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Palos Weekly Commentary

Issue **No. 1** | **JANUARY 3** 2019

Macro View

By Hubert Marleau

The Weekly Narrative: Week Ended January 3, 2019

Forecasts Are Tactics and Strategies. They Are Not Systems nor Philosophies.
If You Want to Be Right, One Must Forecast Often. One Forecast Is a Fruitless Exercise.
This Is the first forecast for 2019 of many more to Come.

The Current Outlook for 2019

The North American stock markets in 2018 turned in their worst performance since the financial crisis, making many investors anxious and unsure about the outlook for 2019. On December 31, the S&P 500 index was 2,509 down 6.2% for the year and on December 24, the index registered a low of 2,351 from the historical September high of 2,931 - a razor blade away from being called an official bear market. Stocks stumble into the new year because of growth scares in the Asian manufacturing sector. Traders and investors alike lost track of their role in free markets because they got lost in their own stories by reverse engineering a recession-scare and talking themselves into recession-like behaviour. Consequently, the markets have been subjected to self-inflicted wounds stemming from fear of the possibility of policy mistakes and left field accidents.

If we are going to get a break away from domestic political chaos and complicated geopolitical issues that could jeopardize both capitalism and democracy as we know it, the fundamentals of the economy seem to be good enough to carry us positively through 2019 and avoid a recession. It should be noted that Moody's Political Uncertainty Index, the Philadelphia Fed's Anxious Index, and the BlackRock Global Risk Indicator have fared better of late. Several market strategists feel that something must give from the Fed throwing in the towel to Trump giving up on the idea that he's going to rewrite the rules of global trade. Barring broader political risks, the U.S. stock market should continue to offer attractive opportunities because monetary policy is bound to be modified, productivity is destined to rise, and valuations have improved considerably. If left to its own devices, the U.S. economy wouldn't even come close to falling into a recession or stocks in a bear market in 2019-20. Should the economy tread a middle road, as I expect, it would mean that growth would not be so fast to create undesirable interest rates and not so slow as to prevent earnings from rising.

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1) The Federal Reserve Bank will be under a lot of pressure to ease its monetary stance because inflation is running around the Fed's objective of 2.0% and full employment has been attained. Therefore, there is government, business and academic pressure on the Fed to modify the current monetary stance. The economy is in a perfect state of equilibrium. As a matter of fact, the Fed's policy rate is only one notch away from neutral, the yield curve is flat, and the annual pace of the money supply is running at 4.0% - enough to support a two-plus-two economy. That is 2% for growth and 2% for inflation. Interestingly, Goldman Sachs revised its growth forecast for 2019 to 2.0%, re-emphasizing that it is not particularly worried about a recession. The consensus forecast shows 2.5% growth in 2019 followed by 1.8% in 2020. The growth potential of the economy is 1.8% - according to the Fed. On the other, the Yield Curve Model of the Cleveland Fed predicts that real growth will increase at the annual rate of 2.0% in 2018 and 2019. On Wednesday, the near-term forward spread, which reflects the difference between the forward rate implied by Treasury bills six quarters from now and the current three-month yield, fell in negative territory. This relationship is viewed as a reliable crystal ball. It suggests that the market is predicting that the Fed will cut the policy rate in early 2019 - the point is that there is no inflation despite wage rate increase. Why is this? The simple answer is productivity.

2) Productivity is gradually replacing employment as the main driver of economic and, in turn, will allow the pace of the economy to grow at the annual rate of 2.0%, permit corporate profits to expand and allow inflation to remain stable. If inflationary pressures do not materialize as was originally expected a few months ago, economic growth might last significantly longer than forecasters and markets think. Scientific researchers, contrary to economists' pessimism, believe that technology is advancing exponentially, and entrepreneurs believe that practical applications are being implemented now. Thanks to new ideas, it seems quite plausible to anticipate a significant pickup in productivity growth over the coming years. Productivity has gained traction since the second quarter of 2016, suggesting that productive processes are being reimagined.

3) Valuations have materially changed for the better over the past three months. Based on Bloomberg's latest market data points, the Equity Risk Premium is 4.20% compared to the September peak of 2.25%. Meanwhile earning yields are 6.85% fetching 5.90 % above inflationary expectation and 5.15 % more than 10-year treasury real rate. I consider these metrics attractive, given my base case scenario. Incidentally, quarterly profit growth has serially outdone quarterly S&P 500 performance over the last 10 quarters. Stocks entered 2019 with valuations beneath some historical averages. The commonly watched price to forward earnings for the S&P 500 stand at near 14.5 times, below the high of 18 times in January of 2018 and the 1990- 2018 average of 15 times. Moreover, the "Rule of 20" is under 20 suggesting that stocks represent good to fair value. That's what Bloomberg data shows.

