Cam Hui, CFA
cam@pennockideahub.com

URSUS INTERRUPTUS

January 14, 2019

Table of Contents

Ursus Interruptus 2
What Is the Market Discounting? 2
Bullish Breadth Thrusts 6
Negative Fundamental Momentum Risk.. 9
China Risk... 11
Political Risk... 13
Credit Market Stress............................. 14
Investment Implications 18

EXECUTIVE SUMMARY

A number of readers were surprised by our recent change of view (see *A Rare "What's The Credit Card Limit" Buy Signal*). We had been adopting a cautious tone since August (see *A Major Market Top Ahead*).

The September–December decline had been highly ambiguous. I believed that unless I could pinpoint the reasoning behind the risk-off episode, it was impossible to call a market bottom. However, U.S. equity prices had already fallen about 20% on a peak-to-trough basis, and the historical evidence indicates that such a decline is already discounting a mild recession. How much worse can it get?

In addition, technical signals such as the Zweig Breadth Thrust, indicate that psychology is washed-out and turning around. The statistical odds favour high prices over a one-year timeframe.

We had mainly focused on the risk conditions in the past, while ignoring valuation. Today, the combination of favourable valuation and positive momentum has changed my outlook. Based on these conditions, we would expect stock prices to grind upward for the remainder of 2019, but in a volatile manner.

A balanced fund that was at target weight in its asset allocation would be underweight equities today. We suggest that accounts raise their equity risk profile by re-balancing back to target weight. Should the stock market weaken and re-test the old December lows, it would be a signal to take a risk-on position and overweight equities.

From a technical perspective, the breadth thrusts were signals of the initial bottom is in, but to expect further volatility in the next few months. Don't be surprised if the stock prices were to weaken again to test or undercut the December lows in a double or multiple bottom. Looking out 6-12 months, history tells us that returns should be positive.

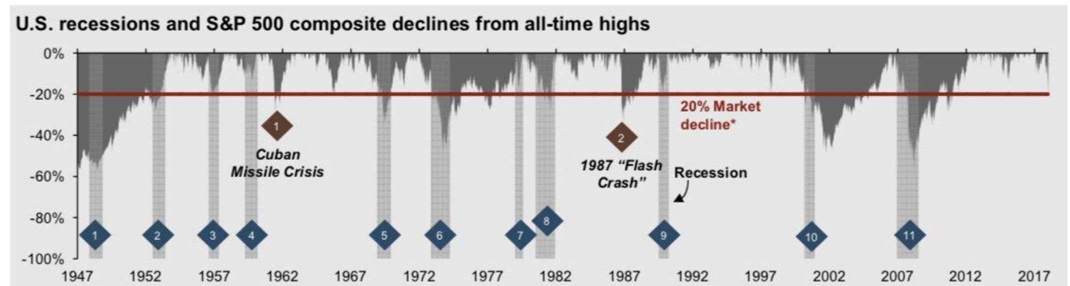
Confidential — Do not duplicate or distribute without written permission from Pennock Idea Hub

Ursus Interruptus

A number of readers were surprised by our change of recent change of view (see *A Rare "What's The Credit Card Limit" Buy Signal*). We had been adopting a cautious tone since August (see *A Major Market Top Ahead*).

The September–December decline had been highly ambiguous. I believed that unless I could pinpoint the reasoning behind the risk-off episode, it was impossible to call a market bottom. However, U.S. equity prices had already fallen about 20% on a peak-to-trough basis, and the historical evidence indicates that such a decline is already discounting a mild recession. How much worse can it get?

