Market Perspectives

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February Re-Cap

A panoply of investors hope that the Fed's dovish policy guidance could successfully affect a soft landing and PM Theresa May's newest plan would eliminate the risk of a near-term no-deal Brexit. Also, a January spike in Chinese credit would cause growth to inflect and President Trump's direct involvement in China talks would lead to a trade agreement combined to facilitate a continuation of January's positive momentum for risk assets. Global equities gained nearly 3% and extended their post-Christmas streak of sub-2% drawdowns as volatility fell back to early October levels. These positive forward-looking expectations trumped depressed readings for current conditions, with the ongoing deterioration overseas reaching US shores, where data was unexpectedly mixed. With the front-end well anchored, the Treasury curve steepened as Fed guidance for prematurely ending its balance sheet run-off while studying the benefits of letting inflation run above target weighed upon longer maturities. The dollar rebounded from its January weakness on reduced recession risks with strength in the British pound being the outlier. Commodities gained despite the strong dollar on strength in crude and refined products.

The flow of US economic news was sufficiently ambiguous as to support Fed critic views that Chairman Powell's dovish turnaround was an obvious and unwarranted capitulation to the markets as well as those who view the Feds pivot as an appropriate recalibration to weakening data, here and abroad. On the one hand and as discussed last month, the labor market remains exceptionally strong with February non-farm payrolls blowing through expectations and accompanied by an increase in three-month core CPI to 2.7% annualized, a twelve-month high (and monthly annualized inflation of 2.9%). Pending home sales surged 5% on lower mortgage rates, the first gain in seven months and the most since 2010. Consumer confidence evidently rallied with the market as the late-month reading showed present conditions rising to an 18-year high. Finally, Q4 GDP growth of 2.6% overcame the government shutdown and California wildfires in beating the 2.2% consensus as capital outlays spiked 6%, which is double the third quarter rate.

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In response, Fed apologists need turn to only one datapoint, in the form of shockingly weak December retail sales growth of -1.2%, the biggest decline in 19 years. The less volatile "control group" number was even worse at -1.7% versus +1.0% in November. Such weakness in the supposedly strongest part of the economy (the consumer) made weakness elsewhere even more ominous as service orders fell to a 14-month low and industrial production fell 0.9% as auto sales plunged to 18-month lows. The Philadelphia Fed business outlook fell the most since August 2011. While not an actual forecast, the Atlanta Fed's GDPNow estimate has plunged from 2.7% on

January 31 to less than 0.5% today.

If US economic news was mixed with negative retail sales numbers warning of risks to the downside, overseas growth reports remained consistently disappointing which was accompanied by an outlier surge in Chinese credit growth that augured for better things to come. OECD leading economic indicators fell for the eighth straight month to the lowest level since October 2016 while a smoothed version of the series fell for the fifteenth straight month, suggestive of the weakest developed market growth since 2009. After the EU downgraded Eurozone growth from 1.9% to 1.3%, with Italy from 1.2% to 0.2%, Eurozone manufacturing fell into an actual contraction with Germany the weakest due to China exposure which confirmed similar weakness in exports to China from Japan and Korea. The manufacturing sectors weakness was pervasive, with China's falling into recession and the global PMI hitting two-year lows. Potentially more than offsetting these dreary reports was a big upside surprise in China's credit growth. At 4.5T yuan beating even the upside "whisper number" of 3.5T, as well as its composition, with disproportionate growth in the shadow lending sector and evidence that the government's non-bank lending crackdown has been reversed.

Following late January's rate guidance double-downgrade where the Fed moved from guiding additional hikes to being poised to cut rates as needed, without stopping at a "data dependent "pause", the Fed doubled down on dovishness as the month progressed. As if the revised rate guidance was not enough, Fed officials felt compelled to preempt any concerns over any negative effects of quantitative tightening with even the usually hawkish Loretta Mester (President of Cleveland Fed) suggesting that net bond sales will end this year. Still not content, multiple Fed officials came out and "gilded the dove" by resurrecting a longstanding argument that the economy would be better served if the Fed's mandate were reinterpreted as a 2% average inflation over time, whereby sub-2% deviations during downturns would be offset by running over 2% during expansions. In practical terms, the Fed is signaling that a pick-up in inflation will not necessarily be met with immediate rate hikes.

