The FACTS Changed (For Now)

Market Viewpoint: April 25, 2019

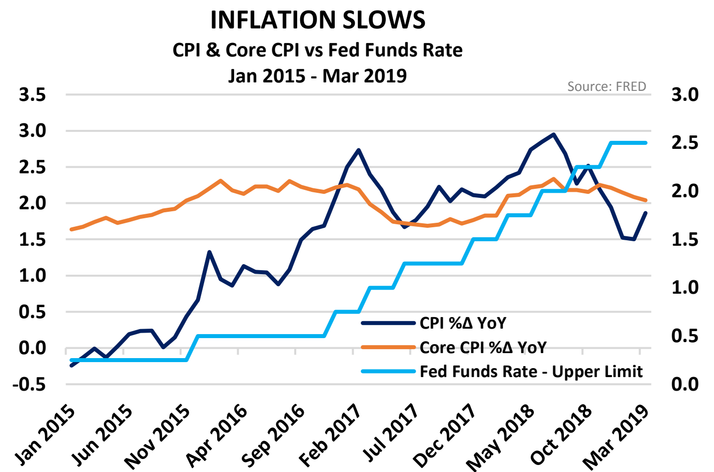
Summary: Between a slowdown in inflation, a sharp decline in treasury yields, and a short-lived bear market, investors have undoubtedly felt a huge swing in momentum; and they're not alone, as the Federal Reserve now seems set in neutral until further notice. While some have had their own theories for why the FOMC voters, chiefly Chairman Jerome Powell, has such a radical and resolute change of heart, the answer may be just as simple as raw data.

"When the facts change, I change my mind. What do you do?" or so the Great, Lord John Maynard Keynes reportedly said over three quarters of a century ago. Some pundits dispute the wording, while others question whether Keynes ever uttered the idea at all. Nonetheless, it is a notable point at this stage in the business and market cycle.

Back in early October 2018, when Fed Chair Powell said we were "a long way" from neutral monetary policy, it seemed inevitable that higher fed funds rates were coming. Inflation looked like it was bouncing back, growth in nonfarm payrolls hit a 2-year high, and the S&P 500 was not far off from its all-time high. To top it all off, GDP was growing at 3.9% in the middle 2 quarters of the year.

By that point, the Fed had raised rates 9 times since they began tightening in 2015, and were preparing for another by the year's end, and the possibility of at least 2 more through 2019. By the time 2019 rolled around, though, the situation had indeed changed dramatically.

Initially, in late November, Powell pulled back a bit, stating that the central bank's policy rate was "just below" neutral. This left room open for the Fed's final planned rate hike of the year, but hinted at a developing dovish tone. Then, just 2 weeks after the FOMC concluded their December meeting where they voted to raise rates, Powell unveiled a full change of heart and described the Fed's stance as "patient", explaining that there was no "preset path" for rates.



The Fed constantly stresses that they are "data-driven", and this is consistent with how Powell has run the show thus far. Crude prices fell off a cliff in the 4th quarter, sending headline inflation spiraling back toward 1.5%. Although employment remained strong and wage growth had been impressive, it simply was not showing up in prices yet. Additionally, the S&P fell about 20%, just touching bearish territory, from its all-time high in September to its trough on Christmas Eve.

Unsurprisingly, such a downturn caused many in the financial media to begin whipping up talk of recession. As MRP described at the time, however, bear markets correctly predict recessions only about half of the time. And given underlying resiliency in manufacturing, consumer spending, and other major data points, a recession appeared

