Patience, Patience

Market Viewpoint: January 31, 2019

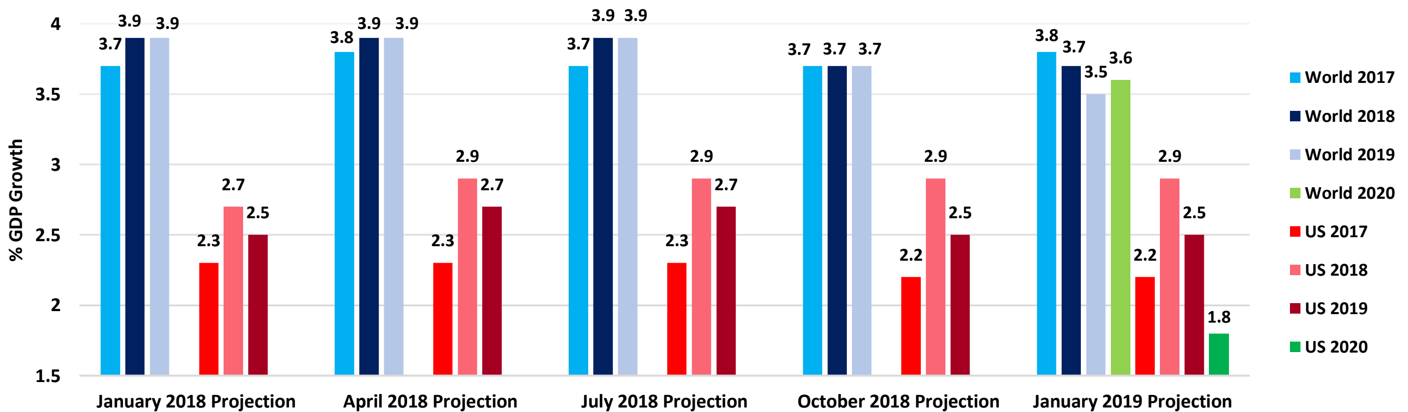
Summary: A month into the new year, things seem a bit more upbeat than they did at the close of 2018 –especially with the Fed adopting a more patient approach to hikes. But recession talk still abound, even with little evidence. In reality, the US economy appears quite robust, touting annual growth near 3% for 2018, and expectations for coming years that will compare well to previous decade. In light of this, the dollar also looks quite strong for now, which could spell trouble for earnings near-term growth. Powell's patient pause should allow for an extension of the recent rally for a while.

In this report we will review what MRP considers to be the primary drivers of the major asset classes in 2019...what is changing, and what is not. In our work, we continue to emphasize that it is change not the status quo which creates alpha opportunities. And the Fed has made a major change in policy.

But first, a look at the **MACRO** environment.

Although the entire globe has entered a period of slowing momentum, we see it as a matter of growth coming off the boil: more like a mild slowdown, as opposed to a broad downturn. The IMF's first World Economic Outlook for 2019, published earlier this month, saw global growth expectations for 2019 and 2020 revised downward by 0.2% and 0.1%, respectively, to annual rates of 3.5% and 3.6%. While such levels would mark the world's weakest output increase in 3 years, the situation is not nearly as gloomy as many in the financial media have painted it. In the words of IMF chief Christine Lagarde at the World Economic Forum: "Does that mean that a global recession is around the corner? No… Yes, there is growth".

It is worth noting that IMF forecasts, like those of all prognostications, are subject to change. The latest prediction of a 0.2% drop in 2019 global GDP growth is essentially equal to the difference between the IMF's original prediction for 2018 growth last January and what they are projecting today.



