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Macro View

By Hubert Marleau

The Weekly Narrative of February 21, 2019

Calling the Market Right

As hard as stock prices plunged in the quarter ended December 2018, their recovery in the early months of 2019 has been as impressive. Understandably, it is reasonable to be skittish about the market's relentless upward trajectory. In the fullness of time, the projected path of interest rates and earnings are the fundamental factors that drive stock prices. At the time of this writing, the S&P 500 was 2780. Based on 2019 average per-share earnings estimates of $169.50, stocks are generally selling for 16.5 times forward earnings - that is the average reading over the past five years. It should be noted that the above earnings forecast considers a negative year-over-year growth in the first quarter of 2019 and minuscule profit increases in the following four quarters. Accordingly, the stock market will probably be stuck in the mud for a while until investors decide to pay above or below the average P/E. History shows that investors are inclined to stay put when the Equity Risk Premium is around 350 bps which is about where it is now. In my judgement the sentiment of investors is presently turning neutral and they are about to adopt a "wait and see" attitude. Which way the market will tilt will depend on what will be the Fed's monetary stance from hereon and whether a serious earnings recession will be avoided.

1) Given that the world is awash with debt with large amounts of long duration and illiquidity parked on balance sheets, a spike in the interest rate volatility is a non-starter for central banks. In this connection, the monetary authorities will go out of their way to ensure that monetary policy remains predictable with carefully craft forward guidance, especially if some unpredictable updrift in inflation pressures or some unforeseen dissipation of various headwinds that are currently buffeting the global economic outlook were to come about.

2) Finally, we are getting proof that the slowdown in revenue growth and the fading benefits of the corporate tax reform are shrinking earnings growth. In the fourth quarter of 2018, the S&P 500 EPS increased 15%, year over year, after three quarters of better-than 20% growth. Earnings growth expectations have been cut to zero in Q/1 and to 3.2% for the whole year from an original 7.1% at the beginning of 2019. Many investment strategists are warning that there will be an earnings recession in 2019, similar to what happen in 2015. One should bear in mind that the cut from the high to the low single digit percentages is because earnings were incredibly strong

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> due to tax reductions, better-than expected revenue and record share buy-backs. In this connection, many stock traders believe that they were robbed of a good year. Earnings rose 25% in 2018 and the S&P 500 fell 6.5% for a net difference of 31.5%. Now that fears of an economic recession have dissipated, the current plateau is justifiable because it represents fair and just value.

I'm fully aware of the futility of predicting the future path of the stock indices. Yet, my readers consistently ask me what my view on the matter is. My bottom line is that we will see 3100 on the S&P 500 before year end. My optimism is based on the belief that the predictable slowdown in economic growth will not bring about a recession. On this one, history is clearly on my side. According to the Federal Reserve and the National Bureau of Economic Research, there have been 34 business cycles since 1850. With the advent of neo-classical monetary policies, modern economic analysis and Keynesian fiscal policies, the frequency, depth and duration of recessions versus expansions have significantly changed since the end of World War II. Daniel Amerman showed with the visual use of some clever graphs that expansions are fatter and longer and recessions are thinner and less frequent since 1946 than they were from 1854 to 1946.

a) Since 1946, the average recession has been 12 months compared to 24 months for 1854-1946.
b) Since 1946, the average expansion has been 96 months compared to 40 months for 1854-1956.

Every time we hear the phrase earning recession, we crunch. But the fact of the matter is that earnings aren't the be-all and end-all when it comes to predicting what the stock market will do. Ben Carlson wrote an interesting article a few days ago on this very subject. The results are surprising.

a) From 1930 through 2018 earnings on the S&P 500 were negative 30 times; yet stocks were up 23 times or 77%.
b) From 1930 through 2018 earnings were up 58 times; yet stocks were down 14 times or 24%.

