Weekly Update: I've asked Santa to do something about the algos, please!

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I started my 2-stop week—Sacramento and Little Rock—in California's capital at a client event that, an advisor told me, was a very rare "full house." No credit to me, for sure. In most places, there always is lively political discussion, and *always* in California. But not this Tuesday night, after a 3%+ decline in the major averages just days after the S&P 500's best week since 2011. Fear of a bear market "trumped" (if I may) complaints about tweets and presidential decorum. My meetings later in the week in Little Rock were relaxed, with debates about how lazy are millennials (who hate that moniker, I was told) and whether China could possibly surpass the U.S. Consensus is visibly turning bearish and many are calling a bull-market peak. There's China and trade and now the arrest of the Huawei CFO. The collapse in oil prices and the waning power of OPEC. Yield curve inversion, at least on the shorter end, and with it, talk of recession. But note that, even after the yield curve inverts, markets and the economy historically tend to keep chugging along for long periods. To wit: the S&P peaked 19 months after the Dec. 14, 1988 inversion of the broader 2-year/10-year Treasury curve for a gain of 41.4% since the moment of inversion. It peaked 22 months after the May 26, 1998 inversion for a gain of 43%. And it peaked nearly two years after the Dec. 27, 2005 inversion for a gain of 28.8%. This isn't meant to suggest the yield curve's inversion should be ignored. A decline in longer yields relative to shorter yields is clear sign fixed-income markets are pricing in slower growth. The past month's outperformance of defensive value stocks are sending the same signal from equities. But none of this is new. Consensus GDP forecasts have been turning softer for weeks.

Slower doesn't mean recession as this week's reports on manufacturing, services and jobs attest (*more below*). Moreover, a more dovish-sounding Fed, a relatively positive outcome from the meeting between Presidents Trump and Xi (despite what news reports say), and OPEC and Russia's agreement to cut production even if they haven't settled on a number should be viewed as market friendly. And they were … fleetingly. Then, why is the market behaving so badly? With quantitative tapering continuing to march along, the monetary base is contracting—*a rare occurrence* that's seldom good for asset prices. Market liquidity is under pressure for other reasons, too. With relatively riskless short-term assets yielding as much if not more than risk assets, money is moving to cash from credit. There's also the covering of record short positions in longer-maturity Treasuries (TS Lombard reports speculative shorts in both 5-year and 10-year positions have been cut by two-thirds); flows out of negative-yielding overseas bonds into U.S. Treasuries; *the explosion of algorithmic-driven (algos) trading as a result of massive passive investing*; and the usual year-end rebalancing and window-dressing (trades to try and make funds look better). Until the start of this year, the Fed had kept financial market liquidity (the excess growth rate in the money supply above what's needed to finance economic activity) remarkably strong, and this excess liquidity had no place to go but to the stock and bond markets, keeping yields low and pushing stock prices higher. So now that liquidity has been contracting for only the second time in this recovery and for the first time since 2010, it's been a rude awakening. Historically, the average annualized S&P total return during periods of weak financial liquidity growth is only a small fraction of the return potential when the Fed has kept the punch bowl full.

The S&P remains increasingly vulnerable as it tests critical support at 2,600 for the sixth time this year. Risk-on factors often work off a low, but that has not been the case to any meaningful extent of yet. Small-caps vs. large-caps are trading at fresh relative lows and the Russell 2000 broke below its October low before late Thursday's bounce. Small-caps tend to be a decent barometer of liquidity conditions, as do BBB spreads (low-investment-grade corporate relative to Treasury yields), which failed to narrow on the brief but strong risk-on rally after Fed Chair Powell's recent retreat from hawkishness. It's not just stocks and bonds and commodities in the U.S. Precious little has worked this year—except cash, which beat most asset classes. While earnings growth hit a cycle high (and almost assuredly will moderate in 2019, another market anchor), the S&P struggled and equity P/E multiples de-rated severely to near 5-year lows, similar to the last two major growth scares. A lot is now priced in, from a sharp slowing to possible recession. If equity investors remain this negative, perhaps it all will get priced into 2018 and we may see a different outcome in 2019. All I want for Christmas is for something to work next year. And seriously, I've been a very good girl!

