Second Quarter 2019 Investment Outlook

Re·dis·tri·bu·tion rēdistrəˈbyo͞oSH(ə)n

"I don't want to be a tone deaf CEO; while the company is doing fine, it is absolutely obvious that a big chunk of [people] have been left behind."

– Jamie Dimon – CEO - J.P. Morgan

"Capitalism is the ideology of capital – the most important thing is the concentration of capital and to seek and maximize profit…so to me capitalism is irredeemable. "

– Rep. Alexandria Ocasio-Cortez

"The consequence of that is we have to think about competitive markets." [We're] protecting competitive markets by breaking these [tech] giants up. But it also means the urgency of new approaches and new laws and new restrictions around data, data privacy [and] data sales."

– Senator Elizabeth Warren

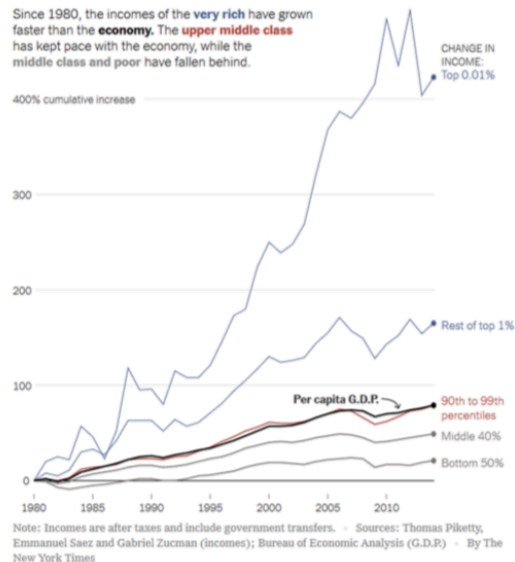
"The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries." "

– Winston Churchill

We live in the Age of Idiots, political correctness being the manifestation of the current age. Wide-eyed greenhorns with various social media platforms available to say whatever and achieve instant publicity while others with substantially more wisdom and life experience remain silent for fear of public backlash. College campuses, once bastions of independent thinking and open public debate, are increasingly intolerant of opposing viewpoints. The Age of Idiots has produced some newbies in the political arena who had no meaningful careers before running for public office, which was a more lucrative option than their prospects in the private sector. Boy, are we lucky to have their fresh perspective.

In the last Presidential election cycle, Bernie Sanders made it cool to be a socialist although how many socialists do you know who own three houses? Capitalism has a plenty of faults but it is the greatest economic model in the history of the world. As Winston Churchill said in 1947, capitalism is the worst economic model in the world, except for all the others. Ever wonder why Ms. Ocasio-Cortez hasn't booked a sympathy tour in Venezuela yet? Because she doesn't want to get paid in bananas, wants to be able to shower on a daily basis, needs electricity to charge her cellphone, and prefers not getting murdered too. The thing about socialism is it all sounds pretty cool and fair and then in about 10 years time under that economic model everything falls apart, and in extreme cases, into anarchy. The French have been quasi-socialists for a long time yet France consistently has the most social upheaval in the developed world, as evidenced most recently by the Yellow Vest movement, which espouses wealth redistribution as its main goal. Venezuela is the current poster child for what happens under extreme socialism. Maduro is a banana republic thug like Chavez was before him. The reality is that thousands of his citizens are dying under the socialist system and its economy is in ruins. But hey, everyone is now equal in Venezuela, equally miserable (here, here, Winston).

There is no denying that the gap between the Haves and the Have Nots has become untenable here in the U.S. Many in the Top 1% like Jamie Dimon know it. Another Top 1%er, Ray Dalio, CEO of hedge fund Bridgewater Associates, went on 60 Minutes recently to say that if President he would declare the current income gap as a national emergency. The next chart shows how extended the income spread between the very affluent and the other 99% of Americans has become since 1980. The chart probably looked very similar in the century leading up to the French Revolution when guillotines needed constant maintenance.



