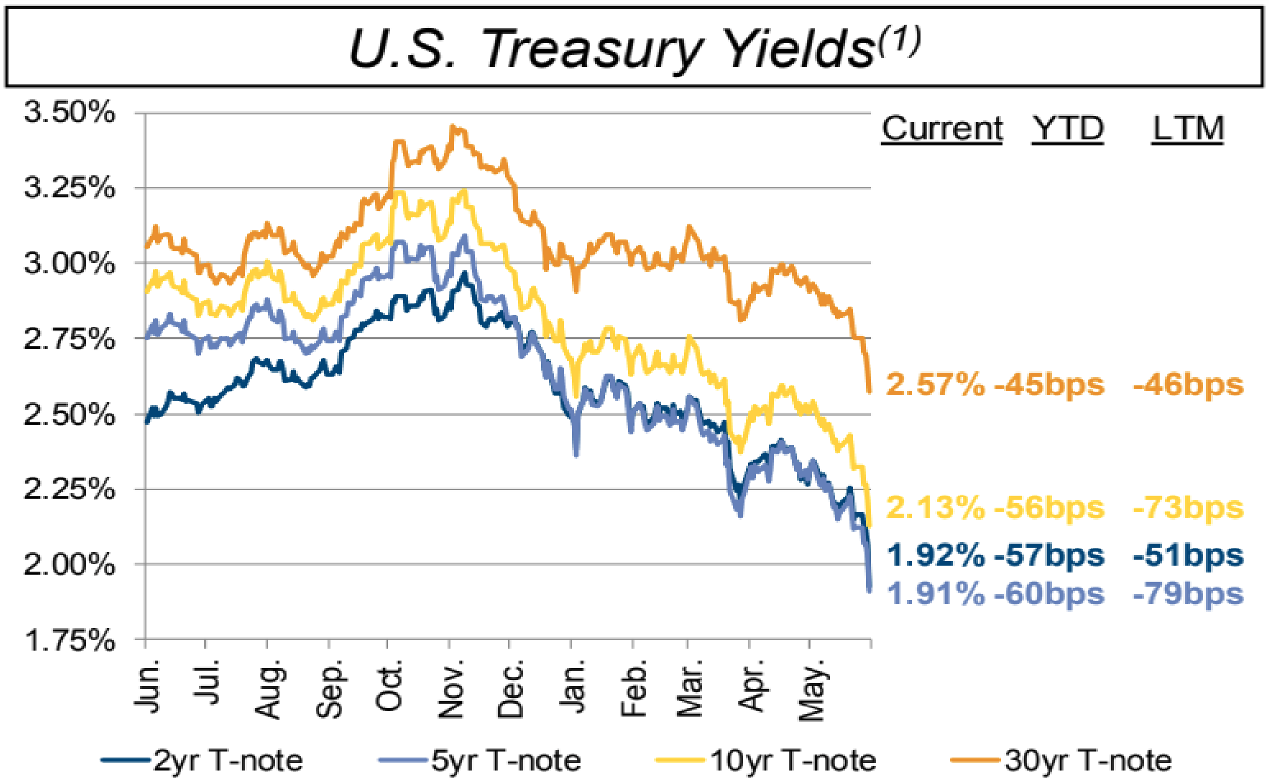
Is there reason to worry? Yes…

It was a struggle to title this week's missive with such a negative connotation, as no one ever wants to be the one to scream 'fire' in a crowded room to then not have the fire manifest itself. Well, this isn't me screaming 'fire', but rather me attempting to point out the growing cloud of smoke in a room filled with flammable material, and all it takes is a nonthreatening spark to ignite a violent combustible reaction. Before I continue, know that my crystal ball is no clearer than the next capital markets prognosticator's, however I am unable to allow career risk or embarrassment for being wrong to impede my objectivity in cataloging the big picture as I see it. You see, one of the biggest shortfalls of our profession is that too much judgement is placed in favor of or against the individual making a right or wrong call, and not enough attention or credit is given to the research, analysis, and thought process that was undertaken to come to such a conclusion. In my opinion, it's the latter that is much more important and indicative of long-term investing success – nobody gets them all right, but insightful, timely, and fundamentally supported analysis is what investors who want to succeed over the duration of a business cycle should really be seeking out rather than superior returns on a weekly, monthly, or quarterly basis.

