Observations and Outlook

January 4, 2019

- After the lowest volatility year in over 40 years, 2018 was very volatile. A top or topping process is likely under way.
- The key difference between 2017 and 2018 is about $1.2 trillion in global liquidity.
- The stock market is telling us of a high likelihood of recession in the coming quarters.
- The Fed has made a grievous error in discounting the scale of the impact from going from negative Fed Funds rate to current levels, focusing only on the nominal difference.
- A recession is often declared after it is over, and not a useful indicator for investing.

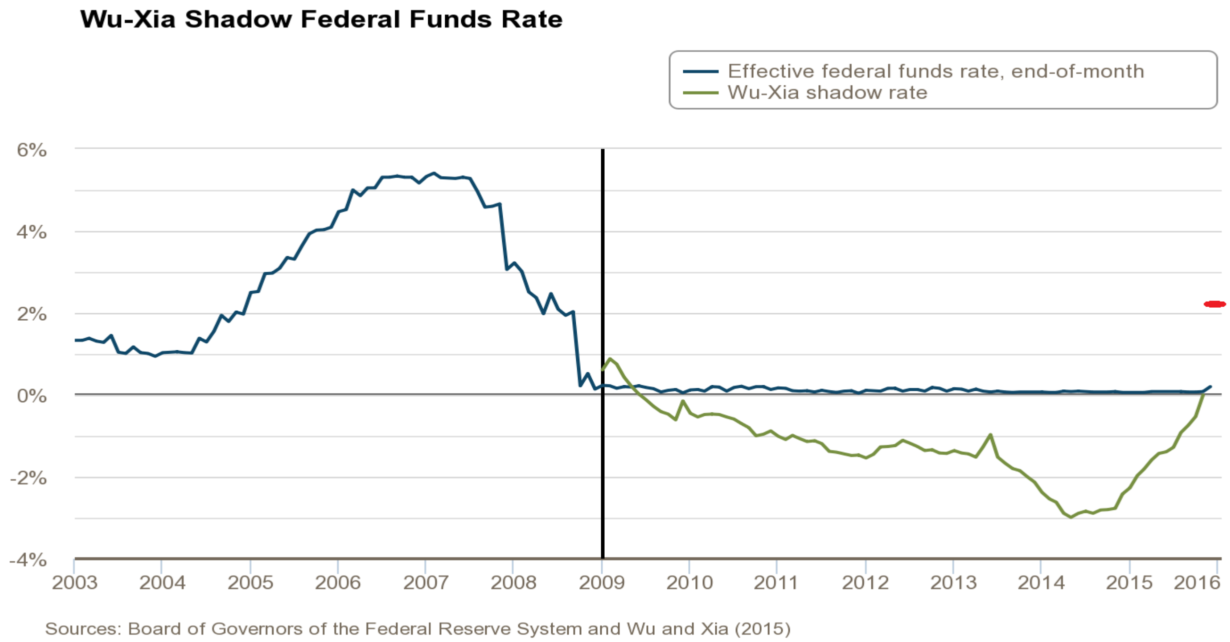
Interest Rates, Inflation, the Yield Curve and Recessions

These are the BIG topics currently. We should see resolution to the debate that exists on the topic of inflation and the yield curve in 2019.

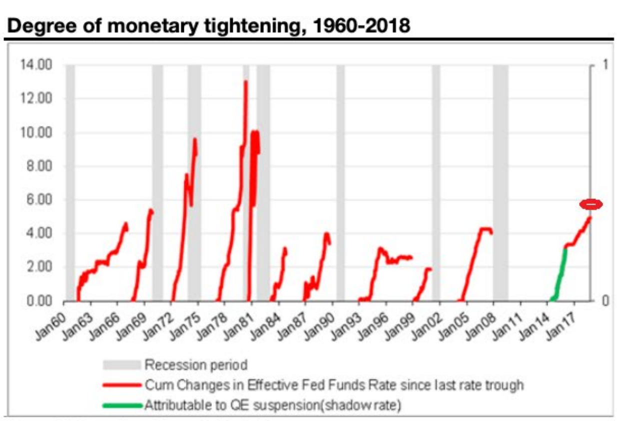
"Higher rates" has been the boogey-man going on 5 years now, ever since the Taper Tantrum market observers have debated over the impact of higher rates on the markets. Post Taper Tantrum most agreed that higher rates were coming, but surprisingly rates fell to historic lows in 2016. Since the low in July 2016 market rates have climbed, possibly spurred on by the promises of fiscal stimulus from the leading candidate for the Presidency of the United States, Donald Trump. Additionally, **the Fed stopped its QE program late 2014**, but gave no indication at the time when it might raise rates or begin to let maturing bonds it holds mature and 'roll-off', but instead the roll-off would begin after "normalization of the level of the federal funds rate is well under way." The first raise was December 2015, the next December 2016 and has continued since. The beginning of the roll off was late summer 2017 as the Fed Funds rate hit 1.25%. **However**, in 2017, the central banks of Europe, Japan and China***, added more global liquidity*** (QE) than any other year since the Financial Crisis, even without the U.S. participation. Only now, in 2018 have we had both Fed balance sheet roll-off and continued rate increases, while at the same time there has been far less QE from China and Europe ended its QE program in December. The ECB plans on reducing its balance sheet, aka quantitative tightening (QT) later in 2019.