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As of today, and according to FactSet, 2019 expected full year S&P 500 EPS is $178 compared to $165 for 2018 representing an increase of 8.0%. The estimated revenue growth rate for 2019 is 5.4%. All eleven sectors of the S&P 500 are expected to report year-over-year growth in both per share revenues and earnings.

This prediction equates to a “fair value” P/E multiple of 13.9 times and an “adequately price” PEG of 1.6 times. PEG is defined as P/E divided by earning growth. In this connection, I’m not surprise that investment houses like Morgan Stanley, Yardini, and BAML are projecting that the S&P 500 will reach between 2,750 and 3,100 by this year end. Wall Street strategists in a CNBC survey maintain an optimistic view for the market for an average year-end target of 3,000. Investors may have yanked a net $75.5 billion from the market in December; but it was done under very awkward trading volume making stock prices extra vulnerable. Therefore, many fearless long-term oriented investors are looking through volatility and even taking advantage of the undergoing rout. We started 2018 with an expensive market and this year we’re going in with an inexpensive one at time when there could be some big upside surprises later in the year like easing of monetary conditions, a U.S.-China deal and more productivity increases.

Yet, this early year forecast is not without some immediate downside risks tied to the political realm. Valuations and fundamentals can take a back seat at a time when sentiment and emotions are the driving force behind the markets. The three big ones that are influencing the present sentiment driven market is the Fed’s monetary stance, U.S.-China trade dispute and chaotic politics. From this perspective as we head into 2019, stock allocation should be focused on segments of the market with emphasis on deep value companies from consumer discretionary, energy, healthcare, utilities and financial sectors that offer attractive dividends because the bar to slash dividends is high. Additionally, a meaningful exposure to gold stocks and investment-grade bonds could be a good strategy.

N.B. I should add that the oil price plunge may have created a rare investment opportunity. Thanks to NOPEC production cuts, gridlock at major U.S. oil production spots, and temporary cuts from Canada, the global oil complex market is likely to move towards a balance equation in 2019. Bernstein, a highly reputable research house, sees West Texas oil rising to $60 a barrel in 2019.

N.B. Canadian Strategists’ call for 2019 ranged from a low of 15,000 for the TSX (Sun Life) and to a high of 18,000 (BMO Capital Markets).

N.B. Since the end of WWII, there have been 14 bear markets, with 7 of them accompanied by a U.S. recession and 7 without one. Recessionary bear markets are painful, with an average S&P 500 decline of roughly 40%. Bear markets without recession tend to stop around a 20% decline and have always recovered quickly, bouncing back on average within twelve months. In the last two bear non-recessionary bear markets in 1998 and 2011, they recovered in three and five months respectively - John Lynch and Ryan Detrick of LPL Financial.

Macro View cont.

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New Technical Perspectives as of January 3, 2019

1) Based on the Dow Theory, the trend for the S&P 500 turned bearish recently with key resistance at 2,599 and key support at 2,279 - on Thursday morning the S&P 500 was 2,470

2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $50.31 and key support at $41.35 - on Thursday morning crude traded around $46.44

3) Based on a proprietary model, the trend for gold turned bullish recently with key resistance at $1,290 and key support at $1,201 - on Thursday morning gold was selling for $1,246

4) Based on a proprietary model, the trend for ten-year treasury yield recently turned bearish with key resistance at 2.99 % and key support at 2.61% - on Thursday morning the yield was 2.91%.

5) Based on a Palos Currency Model, the trend for the Canadian dollar recently turned neutral with resistance at 75.78 US cents and key support at 73.12 US cents - on Thursday morning the loonie was trading for 73.58 US cents, 4.5 US cents below the Purchasing Power parity Rate.

New Economic Perspectives and Recession Risk as of January 3, 2019

I. Moody's Analytics is predicting that there is a 17% chance of a recession in the next six months.
II. The WSJ December survey predicts that there is a 30% chance of a recession in the next 12 months.
III. A December survey conducted by Reuters mark-up the probability of a U.S. recession in the next 24 months to 40% from 35% in November.
IV. The NY Fed is predicting that there is a 35% of a recession in the next 18 months.
V. Moody's Analytics predicts that the U.S. economy grew at the annual rate of 2.7% in Q/4 - down from 2.8% last week.
VI. The Atlanta Fed predicts that the U.S. economy grew at the annual rate of 2.7% in Q/4 - down from 2.9% two weeks ago.
VII. The St-Louis Fed predicts that the economy grew at the annual rate 2.7% in Q/4.
VIII. The WSJ December survey predicts that the economy grew at the annual rate of 2.6% in Q/4.
IX. The Cleveland Fed predicts that annual rate of inflation was 1.5% in Q/4.

