Observations and Outlook

October 12, 2018

Selected Index Returns Year to Date/ 3rd Quarter Returns

Dow Jones Industrials 9.63%/8.83% S&P 500 7.71%/10.56% MSCI Europe .36%/.8%

Small Cap (Russell 2000) 3.58%/11.51% Emerging Mkts -.53%/-1.09% High Yld Bonds .57%/2.52%

US Aggregate Bond .02%/-1.6%% US Treasury 20+Yr -3.04%/-5.92% Commodity (S&P GSCI) 1.34%/11.8%

This past week, the Dow had two 800 point down days, pulling back 2100 points or 7.8% from its all-time highs, at its lowest levels. Large cap indexes like the Dow have pulled back while tech, small cap and mid-cap stocks, the outperformers year to date, fared worse. This divergence has been occurring since the end of August and the performance differential accelerated in the closing days of September. Equities have reversed back to levels from this Spring.

The difference in Relative Strength (between large and small cap stocks), has only been seen twice, December 1999 and 1965. Both marked the ending periods of long-term bull markets. I do expect a rally back up, but new highs are questionable. The nature and relative performance of any bounce or rally will be especially important. Given the mid-term election is a few weeks out, I would not be surprised to see a move up into that date.

Third Quarter Recap

Markets turned up early May exceeding the previous high and marking the end of the 3-month correction. Markets rose through mid-June and tailed off to end the quarter then July and August were strong, **but divergences amongst stocks** began and September rolled back with small cap, growth and mid cap pulling back more than 3% their highs into the end of September.

European and emerging market shares began to fall as the correction in the US ended and vacillated on a mild downward slope, remaining flat on the year. The story is similar with bonds. The Fed has raised and intends to keep raising its key overnight rate into 2019. Depending on whether stocks are up or down, market participants either claim that higher interest costs will be drag on the economy, OR they claim that higher rates are indicative of a “strong” or “robust” economy. One must remember though that the economy and stock prices are only related over long periods of time, not daily or even monthly time frames.

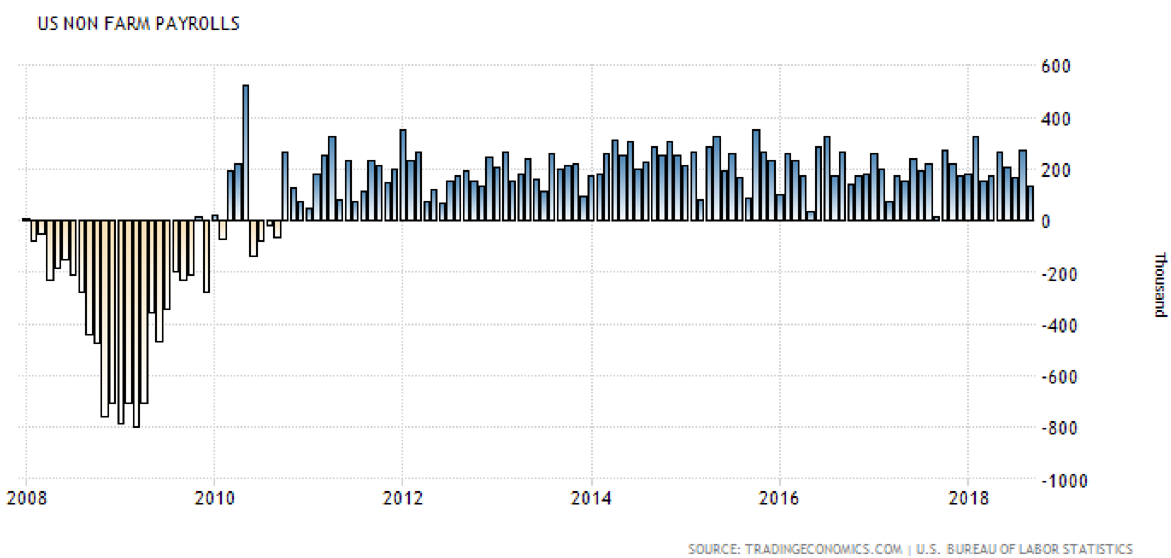
Commodities were generally down, except for oil. Oil, very oddly, has been going up alongside the US Dollar. Over longer time frames through history though, the relationship is negative. Agriculture is slightly positive year to date, all other commodities outside of oil, are negative. Some would interpret lower prices as a decrease in global demand**. China** is trying to slowly let the air out of its numerous bubbles via less and less intervention. China only seems to be intervening in its markets after modest declines. Felix Zulauf contends that the Chinese Communist Party wants a weak economy in 2019 so it can apply liberal stimulus and have a booming economy in 2020 during the 100th anniversary of the Party's existence.

