3Q 2019 Market Insights
Markets at Odds, Bulls & Bears Battle
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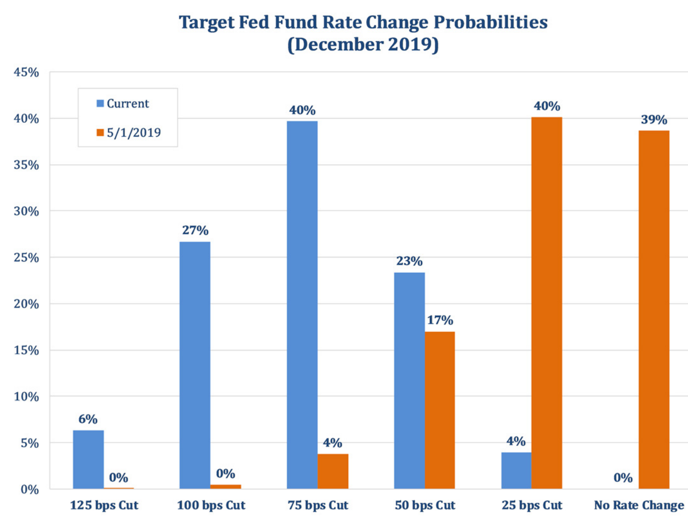
"Wrong does not cease to be wrong because the majority share in it." -Leo Tolstoy[1]

Whenever one attempts to predict or anticipate anything about a future event, there is always uncertainty. Whether we are talking about weather, financial markets, or sporting events, it doesn't matter. Anticipating future events comes with the unknown. Predict the daily weather one year from now, highly uncertain. Predict the weather tomorrow and the likelihood of a successful prediction increases, but it is still far from exact. The same can be said for sports. Have a five-run lead in the 9th inning? It's probably safe to say that your team will win, but it isn't certain. Financial markets are a bit of an odd duck. In the prior two examples, shortening the prediction interval, one year to one day for the weather, and one game to one inning for the baseball game increased our certainty. With financial markets, longer is generally easier because most things that matter to financial markets tend to trend around an average over long periods of time. When markets deviate, assuming they will return to trend over the long run is usually a safe bet. Nonetheless, whether we are predicting the short-term or the long-term for financial markets, like our examples in sports and weather, there is always some degree of uncertainty.

Probability of a Fed Rate Cut



Data Source: CME Group A/O 6.24.2019

In stark contrast to just one month ago, bond markets are now not only expecting an end to interest rate hikes, but that there is a 73% probability of three or more rate cuts by December of 2019. This would require significant economic weakness to rear its head, begging the question; why are stocks trading at or near record highs?

The other interesting dynamic about certainty is that it is expectations-based. Just because we expect something to happen with a great degree of confidence or a high degree of conviction, doesn't mean it happens. Is it likely for a team to overcome a five-run deficit in the 9th inning of a baseball game? No. In fact, the win percentage statistically for the team with the five-run lead is 99.71%. With financial markets, near certain events can also go awry leading to large short-term price movements and elevated volatility. The probability of Donald Trump defeating Hillary Clinton in the 2016 presidential election was forecast just days before the election to be as high

[1] Russian writer and author of War & Peace who is generally regarded to be one of the greatest writers of all time.

as a 30% probability, with some surveys projecting it at as low as a 1% probability. It happened. The U.K. voting to leave the European Union (aka Brexit) in 2016 was a 15% probability on the day voting took place. It happened. When everyone stands at one end of the boat, the boat is unbalanced. When all determine simultaneously that they are at the wrong end, the rush to the other end can cause the boat to capsize. Today, it seems, we have most investors standing at one end of the boat. Ultimately, this is very likely to result in a significant risk of disappointment for either stock or bond investors. Let me say this plainly. It is highly unlikely that we wake up at this time next year and have investors say that both the price of stocks and the price of bonds were correct at this juncture.

The Root of the Problem

As of the writing of this article on June 25, 2019, the bond market is pricing in a 100% probability of at least one cut this year. In fact, they are pricing in a 100% probability of a rate cut at the Fed's July meeting. Similarly, expectations for at least two cuts are priced into bond markets at a 96% probability, with a 73% probability of three or more cuts. While it is not unheard of for economic conditions to deteriorate to a level requiring one or more rate cuts, it would require significant recessionary weakness to get three rate cuts in the next 6 months. In the meantime, US stocks are trading within a stone's throw of all-time highs at roughly 2900 on the S&P 500 index vs the peak of 2954 reached June 20th. Here's the disconnect…if economic weakness is to materialize that is sufficient enough to prove the bond market and, correspondingly the level of interest rates correct, how reasonable is it that US stocks should be teasing their all-time highs? Said differently, how do you expect stocks would perform if the economy was weak enough to cut rates three times in six months?