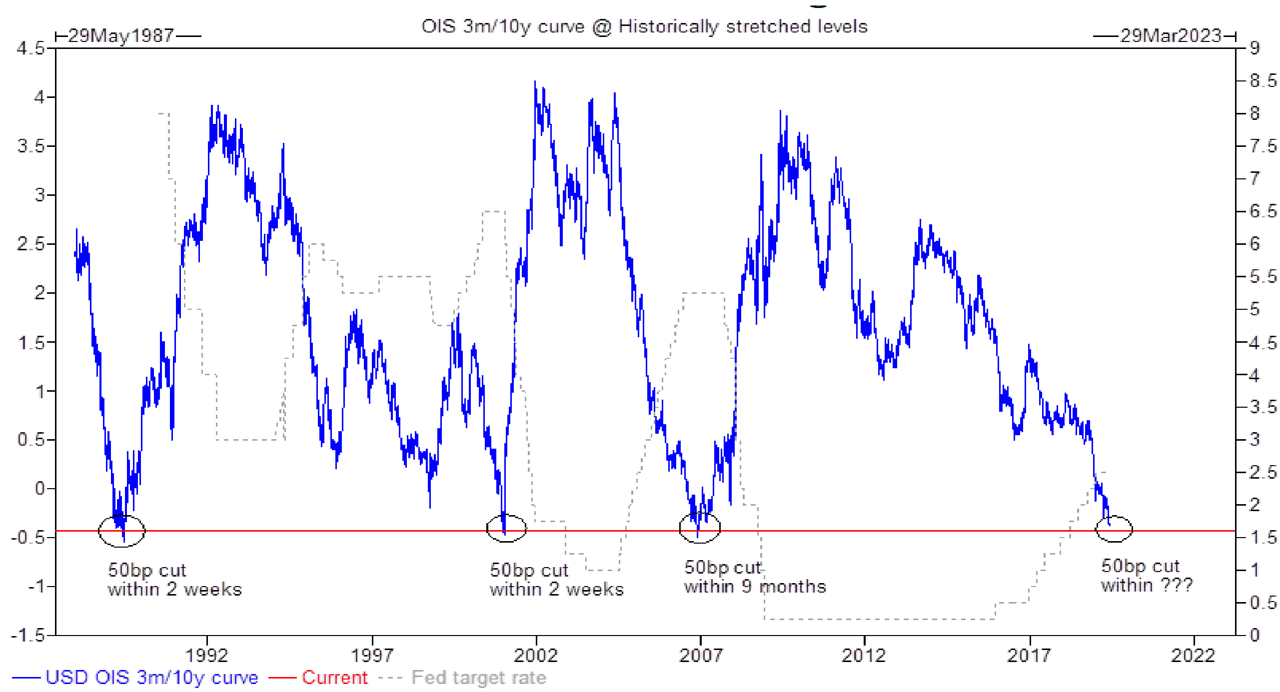
Consider the Global Financial Crisis back in 2008, for example. It was commonplace for investors to highlight and call out (after the fact) the obvious imbalances that existed prior to the crisis actually materializing. However, few were confident and vocal enough to make that call well in advance, and for those that did, in some cases they were a full year to two years early. And it's somewhat true that in being early by a year or two that your negative thesis comes under heightened scrutiny and then eventually people begin dismissing the view altogether as being wrong. But, was turning cautious in say '05 or '06 really wrong? Sure, between the summer of 2005 and the summer of 2006 (when the U.S. housing market was topping) the S&P 500 traded in a range between 1,200 to 1,300, and eventually rallied to a peak of 1,576 in October of 2007. After all, the recession didn't officially start until January 2008 – and there is no doubt that it was difficult from an investment standpoint to remain cautiously positioned over those two years while the imbalances continued to grow – but in the end, with the S&P 500 eventually going on to decline to below 700 by March 2009 – was being early wrong? This is why it's so easy to just go with the crowd and then at those pivotal turning points that happen at the end of every cycle (typically every 5 to 7 years), you can just fall back on the excuse that "no one could of seen have it coming" and all is forgiven because shared pain is much more comforting than individual failure.