Global liquidity, aka "QE", has peaked and will begin to recede. The Federal reserve has accelerated the decrease in bonds it holds on its balance sheet. The Europeans are still adding, but very slightly and Japans rate of purchases of securities has slowed dramatically. Once this turns negative, in the new year, there literally will be less money in the financial system to buy risk assets.

Drivers in Q3

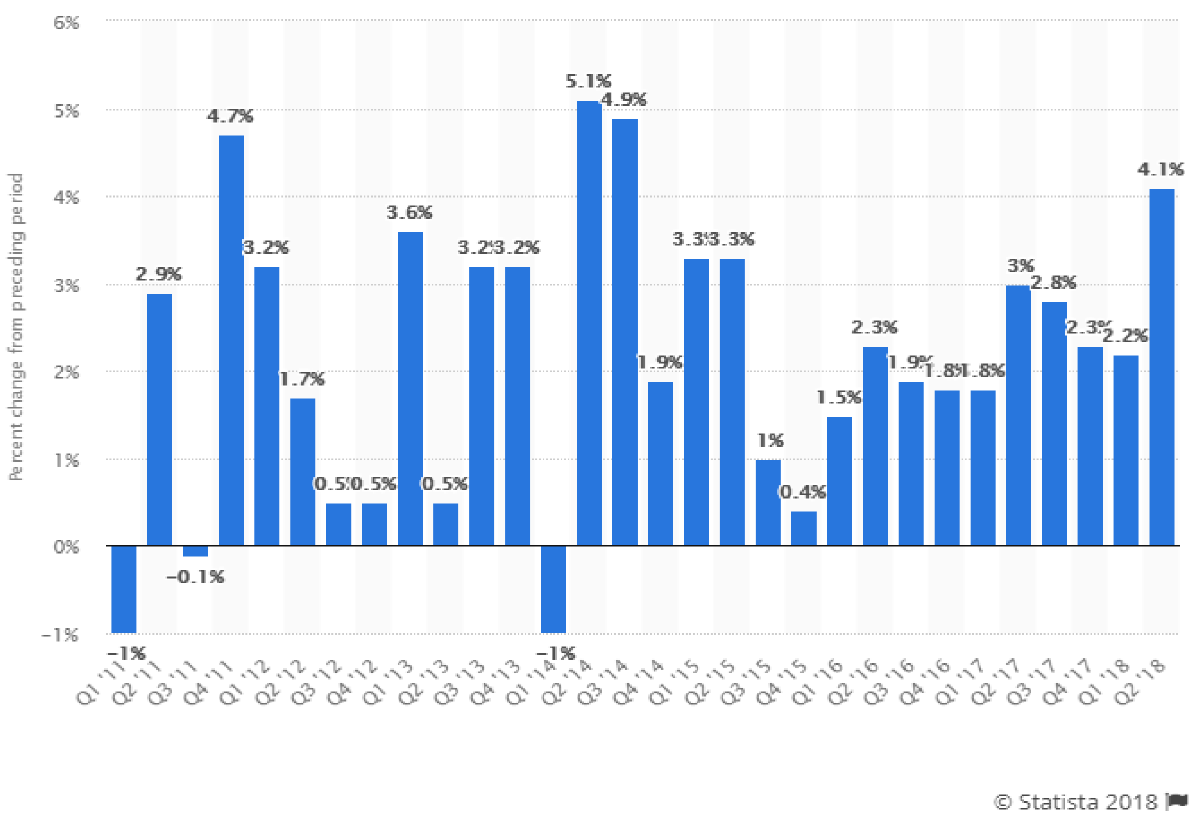
Recent earnings and employment data have kept market participants optimistic that the economy and earnings will continue to grow. Earnings are expected **to grow by 25%** in the 3rd quarter, keeping in line with the rest of 2019. This is a known quantity as it's the continuation of the one-year effect on the growth rate of earnings. Earnings growth will fall in 2019 compared to growth rates in 2018. Margins are at all-time highs of 11%. While historically high, have remained at high levels for the past 3 years. Buybacks, low interest expense and low employment costs have kept margins high, aiding earnings growth.