Source: New York Times

Socialists believe the income gap is the complete fault of capitalism and in reality it is more the fault of bad government policies and globalism in general. Capitalism works just fine and creates greater opportunities for everyone, even if it creates outsized wealth for the few. Oh sure, capitalism has its ugly moments, like the Great Depression, Enron, Bernie Madoff, and the Pinto, but what system is completely perfect? Should anyone despise Bill Gates for developing Microsoft Windows and turning the personal computer into one of the greatest productivity tools in history and becoming a mega billionaire because of it? He is giving away over 90% of his $100 billion of wealth to global social causes and with wife Melinda created the Giving Pledge to encourage other highly affluent to do the same. Warren Buffet took the pledge and will give away his $84 billion fortune when he passes on. If you are a frequent user of Facebook, you shouldn’t be dissing Mark Zuckerberg because he’s a billionaire (now worth $45 billion and eventually giving 99% of it away to charity). If you are an Amazon Prime customer and love free shipping and getting your stuff within two days of ordering it, don’t get salty about Jeff Bezos (c’mon Jeff, make the pledge!) and his $146 billion of wealth or his soon to be ex- wife who will get 25% of it (will she make the pledge? Enquiring minds want to know!).

Government is always slow to respond and often makes poor reactionary policies as a result. For example, requiring businesses to pay a $15/hour minimum (living?) wage including to high school students (college costs are outrageous!) is not going to increase incomes in aggregate for those the minimum wage policy is designed to “help”. In fact, higher minimum wage laws incentivize businesses to invest in technology to eliminate more minimum wage positions (ever seen one of those robot hamburger flippers?), decreasing employment opportunities for those the policy is supposed to help. If you are a patron of Panera (or many quick serve restaurants) and use their in-store ordering screens or

online ordering technology, you should understand that technology is specifically designed to eliminate the minimum wage worker taking your order verbally at the counter. There goes one $15/hour minimum wage job. In addition, the rest of those remaining minimum wage workers are working harder due to one less body on the staff during their shift.

Is there an investment point to this political rant? Yes! This new rise of socialism in the Age of Idiots may have future repercussions for investors. Major technology firms like Amazon, Facebook, and Google are in the crosshairs of this new socialist agenda. These technology companies have contributed a disproportionate amount to strong U.S. stock returns and jobs growth over the past decade and have been a shining star in our capitalist economy. What do you think will happen now that Elizabeth Warren and others like her have become proponents of breaking up these tech giants and introducing more legislation to control their domains? The answer will become clearer over time. Investors will assign a lower valuation multiple to all of them, creating headwinds to returns for U.S. stocks in the years ahead.

During the past decade of artificially low interest rates, companies have loaded up on cheap debt to use it to repurchase their shares, boosting earnings and creating greater returns for shareholders instead of investing more of that capital back into the business in order to produce greater opportunities for both shareholders AND company employees. It is government tax policy that allows companies to deduct the interest expense on debt regardless of its use and leaving less corporate income to tax. The Federal Reserve is a government created entity in charge of making interest rate decisions. Like a poker player, businesses simply react to the cards being dealt. Want to change the behavior or outcomes? Change the policy.

The Federal Reserve has contributed greatly to this widening income gap too because the main beneficiaries of the Fed's low interest rate policies post the Global Financial Crisis have been owners of financial assets, predominately the Top 1%. In addition, other government policies like Obamacare and healthcare cost inflation have pinched the budgets of the other 99% and real wages have not kept up with these rising costs, which means lower standards of living for those at the bottom of the income strata. Given the untenable income gap that now exists, some wealth redistribution may be better for society as a whole but don't kid yourself into thinking that it won't have a negative impact on your investment returns going forward. Lower profit margins means lower stock valuations. In capitalism, there is no such thing as a free lunch. However, paying more for your lunch in the Capitalist Café is much better than the "food" offered in the Socialist Swill Café, where the daily special tastes like cardboard because it is and where bread and water are the main fare on the menu.

