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Bad memories

A number of trends are impacting the way this market operates, and that's not necessarily healthy for investors.

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I just couldn't wait to get on the road again—this time through North and South Carolina, with stops in Pinehurst, Raleigh, Wilmington, Charleston, Columbia and Charlotte. However, some long dormant bad memories came up. In Columbia, an advisor just happens to be friends with the coolest boy in my elementary school, to whom this shy, way too thin (at the time), nerdy girl was invisible. (Ha! His loss!) And in Charlotte, an advisor's acquaintance also went to my grad school in Pittsburgh, the ultra-computer oriented Carnegie Mellon University. She described her time there as terrible. (Me too!) Throughout my meetings, the subject of rising and risky corporate debt kept coming up, reminiscent of the high-yield bond market collapse in 1989. In those years, it was OK to call them junk bonds. Bad memories all! The subject of market structure dominated an advisor meeting in Charlotte. I emphasized this is not considered enough as investors don't know about the risks. It may seem fine now, with the VIX having fallen *an unprecedented nine straight weeks* since Christmas Eve's peak and the Dow having risen nine consecutive weeks for *only the 15th time in its 123-year history*. But we're just two months removed from the *worst year for stocks since the financial crisis* and the *worst December since the Great Depression*. The risks are binary, and binary risks require some ballast.

Bernstein views the risk of illiquidity as a critical challenge, with the convergence of numerous trends—the explosion of high frequency trading and passive investing, easy global monetary policy and ever-increasing corporate debt—impacting market structure. All of this has coincided with an improvement in liquidity conditions and more efficient trading, but what happens in an adverse scenario? Value investors who have tended to step in and buy in oversold markets now account for the fewest assets than at any point in the last 15 years. Similarly, active investors who historically have provided liquidity for issuance and investors who need to raise cash and exit positions are being pushed aside by passive investors. As for corporate debt, its quality is at its worst level in a generation. Yikes! On the other hand, Leuthold Group found the ratio of corporate debt to corporate profits to be no higher today than it was *almost 50 years ago*. And since the start of this expansion, business debt has grown 3.7% annually on average, *less than half its pace since 1952*. Also, because corporations took advantage of this cycle's historically low rates to issue longer-term debt, the average duration of outstanding corporate debt is a very manageable 7 years. The household situation is even better. Total household debt to disposable personal income has fallen to where it stood 17 years ago—that is, unlike any other recovery in the post-war era, *household finances actually have strengthened as this recovery has aged*!

Even though just over half of the economists surveyed by the National Association for Business Economics think a recession will arrive before year-end 2020, risk-on in the credit markets is going strong, and capital markets overall seem to be yawning at economic surprises, whether up or down. This could be one effect of the "Powell put": bad news is not so bad any more. In the current market environment, with the Fed explicitly data-dependent, disappointing economic readings mean the Fed can stay at bay. Evercore ISI believes the lack of inflation is key, giving CPI more influence over the 10-year Treasury yield than payroll employment. This helps explain why long Treasury yields have remained low and range-bound despite the rally in risk assets. The rebound in stocks has been breathtaking—nine of every 10 S&P 500 constituents are trading above their 50-day moving averages and the Russell 2000 is off to its best start since 1987, with the small-cap rally a 99th percentile event. A bull would prefer consolidation. A bull would rather not have unprecedented or outsized moves in either direction. Not

comfortable. Binary outcomes in our future abound—from trade talks to the 2020 election and everything in between. Gotta get some ballast! I relived bad memories this week. I'd rather not make new ones.