The employment rate continues to grind lower as more people become employed and more people leave the workforce, pushing the rate higher. We have yet to see the hoped-for employment gains from Tax Reform. The last 20-month average is very similar to the 20 months previously. There has been no acceleration in job gains and the September report was a massive miss to expectations.



Buybacks have been a source of demand for shares in 2018. The projection for full year 2018 is $1 trillion put towards buying back companies' own shares. This is **the highest ever** and a significant rise over 2017. However, companies have a poor history of buying shares at high prices. Additionally, some reports show that everyone (individuals and institutions) are net sellers while **corporations are the only net buyers** of shares in the first half of the year.

GDP for the 2nd quarter of 2019 came in at a robust 4.1%. This is the highest rate since the last two quarters of 2014, which registered 5.1% and 4.9%. The recent jump is due in large part to Tax Reform and the Tariff/Trade War. The change in depreciation rules, tax rates for businesses and individuals was reduced, incentivizing spending today. The fear of higher prices from higher tariffs caused demand to be ‘pulled-forward’. Orders that might have been placed later in the year were place earlier, pushing up GDP in the second quarter. While in the near term, economic data and market prices are only loosely correlated, **this high reading has bolstered sentiment for higher market prices**.



General optimism that stock market prices will continue higher increased as well. Over the past 6 weeks’ readings, **weekly AAII bullishness** has surpassed 40% in 3 of those readings. The last time we had three 40%+ readings was December of 2017. Subtle optimism is good for the market, euphoria and complacency are not. Too many readings at 40% and higher in too short a time would be a negative indicator for the markets.

Sentiment, GDP statistics, and employment statistics, all underpinnings of bulls’ optimistic outlook; are all lagging indicators. They all tell us where we have been, not where we are going.