So why am I rambling on in this verbose preamble in a C.Y.A. fashion? Well in simple terms, it's because with each passing day I'm seeing more and more data points that no longer just suggest caution is warranted, but rather that actually worry me that an actual recession is much closer than many are willing to acknowledge. Just so we're clear, calling the precise moment of when a recession will start or end isn't the point – the point (and what's important) is identifying and acknowledging the increasing probabilities of one occurring. Why? Because recessions are the biggest risk to economic growth, employment, corporate profits, and financial wealth. As a steward of other people's capital, I just don't find the "no one saw it coming" explanation plausible when sitting across the table from a client who put their trust and confidence in you in the interest of preventing such an outcome from occurring.

Okay, so what has me concerned? Well for starters, the four pillars of the National Bureau of Economic Research (NBER) recession call – real business sales, industrial production, employment, and personal income net of government transfers – have all peaked at some point over the last six months. The Treasury market began to sniff out such an occurrence back in November when interest rates were topping out, and as you can see from the chart below, the pace at which interest rates are falling is quite distressing.

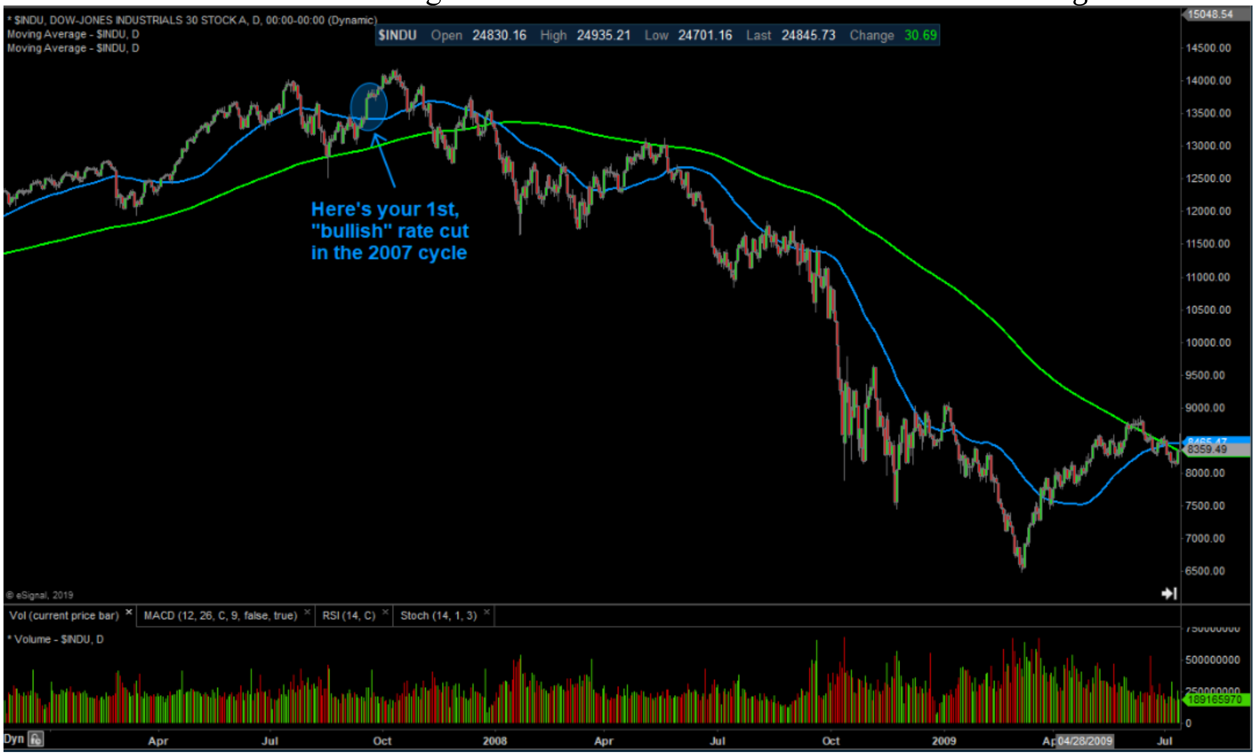


With all deference to the yield curve apologists out there, and their claims that you still have plenty of time given the historical analog before stock market investors need to fear an inverted yield curve – give me a break with trying to squeeze the last tick of profit out of what has been one of the best bull markets in history. Rather than proclaiming to 'stay in, you still have time…', how about reconfiguring that advice to actually call it as it is, and that is when the yield curve inverts to the extent that it did last