That Didn't Last Long

The fourth quarter of 2018 was a dreadful one for investors with double-digit stock declines across the globe leading to negative returns for most balanced portfolios for the full year. Anxiety was high coming into 2019. However, in early January the Fed made a major pivot in its monetary policy position and that was the main catalyst for stocks to put on a massive recovery rally during the first quarter. The Powell Pivot, as it is now called, occurred when Chairman Jay Powell spoke publicly at the American Economic Association confab in early January. On the same dais with Powell were the previous two Fed Chairs, Janet Yellen and Ben Bernanke, obviously there to provide moral support and credibility to the remarks Powell was about to make. Paraphrasing his comments, Powell indicated the Fed was ending its interest rate increase bias until further notice. It was just two weeks earlier on December 19th at the press conference following the Fed's December meeting where Powell said it was full steam ahead with its current policy and despite a notable slowdown in both U.S. and global growth. Financial markets reacted negatively to his comments, as U.S. stocks declined 3% in the two hours of trading after his press

conference started. The January comments were an abrupt about face and completely unexpected by global investors. The Fed was clearly scared straight by the message that was delivered by financial markets in the form of plummeting stock prices and was forced to back off of its policy position.

There is nothing that helps to juice risk assets quite like accommodative central banks. Stocks soared, lead by U.S. small caps, although there wasn't a complete recovery of the prior quarter's losses. Despite the large global stock market rally in the first quarter, the net effect of returns for stocks over the past six months has been mostly negative, with the exception of emerging markets stocks. Bonds and cash have been the clear winners.

	4Q18	**1Q19**	**Last 6 Months**
S&P 500 Index	-13.5%	+13.6%	-1.7%
Russell 2000 Index	-20.2%	+14.6%	-8.5%
MSCI EAFE Index	-12.5%	+10.0%	-3.8%
MSCI Emerging Markets Index	-7.5%	+9.9%	+1.7%
BofAML High Yield Bond	-4.6%	+7.3%	+2.4%
Bloomberg Barclays Aggregate Bond	+1.6%	+2.9%	+4.5%
Bloomberg Barclays Short Term Treasury	+0.6%	+0.7%	+1.2%

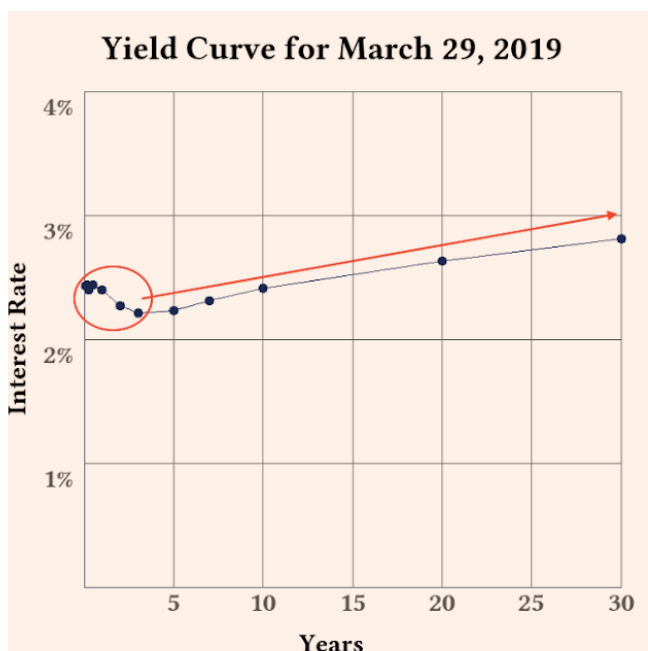
There is one tiny problem with this latest outsized rally in stocks over the past three months. Bonds are not buying it. When stocks crashed in the fourth quarter of 2018, bonds rallied as shown in the table above by +1.6% return of the Bloomberg Barclays Aggregate Bond Index. So, when stocks put on a massive rally in the first quarter, bonds should have reversed course and sold off again, right? No, that didn't happen. Bonds continued to rally and yields declined even further as shown in the next chart. From its early November 2018 high of 3.24%, the 10-year Treasury bond yield plummeted all the down to 2.41% by 3/31/19.