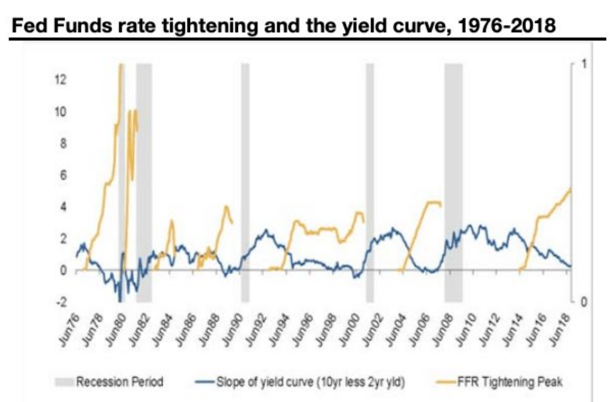
So now that we have seen a full year of tightening financial conditions in the US and then end of QE abroad, what did we get? For the first time in a very long time, 2018 saw across the board price declines in virtually all asset classes.

Low nominal interest rates hide the degree of tightening that has occurred so far. Pundits claim rates are low and the economy can handle more hikes. Most analysts are missing the forest for the trees, as **its not the level of rates, but the change in real rates** that impacts the markets and economy. Global banks holding rates at zero, or even charging negative rate to hold cash has made it difficult to see how much tightening has occurred.



The above chart shows the degree of tightening that has occurred since the end of the Fed's QE program. The coordination of QE bond buying, and zero Fed Funds Rate conspired to create a very negative Fed Funds rate. This chart only includes the first-rate hike in December 2015. The red dot is where we are today.



