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Quantitative & Strategy

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June 20, 2017

FOUR STEPS, WHERE'S THE STUMBLE?

Highlights

Wall Street traders know about the adage, "Three steps and a stumble", which states that the stock market tends to suffer substantial setbacks once the Fed takes three tightening steps in a row. Now that the Fed has raised rates four consecutive times, where's the stumble?

Despite our recent report which suggested that the odds of a hawkish rate hike were high (see *The 2018 Changes to the Fed That No One Is Talking About*), our social media feed was full of misgivings that the Fed is in the process of making a serious policy error like the 1937 rate hike cycle, where the central bank tightened the economy into a recession. Another policy error that occurred in more recent memory is the Jean-Claude Trichet led European Central Bank's policy of tightening into the Great Financial Crisis.

Similar kinds of concerns are rising today. There are preliminary signs of a weakening economy, and the Fed's willingness to stay the course on its rate normalization policy in the face of soft inflation statistics is raising anxiety levels.

While we believe that recession risks in 2018 are rising, our base-case scenario still calls for one last blow-off top in stock prices before the equity party comes to a close. Current concerns about the Fed tightening into a weakening economy can be summarized by this chart of the Citigroup U.S. Economic Surprise Index (ESI), which measures whether macro releases are beating or missing expectations. As the chart below shows, ESI has been weak, and the 10-year yield has declined in sympathy. But ESI is already at very low levels. How much worse can the macro picture get before it rebounds?

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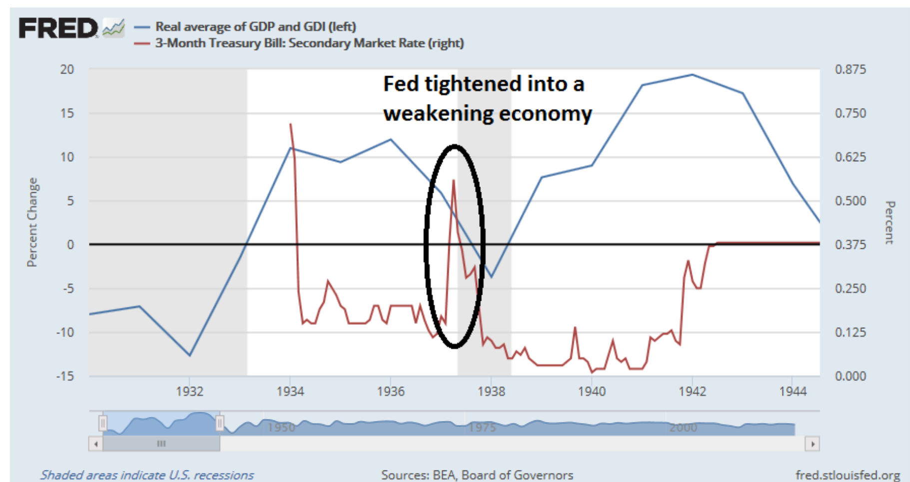
Exhibit 1: The Dreaded 1937 Federal Reserve Policy Error



Source: FRED, Federal Reserve Bank of St. Louis

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Exhibit 2: The ECB Tightened into the Great Financial Crisis

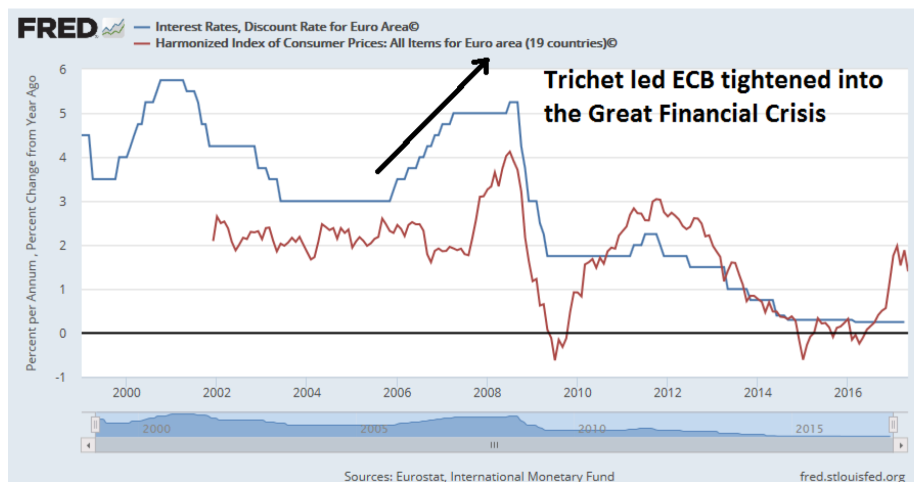

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Exhibit 3: Citigroup U.S. Economic Surprise Index and 10-year Treasury Note

Source: Datastream

A Weakening Economy?

