

PALOS

Palos Weekly Commentary

Issue No. 4 | JANUARY 24 2019

Macro View

By Hubert Marleau

CONTENTS

What Happened in the Last Four Months	1
New Technical Perspectives	3
The Recession Risk	4
The Outlook for U.S. Economic Growth	4
The Outlook for Inflation	5
Historical Market Facts that Matter	5
Disclaimer	6
Contacts	7

The Weekly Narrative of January 24, 2019

What Happened in the Last Four Months

On September 21, the S&P 500 peaked at 2925. Valuations were at maximum levels. The Equity Risk Premium stood at 2.43%, significant less than the level that is considered normal. In this current regime of historically low interest rates normal is 3.50%. At that time, the ERP-to-VIX ratio was very low at 2.0 times because investors were until then pretty sure that the economy was going to keep rolling on at a relatively high speed in an uninterrupted manner. Unfortunately, market sentiment abruptly turned negative because the flattening yield curve made investors nervous about the possibility of an impending recession that the Fed was about to make a major policy mistake. Investors did not like the notion of rising interest rates, as a slowdown in economic activity was becoming apparent. In the following three months, the S&P 500 fell almost 20% to a low of 2350 on December 24, 2018.

The revaluation was dramatic, turning many metrics to minimum levels. The Equity Risk Premium stood at 4.20%, 70 bps more than is considered the normal level. Additionally, the ERP-to-VIX ratio was now too low at 1.2 times giving assurance that the Fed was going to capitulate and ease up on its monetary stance even though big important economic data points were way too strong to suggest that a recession was imminent. Consequently, the S&P 500 recovered nicely increasing 13.7% in the following 30 days. Today, the stock prices are trading just below fair value. The ERP stands at 3.75% and the ERP-to-VIX ratio is 2.0 times. This ratio is great at judging if the market is pricing stocks appropriately. The higher the ratio, the greater the likelihood that the market is pricing stocks too low and vice-versa. It's a bit like the rule of 20 which is the addition of the P/E ratio to the rate of inflation. The more the addition is above 20, the more expensive is the market and vice-versa. Currently, the addition is below 20, indicating again that stock prices are a bit below fair value.

From this point on, the performance of the stock markets will be dependent on whether the economy remains locked in a "goldilocks" scenario - that is two percent for growth and two percent for inflation. In order to fulfil such a scenario, monetary policy will need to be on an even keel and productivity will have to replace employment as the engine of growth.

Macro View cont.

By Hubert Marleau

Inflation is nowhere in sight either in the U.S. or globally. Highly deflationary factors like the globalization of cheap goods from low cost countries, the spreading of an “on demand” economy, the increasing use of internet based global supply chain apps by numerous small businesses, and the popularity of online retailing are still going on, creating downward pressure on prices. Inflation rates in the U.S., the euro-zone, and Japan are dropping below central banks’ targets. For example, the E.U. consumer price inflation fell from 1.9% in November to 1.0% in December, the Bank of Japan has given up on hitting its 2.0% inflation target - currently 0.8% y/y - and the Fed’s preferred measure, the PCE deflator rose 1.8% in November matching the 1.7% bond-market expectations for the average inflation rate in the next decade. Unless President Trump builds a sky-high tariff wall all around America, the rate of inflation should prove to stick around 2.0%.

Economic growth is plainly a function of gains in the number of workers and their productivity. By those measures, the U.S. economy is not in a slog. The U.S. labour force should grow around 0.6% over the coming years now that full employment is here. It means that in order to achieve a “goldilocks” rate of growth of 2.0%, productivity will need to grow at a run-rate of 1.4% where it presently stands. In other words, expectations about future growth will be dominated by supply-side factors. In previous commentaries, I demonstrated that the economy has the capability of producing 1.5% productivity gains for as long as the cost of capital remains below the marginal return on capital. Currently, the average return on capital is about 8.00% while BAA bond yields are 5.15% - a spread that is good enough to sufficiently direct private savings and international capital into business capital formation. Another contributing productivity factor is the brand new \$2.0 trillion cumulative tax savings estimate of the Joint Committee on Taxation (JCT). In 2007, the JCT’s estimate was \$1.1 trillion. In my judgment, the Cleveland Fed’s prediction that the pace of economic growth is going to 2.0% in 2019 and 2020 is in the bag. If I were to factor in the potential cumulative effect of the Chinese proposed trillion-dollar commercial deal with the U.S. on the trade balance and the coming wave of G5-enabled automation on productivity, the R-GDP growth could easily exceed 2.0% without much negative impact on inflation. JPMorgan CEO, Jamie Dimon, said at Davos that U.S. growth could hit 3.0% if the country was able to resolve its internal issues rather than blaming external forces for its trouble. He added “a lot of America’s problems are our own doing”, citing education, health care and infrastructure as areas in need of reform. The bottom line is that lawmakers need to focus on constructive and analytical policies rather than employ slogans.