Exhibit 1: Recessions and Drawdowns



Characteristics of recessions and related stock market declines

Recession	Recession: Peak Quarter	Recession: Trough Quarter	Recession: % Decline	Related Market Sell-off: Peak Date	Related Market Sell-off: Trough Date	Related Market Sell-off: % Decline	Macro Environment: Commodity Spike	Macro Environment: Aggressive Fed	Macro Environment: Extreme Valuations
1 Recession of 1949	4Q48	4Q49	-1.5%	6/15/1948	6/13/1949	-21%			◆
2 Recession of 1953	2Q53	2Q54	-2.4%	1/5/1953	9/14/1953	-15%			
3 Recession of 1958	3Q57	2Q58	-3.0%	8/2/1956	10/22/1957	-22%			◆
4 Recession of 1960-61	2Q60	1Q61	-0.1%	8/3/1959	10/25/1960	-14%			◆
5 Recession of 1969-70	4Q69	4Q70	-0.2%	11/29/1968	5/26/1970	-36%		◆	
6 Recession of 1973-75	4Q73	1Q75	-3.1%	1/11/1973	10/3/1974	-48%	◆		
7 Recession of 1980	1Q80	3Q80	-2.2%	2/13/1980	3/27/1980	-17%	◆	◆	
8 Recession of 1981-82	3Q81	4Q82	-2.5%	11/28/1980	8/12/1982	-27%		◆	
9 Early 1990s recession	3Q90	1Q91	-1.4%	7/16/1990	10/11/1990	-20%	◆	◆	
10 Early 2000s recession	1Q01	4Q01	-0.4%	3/24/2000	10/9/2002	-49%	◆		◆
11 Great Recession	4Q07	2Q09	-4.0%	10/9/2007	3/9/2009	-57%	◆	◆	
Non-recession Bear Markets									
1 1962 flash crash, Cuban Missile Crisis	-	-	-	12/12/1961	6/26/1962	-28%			◆
2 1987 flash crash, program trading, overheating markets	-	-	-	8/25/1987	12/4/1987	-34%			◆
Average	-	-	-1.9%	-	-	-30%			

Source: FactSet. NBER. Robert Shiller. Standard & Poor's. J.P. Morgan Asset Management.

Source: JP Morgan Asset Management

In addition, technical signals such as the Zweig Breadth Thrust, indicate that psychology is washed-out and turning around. The statistical odds favor high prices over a one-year time frame.

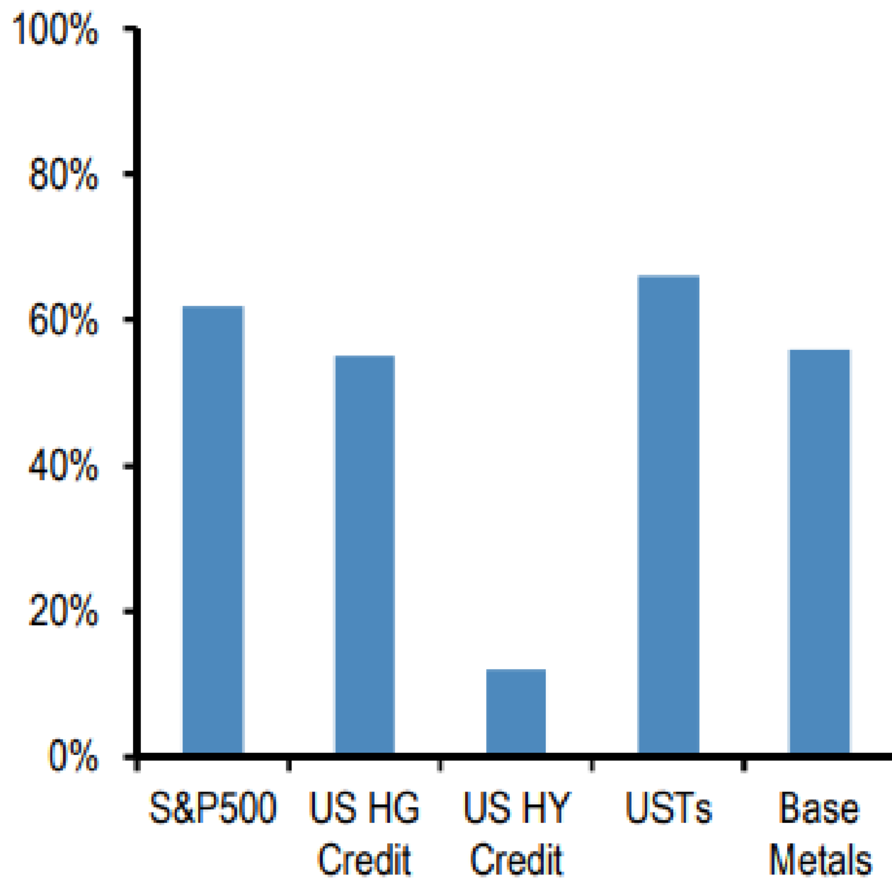
That said, we stand by our assertion of a choppy market for the next few months. Even though the odds are in the bulls favour, key risks remain unresolved and they are likely to weigh on the market in the near term.