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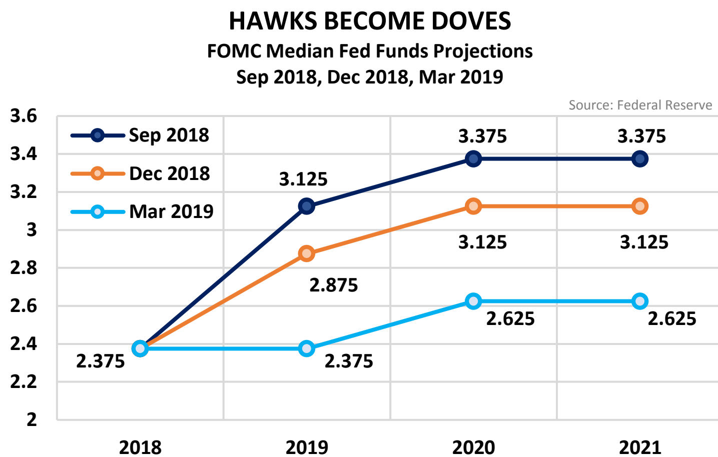
unlikely to us. Now, more and more indicators suggest that the broader macroeconomic picture looks to be relatively on track.

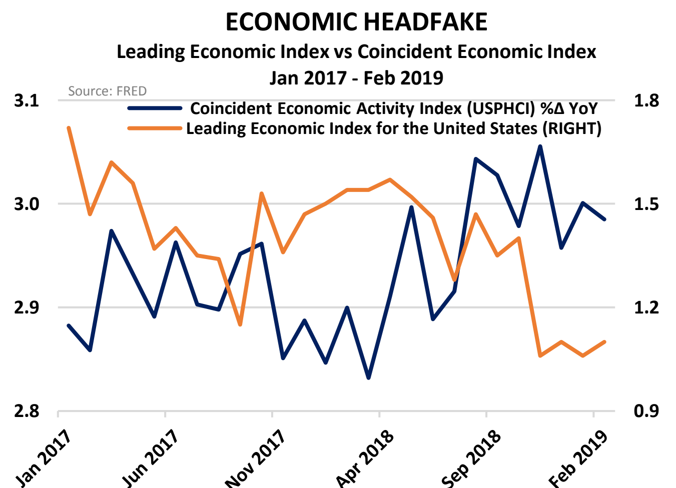
Meanwhile the Fed's dual mandate of maintaining stable price growth and maximum employment does not explicitly mention a responsibility to stabilize equity markets, the deep correction did appear to play some role in Powell's and the rest of the central bank's approach. In February, he updated the Fed's policy stance by stating they will work to "move transparently and predictably in order to minimize needless market disruption and risks to our dual-mandate objectives".



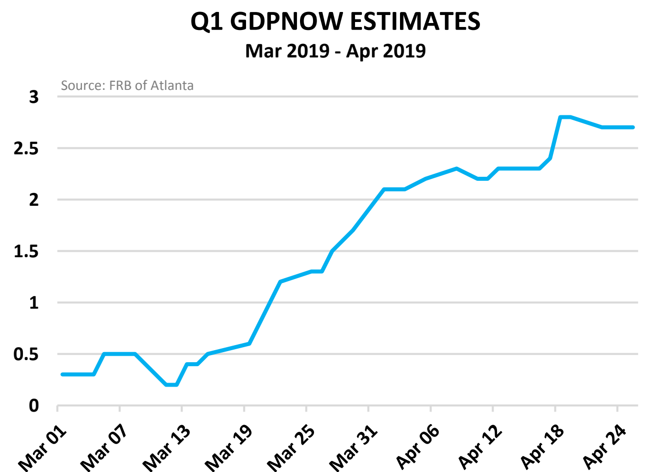
By March, the FOMC's latest dot plot showed no expected change in the fed funds rate at all for the rest of 2019 – a dramatic reversal from the 2 hikes expected only 3 months prior.

Some have taken this and Powell's dovish turn as him bowing to pressure from President Trump, who has openly criticized his former Fed Chair nominee. Trump has lately stepped up his skepticism of ongoing quantitative tightening, now calling for a return to quantitative easing and interest rate declines through his National Economic Council head Larry Kudlow.

But speculation that Powell would give in to Trump is more likely the result of coincidental timing than anything else. Powell has little reason to give into political pressure, as it would undermine his foremost responsibility. Moreover, Trump has no real power to do anything to Powell and they both know it. Powell has reiterated this fact and earlier this month, Trump himself lamented that he is "stuck with" the current Fed Chair. The inflation intermission is still in the driver's seat.