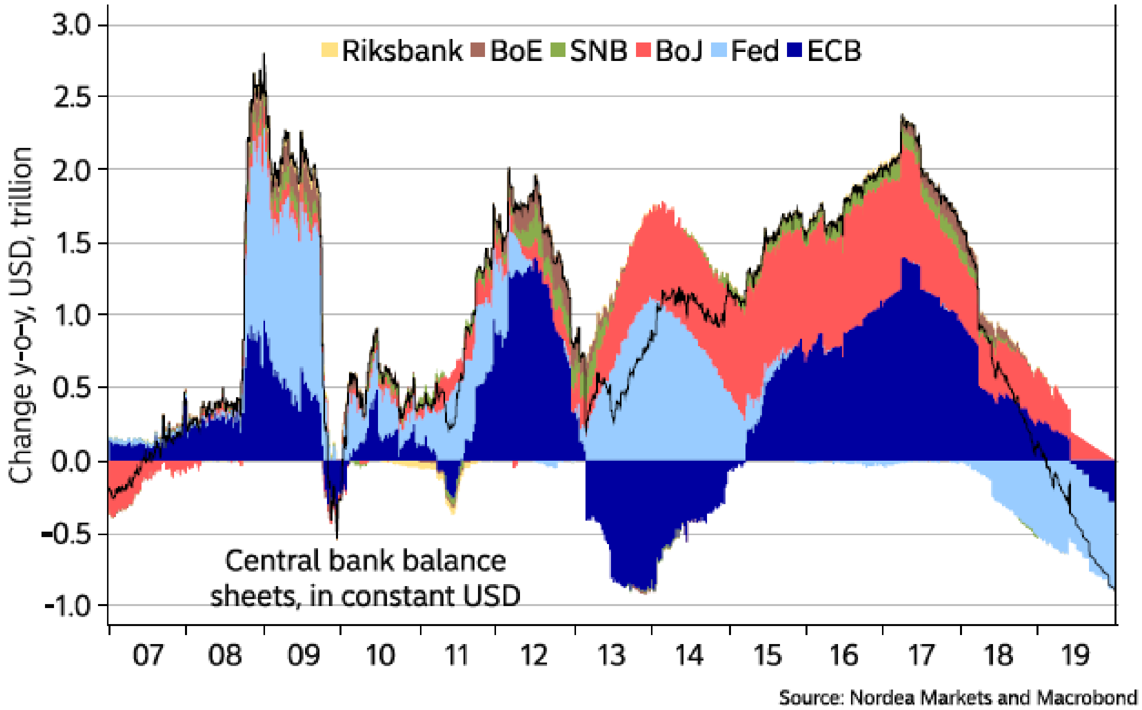
Going Forward

Looking ahead for the 4th quarter and into 2019, the primary concerns are US Dollar strength, Tariffs/Trade, QT, interest rates and Chinese credit expansion/contraction (aka ‘impulse’)

The **US Dollar**, after falling precipitously in 2017 has rallied strongly. Monetary policy divergence, where the US is tightening and raising interest rates vs the rest of the world that are just ending their QE practices. This is the most important topic going forward, as it impacts all other asset classes. The Fed has a long history of keeping rates too low (creating asset bubbles) and then raising them right into the start of recessions. I doubt this pattern will change this time. A strong Dollar causes earnings for US companies to decline due to weak exchange rate (from abroad into the US). A strong Dollar makes other countries' asset prices look worse in Dollar terms. A strong Dollar alongside higher rates causes developing countries to have more difficulty in paying its Dollar-denominated debt, increasing interest expense and slowing new investment. Globally speaking, a strong Dollar isn't good for anyone except US consumers who may see less inflationary pressures from cheaper goods abroad. A global US Dollar shortage is underway as the US repatriates profits at lower tax rates and the Fed raises rates along with letting its balance sheet decline (maturing Treasury and mortgage bonds)

There is a lag, but one can see how the US Dollar rise in 2014 and 2015 set the stage for poor results in earnings and ex-US stocks.

Tightening financial conditions, brought about by the shift from **QE to QT** (quantitative tightening/Fed balance sheet roll off). While this topic is rarely in the papers any more its effect on global capital markets will increase. Starting in October, the Fed is accelerating its roll off maturing securities, from $40 billion per month to $50 billion, and will remain at this pace until the Fed decides its time to stop. In euroland, the ECB is still adding liquidity, but at a much slower pace than in the past, at 15billion euro per month. Liquidity and credit growth are at the core of global financial systems and when the growth rate of these slows it can cause problems for the weaker countries, sectors and borrowers. We have already seen this in some emerging market economies. A rising US Dollar and higher credit rates are longer term negative for much of the globe. The ECB plans on ending its 15 billion euro per month program in December, and in 2019 we should begin to see the effects of an outright global liquidity drain.



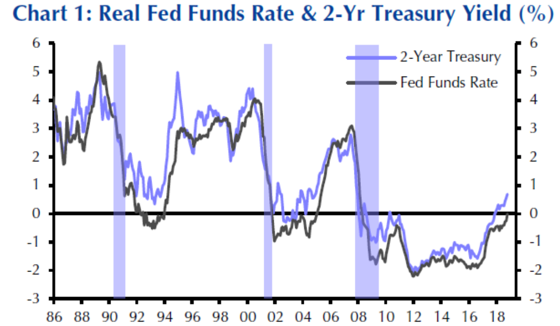
Recent **Tax Reform** in the US is leading to some unforeseen (or at least unacknowledged) impacts. The tax reduction in repatriated profits is **reducing US Dollar liquidity** in foreign markets. Certain depreciation guides have been accelerated and personal and corporate taxes were reduced. The personal tax savings aided spending growth in the first and second quarters, but the change in gas prices and higher rates on consumer credit costs have eaten up a large portion of personal tax reductions. Corporate tax savings have primarily gone to share buybacks (57%) and less than 10% has gone into wages and salaries. Corporate capital investment has ticked up but remains well below previous growth cycles. Tariffs, and the fear of further escalations has caused companies **to pull forward spending** (demand) that would have occurred later to avoid tariff costs. The factors that led to the 4.1% GDP print in Q2 are fading. The impact of lower taxes on earnings growth will end in 2018. There is slower growth in worker incomes, and if tariffs and taxes increase further earnings per share growth will slow dramatically in 2019. Goldman Sachs goes so far to say that if tariffs escalate further we could **see 0% earnings growth** in 2019. Going from 25% earnings growth in 2018 to 0% in 2019 would have a major impact on market sentiment.

