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# If it's consensus, it's already baked into the market

Rising optimism suggests the market is overbought, but momentum suggests that any pullback may prove short-lived.

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**With the real fed funds rate** at roughly 25 basis points and unlikely to move much above that, the business cycle seems almost certain to become the longest in U.S. history in August. The real fed funds rate at the start of the past eight recessions was no lower than about 2%, a level far above a patient Fed's stated plans. While January's minutes weren't all that dovish, they did indicate quantitative tapering (QT) will end this year, with the balance sheet remaining constant afterward. Normally, the Fed would expand the balance sheet to accommodate a growing economy and the corresponding demand for cash. Still, policymakers are planning to swap mortgage-backed securities for Treasuries when QT stops, a sort of back-door easing that highlights what TS Lombard views as a trap central bankers the world over have set for themselves: never-ending ultra-easy monetary policy. A breakout in inflation could lead to a hawkish turn again, but that seems unlikely. March will mark the 2-year anniversary of an unemployment rate below the estimated non-accelerating inflation rate of unemployment, or NAIRU, a show of labor-market strength that textbooks tell us should have caused a sizable increase inflation by now. We've had disinflation instead, which Jefferies views as incontrovertible evidence that the Phillips curve is dead, with rate cuts more likely than rate hikes and a *soft landing more likely than a recession*. From your lips ...

**As equity values climb,** we're not hearing as many warnings about a pending corporate bond implosion, which arguably was more a media creation than market concern. A re-tightening of financial conditions and a sharp deceleration in earnings growth could spell trouble. But risks appear manageable as debt growth has started to slow, debt levels relative to after-tax profits are well within historical norms, defaults are low and debt service is negligible for most companies. Because of low rates, the equity risk premium—the excess return of stocks relative to risk-free rates such as Treasury bills—is running between 1 and 2 standard deviations cheap relative to long-term history, a divergence that typically leads to attractive forward returns. Returns on capital remain high and free cash flow is abundant. This is bullish, too. Investor sentiment has shifted deep into the bullish camp, as reflected by this rally's cyclical leadership, suggesting negative macro surprises could cause a sharp reversal. But short of recession, which is not yet on the horizon, volatile periods historically have represented attractive buying opportunities, as occurred when the VIX spiked in 2008, 2012, 2016 and last year.

**The equally-weighted S&P 500** hit a 3-month high this week, another sign "average" stocks are playing a big role in the rally. The cap-weighted S&P is trading more than 6% above its 50-day moving average (putting it in the 95th percentile since 1950), which is long-term bullish but consistent with near-term consolidation. The MSCI All County World Index has rallied for 39 days without as much as a 3% correction, a far longer run than normal, putting Ned Davis Research's optimism gauge at its highest level since the eve of early October's collapse. It warns of a steep sell-off if sentiment starts to reverse. The move off the December low was largely driven by high beta shares, and history shows such beta-driven rallies tend to fade, with either a shift toward more substantive leadership supported by expanding fundamentals or a retest of the near-term lows. The *overwhelming consensus* is for a pullback. But it's notable the Nasdaq this week joined the Dow and the S&P in breaking through tough resistance at the 200-day moving average, and that the cumulative NYSE advance-decline line hit a new record high. Dudack Research sees such strong momentum in overbought markets as bullish and illustrative of a powerful demand for stocks. Since 1984, there have been seven S&P corrections during an expansion. Each ended with central bank easing, followed by rebounds ranging from 7% to 23% in the first two months (it was 18% in this rally's first two months) and an average 9% gain in the subsequent six months. Consensus is on alert. Gives me the same comfort I get seeing my colleagues carrying their umbrellas when they go out to lunch.

**POSITIVES**

- **Soft landing watch** A jump in services activity to its highest level since last June more than offset a slight slowdown in manufacturing, lifting Markit's flash composite PMI for February to an 8-month high. Services survey respondents said improving domestic economic conditions had underpinned a sustained rebound in new business so far in 2019, with the rate of new business growth its sharpest in four months.
- **China soft landing watch** More favorable-than-expected data out of China in the past week suggests all the stimulus aimed at spurring growth may be having some positive effects, with a surge in bank lending and imports particularly notable. Citigroup's gauge of positive economic surprises in China has risen to a 2-month high.
- **We'll know in spring** While bad weather and the government shutdown were blamed for another drop in existing home sales in January, the prior month's decline was upwardly revised and other data provided hopeful signs for the critical spring selling season that's about to get underway. Notably, builder confidence jumped the most in 14 months to its highest level since last October on improving buyer traffic and expected future sales. Mortgage purchase applications also rose for the first time in five weeks as rates and home prices continued to moderate.