Minutes from the Federal Reserve's March policy meeting described inflation as "muted", with the Fed's preferred inflation measure, the core personal consumption expenditures (PCE) price index, at 1.8%. But officials still expect it to rise to or near their 2% target. Adding to the picture, forward indicators including the leading and coincidental indexes fell sharply in Q4 and remained flat through February, likely also factoring into Powell's change of heart. The FOMC's decision to retain a neutral stance was unanimous.



However, recent data for March and April has offered a brighter picture. Last year ended up being the strongest year for annual growth since 2015, clocking in at at 2.9%, while Q1 GDP estimates from the Atlanta Fed's GDPNow forecast, continually calculated from hard data, have risen sharply from less than 0.5% to 2.7% as the ISM manufacturing gauge reported stronger employment in March, as well as faster

growth in production and new orders, and personal consumption expenditures increased. While tomorrow's advance GDP estimate from the Commerce Dept. will set the tone for the rest of the year, its important to consider that these estimates are subject to a number of updates and revisions in the future. From the initial estimate to the first revision alone, the average absolute change is a little over 0.5%, according to FiveThirtyEight. Employment also remains strong as weekly jobless claims hit a 49 and a half year low this month. Additionally, CPI growth for March bounced back to 1.9% on the back of rising energy prices and U.S. producer prices increased by the most in five months.

Although the IMF has continually been downgrading global output forecasts for 2019 and has now begun revising their expectations for the US as well, a lot of their negativity comes from trade tensions between the US and China, who have now been entrenched in a trade war for nearly a year now. We expect, though, that an end to the conflict is near. If Trump and China manage to come together on a deal, we could see the attitude of the IMF change quickly for the US, China, and as a result, broader emerging markets.

Signs of resilience in Chinese GDP figures, meanwhile, could end up factoring into a turnaround in future IMF projections. Although growth has slowed over the last year, consistent growth over 6% remains the norm. Data for the first quarter shows that the Chinese economy actually surpassed growth expectations, expanding at 6.4%, compared to a Reuters poll of economist estimates at 6.3%, while exports rebounded 14.2% in March YoY. Credit growth also rose more than expected for the month, with aggregate financing at 2.86 trillion yuan ($426 billion), compared with only about 700 billion yuan in February, according to the People's Bank of China. Bloomberg reports that officials are also drafting stimulus measures to bolster sales of cars and electronics.

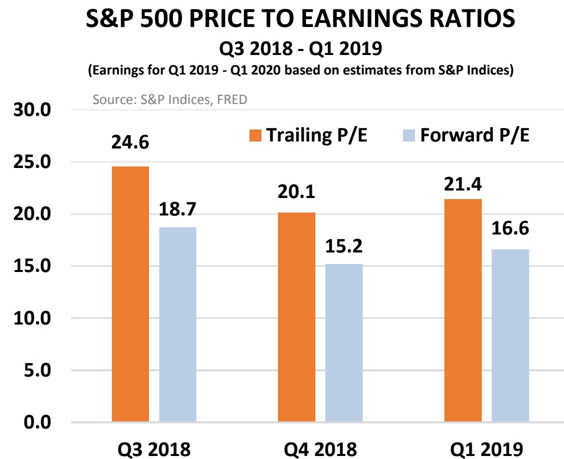
It is still likely, though, that patience will continue, as far as the Fed is concerned. For them to have undertaken such a radical policy shift, it will take a lot to get them back to feeling hawkish again. Suspension of interest rate hikes and talk about the QT have created very favorable environment together with the inflation and growth data that resulted in Powell's shift to patience, and the pause in rate hikes has helped bring ten-year-yields down from a high of 3.2 last year to under 2.4 recently.

The long-term rate decline, together with chatter about suspension of QT, plus the pause in the fed funds hikes have helped boost bond and equity prices back to last year's highs and beyond for the capital markets.