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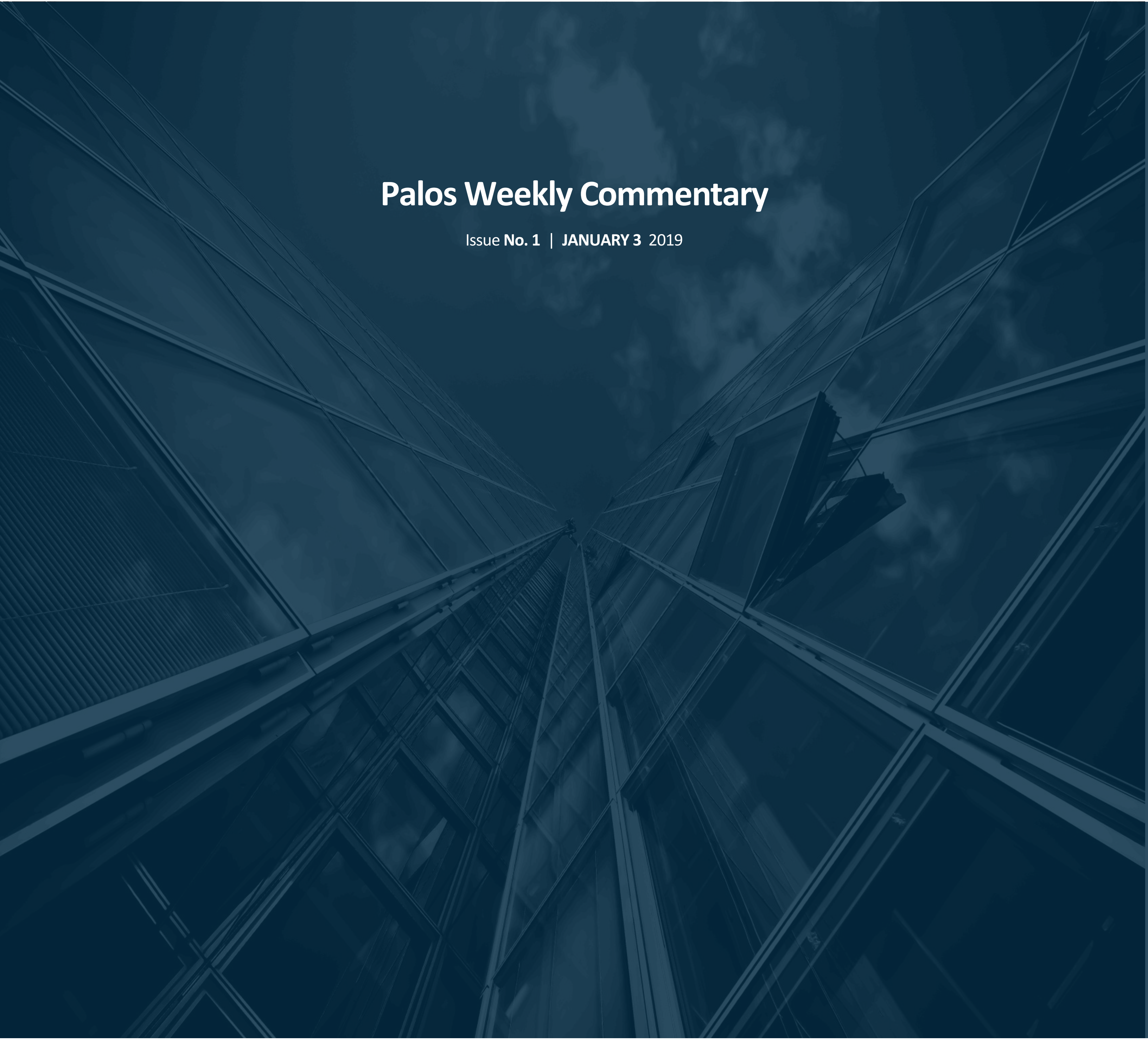
The Global Demand Outlook for Oil:

I. The EIA predicts that global oil demand should rise by 1.52 million barrels per day in 2019.
II. The IEA predicts that global oil demand should rise by 1.40 million barrels per day in 2019.
III. OPEC predicts that global oil demand should rise by 1.29 million barrels per day in 2019.

Disclaimer:



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