POSITIVES

- **We're counting on capex to extend the cycle** Q4's nearly 9% year-over-year jump in private non-residential investment pleasantly surprised in the GDP report. Forward indicators of capital expenditures (capex), including business profits and capacity utilization, point to additional strength in the quarters ahead, with capex leadership shifting from Energy, Tech, Discretionary and Financials to Communications, Staples, Utilities and Industrials. The percentage of S&P 1500 companies expanding capex sits at 7-year high.
- **Soft landing evidence** Consumer confidence surged in February by the most in 3.5 years. Expectations led the increase and the assessment of present conditions improved to its highest level since December 2000, consistent with above-trend economic growth and consumer spending. Final Michigan consumer sentiment also rose vs. January, although it slipped from February's initial read.
- **More soft landing evidence** Two leading indicators of housing activity surprised, as December permits rose and January pending sales soared by the most since October 2010. As with February's jump in builder confidence, lower mortgage rates and moderating home prices (Case-Shiller and FHFA price gauges eased last month) were credited. Mortgage purchase applications are running 3% ahead of the year-ago pace.

NEGATIVES

- **Manufacturing extends its soft patch** ISM and Markit gauges both reflected moderating activity in February on slowing orders. The ISM reading was its lowest since Trump was elected president. Regional readings were more mixed as four improved, led by the biggest jump in two years in the Chicago gauge to a 13-month high, while two declined, led by the lowest reading in the Kansas City Fed barometer since November 2016.

- **December was bad** While consumer spending held up for all of Q4 2018, it wasn't because of December. Data released today shows Americans slashed spending 0.5% in 2018's final month, the biggest drop since the economy exited recession in 2009. This wasn't all that unexpected as retail sales also plunged in December by the most in nine years as the government shutdown and market sell-off scared off shoppers.
- **Tariffs aren't helping** The goods trade deficit jumped in December by the most in nearly four years to a record high as exports plunged and imports jumped. The deficit also hit a record on a 12-month basis, reflecting the continued strength of the dollar and firmer U.S. demand vs. the rest of the world, as well as the shortcomings of tariffs as a policy tool to reduce the trade deficit in the short run.

WHAT ELSE

Putting a potential Q1 earnings recession in perspective Consensus estimates are calling for a modest contraction (actual results should be positive after beats). But underlying dynamics appear more benign, Credit Suisse says. It notes four key items have distorted earnings per share in recent quarters, causing a 21.3% swing between Q3 2018 and Q1 2019 estimates: 1) tax changes, 2) rising/falling energy prices, 3) a turn in the semiconductor cycle and 4) select mega-cap tech stocks. Revenue trends and median growth rates have been far more stable.

Get your popcorn ready for election season After falling modestly during the shutdown, President Trump's approval rating has bounced and is now roughly at the highest levels of his presidency. Noting that Trump's approval rating has been in a narrow range throughout his presidency, Cornerstone Macro wonders if this is just a short-term pop (and his approval rating will remain range-bound) or the beginning of a sustainable trend?

What?! The amount of $100 bills outstanding has doubled since the financial crisis—there are now more C-notes than $1 bills in circulation—and their rapid growth relative to more muted growth in money market funds since the Fed began raising rates is a bit of a head scratcher. Deutsche Bank posits that demand for "Benjamins" may represent

global fear of negative interest rates in Europe and Japan, increasing use in the global underground economy or simply a convenient savings vehicle for U.S. households worried about another crisis.

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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.

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.

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.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

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

High-yield, lower-rated securities generally entail greater market, credit, and liquidity risk than investment-grade securities and may include higher volatility and higher risk of default.

Russell 2000® Index: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. Investments cannot be made directly 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.

The S&P Composite 1500 Index combines three leading indices, the S&P 500, the S&P MidCap 400 Index and the S&P SmallCap 600 Index to cover approximately 90% of the U.S. market capitalization. The index is unmanaged, and it is not possible to invest directly in an index.

The Chicago Fed Midwest Manufacturing Index is a gauge of activity and expectations for the future among manufacturers in the Seventh Federal Reserve District states.

The Federal Reserve Bank of Kansas City surveys manufacturers in its district monthly to gauge the level of their activity.

The Federal Housing Finance Agency's (FHFA) seasonally adjusted purchase-only price index is a gauge of prices of existing homes.

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

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

The S&P/Case-Shiller Home Price Indices measure track changes in the value of the residential real estate market in major metropolitan regions.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

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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