By our count, there have been five unique cycles of lower interest rates since 1990. They are 1990, 1995, 1998, 2001, & 2007. One may be able to argue there are others depending on how you define a rate cut cycle. In that regard, we would be splitting hairs. We looked at macro trends. A pause followed by a resumption of lower rates to us is not the end of one cycle and the beginning of another. We considered it to be one rate cut campaign resulting in the five that we identified. The data surrounding rate cuts is limited and a bit of a mixed bag. Three of the five cycles resulted in stocks moving lower in the first three- and six-month periods, following the first cut. Ironically, the cycle that had the shallowest decline was 2007, with the S&P dropping by only 1.6% within that initial 3-month period. That, of course, ended up being only the tip of a very large iceberg that was to come in the financial crisis of 2008. The other two, 1990 and 2001, saw S&P declines of 17% and 10% respectively in the first 3 months. To be completely fair and balanced in our presentation of this data, 1995 and 1998 were the opposite, with gains of +7% and +17% within 3 months of the first cut. The difference between these environments is that 1990, 2001, and 2007 all coincided with economic recessions. The other two did not. So, the one-million-dollar question is; are we headed for a recession, which supports a drastic reduction in rates, and why should we expect stocks to do well in the face of this weakness?

Goldilocks Argument

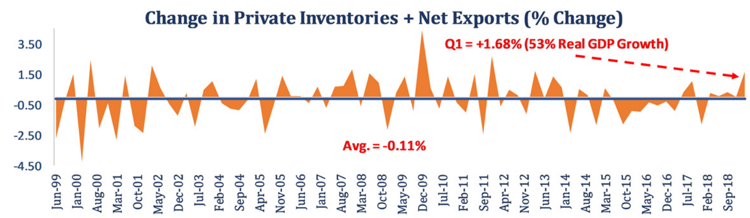
If stocks aren't buying the story being told by bonds, what is the basis for high prices and great expectations in the face of what is seemingly economic weakness? The answer, it seems, is one of a Goldilocks argument; the state of the US economy and business isn't too hot or too cold…it's just right. That argument goes something like…a combination of deregulation, tax cuts, and a president who is pro-American worker has supercharged our economy. Real GDP growth on a quarterly YOY basis for 2018 and thus far in 2019 has been 2.2%, 4.2%, 3.4%, 2.2%, and 3.1%...for an average of 3.02%. For a mature economy like ours, this is truly a remarkable period of economic growth. A driver of this growth is an unemployment rate of 3.6%, which has dropped to a level not seen since December of 1969. Inflation, a concern of a tight labor market, has averaged 2.2% for 2018 and thus far in 2019, despite a brief uptick last year. Likewise, corporate earnings growth has been strong, growing by nearly 18% per year since 2017 and 10% annualized since 2015. While tariffs are a headwind, those with a glass half full view believe that this situation will likely be resolved in short order, creating just enough economic weakness to curtail inflation and coerce the Fed into a few precautionary rate cuts that will add more fuel to an economy that is already burning hot.

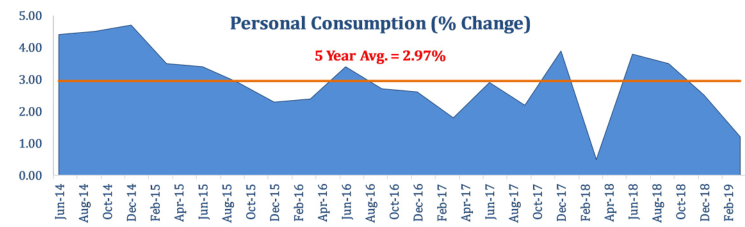
<u>Running on Empty Argument</u>

Despite strong Q1 GDP numbers, the devil is always in the details. Typically, the US consumer contributes roughly 2/3 of economic growth in total and has grown by approximately 3% per year on average over the last 5 years. In the first quarter, personal consumption grew at a rather meager 1.2% growth rate. Picking up the slack in Q1 was the combination of an inventory build up and net exports, which collectively contributed more than half of the first quarter's real GDP growth. How much do these two variables normally contribute? Essentially zero. The long-term average is -0.11%. In short, we were bailed out of a weak GDP number in the 1st quarter by something that doesn't normally happen.

One can interpret this in a few ways. Businesses build up inventories in anticipation of increased demand or perhaps to avoid an external price shock. I would offer two possible explanations of what happened in Q1, neither are sustainable. First, companies accumulated inventory because of unanticipated weak consumer demand. That is, they thought they would sell more than they did. When demand was weak, inventories accumulated. The second possibility, businesses built up inventories to protect themselves from the possibility of an escalation of the trade war. As a result, manufacturers bought any product that might flow through a Chinese supply chain in advance of the spring trade negotiations between the US and China. This frontloaded the supply chain to outmaneuver any potential tariffs that might occur and ultimately did materialize. Admittedly, point two may be a stretch given that all things pointed toward a trade deal until early May. Either way, the US is not known to benefit greatly from exports, nor can companies expand their inventories indefinitely.