If the next six months prove that the above thesis (two-plus-two economy) is correct, there will be no need for the Fed to tighten-up its monetary stance because the economy will prove that it can hold on - on both the inflation and growth fronts - by itself. The outlook should be conducive to a moderate but positive 4.0% to 6.0% rise in corporate profits. It’s becoming clear that while broad obstacles remain, stock market expectations are not as bad as the bull-bear ratio implies. As a matter of fact, the bull-bear ratio is an excellent contrarian signal of future stock performance. Currently the ratio stands at 1.5 times compared to 5.0 times in the highly pessimistic period of last December. This gives rationality to Edward Yardeni’s prediction that the S&P 500 will reach 3100 by year end. I fully acknowledge that models that use only financial market variables like credit spreads and yield curves points to a 40% probability that a recession will occur in the next twelve months; but hard and soft data economic points put the odds of a downturn at only 25%. I prefer economic data over financial variables. Overall, a recession does not appear imminent.

Macro View cont.

By Hubert Marleau

Generally, recessions occur because imbalances develop in asset prices or the economy overheats with too much inflation. Neither appears to be overly threatening currently. The WSJ reported that new research from the Cleveland Fed says that longer expansions don't necessarily end up in deep recessions. Instead, it's the other way around, and it's quite possible the financial crisis and its brutal aftermath explain why the U.S. has done so well over recent years. The point is that deep recessions are often followed by strong recoveries, but long and mild expansions are usually not followed by deep recessions.

Interestingly, correlation across assets has risen over the past year, with the S&P 500, U.S. treasury yields, copper, and crude oil moving in tandem. Such scenarios unfolded in 2010, 2011, 2015, and 2016 when worries over an upcoming recession mounted. As traders realized that the U.S. economy was only going back to its usual low-growth equilibrium, investors that were wrongly positioned were whipsawed. Now, the economy is once again going back to what is commonly called "secular stagnation" as the factors of growth are switching from an above par increase in the labour force to normal productivity increases. The changing economic characteristics means that the natural rate of interest is high enough to contain inflation but low enough to avoid a recession.

New Technical Perspectives as of January 24, 2019

- 1) Based on the Dow Theory, the trend for the S&P 500 is bearish with key resistance at 2700 and key support at 2507 - on Thursday morning the S&P 500 was 2642.
- 2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at \$59.87 and key support at \$48.77 - on Thursday morning crude traded around \$52.29.
- 3) Based on a proprietary model, the trend for gold is recently with key resistance at \$1337 and key support at \$1223 - on Thursday morning gold was selling for \$1279.
- 4) Based on a proprietary model, the trend for ten-year treasury yield recently turned bearish with key resistance at 2.91% and key support at 2.60% - on Thursday morning the yield was 2.76%.
- 5) Based on a Palos Currency Model, the trend for the Canadian dollar recently turned neutral with resistance at 76.25 US cents and key support at 73.75 US cents - on Thursday morning the Loonie was trading for 74.94 US cents, 2.56 US cents below its Purchasing Power parity Rate.

Macro View cont.