While stock prices have risen, earnings are not expected to climb as fast as they have in years past. In 2018, earnings grew 24% over 2017, but S&P indices projects growth of only 9% this year. The slowdown could even be precipitated by an outright earnings recession, according to Morgan Stanley, who projects profits to decline for the first time since 2016. The investment bank says they're expecting two or more quarters of negative or flat growth, meeting the technical definition of a recession. Although Bank of America Merrill Lynch analysts think we will avoid an earnings recession, they did reduce their S&P earnings forecast for the year to just 4%, down from an earlier forecast of 5%. FactSet expects to first quarter profits to contract 3.3% year-over-year. Notably, according to their survey of 23 companies who've already reported first quarter earnings, the number one source of negative impacts on earnings/revenues, reported by 57% of respondents was unfavorable foreign exchange – an issue MRP had written would weigh on earnings in 2019.

So, with slower earnings growth, but stocks rebounding toward their all-time highs, P/E ratios are also on the rise again. The long-term average of the S&P 500's P/E is about 16.64. But unadjusted averages can be misleading. The numerator (price) and denominator (earnings) can both fluctuate, distorting the historic data for the mean P/E. For instance, the ratio can become skewed upward even in a bad market when earnings may be declining faster than

price; a good example is May 2009 when the S&P's P/E reached a maximum level of 124 in the depths of the Great Recession. The converse of this, a P/E becoming skewed downward by earnings growth outpacing price, also happens.



By identifying and removing the outliers via the interquartile range rule, in this case, the highest 4% of observations as well as an equal portion of the lowest values for balance, we calculate a long-term normalized mean P/E of 17.8 when outliers are accounted for. A return to the long-run average level of the data, also known as a mean reversion, would suggest an eventual 8% decline in the current long-term P/E of 19.1.

Using the same method, the current 12-months trailing P/E of about 21.4 is only slightly elevated against a mean of 21.0 when outliers are accounted for. Meanwhile, the forward P/E, currently 16.6, has actually fallen below its normalized mean of 18.9, indicative of concerns about slowing earnings growth in the future.

Also known as the Shiller PE ratio, the Cyclically Adjusted P/E Ratio (CAPE), which utilizes the average of 10 years of earnings adjusted for inflation, is currently around 31 versus a normalized average of 20.5. The CAPE is, by far, the most heavily elevated measure gauge of price to earnings. Another valuation ratio worth looking at is the total market cap to Gross Domestic Product. A ratio between 75% and 90% is typically considered to represent a fair valued market. As of March, the ratio is currently over 123%.

Price/Earnings When Outliers are Accounted For (as of Q1 2019)

Indicator	Current	Mean Reversion	% Price Change
Long-Term P/E	19.1	17.8	-8.0%
S&P Trailing P/E	21.4	21.0	-1.9%
S&P Forward P/E	16.6	18.9	13.9%
CAPE	31.1	20.5	-34.0%
Total Mkt Cap/GDP (%)	123.7%	75-90%	From -27.2% to -39.4%

(Earnings for Q1 2019 - Q1 2020 Based On Estimates from S&P Indices)

Equity Prices are likely to continue to benefit from the Fed's pause over the next few months; but good news could be bad news before long. By the end of summer, the underlying data looks to us as if it will be more like the middle quarters of last year. Already, growth estimates for the first quarter have surged towards 3%! We also expect inflation to perk up again towards 3% and higher by year end. We don't expect this to be reflected in the short-term due to the base effect created by last year's rapid rise in crude prices, which is dulling the YoY growth figures for the energy price component of the CPI this year.

If the Fed's shift to dovish policy was driven by the data and not by Presidential pressure, it makes sense to ask how will the Fed respond when the data goes back the other way? MRP's expectation would be that they will move back to a more neutral/hawkish policy beginning later this year and continuing into 2020. A more challenging capital markets environment may emerge when the "FACTS" change back the other way.

Joe Mac

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