As stated earlier **the US Dollar**, the reserve currency of the world, **is critically important to economic growth**. A stronger dollar can slow global growth and a weaker dollar aids in credit growth and the ability to pay on dollar denominated debt. The strengthening dollar has already impacted emerging markets. A stronger dollar can also impact US corporate earnings via exchange rates for foreign income earned. The recent past gives us an idea of what we might see as the dollar rises further.

Again, the idea that corporate earnings will be facing significant headwinds in 2019. While we can still grow in the mid-single digits, going from 25% growth to under 10% is going to affect the market psyche.

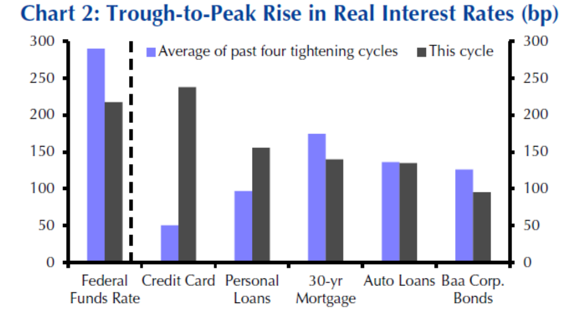
The Fed has already raised rates a similar amount as past cycles. Consumer credit costs have risen further. As the Fed indicates it wants to raise rates in 2019, pushing real yields further into positive territory (a negative for stocks) it also pushes up the value of the US Dollar. Additionally, one could argue that given the base effect, the economy is more sensitive to rate increases. Going from 4% to 5% is only a 25% climb; going from .5% to 2.5% is a five-fold increase. In that light, the Fed has already raised rates, tightening financial conditions more than in the 2003-2007 era.

Chart 1: Real Fed Funds Rate & 2-Yr Treasury Yield (%)