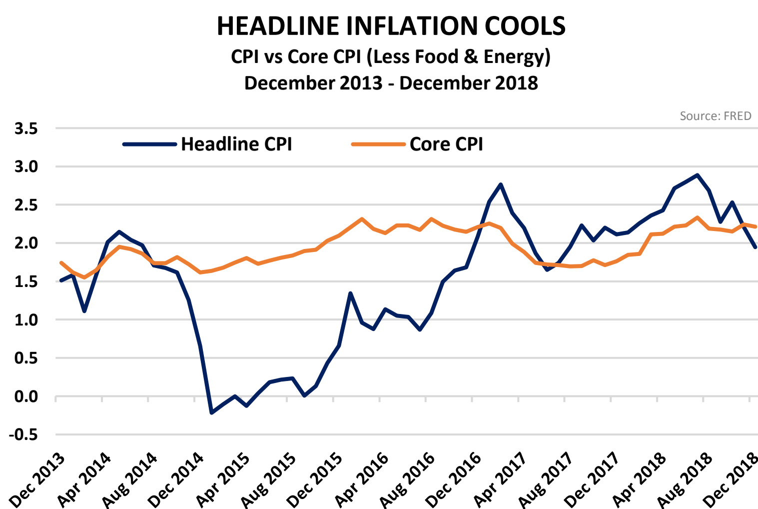
Joseph J. McAlinden, CFA, is the founder of McAlinden Research Partners (MRP) and its parent company, Catalpa Capital Advisors. He has 50 years of investment experience. Mr. McAlinden founded Catalpa Capital in March 2007 after leaving Morgan Stanley Investment Management where he had spent 12 years, serving first as chief investment officer and later as chief global strategist. During his 10 year tenure as chief investment officer, he was responsible for directing MSIM's daily investment activities and oversaw more than $400 billion in assets. As chief global strategist, he developed and articulated the firm's investment policy and outlook. Prior to Morgan Stanley, Mr. McAlinden held positions as chief investment officer at Dillon Read and as President & CEO of Argus Research.

Even in light of the country's trade disputes with China, US growth forecasts remained unchanged in January from October 2018's report, with estimates for this and next year holding steady at 2.5% and 1.8%. In fact, most of the revision for global growth came from declining growth rates for smaller economies in regions like emerging and developing Europe, Latin America and the Caribbean, and Sub-Saharan Africa.

But still, no major nation is projected to fall into negative territory. The world's two largest, the USA and China's, are showing a robust determination to continue their growth going forward, even if at a slightly slower pace.

Even while the estimates show they're still projected to grow well over 6% across the next two years, China has been on the receiving end of much criticism of their progressively slowing economic expansion. Yes, they have fallen significantly below the double-digit growth many became accustomed to seeing in early to mid-2000s China, but those figures have been steadily declining since they peaked in 2007. The fact that the Chinese economy has become the second largest in the world and is still chalking up growth rates at such a pace is a marvel in and of itself that many seem to take for granted.

If there is one big take-away from the IMF's latest projections, it's that while growth is certainly coming off the boil, things aren't really all that bad in the two economies under the most scrutiny.



Headline **INFLATION** has entered a cooling off period, as December's YoY CPI growth slipped to just 1.9%, the lowest level of 2018, and down from July's high of 2.9%. A large part of this was due to energy prices, as this recent disinflation closely tracks the strong decline in crude prices during the final quarter of 2018.

On the other hand, the core CPI (all items less food and energy) has not seen nearly as sharp of a downturn. In fact, Core CPI growth closed out the final month of 2018 at 2.2%, an above-average result for the year, and just a tenth of a percent below the July peak of 2.3%.

So, upon further inspection, the disinflation story in the basic CPI is largely dependent on the price of oil. However, MRP retains our long-held view that the price of WTI crude prices will return to a range of $60 - $80 per barrel.

