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Palos Weekly Commentary

Issue No. 6 | FEBUARY 10, 2020

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Macro View

By Hubert Marleau

No Recession but the Ride Will Slower and Bumpier

Submitted February 9, 2020

The S&P 500 dropped 3% in the two weeks after January 17, when the coronavirus outbreak started to make headlines. However, the index bounced back on January 31st to reach an all-time high last Thursday. The market realized that the reaction from governments and businesses to contain the virus had a much greater impact on the economy than the disease itself. Moreover, the People's Bank of China injected 1.7 trillion yuan of liquidity into the market, lowered banks' reserve repo rates and instructed banks not to call in loans. Additionally, President Xi Jinping created some confidence when he said that Beijing would meet its obligations of the phase one trade deal. The market made the point that its performance is about the long-term growth outlook of the economy and whether the expansion will continue without a recessionary interruption. Let's talk about what is going on.

First, U.S. economic growth is expected to slow down from the unsustainable surge of 2018-2019 back to its more regular annual pace of the past decade because the demographic trends of the last five years are leading to a downward spiral in the working population. Fertility has fallen, immigration has declined, the population has aged and the participation of women in the labour force has peaked. The job numbers for January were great and they did beat expectations. Nevertheless, employment momentum is decelerating as the pace of growth is the slowest since 2011. Fortunately, businesses are turning to efficiency and capability to meet sales projections. Indeed, productivity trends are positive, and they will mitigate the impact of a slower growth of the workforce on economic activity. Productivity growth has been slowly but steadily perking up since the end of 2016. It rose at an annualized rate of 1.4% in Q/4, putting the average gain for 2019 at 1.7%, the strongest since 2010 when the economy rose from the ashes of the great recession.

Macro View cont.

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Second, the path of GDP growth will likely be bumpy, meaning that the growth band will swing widely from a central tendency of 1.75%. Many geopolitical problems surrounding national security remain unresolved, the threat of across-the-board tariffs still exists, the economic effect of the coronavirus will be long-lasting, and the U.S. election cycle will bring all sorts of surprises. For example, an argument could be made that the virus will destroy demand for goods and services in the short term and therefore will be deflationary; but in the long term the disruption of the supply chain will reduce industrial output, and therefore inflationary.

Accordingly, unknowns create noise and in turn market volatility. It is difficult to see how narratives about issues will play out because the invisible hand of Adam Smith works in mysterious ways. Thankfully, narratives about caution, anxiety and concerns are usually highlighted in the ratio between copper and gold prices. The ratio often explains in advance the nature of stock market volatility. The interplay between the haven and deflationary demand for gold alongside the growth and inflationary demand for copper is reflected in the ratio. In the short term, the pendulum swings from overly optimistic to overly pessimistic depending on what the media reports. At the present time, the ratio stands at .1620 compared to .1851 on January 17. It suggests that narratives stemming from the media are causing a bearish sentiment. In this connection, it is understandable that generally technicians believe that in spite of being in a powerful secular bull run, the stock market is due for a correction or a consolidation.

Consequently, it will be important for investors to distinguish signals from noise. In this respect, using probit models on an ongoing basis to access recession risks (RR) and relying on high frequency models (HFM) to estimate economic activity in real time, is very helpful to judge if the stock market is reacting to noise or fundamentals.

Presently, Moody's Analytics believe the odds that the U.S. will be in a recession in the next year have increased from 9% last October to 14%. The average forecast is 22%. Thus, the odds may have risen but they remain low as none of the classic economic causes of a recession looks worrisome. While I realize that the impact of the coronavirus could become visible over time, the productivity situation is in a good starting position for 2020–the best in years— and probably capable of absorbing a good proportion of any

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coronavirus shock. Meanwhile, High Frequency Models are showing that the decade-long economic expansion is intact. The growth estimates for Q/1 are averaging around 2.0%.

For investors who are more conservative in their approach to markets than the norm—that is, being willing to forgo quick daily trading opportunities—it might be a good idea to supplement the aforementioned indicators with the Yield Curve Rule (YCR) and the Sahm Rule (SR) in order to be certain about whether the deeply-ingrained automatic responses to buy dips will continue to be a winning strategy.

The yield curve rule is an excellent predecessor of recession. There's never been a recession without an inverted curve; but not all inverted yield curves have brought economic contraction. Yield curves invert either because the Fed raises money rates or the market decreases bond yields. It should be noted that inversions are dangerous when the Fed makes tightening moves to erase inflationary pressure but safe when the market takes bond yields down because deflationary pressures are present. At the present time, the Fed officials are not about to raise interest rates because inflation is mute. Given that the Fed's policy rate is clearly dovish, yield curve inversions can only be a by-product of the bond market. Currently, the yield curve is sloping positively.

Claudia Saha is the developer of the eponymous Spahn Rule, an early sign for economic downturns. The bottom line is that when the 3-month moving average of the unemployment rate (3.5%) rises by 0.5% above the recent 12-month low (3.5%), that's the signal that a recession is in the offing. At this time, her indicator is nowhere near a danger zone. Unemployment is at its lowest point of the cycle. The employment situation is robust enough to deal with any downside that may arise.

Thus, the YCR and the SR combined with High Frequency and Recession Risk models are telling us that buying corrections is likely to be a good way to trade the current market and moving from expensive growth to cheap value is probably an optimum investment strategy. Evidently, there will be time when these Rules and the Models will turn negative and that will be the time to get out and play another game. It doesn't look as if we are there yet.

Macro View cont.

By Hubert Marleau

Looking at the 11 Sectors of the S&P 500 by the Numbers:

Name	Index Weight	10-Yr Annualized Total Return	Current Dividend Yield	P/E	P/B	P/S	Comment	Dependency
S&P 500 INFO TECH INDEX	24.5%	18.97%	1.3%	28.20	7.99	5.46	Growth	Future
S&P 500 HEALTH CARE IDX	13.9%	14.37%	1.7%	21.52	4.44	1.81	Growth	Age
S&P 500 FINANCIALS INDEX	12.6%	12.07%	2.2%	14.15	1.51	2.45	Neutral	Interest Rates
S&P 500 COMM SVC	10.5%	10.68%	1.3%	23.35	3.58	3.25	Growth	Innovation
S&P 500 CONS DISCRET IDX	9.8%	17.57%	1.3%	25.91	8.48	1.82	Growth	Inequality
S&P 500 INDUSTRIALS IDX	9.0%	13.49%	1.9%	20.26	5.41	1.90	Cyclical	Exports
S&P 500 CONS STAPLES IDX	7.1%	12.27%	2.8%	22.00	6.86	1.62	Defensive	Population
S&P 500 ENERGY INDEX	3.8%	2.57%	4.6%	18.85	1.43	1.04	Cyclical	Gas & Oil
S&P 500 UTILITIES INDEX	3.4%	13.08%	3.1%	22.48	2.45	2.94	Defensive	Bond Yields
S&P 500 REAL ESTATE IDX	3.0%	11.95%	3.1%	51.54	3.94	7.37	Defensive	Population
S&P 500 MATERIALS INDEX	2.5%	9.40%	2.3%	21.32	2.51	1.84	Cyclical	Global

Source: Bloomberg

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