This may seem counterintuitive because the stock market is supposed to be forward-looking. The thing is that by the time earnings are released, the numbers are already old news--that is priced in. Talks of an upcoming earnings recession have been going on for months. The stock market is a curious animal and there is no single fundamental variable that can tell investors how healthy it is at any given moment. Too much depends on inflation, deflation, interest rates, and everything else. The point is that while earnings are important in the overall equation, it remains that the expectations of other fundamentals are also important. It's really about how investors react to the bigger story. In my judgement, there are better ways to play the game.

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The Robeco Study:

There is empirical evidence and theoretical validity found in academic literature that shows that there are other factors than interest rates and profits, which can bring consistent superior market returns. John Authers, a columnist at Bloomberg, wrote in a recent article that a group of quants at Robeco Group, a Dutch investment house, proved by going back to 1800 that there are six investment factors which can bring superior market returns that in my judgement require less guesswork. These are momentum (winning stocks tend to keep beating stocks that are losing), trend (securities that do well in absolute terms tend to keep doing well), value (stocks which are cheap compared to their fundamentals tend to well), carry (securities that pay out a high income do well), seasonality (buying at times of the year when stock performance tends to be good), and betting against beta (relatively low risk stocks tend to outperform in the long run).

Given the statistical robustness and the sheer durability of the correlations between these six factors and asset performances over a period of two centuries, John Authers concluded that there is something to be said about factor investing. What is fascinating is that with two hundred years' experience including many global disasters, numerous slumps, several depressions, 43 bear markets and more than 200 instances of markets trading downward by more than one standard deviation shows no discernible difference in how these factors performed over time. As I showed in last week's commentary---in the fullness of time the difference on how well savants and idiots perform in the market is negligible.

The point is that if one systematically pursues one of these six strategies, the chances are excellent that one would end up doing better than the market most of the time. John simply stated that there is " very limited evidence of a link between macroeconomic risk and global return factors". As van Vliet, the author of the Robeco study, puts it: "It's very difficult to find an explanation." Yet, the evidence points in the direction of behaviourism and, in turn away from rationality. Persistent market anomalies stem form anomalies in human nature and reasoning and not from rational and predictable responses to changes in risk. So how do these factors work ? Again, John gives us a good briefing.

The Trend Is Your Friend.

Over two centuries, trend-following strategies have worked better and more reliably than any other factor. Trend factor tends to subsume the "momentum" factor, which involves looking for stocks that perform well relative to others. It means that technical analysis - looking at charts and patterns - is important.

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The Carry Is positive.

Buying assets that produce yields that are higher than cost of financing them has work well for centuries. In other words, buying high yielding securities is a good way to make money.

Sell in May and Go Away.

History shows that even though stock market crashes have always occurred in October, the best time to buy is in September because one would get the fall upswing, the Santa rally and the January effect.

Betting Against Beta.

This is otherwise known as the low-risk anomaly. Theory states that returns come as a reward for taking higher risk. Strictly, it's not the case. According to van Vliet, the reason why the anomaly exists is because humans are constantly envious and tend to follow the herb. He goes on to say that benchmarks have institutionalize these two forces and therefore exacerbated or speed up the anomaly.

Behavioural Economics Versus Market Efficiency.

While the performance of different factor changes under different risk environments, it appears that anomalies are real and that the markets are not as efficient as they are supposed to be. The theory of market efficiency holds that anomalies can be accounted in terms of risk. John uses the following example. " Value stocks that have grown cheap tend to have something scarily wrong with them. Perceived risk is high, which is why they can be bought at a discount."

Daniel Kahneman, a psychologist turned Nobel prize economist, came up with a rival theory. He argues that anomalies can be explained in terms of predictable flaws in our perception and ways in which information is process. " For example, present an investment as a chance to avoid a loss and it will appear far more attractive to most investors than the exact same investment presented as a chance to make a gain." This debate is far from over and the last 20 years have rewarded growth over value.

