Weekly Update: As long as neither storms out, we're good

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This week was my annual trip to Phoenix—a favorite destination, always tempting me to move there—with a late-week stop in Santa Fe. The warmth of abundant sunshine is just what I needed with winter in full force at home. Lots of students of the market were among the advisors, and lots of debate, especially regarding a new Cold War with China, and whether valuations signal an "all clear." One remarked, "I am tempted to fall back on valuations which are compelling but the correlation between the P/E ratio and the stock market is essentially nil 1 to 5 years and gold, Jerry (must be a "Seinfeld" fan) over 10 years.'' To wit: in 1978, the Dow was around 850 with a P/E of 9, seemingly "the buy of the century." Four years later, the P/E was 8 when the Dow bottomed in August at 777. But if you bought the market in 1978 and held to 1998, you enjoyed the third-best 20 years ever out of 72 20-year periods, compounding at 16.5% per year on the S&P 500. The last 20 years for the S&P rank 62nd out of the 72 20-year periods—10th worst ever, at 7.1% a year. "Few clients or advisors know this." Another scoffed at comments heard in another meeting that the popular Cyclically Adjusted P/E ratio (CAPE), which is based on the last 10 years of earnings, is too high. "Would you consider the last three months of comparables in selling your house, or the last 10?" he argued. Yet another noted very few people know what the Bretton Woods system is or that this global agreement for currency management and rules of commerce is at risk. "Global supply chains are breaking down as we speak," he said. "Still, it's all about the geography. We don't need China, it needs us."

With Presidents Trump and Xi set to meet in coming days, the main question on investors' minds is whether Trump will put a halt to the planned January hike from 10% to 25% on $200 billion of Chinese exports. Evercore ISI expects the meeting to end with a whimper, not a bang, with a delay in January's ramping up of tariffs the least likely outcome. Betting odds put a 55% likelihood of solely a "grip and grin" photo op and a 40% possibility of "grip and grin" plus an "agreement to keep talking." TS Lombard thinks recent developments have morphed the trade war into a broader economic confrontation that may prove long and ugly, with the White House adamant about preventing China from accessing cutting-edge U.S. technology. Last week, it opened for public comment a proposed rule that would significantly expand the criteria for identifying dual-use technologies deemed essential to U.S. national security, widening the definition of "national security risk" to include artificial intelligence, robotics and biotechnology. With anger over the economic cost of forced technology transfer running deep, the administration is presenting these steps as a corrective measure to historic theft. But this is, in fact, more of a forward-looking than retributive action, primarily aimed at blocking China's ambitions to become a leading global technology power via its "Made in China 2025" initiative. Through unilateral actions, Trump's goal is to cripple China's ability to develop advanced technology products built on pirated U.S. intellectual property.

The potential for one-off confidence-boosting trading sessions like Wednesday's remain the exception and require follow-through, i.e., definitive guidance on the outlook for a pause in Fed rate hikes and a deal on trade. In the meantime, high shareholder yield continues to outperform across nearly all sectors while growth factors such as sales and earnings-per-share (EPS) have seen pressure on wavering economic confidence. What was surprising Wednesday was the lack of any real relative advantage from the "weakest stocks"—they often lead off lows. Instead, momentum stocks led and health care was the only sector to make a relative high vs. the S&P. True, the equity market's interpretation of a looming pause in Fed Chair Powell's speech was unambiguous—breadth was as good as it's been all year. But less than half of S&P stocks were above their 200-day moving average, indicating limits to this up-move. In parsing Powell's comments, it could be argued they simply reinforced the idea of a data-dependent Fed. This is not news at all. Moreover, the spread between the federal funds rate and 2-year Treasury yields remains close to 50 basis points—not flat, but rather accommodative. The liquidity story is in the supply of money (Fed balance sheet), not the price of money (fed funds rate). The real tightening is taking place through quantitative tapering, and that hasn't changed—yet. In my travels this week, there were lots of discussions around the outlook for 2019—where are we in the economic cycle? Will emerging markets (EM) outperform the U.S.? Possibly if the markets hear encouraging words from the G-20, given the drubbing the EM has taken this year. The markets love to kick the can down the road. Still, we are late cycle and, with an EM "trade" proviso, I remain team U.S.A.

Positives

- **Is that Santa I see?** October consumer spending surged and November consumer confidence hovered near an 18-year high, with the present situation component edging up to its highest level since December 2000, a good

sign for holiday sales. JP Morgan said Black Friday online sales soared well above its forecasts, while weekly chain-store surveys reported strong sales.