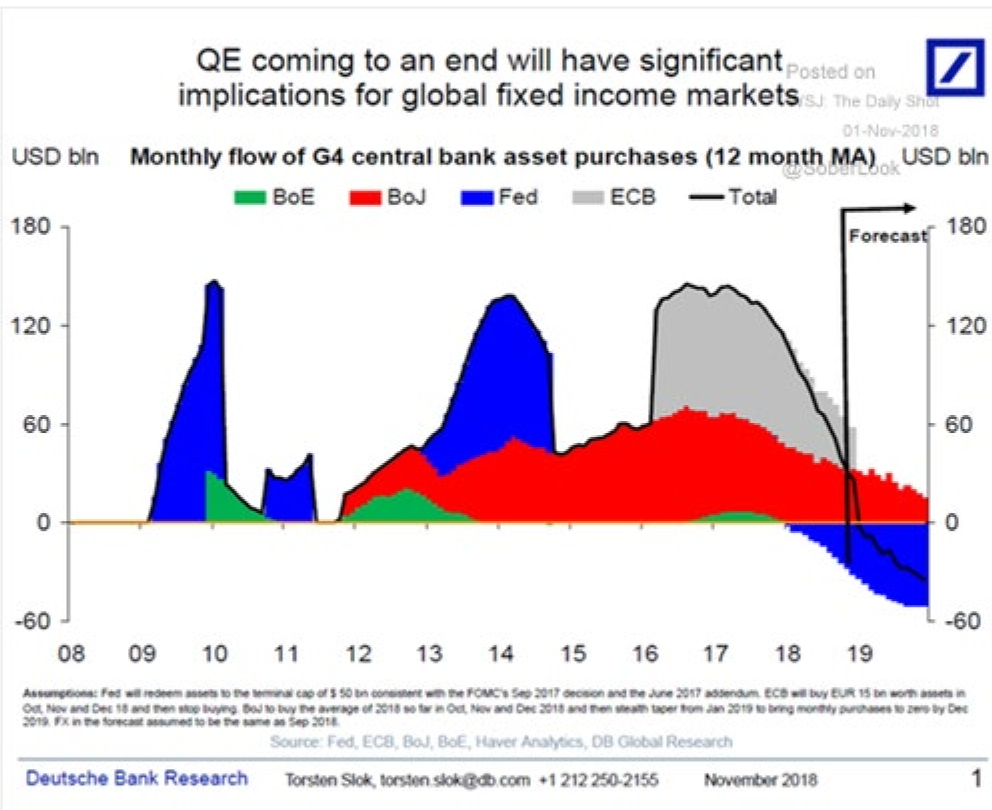


Source: SG Cross Asset Research/Equity Quant

The chart above left compares previous Fed hiking cycles to previous ones. This is as of January 2018, and the red line can be extended to the 6% level, making this the largest and most rapid tightening series since Volcker killed inflation in 1980, and before that, 1972 just after the US left the Bretton Woods monetary system (gold standard) and Nixon's wage and price controls sparked serious inflation. The Fed has made a grievous error in underestimating the impact of going from 0% to 2.5% while not appreciating QE's (and now QT's) effect on financial conditions. Everyday I am finding more parallels between Nixon's era and today.

Blame the Fed!

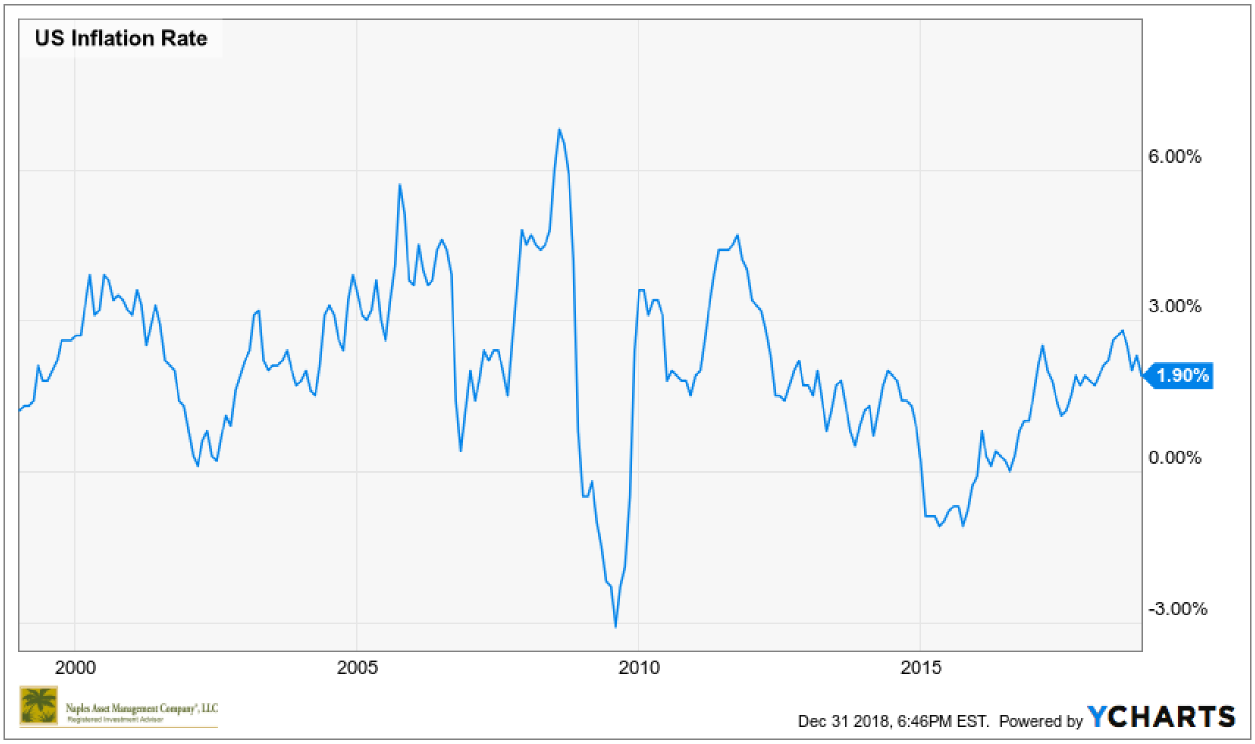
During the awful market rout of December 2018, there was a very unfounded rumor, or hope, that **the Fed would suddenly not raise** the Fed Funds rate AND announce no more hikes in 2019. This would be contrary to how the Fed has behaved for the past 20+ years, and shame on MSNBC for even giving the idea airtime. One can see from the evolution of QE, its end and now QT that the Fed broadcasts clearly and far in advance what it intends to do. Currently the Fed is figuring on 2 more rate hikes in 2019, while at the same time continuing its $50B/month bond roll-off, while also Europe plans on reducing liquidity in 2019.