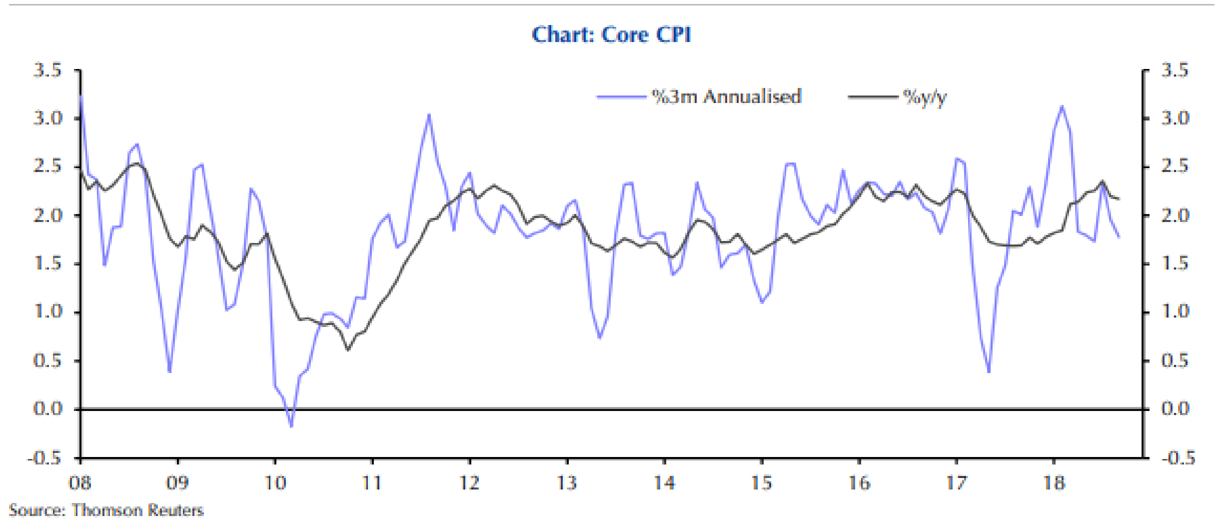
Shaded areas indicate recession

Chart 2: Trough-to-Peak Rise in Real Interest Rates (bp)

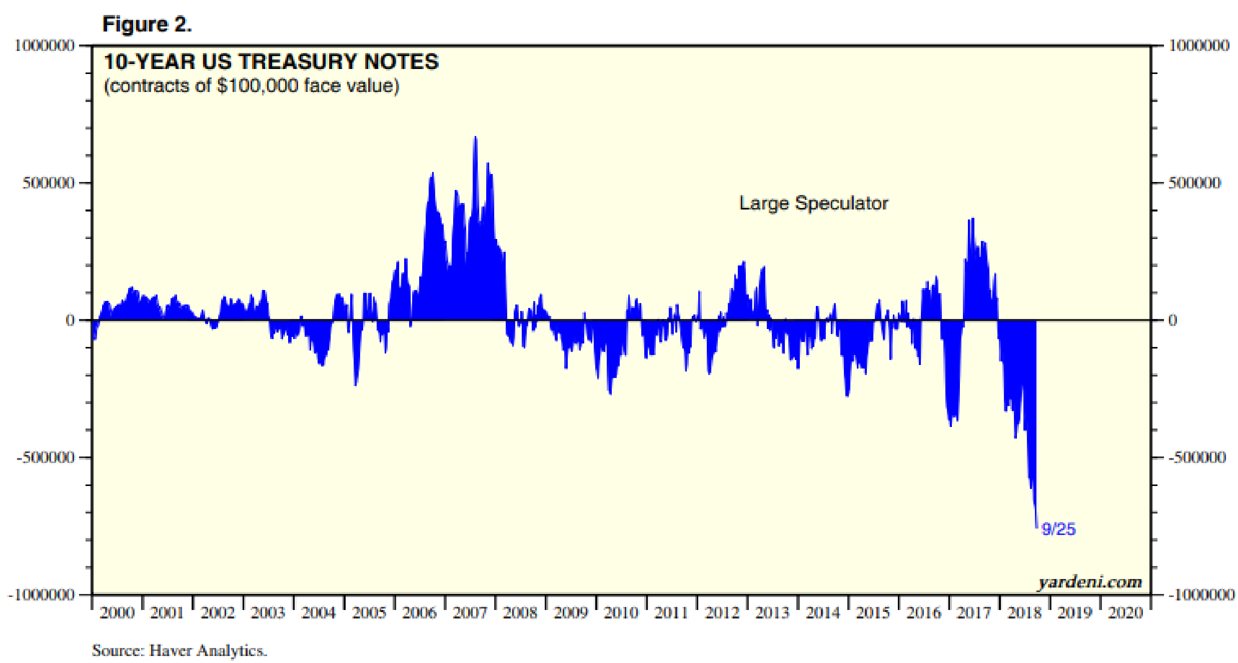


Sources: Thomson Reuters, Federal Reserve, Capital Economics

There is a theme in the media that the rise inflation is the cause of the Feds plans to continue to raise its overnight rate. The claim that at 2.1% CPI is a new 'accelerating' level and shows the strength of a growing economy doesn't square with recent past. In 2012 and 2015 we saw periods of inflation at a similar rate to today, but only fell back into disinflation in the coming quarters. The difference today is we have Tax Reform stimulus, but this is front-loaded (most benefits occur in the first 2 years then begin to rise again) and will fade in 2019.   Tariffs/taxes can cause prices to climb, but this is not 'good inflation'—higher costs for the same amount of goods will lead to demand destruction.