- **Recession watch** Economic growth held at a 3.5% annual rate in the second take on Q3 GDP, with a slight downward revision to still-above-trend consumer spending offset by an upward revision to capital expenditures. Elsewhere, the Chicago Fed's gauge of national activity ticked up, a sign of acceleration into the fourth quarter, while regional Richmond and Dallas Fed surveys reflected robust but moderating manufacturing activity.
- **If we were ever going to get inflation, this should have been the year** One reason the Fed may be signaling a pause: inflation is losing steam. In less than two months, oil prices have plunged by a third, U.S. retail gasoline prices are on track to fall a cumulative 80 cents a gallon, U.S. headline CPI is on track to be 0% in both November and December, and core PCE has moderated, falling in October to 1.8% year-over-year (y/y). Even Christmas is a bargain—the y/y cost of the "12 Days of Christmas" gifts is expected to be up only 1.2%.

Negatives

- **Housing is a problem** October new home sales fell the most this year to their lowest level since March 2016, and pending sales plunged to a 4-year low. The drop-off marked a bad start to Q4, worsening downward momentum that has seen residential investment slide in five of the past six quarters. Tightening monetary policy has far-reaching consequences, many of them unintended. Mortgage rates on many homes are now lower than what's available for a new mortgage—a bad omen for housing turnover.
- **Exports are a problem** They sank at a revised 4.4% annual rate in Q3, the biggest drop since Q1 2009, trimming 1.91 percentage points off real GDP growth for the quarter—the biggest subtraction from growth in more than 34 years. Led by food, which fell a fifth straight month because of tariff policies, the export drag continued in October.
- **Can oil prices plummet in isolation?** West Texas Intermediate and Brent prices collapsed by a third since early October, marking the 13th time oil has fallen at least 30% since 1982. In eight of the previous 12 cases, the oil drop overlapped with a cyclical bear market.

What else

Will 2019 party like it's 1995? 1995 was a great year for U.S. stocks, in which buy-and-hold and owning the market worked as practically everything equity-related moved higher. The prelude, 1994, had one thing very much in common with 2018: the Fed raised rates all year, then stopped. If this repeats in 2019, the market could see a mini-repeat of 1995.

Why the worry about peak earnings? Ultimately, stock prices are a function of future earnings and interest rates. While concerns about economic growth abound, rates remain extraordinarily low, with equity risk premium (ERP)—the excess return investing in the stock market provides over a risk-free rate—currently 1-standard deviation from the mean based on the yield gap between 10-year Treasuries and investment-grade corporate bonds. At 14.4%, 1-year forward returns are highest when the ERP is between 200 and 300 basis points; currently, it sits at 258. As for earnings, consensus expects EPS growth to fall from about 20% to less than 10% but remain easily positive. In the past, the S&P has continued to increase after earnings growth has peaked, typically about 4½ years before recession.

Take it easy, we're still in a range Lacking convincing signs of a momentum shift that can flip the tone of the tape, the S&P remains on pace to trade within the most narrow ranges on record. Just half of the S&P is in an uptrend (50-day average trading above 200-day average), meaning the bar remains high for a seasonal bounce to give way to a more durable advance that can break formidable resistance above 2,750-2,800.

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Consumer Price Index (CPI): A measure of inflation at the retail level.

Correlation expresses the strength of relationship between distribution of returns of one data series and its benchmark. The coefficient correlation is always between +1 (perfect positive correlation) and -1 (perfect negative correlation).

Dow Jones Industrial Average ("DJIA"): An unmanaged index which represents share prices of selected blue chip industrial corporations as well as public utility and transportation companies. The DJIA indicates daily changes in the average price of stocks in any of its categories. It also reports total sales for each group of industries. Because it represents the top corporations of America, the DJIA's index movements are leading economic indicators for the stock market as a whole. Indexes are unmanaged and investments cannot be made in an index.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging-market and frontier-market securities can be significantly more volatile than the prices of securities in developed countries, and currency risk and political risks are accentuated in emerging markets.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Standard deviation is the measurement of the spread or variability of a probability distribution; the square root of variance. It is a simple, symmetrical distribution where 66% of all outcomes fall within +/-1 standard deviation of the mean, 95% of all outcomes fall within +/-2 standard deviations, and 99% of all outcomes fall within 2.5 standard deviations. Standard deviation is widely used as a measure of risk for the portfolio investments.

The Chicago Fed National Activity Index is a gauge the level of economic activity in the United States.

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