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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Weekly Narrative of February 7, 2019

Back to the Drawing Board.

Many investors are of the opinion that the economy is unpredictable, that its evolution is random, and it marches disorderly toward disaster. This pessimistic notion is at odds with economic history. The science of economics helps us to figure out what is likely to happen. Market changes do not strictly arise by chance without rhyme or reason. They are basically caused by movements in the economy that result from human desires like valuation, growth and interest rates.

Last week, I argued that the Fed officially took a dovish turn because hard economic data and sensitive financial conditions warranted it. The monetary authorities signalled four times that normalization was put on hold, underlining that they were worrying more about undershooting than overshooting the inflation target of 2%. Basically, the Chairman Powell restored the famous “Fed Put” that supported the stock market in 1998, 1987 and 2008.

The big question is whether the Fed had other reasons to act as it did. Bad things were happening everywhere, and uncertainty was on everybody’s’ lips--China’s enduring credit crunch, the high level of corporate debt, EM vulnerability to the strong dollar and the Washington trade war-- that could logically put an end to the American economic party. The Fed decided to cave-in to market turmoil and put an end to these concerns by instituting a “new regime” that would reflect what the market wanted. It's not the first time that the Fed has capitulated to a slower global economic outlook and to a universal sentiment of nervousness. It occurred in 2016 in response to weak European and Chinese data. Instead of having four rate hikes, as planned, the Fed came up with only one.

Watching economic data and listening to markets is what central banks are supposed to do, detecting trouble before bad sentiment hurts the broader economy. It now appears that the bond market is doing more than telling us that the Fed has just paused. It’s suggesting that the Fed is at the very early stages of a pivot towards the next easing cycle. A Goldman Sachs (GS) study shows that equities have generally performed well after the Fed stopped hiking rates. Specifically, the median S&P 500 return following the last rate hike of the past four cycles was 7% over three months and 15% over 12 months. That puts the S&P 500 at 3100. If it so happens that you do not want to trust GS, I

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invite investors to monitor closely a set of indicators (Shown Below) that should tell whether the new monetary regime will overcome world-wide deflationary forces from taking hold.

The DXY/ Copper ratio	D/C	Higher is Better
10-year minus 2-year treasury yields	10-2	Wider is Better
The Copper/Gold ratio	C/G	Lower is Better
The S&P 500/Gold ratio	S/G	Lower is Better
The Policy minus the Natural rates	P-N	Lower is Better
Inflation expectations	I.E.	Lower is Better

	D/C	10-2	C/G	S/G	P-N	I.E.	COMMENT
SEP 21 /18	33.18	26	236	2.44	(84)	2.18	Very Bearish
DEC 24 /18	36.31	11	209	1.85	(28)	1.71	Very Bullish
FEB 6 /19	34.23	19	213	2.07	(16)	1.88	Mildly Bullish

Obviously, it is impossible to know if the above fast-moving and real-time data points will work; but it remains that they rationally give evidence that the recession narrative is overblown, and investors should not be confused by the diminishing outlook for growth with a recession. High-frequency Economic models are not pointing in that later direction. As a matter of fact, for as long as the six indicators don't all deteriorate into bearish territory, investors should maybe reconsider the timing of the investment cycle. The sevens Report suggests that 3 indicators should be closely watch—the Chinese money supply, the U.S. dollar index and the shape the U.S. yield curve. One should always be aware of bull market complacency. In this connection, I would remain invested but tilt one's portfolio towards more defensive positions.

Market Facts that Matters: courtesy of Barry Ritholtz and FT.

Albert Capital Bridge came out with study this last week that shows the futility of market timing. It compared a strategy of annually investing $1,000 in the S&P 500 at its low for the year every year from 1985 to 2018 with a strategy of buying its high each year. The good market timer would have done better than the lousy one---$155k versus $122k. However, what is extraordinary is that to achieved $155 the genius would have needed to be 100% right over 33 years--not very likely. Whilst the idiot's 122k was the least he could have done and without effort, capturing 80% of the nest egg.