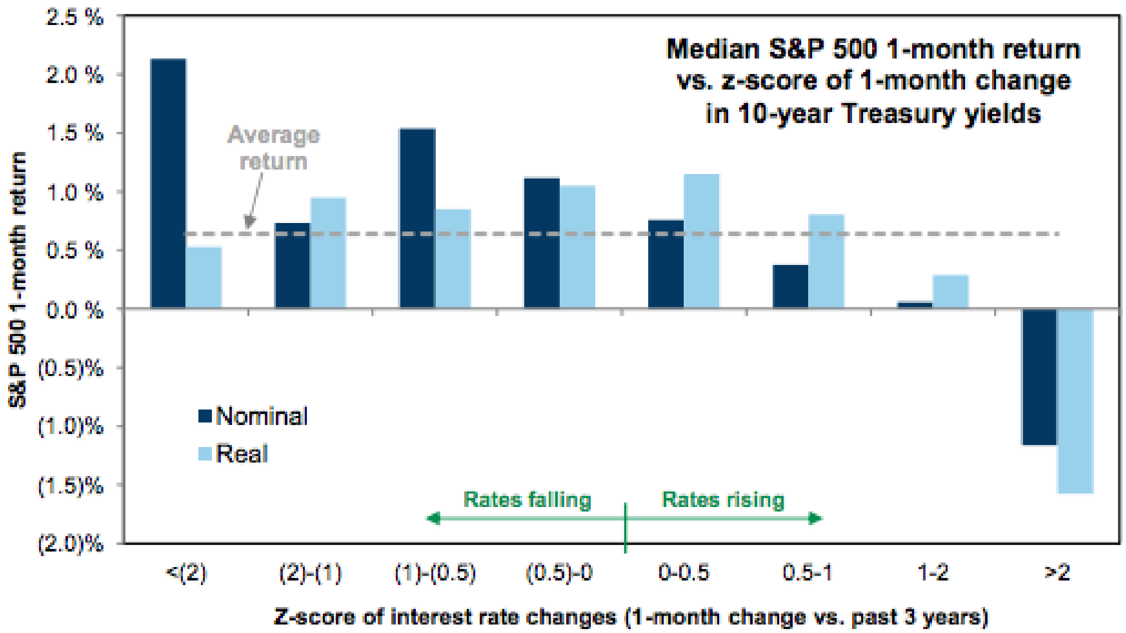


Higher yields cause bond prices to decline.   Many market participants have been sellers of US Treasury bonds, betting on a continued rise in yields. One can see below the size of the current short-Treasury position.



The previous two extremes, the late 2016 short positioning reversed to net longs from late 2016 to mid-2017, where the long Treasury bond increased in price by almost 11%. The net long positions from mid-2017 through todays extreme short, we saw the long bond fall by about 12% in price. The extremeness of the short position today could elicit a rapid rise in prices. However, at the same time, yields/rates would fall quickly. Finding a fundamental reason for rates to decline is difficult currently.

Exhibit 3: S&P 500 typically cannot digest rapid increases in bond yields
as of September 30, 2018; z-score versus trailing 3 years since 1965



Source: FRB, FactSet, Goldman Sachs Global Investment Research

The chart above shows us what the returns are for the S&P 500 when the rate on the 10-yr treasury rises quickly or slowly. It is plain to see that stocks perform worse as rates move up more quickly. That is the essence of the argument for folks who saying the Fed is making an error. I also think the Fed is making an error in judgement as to what the neutral rate should be. In an economy barely growing at 2.5% annually, raising interest rates by 1% in 12 months is going to have an impact.

At the end of the day prices are most strongly influenced by sentiment. We can have higher than average valuations and prices for a long time before prices come back down. And when they go back down they usually go to lower than average valuations. Sentiment and feelings about the potential future growth are the reasons why investors will pay 20 times earnings at certain times and only 10 times earnings at others. Long term bull markets begin with low price to earnings ratios and end when credit offered to buy stocks is reduced or becomes too expensive.

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