**NEGATIVES**

- **Disconcerting manufacturing data** More signs of a slowdown in manufacturing emerged, as the Philly Fed's monthly gauge contracted for the first time in nearly three years on big drops in new orders and shipments. Markit's flash read on the month also showed domestic factory activity slowing, while the global PMI has now fallen nine straight months, its second-longest losing streak in history, with only 2008 worse. Overseas, the eurozone manufacturing PMI signaled contraction for the first time since mid-2013, with export orders falling to 6-year low.

- **Government shutdown distorts data** Conference Board leading indicators slipped in January after December's decline was revised to no change. Much of the deceleration was tied to a government shutdown-led jump in unemployment claims that have since reversed (average claims fell 23K in the latest week, to a near 50-year low of 216K). Consumer expectations also were a drag but have since reversed following the shutdown's end.
- **Trade war distorts data** Two measures of North American freight activity—the Cass Freight Index and the American Trucking Association's measure of tonnage moved—continued to decelerate on a year-over-year (y/y) basis, reflecting weaker global growth and trade flows, partly due to increased tariffs. However, both measures were still indicative of expansion, with expenditures rising y/y in a push to offset tight capacity.

#### WHAT ELSE

**Nobody knows** While refunds to date have been running below a year ago, nobody knows whether they will be larger or smaller than in past years, as small changes in the assumptions on any of three factors affecting the new tax law—fewer taxpayers impacted by alternative minimum tax, increases in the child tax credit and 2018 withholding tables that were not adjusted correctly—lead to large changes in net payments to households. This is important because refunds are often spent in this consumer-led economy of ours.

**It's not just the SALT states** At 15.1%, home listings with a price cut are now running 210 basis points above year-ago levels, according to Zillow. And contrary to macro arguments, this is not isolated to homes in high-income tax states, where there is a $10K cap on the blend of state and local income and property tax deductions as a result of the new tax law.

**There have been a lot of 'emergencies' in recent decades** Since 1976, presidents have declared a state of emergency 60 times, and 31 of those declarations remain in effect.

Former Presidents George W. Bush and Obama also directed the use of the military to assist in securing and managing the southern border, with Bush declaring a national emergency in 2001 and both he and Obama using reprogramming authority a total of 18 times to fund projects between 2001 and 2014.

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**DISCLOSURES**

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio, in comparison to the market as a whole.

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

Cass Information Systems provides monthly indicators of industrial shipping activity by monitoring the freight billings and shipments of companies and divisions across the country.

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.

MSCI All Country World Index (MSCI ACWI): A free float-adjusted, market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of November 2011, the MSCI ACWI consisted of 45 country indices comprising 24 developed and 21 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and United States. The emerging market country indices included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey. The index is unmanaged, and it is not possible to invest directly in an index.

Nasdaq Composite Index: An unmanaged index that measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. Indexes are unmanaged and investments cannot be made in an index.

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 Conference Board's Composite Index of Leading Economic Indicators is used to predict the direction of the economy's movements in the months to come.

The Eurozone Purchasing Manufacturers Index (PMI) of manufacturing is a monthly gauge of the level of manufacturing activity in the euro zone.

The Federal Reserve Bank of Philadelphia gauges the level of activity and expectations for the future among manufacturers in the Greater Philadelphia region every month.

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

The Markit Composite PMI is a gauge of manufacturing and service activity in a country.

The New York Stock Exchange (NYSE) advance/decline line measures the ratio of advancing stocks to declining stocks.

The value of some mortgage-backed securities may be particularly sensitive to changes in prevailing interest rates, and although the securities are generally supported by some form of government or private insurance, there is no assurance that private guarantors or insurers will meet their obligations.

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

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