It makes me wonder if trying to figure the perfect timing is worth the kind of effort needed to invest at the best time each year. It proves that picking long term winners is a better way to outperform than trying to pick market bottoms. Stock pickers are like foxes, they know many things because they read reports, listen to analysts, interview

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managements and attend conferences. There are also market gurus who are hedgehogs who only know a few very big things like where inflation, demography, globalization, and productivity are heading over the long term. Which one would you rather be ?

One final thought for hedgehogs, there is growing evidence that we are on the cusp of a major productivity boom. Productivity has started to show light as it has increased gradually since the end of 2016. The media-neglected productivity of U.S. manufacturing workers uptick again in the final three months of last year. Economists surveyed by the WSJ projected that of all workers rose at a 1.6% annual rate in the fourth quarter. From a year earlier, the economy should show an increased 1.7%. From 2010 to 2016, productivity increased at the average annual rate of only 0.9%. At the end of 2016 productivity broke to the upside. In 2017, it registered an increase of 1.3% and of 1.7% in 2018. Firms' capital investment plans might look moderate; but, it's not. Businesses are spending big on technology to support better worker productivity. Big industrial firms of the S&P 500 index (leaving out the technology firms) invested $460 billion on in the first nine months of 2018–up from $400 in 2017. The Institute of Supply Management (ISM) has an index that rose to 56.6 in January - anything number over 50.0 defines expansion - has shown expansion for 29 consecutive months.

This morning, I ordered my daily coffee while I was walking to the office. When I got at the coffee shop, the coffee was ready to be pick-up and it was hot. I saved 10 minutes of waiting.

The Recession Risk as of February 7, 2019:

1) Moody's Analytics is predicting that there is a 17% chance of a recession in the next six months.
2) The Yield-Curve-Based N.Y. Fed model is currently calculating that there is a 23% chance of recession in the 12 months.
3) Longview Economics' U.S. Recession Indicator is signalling a 22% probability of a recession in the coming quarters. Based on 50 years of history, the Indicator needs to be above 60% to call a recession.
4)

Estimates for Real GDP Growth in Q/4, 2018 as of February 7, 2019

1) The Atlanta Fed's R-GDP estimate is 2.7%
2) Moody's R-GDP estimate is 2.7%
3) The St-Louis Fed's estimate is 2.9%
4) The Cleveland Fed estimate is 2.8%

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The Outlook for U.S. Economic Growth in Q/1 as of February 7, 2019

The NY Fed's first quarter GDP Tracker made an upward adjustment to 2.4% from an estimated 2.2% last month.

The Outlook for Inflation in Q/1 of 2019 as of February 7, 2019:

The Cleveland Fed's Inflation NowCasting Model expects the PCE Deflator to increase at the annual rate 0.9% in Q/1 and the CPI at 0.7%.

The Global Energy Complex:

The WSJ reported that Saudi Arabia and its Persian Gulf allies are backing a formal partnership with a 10-nation group led by Russia to try to manage the global oil market. The purpose of the alliance is to put a floor on oil prices.

Given that the marginal cost of producing oil is about $45 a barrel, $45 could be considered as the intended floor. This alliance could prove to be ultimately beneficial to North American producers.

New Technical Perspectives as of February 7, 2019

1) B Based on the Dow Theory, the trend for the S&P 500 is bearish with key resistance at 2790 and key support at 2582 - on Thursday morning the S&P 500 was 2712
2) Based on a proprietary model, the trend for crude oil is neutral with key resistance at $59.87 and key support at $50.78 - on Thursday morning crude traded around $53.25
3) Based on a proprietary model, the trend for gold recently turned bullish with key resistance at $1359 and key support at $1256 - on Thursday morning gold was selling for $1307
4) Based on a proprietary model, the trend for ten-year treasury yield recently turned neutral with key resistance at 2.78% and key support at 2.55% - on Thursday morning the yield was 2.66%
5) Based on a Palos Currency Model, the trend for the Canadian dollar recently has mildly bearish with resistance at 76.25 us cents and key support at 73.90 us cents - on Thursday morning the Loonie was trading for 75.39 us cents, The Purchasing Power Parity Rate is 77.50 us cents.

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