It's not normal that bond yields fall whether stocks are +/-13% as they were doing over the past two quarters. Either stock investors are wrong or bond investors are wrong but they're both not right. Bond yields typically decline when investors believe economic growth and inflation will be weaker looking forward. Stock prices typically increase when then forward outlook for economic growth and corporate

earnings improve. During the first quarter, the strong recovery rally in the stock market was more about the Fed's abrupt policy pivot towards an accommodative stance as opposed to rising earnings expectations and improving fundamentals. Either stocks will decline to reflect the weaker outlook reflected in lower bond yields or bond yields are going to rise to reflect the fact that the growth and inflationary outlook is just in a temporary soft patch rather than an outright recession.

No Need To Stretch

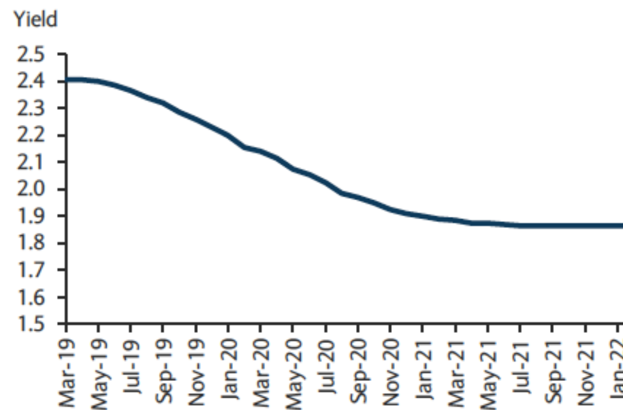
A yield curve inversion occurs when shorter maturity bonds have higher yields than longer maturity bonds. It's a key focus (fear) of investors because in the past when the yield curve inverted it has been a decent predictor of a pending recession. The 3-month Treasury bill yield was 2.43% as of 3/31/19 compared to the 2.41% yield for a 10-year U.S. Treasury bond. The following chart of the U.S. Treasury yield curve shows that Treasury bond maturities from 1 year out to 10 years had lower yields than the 3-month Treasury bill yield. Effectively, there is no reason to hold a 1-10 year U.S. Treasury bond if an investor can get an equal or higher yield in a shorter maturity U.S. Treasury bill with significantly less interest rate risk associated with it. As shown in chart below, even Treasury bond maturities of 20-30 years yielded less than 3% at the end of March.



Source: The Daily Yield Curve

A risk to holding cash or cash-like investments is if the Fed decides to cut short-term interest rates because the economic outlook deteriorates further, which will cause money market yields to eventually head lower. The Fed Funds Futures market, which provides a forward view on where investors expect the Fed Funds rate (the rate the Fed uses to manage interest rate policy) to be in the future, has officially turned to a rate cut outlook. As shown in the next chart, the Fed Funds futures market expects the Fed Funds to go from the current 2.4% level (far left) to 1.9% by late 2020. This means there is a 0.50% rate cut expectation currently in the market. This chart would have looked much different in early January before the Fed capitulated and moved to the sidelines on more rate increases. The Fed's own forecast (the famous Dot Plots) now shows only one rate hike out through 2020 and we know from the March

FOMC meeting that none of them will occur during 2019. So, the Fed still has some level of rate hike expectations still in their forward outlook while the market presently expects 0.50% of rate cuts going forward.

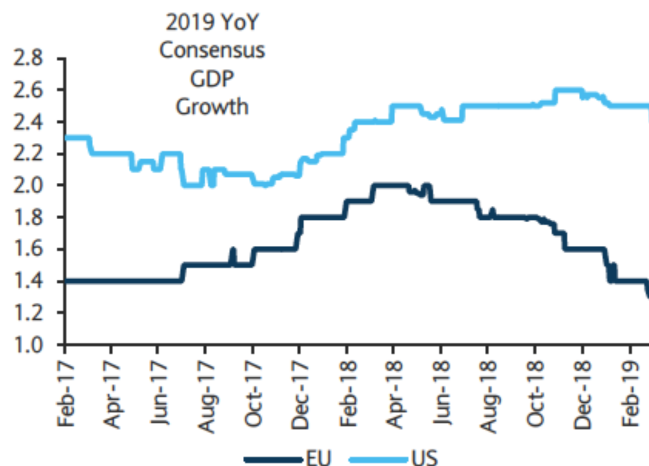


Source: Bloomberg

The message from the bond market is the economic outlook has deteriorated and the Fed is now likely to cut rates 0.5% over the next 12-18 month window, a much different message the stock market was sending in the first quarter rally, even though global growth and earnings forecasts are declining.