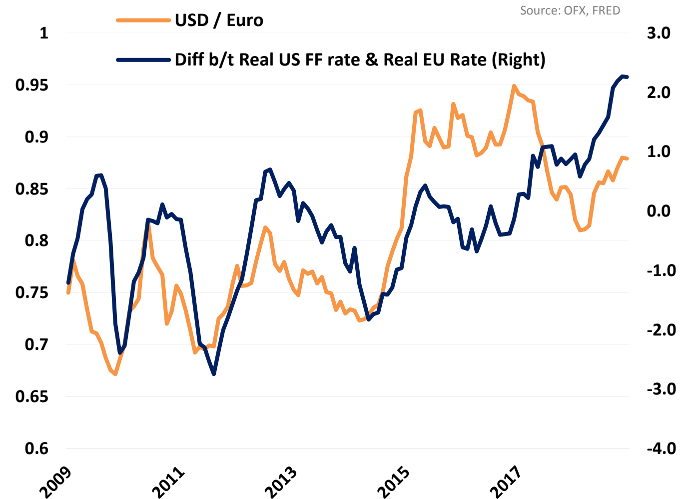
To start the year, **OIL PRICES** have rebounded 28% from their bottom on Christmas day, enjoying their longest streak of consecutive gains in nine years, as well as the largest monthly decline in OPEC inventories in almost 2 years. That second figure is especially significant as it shows OPEC and its allies, headed by Russia, are serious about this year's renewed supply cuts. The OPEC+ alliance aims to bring 1.2 million bpd off the market during the first six months of 2019, and some producers at the forefront of the operation are jump starting the process. Saudi Arabia, for instance, plans on bringing exports 800,000 bpd below November levels, a larger cut than mandated by the OPEC+ treaty.

Additionally, Canada's oil production pullbacks should continue to hamper supply until they can beef up their pipeline infrastructure and Venezuela is expected to see its output continually fall by a third into 2020. Finally, slower US production growth could be in the mix as shale producers struggle to cope with costs at current

prices, and could continue to suffer even when prices rebound, due to a growing shortage of water. Water accounts for 15% of total costs for shale wells and, according to Morgan Stanley, 53% of Permian wells being drilled today are located in areas with high water risk.

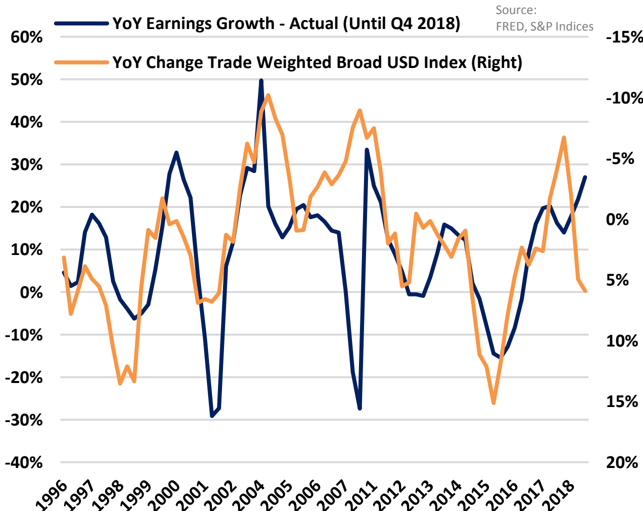
An oil price recovery, which may already be underway, could lead the CPI back toward the sizable increases seen during the second quarter of 2018.

DOLLAR strength has been continuing but may have peaked as consensus moves towards fewer US rate hikes. The latest Fed statements stress patience, giving inflation a chance to reaccelerate. MRP expects the dollar to maintain its recent gains against the Euro through much of early 2019, especially now that ECB rate hikes are likely to be postponed yet again. However, the return of stronger inflation will reverse that trend further along into the year.



We continue to emphasize that the key determinant of short-term FX swings is the difference in real interest rates between countries. Recently, that calculation has been pointing towards a stronger dollar. But as inflation in the US picks up, while the Fed has slowed its rate of increases and fed funds rate, that calculation will be peaking and starting to slip.

The trend of the dollar has had important implications for both stocks and bonds. Last year's surge in U.S. equity prices to all-time highs had been largely due to exceptionally strong reported earnings. Those record gains were partly the result of a strong economy and the bottom-line impact of historic tax cuts being compared with year ago numbers when a tax cut was only a glimmer in Trump's eyes and the economy had not yet begun to accelerate from its long malaise.