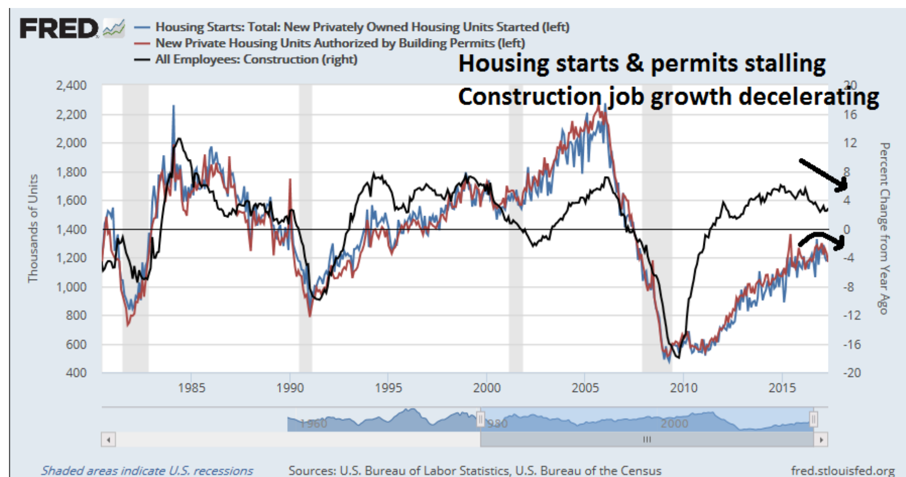
Evidence of a slowing economy is piling up. Markit wrote that "Weak PMI confirmed by official data", as illustrated by this comparison of Markit PMI and manufacturing output.

Exhibit 4: PMI Signaled Manufacturing Weakness

Source: IHS Markit, Datastream

Friday's release of housing starts (blue line) and housing permits (red line) was another month of weakness in housing, which is a highly cyclical sector that is part of my suite of long leading indicators. Nascent weakness in this sector is confirmed by the deceleration in construction job growth, which remains positive on a year-over-year basis. If housing activity does roll over, the likelihood of a recession next year rises significantly.

Exhibit 5: Housing and Construction May Be Stalling



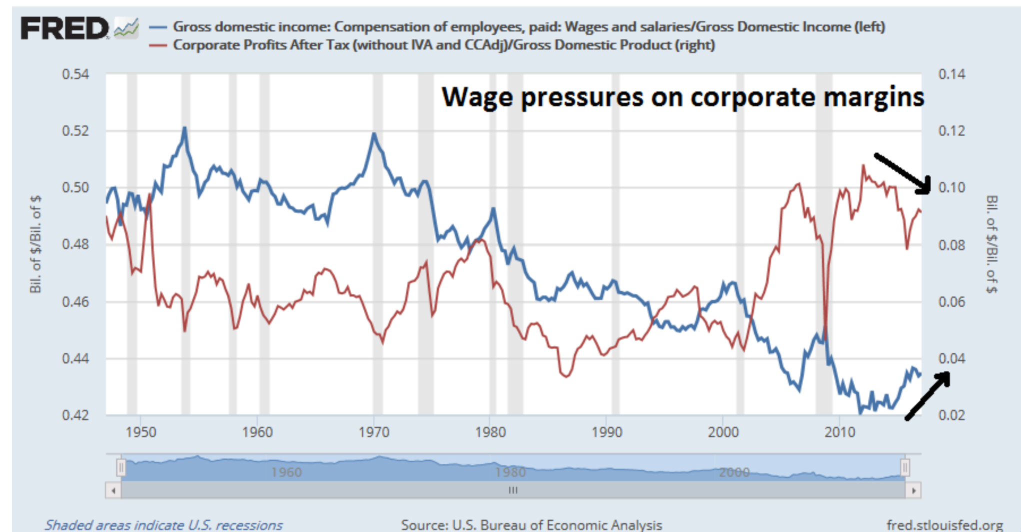
Source: FRED, Federal Reserve Bank of St. Louis