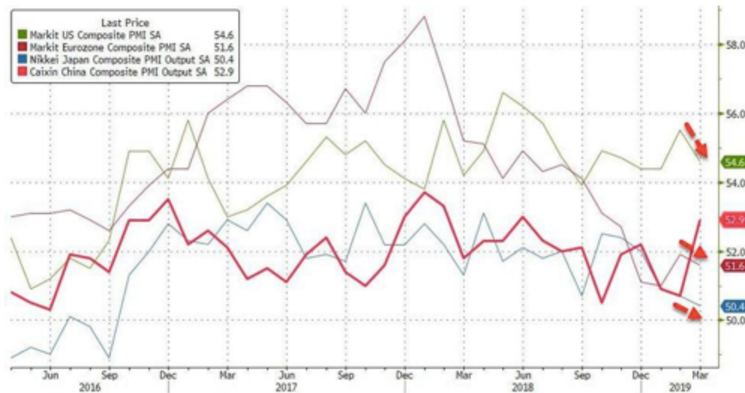
Global Growth?

The first quarter of 2019 marked a notable deceleration in global growth but most especially for Europe, which decelerated much faster than the U.S. as shown the next chart. Europe has more export exposure to Asia, especially China, and China's slowdown is reflected in the weaker European GDP forecasts. The Brexit situation is also creating more of an overhang on European economies as well.



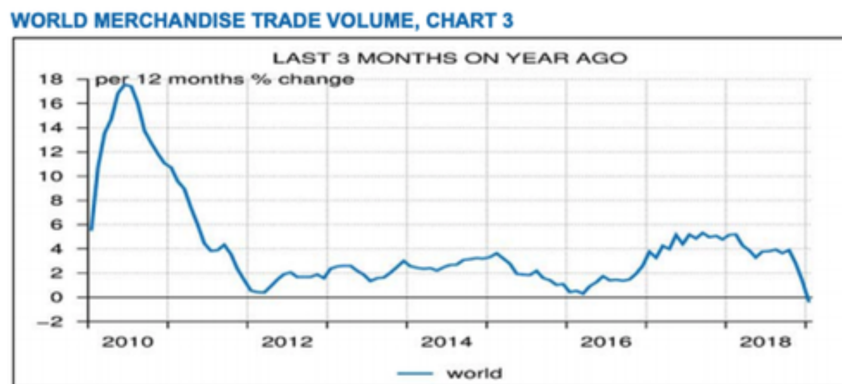
Source: Bloomberg

The Purchasing Managers Index (PMI) measures manufacturing activity. The PMIs for the world's four major economic regions are shown in the next chart and reflect slowing global growth trends since early 2018.



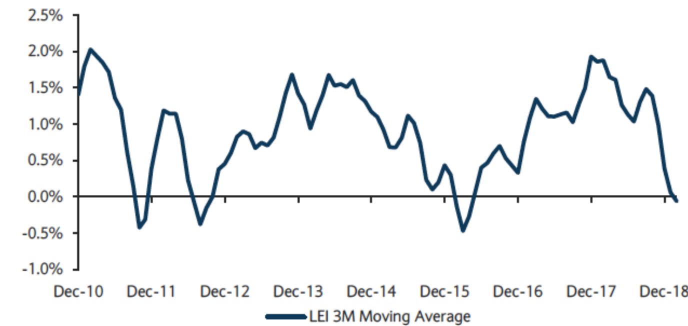
Source: IHS Markit

The next chart shows how global trade also peaked in early 2018 and has since fallen quite a bit as trade wars have escalated and global growth has been negatively impacted as a result.