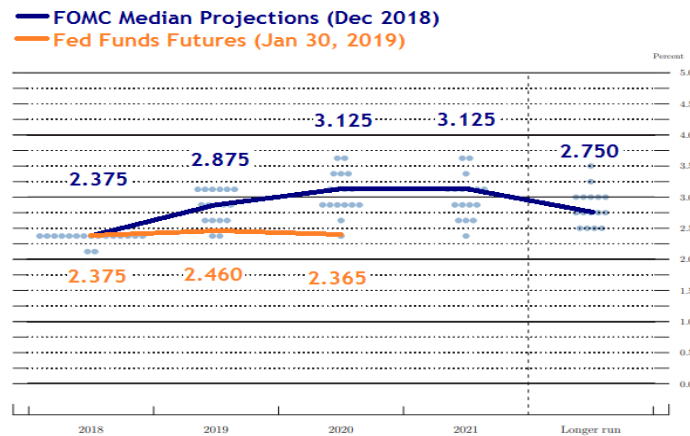


In addition, a previously weak dollar vs the prior year boosted those earnings comparisons as a result of the currency translation effect. Essentially, due to other major currencies' stronger exchange rates with the dollar, US companies that did significant business overseas saw inflated earnings growth when other currencies were translated into dollars. It is estimated that companies in the S&P 500 generated 44% of sales from non-U.S. operations, so the earnings boost from a weak dollar can be substantial, as it was last year.

Now, going forward, comparisons will be more difficult as the base effect has already begun to reflect the stronger dollar. Bank of America Merrill Lynch has estimated that a sustained 10% appreciation in the dollar against the euro would result in a 3-4% reduction in the S&P 500's EPS. So far in 2019's first quarter, the dollar is up over 8%.

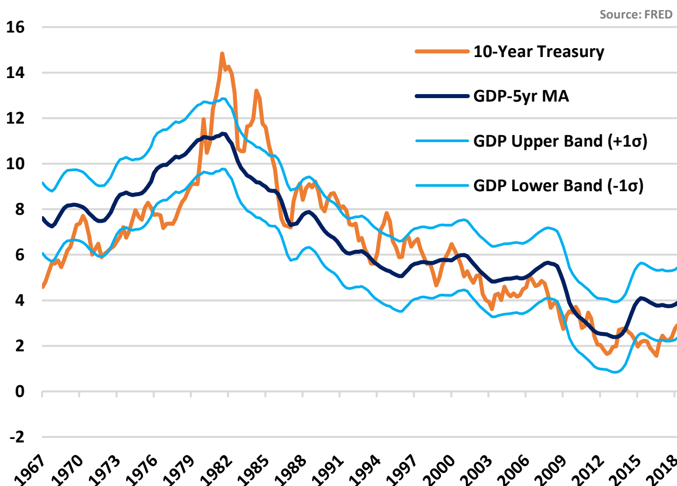
DOTS OUT OF DATE

FOMC December 2018 Dot Plot + CME Futures



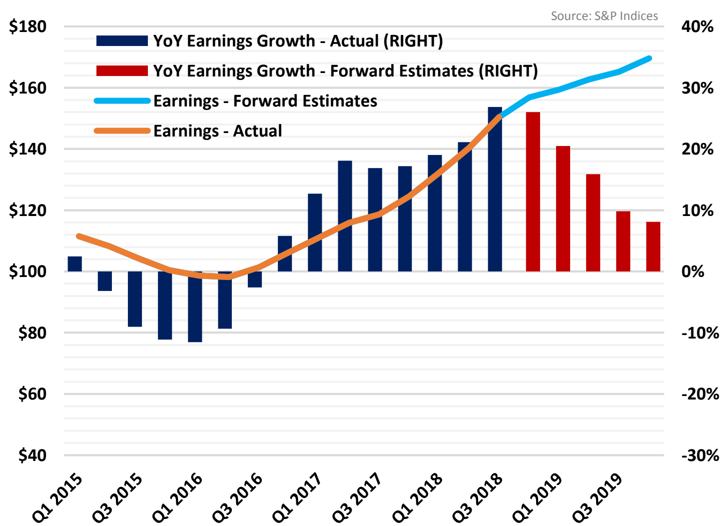
TREASURIES TICKING UP

10yr Treasury vs GDP - 5yr Moving Average
Q1 1967 - Q1 2019



EARNINGS ESTIMATES EASING

S&P 500 Earnings Growth
Q1 2015 - Q4 2019



Only a sudden plunge in the greenback could stop the currency translation effect from deducting several percentage points from the growth rate for the first quarter sales and earnings.

