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It's getting late

The next few weeks could prove significant as the market awaits signs of progress on U.S.-China trade and the global economy.

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With a March 1 deadline less than three weeks away, the market is focused on the U.S.-China trade talks for good reason: global industrial production has almost stalled largely because of deteriorating trade due to tariffs. In the U.S., November exports fell for the fifth time in six months and imports plunged nearly 3%, with potential buyers put off by costlier consumer goods because of tariffs. In China, manufacturing activity contracted a second straight month as tariffs clogged the export spigot. It's not all gloom and doom—job openings are running ahead of job applicants in China and there are signs its economy may be stabilizing amid massive stimulus. Still, China matters a lot because it has become the dominant global growth driver. In an unprecedented stretch since 2007, its economy increased fourfold, *accounting for almost a third of global growth last year*. We really want China to avoid recession! Across the Atlantic, the Bank of England said trade is a drag on U.K.'s economy and is weighing a potential rate cut, and German factory production declined a fourth straight month as the European Union's (EU) largest economy and exporter teeters on the brink of recession. EU partner Italy already is in recession, and the EU this week slashed 2019's growth forecast to 1.3% for the entire 19-country union. It's getting late.

While Q4 earnings continue to be revised up as results come in, there's apprehension about the legitimacy of 2019 estimates. Post-tax cuts, companies are facing exceptionally difficult comparisons. Q1 and Q2 comps are expected to be the toughest, with some expecting Q1 earnings to contract as the lower tax rates that added 7 to 8 percentage points to earnings growth last year are forecast to subtract a point in 2019. This has a lot to do with the roll-off of favorable one-time items such as accelerated depreciation of capital expenditures (capex), and helps explain why the forward P/E has plunged below 16, a level that historically has represented good value. Speaking of capex, after an early post-tax-cut pop, it has leveled off, representing a potential threat to an expansion that will become the nation's longest at 121 months if it continues to July. Seems to be getting pretty late. While there have been encouraging signs on productivity (*more below*), more capex is needed. Historically, expansions transition from consumer-led to capex-led growth, with the latter spawning productivity improvements that help to both keep inflation pressures—and the Fed—at bay and the economy growing. The good news: there has never been a global recession without the U.S. being in recession, and stellar job growth, accelerating wages, solid consumer spending and rising labor participation rates are supportive for continuing, albeit more modest, GDP growth here this year.

Citing a "less favorable outlook," U.S. banks have tightened lending standards for the first time since 2015, according to the Fed's quarterly survey of senior loan officers. This shift is most apparent at small banks, defined by the Fed as all but the top 25. This is significant because small banks have been a crucial source of credit for business, consumers and real estate in this cycle. Tick-tock, tick-tock. The last time banks tightened lending standards in 2015 and the economy slowed, the Fed "eased" by lowering the forward projection of policy rates. This time, the Fed is vowing patience (after confusing the markets with its December policy language), *although the monetary base continues to shrink*. Former Chair Janet Yellen this week said she thinks the Fed might even cut rates if global growth keeps slowing. Central banks elsewhere either cut rates (India) or signaled potential rate cuts (Australia and the U.K.). This could represent the biggest macro risk facing the S&P 500: U.S. dollar strength as global easing potentially blunts the effectiveness of Fed's dovishness. After a 16% rally over 28 trading days and its fourth-best January since 1950, the S&P is testing its 200-day average of 2,742. This is a logical area for a market pause/consolidation in a month that tends to be choppy. January gains historically have been followed by annual gains 77% of the time, and the rally's breadth was good. All of this is supportive of the long-term bullish trend. Still, *with absolutely no evidence of recession on the U.S. horizon*, you've got to admit, it's getting late.

POSITIVES

Soft landing watch ISM services activity moderated in January and has now declined three of the past four months to a 6-month low. Still, at 56.7, it remained at a level consistent with above-trend growth and in line with January's ISM manufacturing survey, which rose to 56.6.

Productivity rises Manufacturing productivity increased a second straight quarter to a 1.3% annual rate in Q4, led by gains in durable goods manufacturing. Still, on a year-over-year (y/y) basis, manufacturing productivity remained subdued, up only 0.7%, well below the historical mean of 2.6% y/y.

This will help Q4 GDP but … November's trade gap narrowed more sharply than expected, which should add to Q4 growth even though the reasons (*as mentioned above*) aren't great. The drop-off reflected declines in real volumes of trade, with the softening in activity primarily due to tariffs.

NEGATIVES

It's getting late Auto sales dropped 5.1% in January, the most since May 2011, to a 16.6 million unit annual rate, the lowest level since August 2017 and below forecasts. Severe weather may have played a role, but the report also seemed to reflect some genuine pullback in demand. Light truck sales, a strong performer in 2018, fell the most since September 2009.

… late Evercore ISI's truckers survey, which has the highest correlation with real GDP growth of any single sector survey, has plunged nearly 4% over the last four weeks to a level consistent with just 2% real GDP growth.

... late The amount of debt globally trading at negative interest rates is trending higher again, currently at $8.8 trillion.

WHAT ELSE

What's up with Industrials? Since the Christmas Eve low, Industrials have been the best-performing S&P sector, up more than 20% and accompanied by strong internal momentum. More than 90% of Industrial stocks recently traded to a 20-day high, the strongest reading in roughly 30 years. While this has left a number of individual names overbought and at resistance, momentum surges historically are consistent with above-average forward returns. Seasonality through spring should offer support as overbought conditions likely have to be consolidated.

What a great time to be alive The Institutional Strategist shares its optimism over technology's continuing advancements. The first few weeks of this year alone have seen: driverless and electric tractors charged via solar panels starting to penetrate the agricultural machinery industry; China set to release its first driverless bullet train that can travel at speeds of up to 217 mph; Samsung unveil a 1-terabyte embedded universal flash storage for smartphones; MIT's test of a laser that interacts with water vapor in the air to send sounds to a single listener's ear; and Google announce a "Live Transcribe" feature that will use the phone's microphone to translate speech to text in real-time for the hard of hearing, with a Google Assistant real-time translator in 27 languages.

What a scary time to be alive 5G, the array of networking technologies meant to work together to connect everything from home appliances to self-driving cars, is expected to provide bandwidth of up to 20 gigabits per second, with the first 5G smartphones and infrastructure arriving this year. To work, it will require a lot more transmitters and antennas than existing 4G and Wi-Fi networks. This opens the door for many more devices to be connected to the internet, requiring a layer of control software that could allow a malicious network operator to snoop on and manipulate data. Huawei is the world's biggest networking equipment supplier ....

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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.

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).

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.

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 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.

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