Global equities tacked on an additional 2.8%, with gains led by US shares at 3.5% while emerging market shares were little changed. Within the US market, smaller capitalization, and to a lesser extent growth segments outperformed. Sector performance was interesting as while the higher Beta and more international tech and industrials could have been expected to outperform, so did utilities, despite the higher long-term Treasury yields. Energy shares lagged despite the higher crude prices.

International shares gained 2%, with progress on US/China trade talks particularly impacting China, which gained 14%. In contrast, emerging markets were little changed, restrained by dollar strength and profit-taking in Latin America. Argentina fell 10% in giving back half of January's gains as monthly inflation surprised to the upside, growth fell to a cycle low and a radical leftist won a governor's race. Brazil fell 4.5% on weaker than expected growth amidst the ruling party's struggles in congress. Eastern Europe was mixed as Greece gained 11% on improved market access amidst improving economic news with ten-year borrowing costs falling to 3.7%, far below the 37% peak in 2012. Romania recovered all of January 10% loss after the government indicated that its surprise tax on bank assets would be substantially revised. Russia lost 2% despite higher oil prices as both the US and EU contemplated new sanctions. Outliers includes a 14% gain for the Lusaka market as Zambia benefitted from the copper rally and its first trade surplus in a year; Pakistan fell 5% on a border skirmish with India.

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Treasury yields reflected revised Fed guidance, both the new neutral rate posture and the perceived tolerance for above 2% inflation. While the Treasury index returned -0.3%, performance varied by maturity as the yield curve steepened. Shorter-maturity bonds posted modest gains as markets moved to price-in nearly one rate cut over the next year, while longer maturity issues lost more than 1% as 20-year yields increased from 2.83% to 2.94%. European bond activity suggested that the new Fed guidance gave renewed impetus to "carry-trades" and a reach for yield as core French and German yields were little changed. Spanish yields fell modestly and Portuguese yields declined 15bp. Macro fund flows remained somewhat discriminating in that Greek yields plunged 20bp for the month (and 70bp YTD) as a large long-term bond issue was heavily oversubscribed. In contrast, Italian bonds gave up all of their gains for the year as 2019 growth expectations fell sharply to near-zero levels. The UK was a core European outlier, with yields increasing 8bp as fears over a possible hard-Brexit receded.

Credit market performance was location-driven, with riskier and dollar-denominated issues outperforming investment grade and non-dollar peers. For example, while credit spreads narrowed, AAA-rated bonds returned -0.7% as their longer duration (11 years) made them vulnerable to the yield curve steepening. At the other extreme, US high yield bonds built upon their outsized January gains in returning 1.7%, with CCC-rates issues up 2%, as reduced near-term recession risks and higher energy

prices supported the market. Emerging market debt performance was mixed, as the reach for yield supported a 1% gain for dollar-based issues while local currency bonds gave back some YTD gains in falling 1% on widespread emerging market currency weakness. Municipal bonds continued their streak of outperformance versus Treasuries in gaining 0.5%, with five-year relative yields plunging from 73% to 68% of Treasuries. Both real estate and MLPs were little changed after double-digit January gains.

The 0.6% gain in the dollar-index understates both its broader strength as well as the dispersion over the month, which reflected profit-taking in emerging market currencies and risk-on/carry-trade considerations in the developed world. For example, the safe-haven Japanese Yen plunged 2.3% as the carry-trade participants increased borrowing in their favorite funding currency. Similarly, while traditionally a risk-on beneficiary, the Swedish Krona also fell 2% as weak inflation data dashed rate-hike-hopes for this fundamentally cheap currency. The Australian dollar fell 2.5% despite trade truce optimism, perhaps in response to Chinese import quotas on their coal exports. The dollar gained 1% against emerging market currencies, with the Brazilian Real falling 3% on disappointing politico-economic news and the South African Rand reversing much of its January gains in falling 6% as financial, operational and governance issues with its electric utility company reached a critical stage. While the Swiss Franc, Canadian dollar and Euro were only modestly weaker, the real outlier was the British Pound which gained 1% on Brexit hopes.