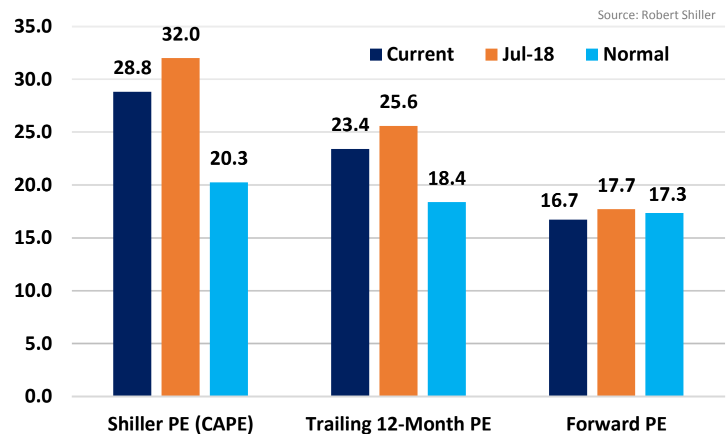
THE FED's recent statements have become much more dovish. It has been characterized by some pundits as Powell having caved to the pressure from Trump. MRP does not see it that way. The Central Bank has always been fairly clear that they would be data dependent as always. And the data has softened for the moment. Moreover, chairman Powell does not set the median expectation for fed funds: Each FOMC member submits a set of projections; the median is determined by the midpoint of the range of those 16 different projections, only 12, though, are actually voters.

In December, the FOMC indicated it is looking for two more rate hikes in 2019, down from three previously. Although the FOMC noted in their January press release that "survey-based measures of longer-term inflation expectations are little changed", they removed references to "gradual increases" in the fed funds rate and opted to instead focus on "maintaining". The futures markets now predict no further increases. The Fed signaling that they now will be "patient" will only reinforce that thinking.

BOND YIELDS are likely to rise in 2019. Nominal GDP growth continues to point to an above 4% handle on the 10-year Treasury. Even if GDP growth this year slips to 2.5% and inflation remains around 2%, nominal growth this year of 4.5% will be tugging up its 5-year moving average to 4.1%, consistent with a 4 handle on the 10-year.

In addition, the long-term average spread between fed funds and 10-year Treasury of 100 basis points would suggest a high-threes 10-year even if the futures markets are correct and there are no further rate hikes. But if the Fed ultimately does move ahead with the two hikes that have been indicated by the FOMC, a handle of 4 on the 10 year would be consistent with the long-term average. In the meantime, a steeper yield curve is likely.

US **<u>EQUITIES</u>** hit a peak early last September, then fell almost 20% in the 4th quarter. So far in 2019, prices have recouped around half of what was lost. While it is tempting to declare that the worst is over, the confluence of fundamental forces do not appear to support that conclusion. The trend of equity prices in the year ahead will be driven, as always, by interest-rate and earnings expectations. Currently, the consensus looks for about an 8% gain in S&P 500 profits which is down dramatically from the 27% for 2018. Meanwhile, not withstanding the Fed's pause on short-term rate hikes, longer-term rates are likely to trend higher as investors see that there's no plunge into recession and the dive in inflation is temporary.



Since our 2018 mid-year review, prices have fallen, and valuations have followed them down, coming closer to their longer-term averages. In fact, the market's current forward PE of 16.7 is now below its normalized long-term average of 17.3, when outliers accounted for, hinting that current prices have fallen at a faster clip than earnings expectations down the line. It is important to remember, however that, some of the worst bear markets have occurred when valuations were fairly normal. Also, when the Fed stopped raising rates in 2006, stocks rose for more than another year. but then plunged in one of history's worst declines.

Powell's patient pause should allow for an extension of the recent rally for a while. Even so, equities in 2019 are facing a lose-lose scenario. If profits come in stronger than currently expected, it will be because the economy picks up more steam; if that happens, the Fed will be less patient and interest rates are likely to rise more than investors anticipate. If profit growth weakens, further interest rate hikes will be unlikely. Either way it's hard to envision the downtrend in stocks abating, at least not until the second half of the year.

Joe Mac

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