week, it's nearly an 80% probability that the U.S. economy slips into a recession, so perhaps investors should look to lock in some profits and reposition in a more defensive posture for the rough waters that history suggests are on their way. There is no better 'economist' than the yield curve, and parts of it are inverting to levels they last saw in the fall of 2007. As is visible in the chart below which Bianco Research put out on Twitter last week, the OIS 3m/10yr curve is trading near the all-time lows at -40bps. The $1^{st}/5^{th}$ Eurodollar curve is trading close to all-time inversion lows at -59 bps, and "such extreme curve inversion has been a historically reliable indicator for imminent Fed cuts".



I got news for you all the investors out there clamoring for a rate cut by the Fed to save the markets: rack a history book, because outside of three occasions ('98, '94-'95, and '87) in the last six decades where the fundamental backdrop was much different than it is today, interest rate cuts by the Fed were not the saving grace most are ascribing at the moment. Don't get me wrong, eventually (after enough cuts, perhaps another foray into QE, and the passage of time to allow this stimulus to work its way into the system…) it will be positive for economic growth and risk assets, but we're not there yet. Consider that the Fed – while they should be cutting and likely will be before long – they haven't cut yet and are still holding firm to their "patient" stance. This is what happened with the S&P 500 from 2000 to 2002 while the Fed was cutting interest rates:

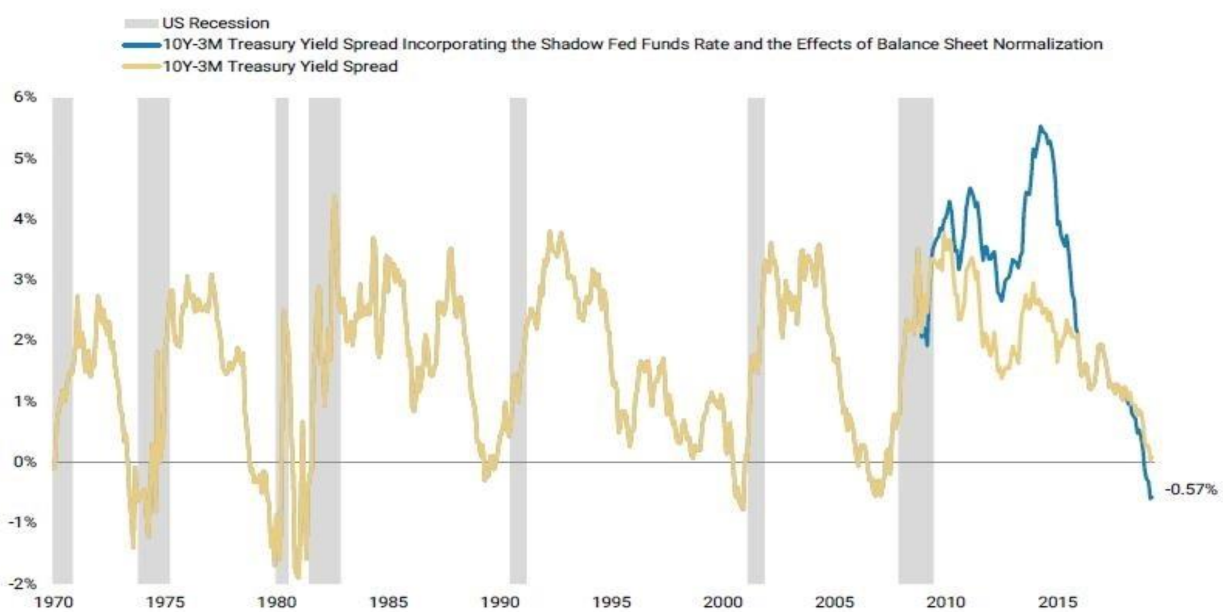
Here's the Dow Jones Industrial Average from 2007 into 2009 after the Fed started cutting rates:



It's not unusual to get a relief bounce (as was the case on these last two occasions) when the Fed starts to cut, but keep in mind it's the last interest rate cut where investors want to start the process of repositioning their portfolios in a bullish fashion, not the first.