Commodities gained 1%-5% depending on the index as differential weights to the top performing energy (and particularly refined products) complex explained the dispersion. While WTI crude oil tacked on an additional 6% gain in taking the YTD move to 26%, the real action was in Brent crude oil, heating oil and gasoline which all gained 8-10%. The escalating Venezuelan crisis and the announcement of a Saudi Arabian production cut supported crude prices while refined products gained as refiners continued their seasonal downtime for maintenance in transition to producing the higher-grade and more expensive summer blends. Base metals were volatile over the month before finishing higher on trade optimism with copper and zinc up 5-6%; iron ore gained an additional 3% in the aftermath of the catastrophic collapse of a mining dam in Brazil. Precious metals fell on the stronger dollar and risk-on sentiment, with gold fractionally lower and silver down 3%. Agriculture had pockets of weakness with both coffee and wheat down 10%.

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March Positioning

US equities have spiked 20% from late December lows despite continued disappointing growth overseas, a shockingly weak US retail sales report and signs that the overseas manufacturing slowdown has hit US shores. That safe-haven Treasury yields are unchanged over this risk-rally period points to the unexpectedly weaker US data (as well as the remarkable pivot in Fed guidance). My macro outlook has become modestly less constructive as while clear evidence of a credit surge in China supports our sanguine view on second-half international growth, first quarter US growth is tracking at well below-trend levels which is something I did not anticipate occurring until 2020. While seeing few near-term recession risks, the combination of significantly less attractive valuation metrics and a less positive outlook mandates a further reduction in risk exposure.

Whether or not this guidance turns out to be accurate remains to be seen, but at least has the benefit of being straightforward and easy to articulate. Our tactical positioning has always been based on an assessment of underlying asset class valuation, with “crystal ball” macro considerations potentially reinforcing or diluting that positioning, but never supplanting it.

By late December, the Q4 equity market decline brought the overvaluation of US stocks down to only moderate levels, with disproportionate declines in lower quality and more economically sensitive segments producing relative bargains. As laid out in some detail at the time, our macro view was that the market had significantly overestimated the odds of a near-term recession. The congruence of some fundamental valuation appeal with a constructive macro outlook triggered meaningful purchases that were contrary to the prevailing sentiment and advice at that time.

While little has changed in my outlook for near-term recession risks, my once contrarian view has rapidly become a consensus one with the continued rally in risk assets, supportive Fed guidance and reassuring economic numbers suggests first quarter growth could well fall to 1.5% and growth should rebound to 2% going forward. While this week’s manufacturing survey was disappointing, the service sector report confirmed that the broader US economy remains strong with both business activity and new orders spiking to 14-year highs. While a lagging indicator, this morning’s ADP private

report confirmed that the labor market continued to tighten, with February net job growth in line despite an upwardly revised 300,000 gain in January which is the most in more than three years. Since downturns in employment tend to lead recessions by roughly 12 months, the question is more one of the path and magnitude of the slowdown than outright recession risks (in line with our December commentary). Additionally, the private sector is running a "surplus" of over 2%; recessions typically occur after that number goes negative, reflective of private sector spending excesses. A look at the Fed-sensitive two-year Treasury confirms the change in market perspective with yields increasing from 2.38% in early January to 2.53% today, with the previous market expectation of a Fed rate cut over the next twelve months erased last week.

If my near-term macro outlook has become consensus, my intermediate-term outlook has also been downgraded. First, December's retail sales numbers were such an outlier relative to wage growth, employment trends and other retail sales indices as to strain credulity. If we can't say with confidence even where we are today (ala China), it is hard to maintain a high level of conviction about the likelihood of maintaining above trend growth into year-end 2019. While others have chosen to dismiss the number completely, in blaming it on poor data collection during the January government shutdown, the implications should the number be accurate are sufficient to reduce my conviction level.