Positives

- **This is Goldilocks** November's nonfarm and ADP payroll gains were below forecasts but still solid, with unemployment holding at a 49-year low and year-over-year wages rising 3.1%. Hiring trends remained strong, just not as robust as earlier in the year, largely because employers are encountering difficulties finding the skilled

workers they need. This slowing with moderate wages adds to factors that can keep the Fed at bay.

- **Services strong** Led by new orders, ISM's gauge of non-manufacturing activity unexpectedly rose again to its second-highest level since August 2005. The growth was broad-based—17 industries expanded while only one contracted. Markit's services survey also surprised to the upside, aided by a jump in export orders. This bodes for well for broad-based expansion going into the heart of the holiday season.
- **Manufacturing accelerates** November's ISM rose for the first time in three months to a level historically consistent with above-trend GDP growth. A near 5-point jump in new orders drove the increase, with continued tight labor conditions and trade-war supply disruptions the only drags. Markit's separate take wasn't as bullish but was still strong, again with a surge in new orders leading the way.

Negatives

- **Global recession watch** Global manufacturing conditions continued to slow in November, with the PMI holding at a 2-year low and the percentage of expanding manufacturing industries slipping to its lowest since October 2016. China (this is before potential 25% tariffs), the eurozone, Japan and several other emerging markets (EM) led the slippage, while the U.S. and a few EM countries—Italy, Russia, Brazil and Vietnam—improved.
- **We're counting on capex** Many companies told the Fed's Beige Book that tariffs are becoming a big headwind to capital expenditures (capex), a critical component to improving both productivity (revised up a tick for Q3 to 2.3% annualized) and GDP's growth potential. With much of capex related to the oil patch, the collapse in oil prices represents a similarly big constraint. There was some good capex news this week: capex orders ended a 2-month slide and capex shipments that feed directly into GDP rose.
- **Trump is sure to notice this** The trade deficit widened again in October to its highest level in 10 years, as exports slipped for the fourth time in five months and imports edged up the sixth straight month—both signaling that, to date, the tariffs aren't working as intended.

What else

Xi might be caught between a rock and a hard place China's president doesn't have to run for re-election the way Trump does, so the political question is whether he can wait Trump out? The problem is Democrats are trying to outflank Trump on China because they know it is politically popular and because he is vulnerable. So if a Democrat wins in 2020, it's likely that person would continue the trade war with China. And should Trump win again, he would have four years to pursue a very aggressive approach—a position he may be more willing pursue should China renege on commitments made during this negotiation.

This common concern came up in Little Rock The narrative that all or most of the tax cut went to buybacks is not borne out by the data—buybacks and dividend increases represent just 28% of companies' use of cash from tax savings, leaving them with more than $350 billion for other uses such as capex, pensions, paying down debt, wage increases and M&A activity.

I think I see Santa, but he's still weeks away If a traditional Santa Claus rally appears, it shouldn't be expected until the day before Christmas, with the equity market potentially lower in the interim. December contains a number of unique cross currents, including tax-loss selling, portfolio window dressing and—this year—a significant headwind from struggling hedge funds. With hedge funds appearing on track to their worst year since 2011, many managers are expected to close funds, adding to selling pressure.

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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.

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

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.

Small-company stocks may be less liquid and subject to greater price volatility than large-capitalization stocks.

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.

The Global PMI is compiled by Markit Economics and is derived from surveys covering more than 11,000 purchasing executives in 26 countries.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

The Institute of Supply Management (ISM) nonmanufacturing index is a composite, forward-looking index derived from a monthly survey of U.S. businesses.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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