Edward Harrison at Credit Writedowns Pro recently sounded a warning about the commercial real estate market:

> *Commercial real estate is near its pre-recession peak in terms of value as a percentage of GDP. And that level will soon be broken given the huge slug of projects now in the works.*
>
> *This is an interest-sensitive business because a lot of it is done using leverage in order to multiply profits. And this makes commercial real estate vulnerable to the Fed's present rate hike cycle.*
>
> *Bottom Line: Commercial real estate is a sector that continues to do well and power the US economy forward. But there are signs of overbuilding in the absolute number of units coming online right now, particularly in residential property. This makes the commercial property market vulnerable, and we should pay attention to signs of weakness in the sector.*

As well, corporate profits (red line), another key long leading indicator, may have peaked this cycle. As well, a 4.3% unemployment rate is likely to lead to greater wage pressures (blue line), which will further depress corporate margins.

Exhibit 6: Labour and Capital's Share of the Economy Are Starting to Converge



Source: FRED, Federal Reserve Bank of St. Louis

Risks are also rising on both the monetary and fiscal policy fronts. In the past, we had pointed out the risks of a significantly more hawkish Fed as Trump appointees join the Board of Governors. At the same time, Trump Administration officials are still climbing a steep learning curve. Business Insider reported that Treasury Secretary Steve Mnuchin seemed to be preparing the country for a government shutdown as legislation to raise the debt ceiling could be in jeopardy:

> *During a hearing before the Senate Budget Committee, Mnuchin was asked by Democratic Sen. Tim Kaine about a May 2 tweet from President Donald Trump that suggested the federal government needs a "good shutdown."*
>
> *"It's an unfortunate outcome. At times there could be a good shutdown, at times there may not be a good shutdown." Mnuchin said. "There could be reasons at various times why that is the right outcome."*

Office of Management and Budget director Mick Mulvaney echoed Mnuchin's warning back in May.

> *"What we just did this week was fine and passable but not ideal," Mulvaney told CBS' Fact the Nation on May 7. "The appropriations, the spending process, Congress using the power of the purse has been broken here in Washington for more than 10 years. And I think a good shutdown would be one that could help fix that. It's part of that overall drain-the-swamp mentality about Washington, DC."*

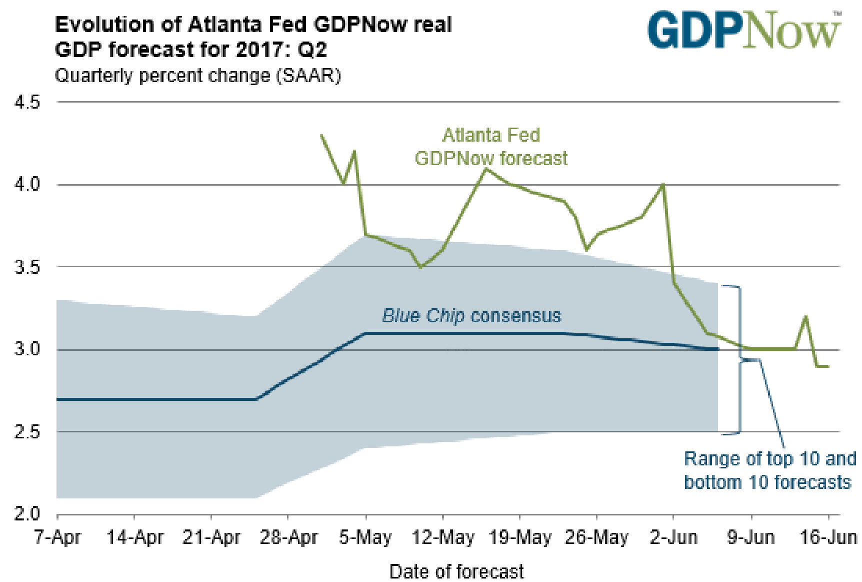
Mishaps such as a government shutdown is something that this market doesn't need. (As another example of Trump officials' steep learning curve, the Washington Examiner reported that OMB director Mick Mulvaney looked through the ADP jobs report for government job data as he didn't realize that ADP only covered private sector employment).