By Hubert Marleau

The Recession Risk as of January 24, 2019:

- 1) Analysts surveyed by Bloomberg in January see a median 25% chance of a slump in the next 12 months.
- 2) Moody's Analytics is predicting that there is a 17% chance of a recession in the next six months.
- 3) The WSJ January survey predicts that there is a 38% chance of a recession in the next 12 months.
- 4) The message from the latest survey of fund managers from BAML is that we are back to secular stagnation as a net 60% of survey respondents expect global GDP will slow but only 14% foresee an economic recession in 2019.
- 5) A January poll conducted by Reuters, showed that the probability of a U.S. recession in the next twelve months held steady from last months at 20%.

The Outlook for U.S. Economic Growth in Q/1 as of January 24, 2019:

- 1) Oxford Economics predicts real growth of 2.0% in Q/1.
- 2) The Bloomberg median projection for 2019 economic growth edged down to 2.5% following a 2.9% estimate in 2018, buoyed by a strong job market, rising wages and lingering effect of tax cuts.
- 3) The January WSJ survey predicts that growth will grow at the annual rate of 2.2% in Q/1, 2.2% in 2019 and 1.75 in 2020.
- 4) The IMF cut its global growth forecast last Tuesday from 3.7% to 3.5%, largely because of weaker than formerly expected economic performance.
- 5) The latest Reuters poll of over 100 economists taken January 16-23 showed that real growth in Q/1 should rise at the annual rate of 2.1%.

The Estimated Real GDP Growth in Q/4, 2018 as of January 24, 2019:

- 1) Moody's Analytics predicts that the U.S. economy grew at the annual rate of 2.5% in Q/4.
- 2) The Atlanta Fed predicts that the U.S. economy grew at the annual rate of 2.8% in Q/4.
- 3) The St-Louis Fed predicts that the economy grew at the annual rate 2.7% in Q/4.

Macro View cont.

By Hubert Marleau

The Outlook for Inflation as of January 24,2019:

The Cleveland Fed's Inflation NowCasting Model predicts that the PCE Deflator is expected to fall to an annual rate 1.4% in Q/1 of 2019 and the CPI to 1.2%.

Historical Market Facts that Matter:

The table below shows how the S&P 500 has performed following its worst quarters since 1940 - courtesy of Tridelta Financial and National Post.

Quarter Ending	Quarterly Performance	Forward Performance		
		1-year	3-year	5-year
Sep. 1974	-25.20%	38.13%	72.72%	117.46%
Dec. 1987	-22.60%	16.81%	48.82%	108.97%
Dec. 2008	-21.90%	26.46%	48.59%	128.19%
Jun. 1962	-20.60%	31.16%	69.20%	98.84%
Sep. 1946	-18.00%	6.45%	24.47%	115.41%
Jun. 1970	-18.00%	41.87%	57.39%	56.30%
Sep. 2002	-17.30%	0.26%	26.96%	66.20%
Average	-20.50%	23.00%	49.70%	98.20%

It shows that the timing to purchase stocks is good after major drawdowns. Analysts at UBS recently look at 26 cases since WWII of meaningful valuation drops for U.S. stocks found that median returns the following year were 16%. In this regard, fair value for the S&P 500 is 2750.

UBS has also found that while an inverted yield curve has happened before past recessions, the average lag time from inversion to recession has been longer than 18 months ranging from 10 to 32 months. Additionally, the average return for the S&P 500 from the date of inversion to the date of recession has been around 10.5%, ranging from 2.5% to 19.5%. It should be noted that yield has not yet inverted. The yield spread between ten- and two-year treasury is 17 bps.

Macro View cont.

By Hubert Marleau

Disclaimer:

This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., “Palos”). This publication may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means, but only as long as it is unaltered and attributed to Palos. This publication and its contents may not be sold or licensed without Palos’ written permission. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made or implied regarding accuracy or completeness. The information provided does not constitute investment advice and it should not be relied upon on as such. If you have received this communication in error, please notify us immediately by electronic mail or telephone. This document may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Past performance is not a guarantee of future performance. “S&P” is a registered trademark of Standard and Poor’s Financial Services LLC. “TSX” is a registered trademark of TSX Inc. The Bloomberg USD High Yield Corporate Bond Index is a rules-based, market value weighted index engineered to measure publicly issued noninvestment grade USD fixed rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.



Palos Weekly Commentary

Issue No. 4 | JANUARY 24 2019

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 276-0110

www.palos.ca