Bottom Line: The long history of time is clear that low-beta strategies offer higher alpha. Yuval Taylor, the stock evaluator, concludes that one of the primary principles of investing is not to follow what everybody is doing. He mathematically proved that high alpha is correlated with low beta. If you want to beat the market, you have to take the road less travelled. In this connection, I suggest that a blend of investment factors combined with a policy of snapping up shares at depressed valuations will ultimately prove to be a winning practice. Even if it hurts for a while.

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The New Gold Story Is Bullish:

The price of gold has been stuck in a box since 2013, trading between $1125 and $1375. But something new is going on. Gold prices have risen in the past few months without help from the U.S. dollar. In other words, its price has increased in real terms. Why?

The short answer is that central banks have been buying bullion in large amounts. As a matter of fact, net purchases have risen every year since 2010 - the year that they got off two-decades of being net sellers. In 2018, approximately 3,300 tonnes of gold were mined - of that amount central banks bought 652 tonnes, 20% of what was produced and 75% more than in 2017. This was the highest annual net purchases since Nixon closed the gold window. I believe that this dramatic shift is related to countries who do not like Trump's foreign policies, to the increasing belief that the U.S. dollar's international dominance is waning and to the reckless ballooning budget deficit in the U.S.. Moreover, supposedly intelligent policy members of the extreme political left and right are increasingly adopting a Modern Monetary Theory that stipulates that government deficits resulting from unlimited spending should not be constrained or feared because the government can print its own money. This is asinine and insane. If I was to postulate that this new economic philosophy was to become viral, U.S. debt as a percentage of N-GDP could easily end up above 90% - a level that both Goldman Sachs and Kenneth Romoff and Carmen Reinhart of Harvard University believe detrimental to the international status of the dollar.

Gold may have been stuck in a compressing range for five years, but it seems to be getting out of that rut and therefore technically favouring my bullish thesis. So far, money managers remain only modestly allocated to the yellow metal and it looks as if the fast money has largely missed the current uptrend. There is a chance that gold could break free because there is growing concerns that the U.S. dollar is a crowded trade - meaning that gold could find itself as a good alternative as a safe haven if speculators start to believe that enough is enough for the greenback.

Economic, Financial and Market Statistics That Matter for the week ending February 21, 2019

The U.S. Empire Manufacturing Index showed some improvement in February rising to 8.8 from 5.0 In January. Recent reports show that mortgage delinquencies and foreclosures are at multi-year lows.

The Bloomberg Consumer Confidence Index is stabilizing while y je U of M consumer sentiment Index rose in February to 95.5 from 91.0 in January - it was driven by a bounce in expectations.

U.S. industrial production report was considerably below consensus forecast in January. But, it's still up 2.5% year-over-year.

It appears that the source of the December market disaster stems for the foreign selling of U.S. securities - $106 billion.

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The NAHB Housing Market Index increased 4 points to 62 in February. Builder confidence is rebounding partly thanks to lower rates and higher employment. The traffic of potential buyers was good.

The U of M one-year Inflation Expectations is down from 3.0% a few months ago to 2.4%.

The January U.S. import price index is 1.7% lower than it was one year ago.

The Scotiabank NowCasting model predicts that the Canadian economy increased at the annual rate of only 1.0% in Q/4 of 2018.

The Cass Corp Freight Index is showing that logistics bottlenecks are gone.

Goldman Sachs' Current Activity Index (CAI) is predicting that the U.S. economic expansion is slowing towards what we been accustomed to over the last decade - 2.0% growth and 2.0% inflation.

The Federal Reserve reported this week that U.S. households' balance sheets are healthy. Their liabilities as a % of net worth is currently 14%--down from 25% in 2007. In 1984 it was also 14% when the previous 1980-2001 expansion started.

Gavekal Research in a note to its clients reported that Beijing's effort to juice up Chinese credit growth in order to support economic activity are beginning to payoff. Credit growth surprised to the upside in January--rebounding to 10.6% year-over-year, after languishing for two months.