The more significant consideration is that the Fed may have made an understandable mistake in seemingly capitulating to the markets in electing to go "all-in" with the supportive guidance instead of simply stopping at the level of a "data-dependent" pause. Conditions appear very different from a similar pause in late 2015-early 2016 which followed a 50% fall in energy prices, sub 1% growth and double digit negative quarterly earnings growth. To my mind, in bypassing "pause" and moving directly to a neutral stance (with the next move presumably a rate cut), the Fed has kicked the can down the road and successfully reduced 2019 recession risks. In addition, they have seemingly minted a two-headed coin whereby they will "win" if growth disappoints as they will have been seen as being remarkably prescient; if a tightening labor market causes inflation to remain above 2%, they can say that it was all part of their plan to redefine the inflation target as an average to be obtained over time.

While it is true that the Fed and "the market" are finally on the same page in terms of the rate outlook and it is hard to argue its political savvy. The Fed's likely success in reducing 2019 recession risks comes at the cost of the increased likelihood of a recession that comes earlier and is more severe had they not chosen to be so aggressively accommodative today. Given our expectation that international growth stabilizes as a result of the spike in China's credit impulse and better news in the Eurozone as one-off drags roll off (emission-related auto cuts) and a 0.4% of GDP fiscal stimulus kicks in, the international backdrop could be much more benign in the second half of the year at a time of increasing wage pressures from the ever-tighter US labor market. The consequent unexpected rate hikes might be the trigger for a market correction and an earlier recession than I had previously anticipated, perhaps late next year. Should Fed-enabled speculation drive asset prices higher as the QE phenomenon of interest rate levels falling far short of nominal growth rates continues, the impact of a potential market fall on the real economy would be greater.

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If our appraisal had been that US equities were only modestly overvalued in late December, while near-term tail risks have been reduced, it seems plausible that the market is more than 30% overvalued today after a 20% recovery in just two months. For historical context, the market may have been 90% overvalued at the dot.com peak and 20-25% undervalued at post-GFC lows. While valuation considerations alone have never been the basis for successful market calls, some of the internal dynamics suggest volatility to come, particularly for top-performing market segments. While 2019 US estimated earnings growth has fallen from 12% in August to 7% today, perhaps lowering the bar for future earnings beats, the estimates are back-loaded with Q4 estimates likely to be revised downwards. Second, anecdotal suggests that a portion of the recent recovery is more technically than fundamentally driven and consequently more vulnerable to a reversal. For example, the CTA community (trend-followers) has reportedly switched to an extremely bullish equity posture after paying the price for being flat/short in late December and January. In addition, the most shorted tech stocks have continued to outperform the sector, even during this recovery, in gaining 40% nearly twice the sector benchmark. Finally, quantitative researchers at Sanford C. Bernstein reiterated their year-end call that popular growthier and higher quality names are likely to underperform, as their valuation premium relative to unloved value shares has approached 70-year highs.

Finally, the resilience of safe-haven bonds in such a risk-on environment reflects divergent investor views as it is atypical for Treasury yields that plunged on recession fears to not snap back higher on a recovery in risk assets. Furthermore, this phenomenon is somewhat date, location and risk-asset

agnostic. For example, US ten-year yields have fallen from 3.24% in early November to 2.70% today; over that period, both equities and high yield bonds have generated positive returns, with the latter up 1.2%. Comparative returns starting from Christmas lows are perhaps even more striking, with near 20% equity and 7% high yield gains coinciding with modestly lower ten-year Treasury yields. From a global perspective, core bond yields have fallen from 1.9% in early October to 1.55% today; over that same period, risk assets are little changed, with global equities down 1.5% and global high yield bonds up 2.5%. Since late December, global Treasury yields have fallen 5bp despite gains of 6% and 15% for the global high yield and equity sectors.