Morgan Stanley's economics team put out an interesting piece of research last week where they adjusted the yield curve for both the nine interest rate hikes the Fed implemented since December 2015 and the balance sheet reduction, and found that the yield curve has actually been inverted for more than six months. The chart below and their comments speak for themselves:

Exhibit 3: Adjusted Yield Curve for QE and QT Suggests the Clock Is Ticking



Source: Morgan Stanley Research as of April 30, 2019. Note: Shadow Fed Funds rate from Atlanta Fed replaces 3M yield from 2009-2015. Starting October 2017, 3M yield is adjusted for effects of Fed balance sheet reduction– every $200B that rolls off balance sheet equates to roughly a 0.25% rate hike based on estimates from various Fed officials. Note that this is an approximation.

> While it's difficult to see on the chart, **the adjusted yield curve inverted last November and has remained in negative territory ever since, surpassing the minimum time required for a valid meaningful economic slowdown signal.** It also suggests the "shot clock" started 6 months ago, putting us "in the zone" for a recession watch. We think the bond market has it right to suggest the next move for the Fed will be a cut. We also think the equity market has it right given how defensively it has traded since last summer (Exhibit 4). Furthermore, the curve inverted about the same time the trade truce happened in late November and has stayed inverted despite all the positive rhetoric earlier this year around a trade deal. **We think this means the US economic slowdown and rising recession risk is happening regardless of the trade outcome.**

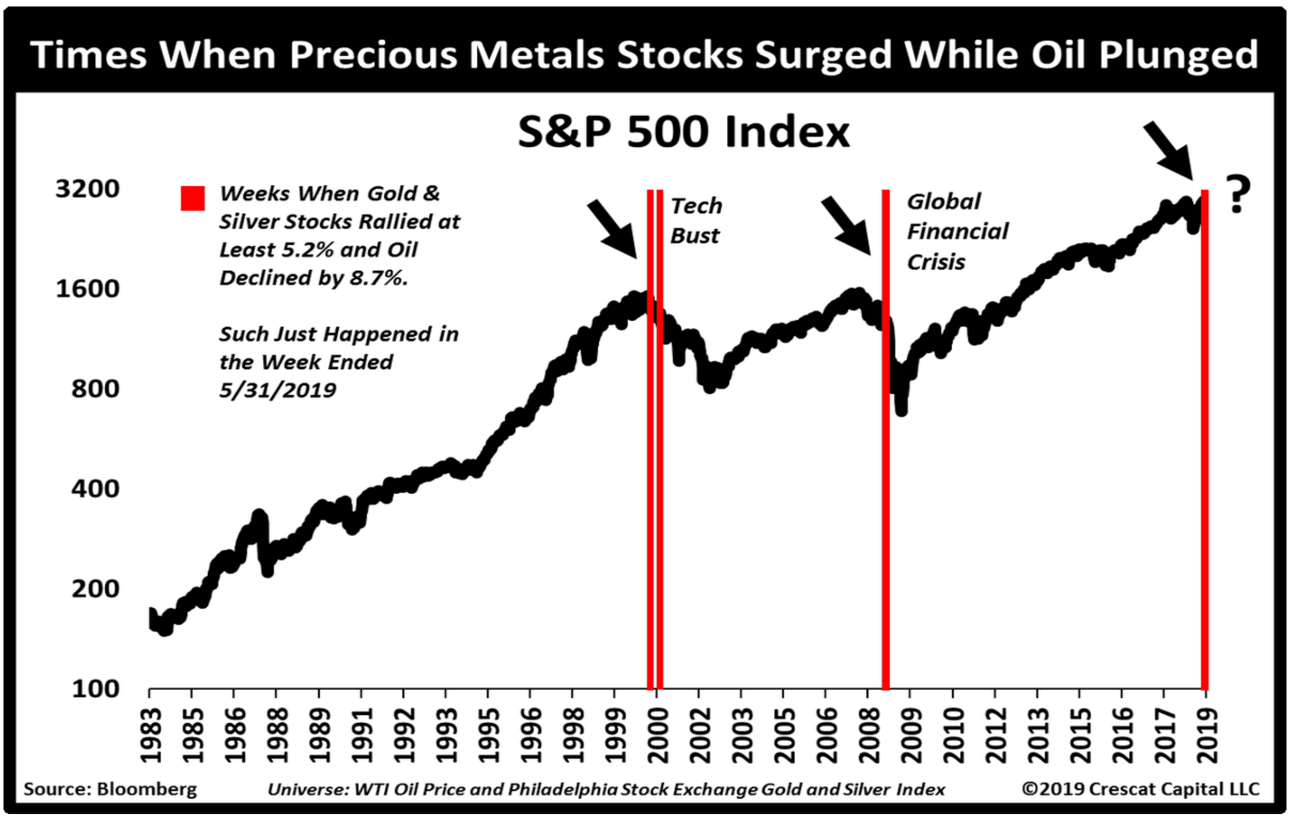
As for those looking at the S&P 500 still up 9% on the year as a vote of confidence that all is well and this isn't signaling anything concerning, I'd kindly encourage them to take a look at the complexion and market internals within the last month, where Utilities and Real Estate were the only two sectors to generate a positive return in May. Well Corey, that isn't saying much given the S&P 500 was down -6% on the month. But, since January 2018 when the S&P 500 first crossed the 2,800 milestone, it's the defensive sectors that have been the outperformers over this 18-month period. Sure, there have been pockets of outperformance by growth factors, but even the 10-year Treasury bond has managed to out-return the S&P 500 by 480 basis points since January 2018. We have regional banks, transports, retailers, and small cap stocks all down more than -10% from their highs, and yet another confirmation of risk-off sentiment on the rise is the sharp widening in high yield spreads to 443 basis points, now up 127 basis points from the low. Everyone loves to talk about the 'disruptors' – you know, those tech companies that money is hiding out in because they are perceived to be insulated from the business cycle. Well, have a look at where they stand relative to their highs:

- Baidu (BIDU) -62%
- Tesla (TSLA) -54%
- Twitter (TWTR) -54%
- Nvidia (NVDA) -54%
- Alibaba (BABA) -30%
- Apple (APPL) -27%
- Facebook (FB) -26%
- Google (GOOGL) -20%
- Netlix (NFLX) -20%
- Amazon (AMZN) -17%

Not that Warren Buffett cares much about what happens in the short-term, but the timing of his publicly applauded purchases in Apple and Amazon by Berkshire at the moment looks a little bit like a value investor turned momentum investor just about at the point where the momentum was turning.

If you ask me, it's the corporate debt market that is acting as the poster child for this cycle's excesses. Last cycle it was households gorging themselves at the borrowing buffet, but in this cycle it's corporations who have increased corporate debt levels from roughly $5 trillion in 2007 to over $9 trillion today, with nearly 50% of outstanding investment grade debt rated BBB (just one notch above junk status). The corporate credit gurus at PIMCO have taken notice, and just last week made the following comments: "we probably have the riskiest credit market that we have ever had" in terms of size, duration, quality and lack of liquidity. PIMCO's CIO Mather did provide some soothing remarks, suggesting "it's not at the point where it will fall of its own weight, but it certainly is a vulnerability today and all the ingredients are there for the vulnerability to grow". This is one of the biggest stresses I see on corporate profits and stock buybacks going forward, in that companies are going to be forced to shore up their balance sheets and pay down debt which will limit their ability to favor more short-term, shareholder-friendly endeavors.

So, you have flight to safety assets like sovereign bond yields in free fall, defensive areas of the stock market outperforming cyclicals, high yield spreads widening, and now we have gold ripping through the $1,300/oz level that has acted as a ceiling so far this year. The move in the precious metal space last week was really something, especially given that it occurred in tandem with a meaningful decline oil prices (as pointed out in the chart below). There have only been a handful of occasions in the last four decades where gold and silver have rallied more than +5% and oil sold off nearly -9% in the course of a week, and as you can see from the red bars on the chart below such occurrences haven't exactly marked the start of something good.