Source: Netherlands Bureau for Economic Policy Analysis

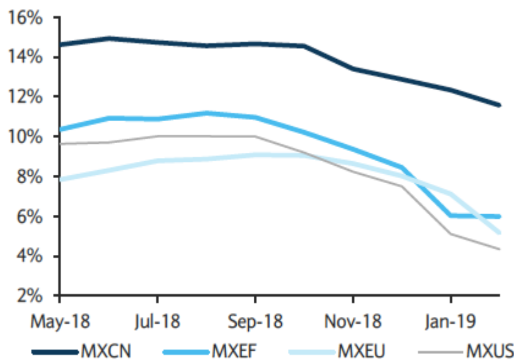
Even though the PMI for the U.S. is holding up better than other economic regions, the U.S. is not immune to the rest of the world slowdown as shown by the rollover of the U.S. Leading Economic Indicators Index in the next chart. Consistent with the global trade data, the LEI peaked in early 2018.

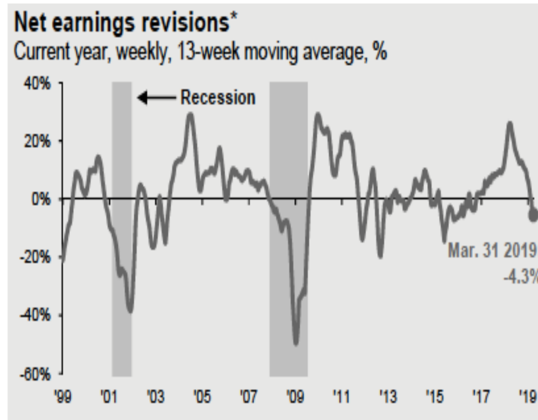


The net effect of all of this slowing global economic data is that the IMF in January cut its 2019 forecast of global growth from 3.7% to 3.5% and cut it again in early April from 3.5% to 3.3%. It was the IMF's third cut in the past six months and 3.3% is the lowest annual global economic growth forecast of the past decade.

Earnings Decouple from Stock Prices

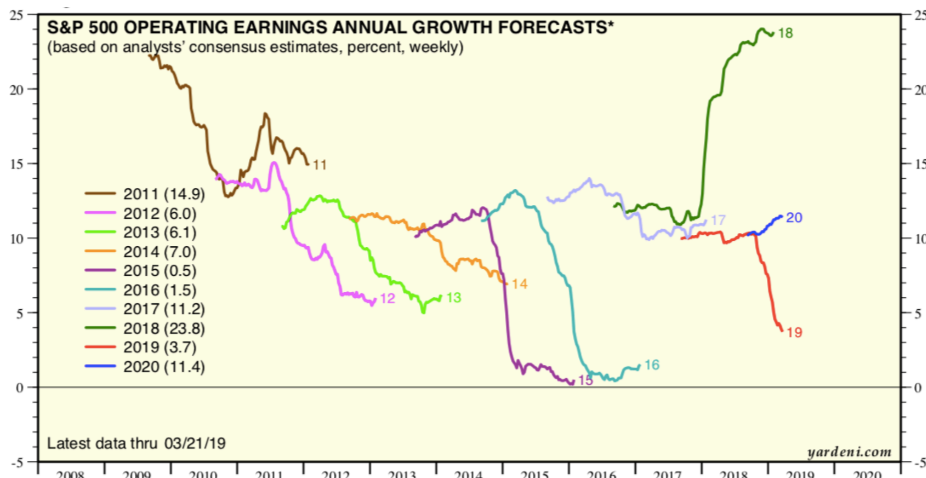
The forward earnings outlook globally has also taken a notable turn lower since the summer of 2018. As global economies slow, corporate earnings expectations are getting reset lower across every major region of the world as shown in the left chart below. Taking the U.S. as just one example, back in May 2018, 2019 earnings growth expectations were just under 10% and nine months later they have been cut to just under 4% growth (vs. 2018). The latest 13-week moving average earnings revisions trend is shown in the right chart below. If we are only in a temporary soft patch, then recent earnings cuts may already reflect that type of outcome. However, if we are really headed for a true recession, 2019 and 2020 earnings forecasts have more downside risk. As of today, 2020 earnings growth expectations for the S&P 500 Index are currently at +11.4% (vs. 2019). Clearly, a low double-digit earnings growth rate expectation does not assume a recession outlook and may even be too optimistic if we are just in a temporary soft patch. The stock market will have headwinds if the 2020 earnings outlook starts to get cut as well.