Drivers of Sustainable Growth?





Data Source: Bloomberg

Typically, consumer activity is a major contributor to the US economy, accounting for nearly 2/3 of real GDP. In the first quarter of 2019, real GDP growth was just over 3%. Hidden in the details was a very weak contribution by the consumer of about +1.2% vs a 5-year average of nearly +3%. Making up the slack were US companies stockpiling inventories and an increase in net exports, which contributed 53% of the first quarter's real GDP growth. Historically the contribution from these two sources has been essentially zero, bringing into question how strong and how sustainable was Q1's real GDP growth.

If weak consumer demand is the first headwind, the next headwind is the impact that increasing tariffs will actually have. This will certainly squeeze profits, hit consumer wallets as increased fees, and/or reduce demand for goods. If we couple all of this with a dollar (headwind #3) that is stronger than it was a year ago, which also acts as a de facto price increase on our exports, one can see some meaningful challenges pertaining to business results and consumer behavior.

A recession is typically thought of as two consecutive quarters of negative real GDP growth. If 2018 was a year where the US economy was on a sugar high from tax cuts, once that high wears off not only will the economy be lethargic, but it will also need to overcome a lofty 2018 base that was artificially enhanced (largely a one-year impact) by tax cuts.

Now, how about corporate earnings growth? While earnings per share increased by 18% per year since 2017 and 10% since 2015, top-line sales per share have grown at 7% per year since 2017 and 5% per year since 2015. An obvious conclusion to draw is that results were enhanced by some greater improvement in the bottom line, through cost cutting, increased efficiency, things of that nature. This is confirmed by an enormous 40% jump in operating profit margins over this period. How about share buy backs? Helpful certainly, but since a reduction in shares via a buyback impacts both earnings per share and sales per share equally, this isn't likely to explain any of the difference of why EPS growth has surpassed per share sales growth. Bottom line, financial engineering cannot indefinitely manufacture EPS growth greater than sales growth. At a certain point, the topline needs to grow at a faster clip, or earnings will be constrained by that number.

Which is Right, Stocks or Bonds?

Ironically, in the short-term I'm inclined to say stocks have the narrative about the economy more correct than bonds, which may come as a surprise to those who know us and have watched us warn of a growing bubble in US stocks. This is not to say that we view the valuation as correct. We don't. US markets are expensive any way you slice it. It's difficult to view, even from our admittedly pessimistic perch, a US economy that has deteriorated so rapidly that we will move from exceptional 3% growth to business conditions requiring three rate cuts by year end. Is it possible? Sure. As we saw in 2008, things can spiral quickly. Regardless, if the Goldilocks argument is true, I don't know if it really solves anything, even as much as protecting US stocks from short-term disappointment.

At current valuation levels, US stocks are priced to provide returns for the next decade of between 0 to 5% per year, with a single point average of 2.66%. That doesn't change even if a near term correction is avoided. As discussed on many prior occasions, as valuations decline long-term future returns tend to increase and vice versa. Avoiding the correction doesn't improve the outlook for US stocks in the long run. Correspondingly, this means rates should probably be higher, maybe by 75 bps at the intermediate portion of the curve. Bad news for bonds by probably 5 to 7% for Intermediate Treasuries. Good news for stocks? Maybe not. Unless business conditions deteriorate, I doubt the Fed will accommodate stocks with a sought-after rate cut. US markets will likely stomp like a petulant child reminiscent of late 2018, when stocks believed that the Fed was ignoring the signs to stop hiking rates. US stocks declined by nearly 20% peak to trough. Finally, I am also not suggesting that I think the US economy is bullet proof and will not end in recession. It always does. Business cycles exist. What I am saying is that I think it is unlikely things will deteriorate so rapidly that the Fed can justify three rate cuts by year end.

Over the last 9 months, the market pendulum has swung from fear to greed and back again. Bond markets, which 9 months ago were reflecting meaningfully higher rates in 2019 and 2020, are now reflecting significantly lower rates. To get this, in my opinion, the Fed will need to see drastic deterioration of business conditions from an economy that just produced a 3% growth rate at the most recent quarterly reading along with lower stock prices. If true, this could justify three rate cuts (or more) by December, which are now priced in as being pretty likely, at a 73% probability. At the same time, the US stock market has completely dismissed this weakness being priced as a certainty into bonds as nothing more than transitory. The disconnect between is meaningful and potentially disruptive to both markets, as market participants all rush from one end of the boat to the other simultaneously. As an investor, should this change what you do? Yes and no. I would advise that expectations should be tempered. I would not be shocked to see a barely positive, or even marginally negative return from bonds in the near-term. I would also not be surprised to see significant stock market turbulence that would, at best, keep gains on US equities in check and, at worst, provide a similarly disappointing result. Other than that, continue to be mindful of your goals, your time horizon, and stay the course. We are confident that our approach is sound and appropriate for what may prove to be challenging times. Thank you, as always, for your trust and confidence.

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