From a portfolio positioning point of view, US equity exposure should be reduced, particularly amidst the better performing segments. They are vulnerable either to higher interest rates should global growth stabilize or to an unexpected downturn, as there is little valuation support to cushion surprises in either direction, particularly in the better performing segments. I continue to prefer international equities despite their recent gains and deteriorating economic backdrop, as relative valuation remains attractive, their recovery is half that of US shares (11% versus 20%), green-shoots of stabilization are appearing and many currencies remain fundamentally attractive, evidenced by the Euro's 3.5% current account surplus despite weak exports to China and inbound portfolio flows, given the ECB's negative interest rate policy.

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Perhaps lost in the headline talk of recession risks and inverted yield curves is that longer-dated yields really do matter-it is not just the Fed fund rate. While the two-year/ten-year Treasury yield spread has been range-bound near 15bp the past few months, the five-year/thirty-year spread has spiked to 55bp from the unusually low 20-25bp levels we identified last summer. With short term rates anchored for now, my forecasted warmer economic temperatures could result in further curve-steepening, potentially broadening to the ten-year maturities, with implications for both financial markets and the economy.

While less concerned than many over potential risks from a major downturn in homebuilding or housing prices, a potentially steepening yield curve would threaten the recent boomlet in home sales and builder confidence. It is not surprising that the fall in 30-year mortgage rates from 4.8% in November to 4.3% this year triggered a surge of activity, but rates have risen 10bp from those lows and some of the market internals have deteriorated as dispersion has increased. For example, using eight months or more of inventory as a threshold, the weakness at the upper end may be spreading as the number of buyers' markets has increased from 31/100 to 40/100 over the past year. Manhattan home prices have fallen 5% over the past year due to tax reform, affordability issues and the stronger dollar. While respondents saw a plateau in prices more likely than an actual downturn, the Real Estate Roundtable's Sentiment survey fell five points over the quarter to the lowest levels since 2009.

Fed guidance may have temporarily crushed Treasury market volatility, with the MOVE index plunging to all-time (thirty-year lows), but the fixed income world should soon become much more interesting. At the benchmark Treasury level, volatility will either be driven by equity market falls should growth disappoint or from a major Fed rate reversal should US growth remain above-trend. The high yield and municipal bond markets are a comment. While high yield spreads have plunged 140bp since late December, they remain well above September lows. While the spread appears modestly attractive assuming a low near-term recession risks over a short time horizon, the analysis needs to incorporate a forward-looking view of forecast default risk a year from now. Should that risk be closer to 4% than the usual 2% assumption, the high yield market becomes more a bond-pickers market than a beta play.

The sleepy investment grade municipal bond market is my volatility resurrection candidate, as it checks the precondition boxes of complacent investors in an overvalued asset class. Investors have enjoyed their municipal portfolios as municipals have outperformed due to tightening credit spreads and ever-lower relative yields versus Treasuries. Volatility is not far from 10-year lows (and 90% lower than spikes in 2009, 2011 and 2013); yield curve positioning is paramount and populist political considerations cannot be ignored. In building upon what should be increased benchmark Treasury volatility, municipals are vulnerable to a repricing of relative value as five-year AAA municipals yield only 68% of Treasuries versus a long-term average of 89%. The reach for yield has impacted even longer maturities, with ten-year municipals yielding more, at 79% of Treasuries, but still close to an 18-year low. Maturities longer than 15 years offer relative value at 100% of Treasuries, at least before adjusting for the issuer's call option.

Investors may not find the municipal market as benign going forward as short and intermediate maturities are vulnerable to a reversion of their relative valuations, while longer dated holders are the most directly exposed to further Treasury curve steepening. The 2020 election could well result in

meaningfully higher marginal tax rates some individuals; this would support even lower relative yields for municipals, with the longer maturities benefitting disproportionately. If part of a more comprehensive agenda that spooked equity investors, municipals would be further supported by a Treasury rally.

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