There is no doubt that the escalating trade frictions have heightened uncertainties even more and further eroded business and consumer confidence beyond the global slowdown in growth. But the reality is that the overall decay in economic activity would be occurring without this nagging constraint. Just reflect back on the last couple of years where the U.S. and global economy got some reprieve from what appeared to be an unraveling industrial recession when the Fed, the BOJ, and ECB stepped back on the monetary policy accelerator and China unleashed the largest fiscal stimulus in its history outside of 2008/2009. Then this momentum in the U.S. picked up some steam with the surprise GOP sweep and Trump victory later that year that unleashed some encumbered 'animal spirits'. Additional time was bought last year with the passage of the tax cut bill in December 2017, and a rather bloated fiscal spending package. But all this fiscal stimulus has now run its course, and now it's fiscal hangover time which is coinciding with the lagged impacts from prior Fed tightening that is kicking in. To start out this year, everyone thought that we dodged a bullet with the Fed pivot and that the growth scare in Q4 2018 was nothing but a false alarm with growth set to reaccelerate in the second half of 2019. Well, given what we are witnessing with the incoming economic data and price signals from the capital markets, it appears this line of thinking was supported by nothing more than hope and a false sense of optimism.

It should not be lost on anyone that the Fed pushed the envelope this cycle by tightening monetary policy by 350 basis points, and history shows that 'soft landings' occur just 15% of the time in the wake of Fed tightening cycles. Rare has been the occasion that such a degree of constraint didn't push the U.S. economy into recession, and the lags range from 6 to 18 months. The fact that Trump is elevating the trade war with China and using tariffs as a negotiating tool with other regions only adds downside pressure to what was a fundamental setup that was heading to an extremely fragile area.

So yes, there is plenty to worry about, and in my opinion investor complacency still remains abnormally high given all that has/is transpiring. The question is what is an investor to do? My advice is to continue to focus on the overall risk profile of your capital. Now more than anytime this cycle it is important to know what you own. One adjustment I've been making with portfolios is swapping out of individual equity holdings we hold for various reasons (investment thesis isn't as strong in this environment, fundamentals changed in a detrimental way, valuation isn't cheap in a rising volatility environment, or I just don't want the single security risk at the moment) into broad based equity indexes. The U.S. equity index I prefer to hold at this time is the equal weighted S&P 500 (EUSA or RSP) vs. the traditional market cap weighted S&P 500 (SPY). The main driver of this choice is the concentration into the Technology sector that is now represented in the market cap weighted S&P 500 (Tech is nearly 22% of the Index), where over 15% of the index is made up of just five companies (Microsoft, Apple, Amazon, Google, and Facebook). Ironically, today just so happens to represent a perfect example of why at this time I don't want to have over-exposure to this area, given the recent investigations by the DOJ into Google and by the FTC into Facebook – as a result, all of these companies traded down meaningfully today which saw the market cap weighted S&P 500 (SPY) to decline by -0.28% compared to the equal weighted S&P 500 index (EUSA) which increased by +0.34%. The same companies are owned in each, it's just the weighting to these constituents that differs.

Furthermore, given that the Russell 2000 small cap index is down nearly -15% from its peak last August, and given my long-term constructive view on the U.S. economy and U.S. stock market, this index will provide for the ability to own more of this segment of the market that has already experienced a material decline. Don't get me wrong, I am far from a present day raging bull, but positioning-wise our portfolios have been and continue to be defensively positioned, and given what I expect to materialize over the next 18 months – a U.S. / Global economic recession and bear equity bear market in both – I'm looking to take advantage of any price weakness in this time window to accumulate exposure. That's my best recommendation, and that is to continue to tilt portfolio exposure in a defensive / capital preservation orientation but be prepared and on the margin pick your spots to take advantage of opportunities that have started to and will continue to present themselves over the next year or two. I have no doubts that the Fed and political officials will step in at some point to either prevent things from getting ugly, rescue things from getting uglier, or bail things out after we cross the Rubicon.

If the last ten years haven't taught you this, then you haven't been paying attention. Whether it's zero interest rates, negative interest rates, a $2 trillion infrastructure bill, Universal Basic Income (UBI), Modern Monetary Theory (MMT), or something that hasn't been floated out there yet – the Fed and the power players in Washington D.C. want higher inflation, a growing economy, and higher asset prices. The question to me isn't whether they get it or not – I believe they will – the question is the what and how. That being said, I'm of the view that they can only bring the bazooka policy out (a la Hank Paulson negotiating the Emergency Economic Stabilization Act in 2008 to bail out the banks) when a crisis occurs. If (and it remains an 'if'), we experience a recession in the next 12 months, then I'm of the view that one or several bazooka policies will be implemented, and as ugly as it may be in the time leading up to and following that event is when you'll want to be plugging your nose and acting on taking advantage of opportunities.

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