Storm clouds are beginning to gather on the horizon. The risks to this expansion are rising, but there is no need to panic just yet.

Slowdown Fears Are Premature

Market fears about the Fed tightening into a slowing economy are premature. The near-term outlook for the economy and market remains bright. The Atlanta Fed's GDPNow nowcast of Q2 GDP currently stands at 2.9%, which is roughly in line with Street expectations.

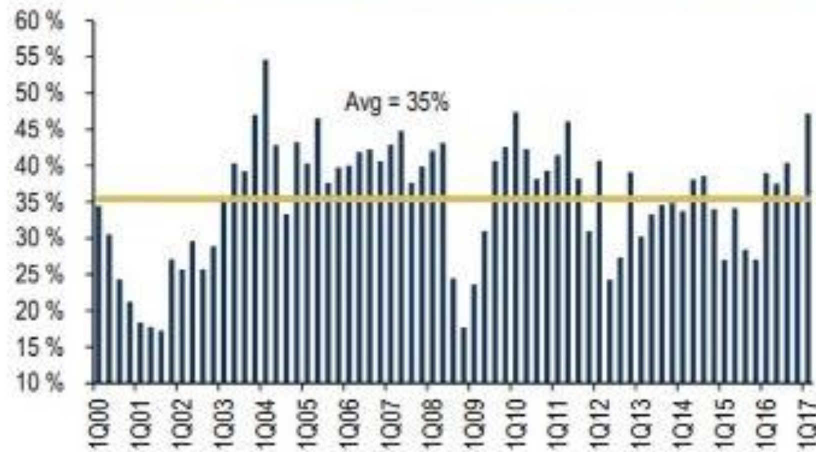
Exhibit 7: Atlanta Fed`s Q2 GDPNow



Source: Federal Reserve Bank of Atlanta

At the same time, the Q1 earnings season came in ahead of expectations. As the following chart from BAML shows, the percentage of companies that showed both sales and earnings beats were at the top end of historical experience.

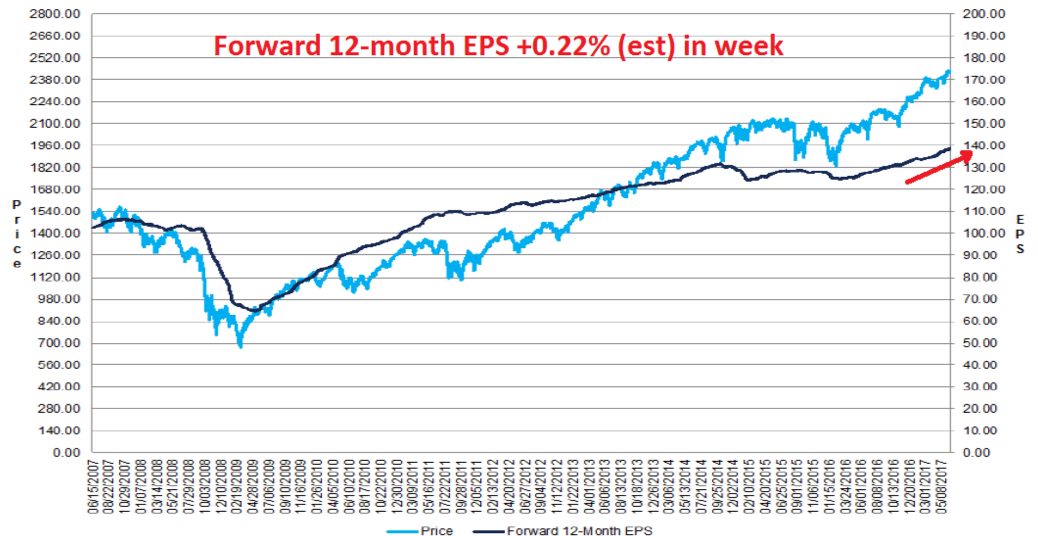
Exhibit 8: Q1/17 Earning Season Has Been Strong



Source: FactSet, BAML Equity & US Quant Strategy

The latest update from [FactSet] shows that forward 12-month EPS continues to rise, indicating Wall Street optimism about the growth outlook.