Plan on the Fed raising rates at least once, **plan** on continued bond roll off and **do NOT plan** on the Fed reversing its path suddenly. A sudden change will only confirm the Fed has already overshot and is realizing its mistake, too late as usual.

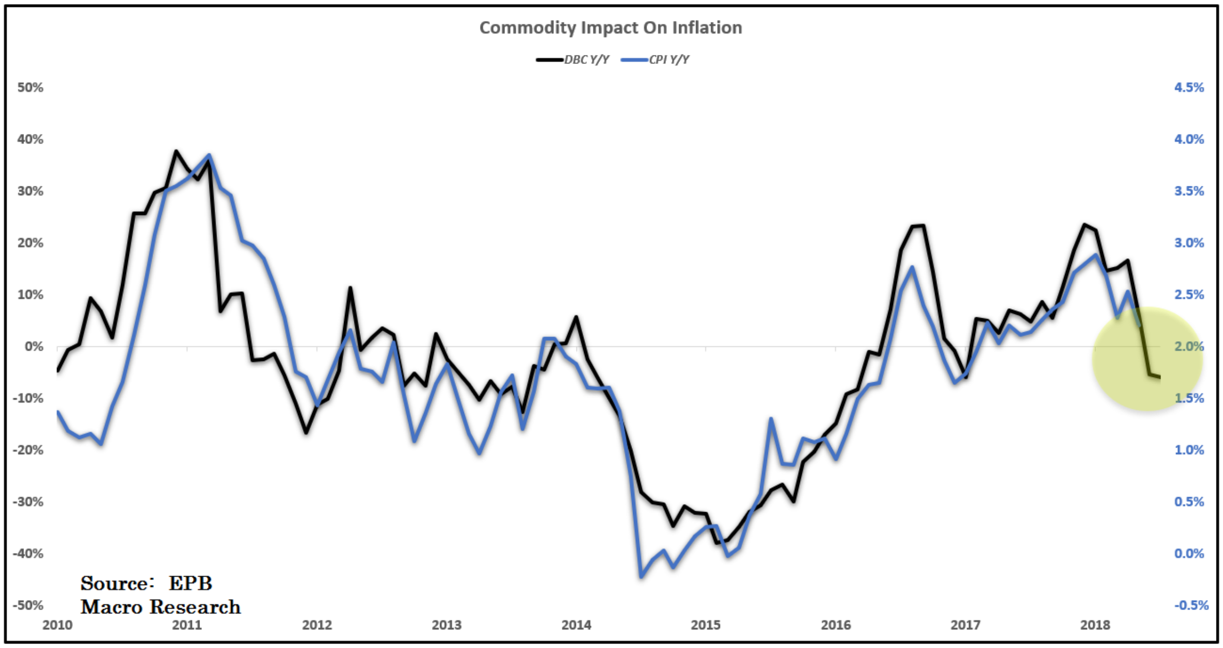
Inflation

Expectations for a rise in inflation have been around for about 10 years now, ever since the Fed started on its QE program.   Initially, it was simply QE that would do it, then it morphed into the idea that a tight labor market would spur inflation. Neither of these has occurred as we have 'normal' inflation over the past several years.



There was a brief period of deflation during the Earnings Recession in 2015, otherwise year over year inflation is quite tame.   So why does the Fed need to raise rates? The simple answer is that in its never-ending Quixotic endeavor to tame the business cycle, the Fed over-eases during down cycles and then re-tightens to be ready for the next down cycle. A more complex answer lies in the need for pensions and insurance interests to earn a rate of return that allows them to feign their ability to meet long term obligations.

Inflation will decline in 2019 and 2020 most likely, and the possibility of entering a deflationary period is real. Here is the evidence.