Initial jobless claims are back on track, declining to 216,000 this week from 236,000 last week - sign of enduring strength in the labour market.

New orders for durable goods manufactured goods increased 1.2% in December.

The Conference Board's Leading Indicators fell 0.1% in January, suggesting that economic growth is in a modest declining process.

The Philadelphia Fed Manufacturing Survey, a diffusion index, declines from 17.0 to -4.1 in February - far below consensus forecast of 14.0. The first negative report since 2016.

The housing market is not off to a start for 2019. Existing home sales decreased in January to 4.94 million for six months in a row. Last July they were 5.39 million.

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The Recession Risk as of February 21, 2019:

1) Moody's Analytics is predicting that there is a 17% chance of a recession in the next six months.rs
2) The Yield-Curve-Based N.Y. Fed model is currently calculating that there is a 23% chance of recession in the 12 months.
3) Longview Economics' U.S. Recession Indicator is signalling a 22% probability of a recession in the coming quarters. Based on 50 years of history, the Indicator needs to be above 60% to call a recession.

Estimates for Real GDP Growth in Q/4, 2018 as of February 21, 2019

1) The Atlanta Fed's R-GDP estimate is 1.5%
2) Moody's R-GDP estimate is 2.0%

The Outlook for U.S. Economic Growth in Q/1 as of February 21, 2019

The NY Fed's Nowcast model growth forecast for the first quarter GDP tumbled to 1.1% from 2.2%. The lower revision is blamed on the government shutdown and the market drawdown that occurred in December.

The Cleveland Fed predicts that the growth will be increased 2.2%.

The Outlook for Inflation in Q/1 of 2019 as of February 21, 2019:

The Cleveland Fed's Inflation NowCasting Model expects the PCE Deflator to increase at the annual rate 0.9% in Q/1 and the CPI at 0.7%.

The NY Fed UIG inflation index is rolling over.

Oxford Economics predicts that year over year increase in Consumer Price Index will remain below 2.0% in 2019.

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New Technical Perspectives as of February 21, 2019

1) Based on the Dow Theory, the trend for the S&P 500 is bearish with key resistance at 2790 and key support at 2665 - on Thursday morning the S&P 500 was 2789
2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $61.59 and key support at $52.45 - on Thursday morning crude traded around $57.39
3) Based on a proprietary model, the trend for gold recently turned bullish with key resistance at $1359 and key support at $1280 - on Thursday morning gold was selling for $1338
4) Based on a proprietary model, the trend for ten-year treasury yield recently turned neutral with key resistance at 2.74% and key support at 2.55% - on Thursday morning the yield was 2.65%
5) Based on a Palos Currency Model, the trend for the Canadian dollar recently has been bullish with resistance at 76.57 us cents and key support at 74.98 us cents - on Thursday morning the Loonie was trading for 75.98 us cents, The Purchasing Power Parity Rate is 77.35 us cents.
6) The Equity Risk Premium for the S&P 500 is 336 bps, the P/E multiple is 16.6x and the earning yield is 6.00% - 4.11% above inflation expectations and 1.05% above Baa bond yields (4.95%). The Rule of 20 is 18.24. Odds and Edges puts the Rule of 20 at 19.0. I used forward earnings and inflation expectations, Denis Ouellet, the writer of “Odds and Edges” uses trailing earnings and current inflation. Both good methods are good. Overall the above set of numbers indicates that valuations are fair and average.
7) The Equity Risk Premium for the TSX 300 is 476 bps, the P/E multiple is 15.0x and the earning yield is 6.65% - 5.45% above inflation expectations and 1.70% above Baa bond yields. The TSX, foreign exchange adjusted, trades at 4.35x the S&P compared to 4.32x one month ago and 4.23x three months ago. The long-term average is 5.75x.

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