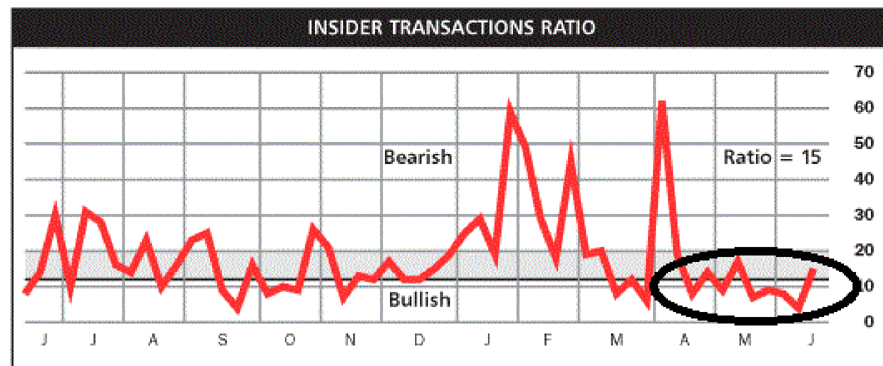
Exhibit 9: Forward 12-Month EPS Revisions Are Rising



Source: FactSet

As well, the latest update from Barron's shows that the insider activity has retreated from several weeks of buy signals to a hold signal. Readings for this indicator tend to be noisy from week to week, but the current pattern is constructive for stock prices.

Exhibit 10: Insider Activity Constructive for Equities



Source: Barron's

In short, the nowcast and near-term outlook for equities are still rosy. While storm clouds may be forming on the horizon, those concerns are unlikely to materialize until later this year. New Deal democrat's weekly assessment of the economic outlook concluded this way:

> *While the present remains positive, as does the near term forecast, there were two significant negative events for the longer term forecast this week. The first was the Fed raising rates, which caused the yield curve to flatten some more. It is just barely positive now (as opposed to neutral). The second was the poor housing starts and permits report, which was just bad enough to turn housing, on net, negative. As a result the longer term forecast is now just slightly above neutral.*

The outlook for 2018 is decelerating from positive to neutral. Add in the possibility of a more hawkish Fed, and the likelihood of a recession in 2018 rises significantly.

Timing the Market Top

Conor Sen, writing in Bloomberg View, recently postulated the following sequence for the current late cycle expansion: full employment, followed by an oil spike, and then a Fed-induced recession.

We concur with that assessment, but amend the oil spike to a spike in commodity prices as crude oil has been dragged down by idiosyncratic supply factors. As well, the scenario outlined by Sen also conforms to the market cycle framework of technical analysis, where market leadership begins a bull move with interest-sensitive stocks early in a cycle, then rotates through to consumer spending sensitive stocks, capital goods sectors as capacity utilization becomes pressured, and ends with the inflation-hedge commodity producing sector.

Already we are starting to see life in the capital goods industrial stocks, indicating a possible revival in the global reflation trade. As the chart below shows, industrial stocks have staged a breakout out of a trading range relative to the market. The bottom panel shows that the global nature of the move. European industrial stocks have already been in a relative uptrend

compared to Dow Jones Europe for all of this year. If the relative breakout in U.S. industrial stocks holds, expect the reflation theme to revive, a recovery in the Economic Surprise Index, and the yield curve to start steepening again.

Exhibit 11: Capital Goods Industrial Stocks Are Showing Signs of Life

Source: Stockcharts

By contrast, late-stage cyclical stocks, such as gold, energy and mining need more time to base relative to the market. Golds and mining stocks are starting to bottom and consolidate on a relative basis, though energy stocks (middle panel) remain in a relative downtrend.

Exhibit 12: Late Cycle Inflation Hedge Sectors Need More Time

Source: Stockcharts

If our hypothesis is correct, the U.S. equity market will see a second wind after a shallow June swoon. A surge in inflation hedge groups and the TSX Composite would be the signal that the market is in the late stages of a blow-off top.

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