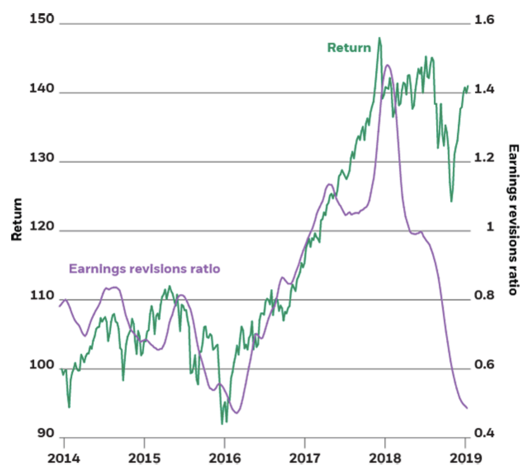


Source: JPMAM, Factset, IBES

Notice in the next chart below how much 2019 earnings have been cut while 2020 earnings still reflect a positive 11.4% growth outlook. The big gap higher in 2018 earnings was in large part due to the reduction in corporate tax rates in the Tax Cuts and Jobs Act bill passed in late 2017.



In the long run, stock prices and earnings revisions trends normally have a tight correlation. The next chart below shows this relationship back to 2014. However, notice how these two have diverged in a big way from each other since early 2018. The major reversal higher in the green price return line at the start of 2019 was all about the Fed capitulating on their policy position and effectively going to the sidelines on further rate hikes. The stock market reacted quite favorably, with a strong recovery rally, even as the earnings outlook deteriorated.



Deal or No Deal?

With the Fed's abrupt policy pivot now reflected in stock prices, and with the earnings outlook having deteriorated, the stock market needs some positive catalysts to maintain its first quarter gains. The biggest potential catalyst remains a U.S./China trade deal being consummated. The stock market has already priced in some degree of success, thanks to consistently positive news spins by the Trump negotiating team, but it's not a done deal yet. Only if a deal is consummated and the details are analyzed

will it become more apparent if the deal will be a positive catalyst for global economic growth. As discussed in our 2019 Investment Outlook, it cannot be understated how important Chinese economic growth is to world economic growth. The trade war introduced a large degree of uncertainty and upheaval and the deceleration in global PMI data since early 2018 show the negative impact. If we are only in a temporary soft patch brought on by the uncertainty caused by the global trade wars, then a U.S./China trade deal has the prospect of restarting global growth and reversing recent weakening economic trends. If a deal falls apart then the prospects for a true recession rise even more and stock markets around the world will sell-off as a result.

Summary

The two major questions facing investors at this moment are as follows: 1) are we in just another temporary economic soft patch that occurred periodically and for several quarters over the past decade or 2) is the U.S. economy heading into an actual recession after experiencing the second longest economic expansion on record (albeit the weakest one). Equities seem to saying it's the former while bonds seem to be saying it's looking more like the latter. Bonds are acting one way through declining yields while stocks are acting another way via rising stock prices. Both can't be right. A U.S./ China trade deal that gets completed in the near future has the potential to be a positive catalyst for risk assets and will remove a large overhang and help the global growth outlook to improve. Five months into negotiations, a deal has so far proved elusive. Both parties are fully aware of the high stakes but it remains to be seen if a deal will get done. In addition, a new U.S./Mexico/Canada (replacing NAFTA) trade deal has not yet passed Congress and Trump is now setting his sights on Europe as well.

As 2019 unfolds and we move into 2020, the political landscape will start to take center stage in front of the November 2020 election. Socialist leaning politicians will have more public platforms to push for more drastic change in government policies and regulations to address the wide income disparity that exists between the Haves and Have Nots. Redistribution policies that strike a better balance may be better for society but depending on what form they take may not necessarily be good for stocks. An increasing number of high profile Haves recognize the current income disparity is untenable and if not addressed could lead to more severe social conflict but just remember that income redistribution policies come at a price because nothing in capitalism is free. The price could be higher corporate and personal tax rates or more government regulations on business, especially the large tech companies that have been the engine of economic growth and jobs in the U.S. and a primary catalyst for the U.S. stock market gains over the past decade. More socialism and less capitalism means lower stock market valuations and lower returns for investors.

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