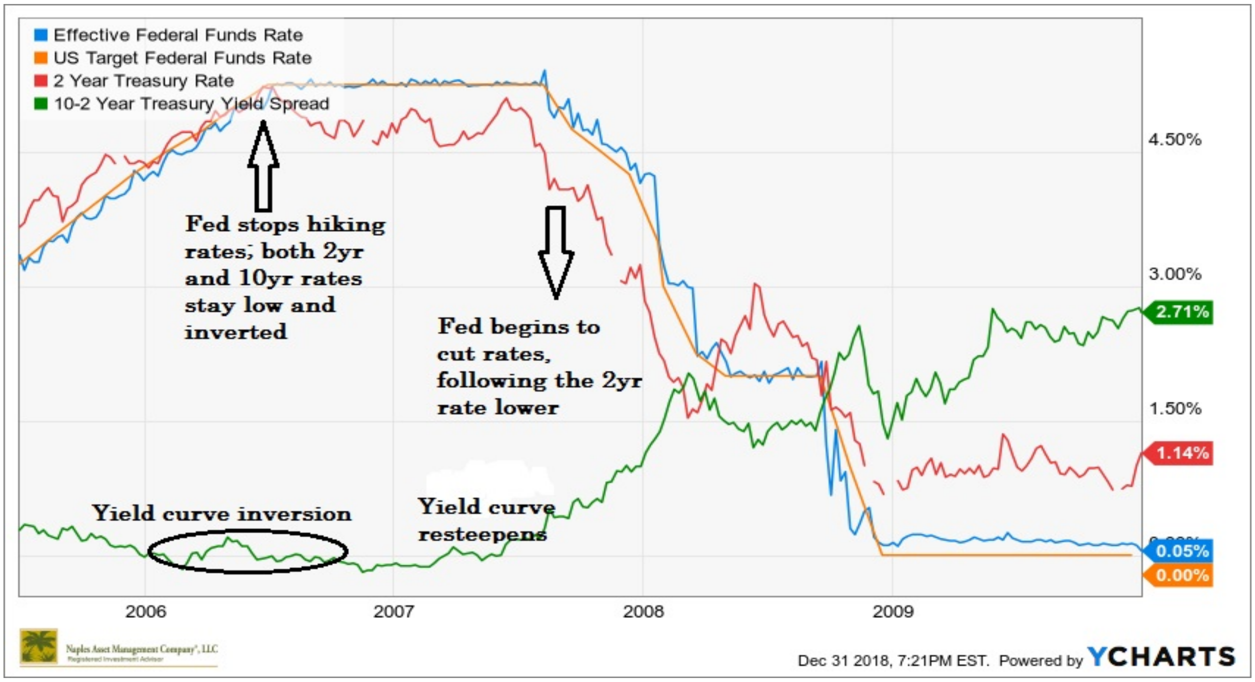


This is the change in inflation year over year compared to the change in DBC, the Invesco Commodity Index Tracking fund. It is 45% energy related, the remainder are precious metals, food commodities and a small amount of industrial metals. One can see the very strong correlation to inflation, it's the best indicator I have come across. As oil, its largest component continues to fall, one can expect the year over year rate of inflation to fall. There is little inflationary pressure currently and its likely to decrease.

Yield Curve and Recessions

The inversion of the yield curve, when longer term rates are lower than shorter term rates has signaled an oncoming recession 90% of the time. The debate is which rates need to invert. The 'no recession in sight' crowd thinks the 10-year treasury rate needs to get below the Fed Funds rate. Given the Fed Funds rate was pegged at zero for several years may make that group miss the bus. We have seen the 7-year rate go below the 2-year rate and very recently the 2-yr rate has declined below the 1-year rate, very odd! However, its not the inversion that matters, it's the re-steepening of the curve that matters. Re-steepening occurs when the shorter-term rates begin to ***decline*** while longer term rates either increase or remain steady.

This was the lead up in 2006 for the re-steepening that occurred when the Fed left rates too low for too long after the Dot-com bust. First the Fed stops raising rates, longer term rates also cease going up and decline leading to yield curve inversion. Then shorter-term **market rates** begin to decline due to economic slow down (the real estate bubble had already burst a year earlier by the time the Fed stopped). Short term market rates begin to decline anticipating (or leading the Fed) to lower Fed funds rate. Longer term rates stay low, while short term rates get lower, causing the curve to re-steepen. At first, some might say a steepening curve is a good thing, but NOT while short term rates are starting to decline. A steepening, or bullish yield curve is only a positive if both short and long-term rates are moving up.



Here is the same idea in today's market. But the Fed hasn't even stopped yet. This may set up a sudden Fed reversal, which would be a capitulation on the part of the Fed that the economy isn't as solid as they thought and would likely impact the market's psyche negatively.

If or when the re-steepening occurs, it should signal the onset of a recession soon. So, the question is, would that be the time to move out of the market, once the NBER (National Bureau of Economic Research) declares a recession is occurring.

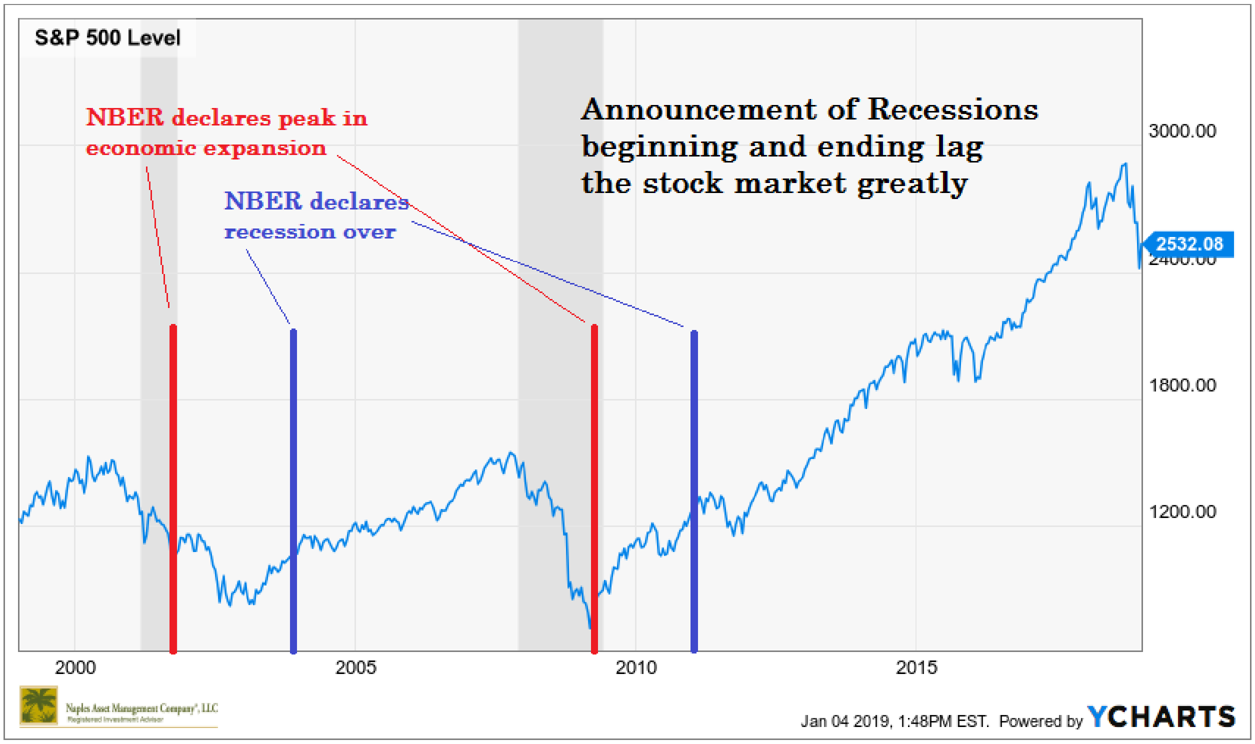
Source: NBER

The determination that the last expansion began in June 2009 is the most recent decision of the Business Cycle Dating Committee of the National Bureau of Economic Research.

Announcement Dates with Links to Announcement Memos

Turning Point Date	Peak or Trough	Announcement Date with Link
June 2009	Trough	September 20, 2010
December 2007	Peak	December 1, 2008
November 2001	Trough	July 17, 2003
March 2001	Peak	November 26, 2001
March 1991	Trough	December 22, 1992
July 1990	Peak	April 25, 1991
November 1982	Trough	July 8, 1983
July 1981	Peak	January 6, 1982
July 1980	Trough	July 8, 1981
January 1980	Peak	June 3, 1980

Above are the dates of NBER's announcements of either 'end of expansion' (aka 'beginning of recession') and 'end of recession'. Below is a chart with the recessions in grey and the announcement dates marked. The message is clear—do not spend much time waiting to be told whether a recession is occurring to adjust your portfolio.



As it appears, we are entering a bear market phase likely accompanied by a recession. The long-term strategy is to avoid as much of the bear market declines as possible so that once it is over an investor has as much dry powder as possible to take advantage of the next bull market. One can do this by decreasing exposure to stocks and/or increasing exposure to assets that move opposite or independently of stocks.

The average bear market is seeing a 33% decline, and on average lasts under 2 years. No strategy is perfect but if one sees -15% while the bear does -40%, that is success. It sets up an investor to buy low and compound the gains that the next bull market will offer.

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