- Negative fundamental momentum, in the form of downward earnings revisions and a decelerating macro outlook;
- China and the trade war;
- Trump's likely confrontation with the Democrats may lead to a political risk premium; and
- Credit markets remain unsettled, and monetary policy could put downward pressure on stock prices.

What Is the Market Discounting?

FT Alphaville reported that Nikolaos Panigirtzoglou at J.P. Morgan Securities calculated the recession probabilities embedded in different asset classes, and most asset classes were already pricing in recession odds of over 50%.

Exhibit 2: Recession Probability Across Asset Classes



Source: JP Morgan

More importantly, earnings are already discounting a mild recession:

As some recessions are shallower than others, Panigirtzoglou breaks down the historical data even further: deep versus mild. A deep recession is one in which the S&P 500 earnings fell by more than the median amount of bygone recessions — typically this occurs when the S&P 500 drops 33 per cent. A mild one is the reverse and an average slide of 18 per cent. Given this, Panigirtzoglou calculates that if a recession comes, the chances of it being a mild one sit at 88 per cent.

With respect to earnings, a mild recession is already priced in. In the 11 recessions since 1948, S&P 500 earnings have fallen an average 18 per cent from their peak. Given that prices average 26 per cent, Panigirtzoglou reckons that earnings account for 70 per cent of the decline in equity prices during recessions. Therefore, with the 16 per cent slide in U.S. equities since their peak, markets are already pricing in an 11 per cent decline in earnings — two percentage points more than what normally happens during a mild recession.

The price action of the U.S. equity market is pricing in a 16/18=88% chance of a mild recession or a 16/33=48% chance of a deep recession.

Exhibit 3: 88% Chance of a Mild Recession, 48% Chance of a Deep Recession

Figure 2: US equities during past 11 recessions

We separate recessions into DEEP and MILD based on the whether S&P earnings fell by more or less than the median amount over the past 11 US recessions

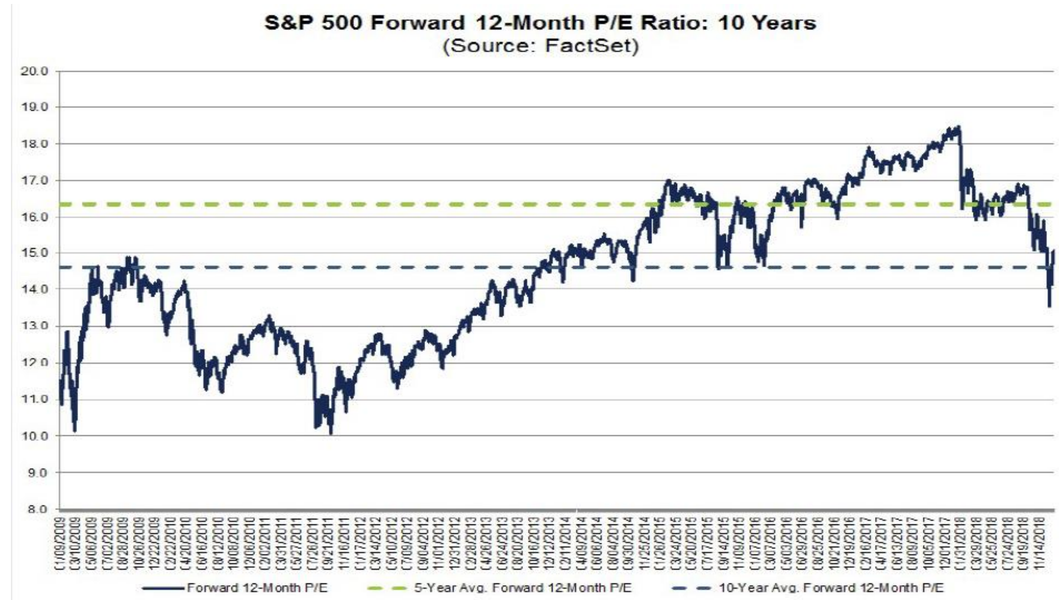
S&P500 peak	S&P500 trough	S&P500 price decline peak-to-trough	S&P500 EPS decline peak-to-trough	Earnings decline
Jun-48	Jun-49	-17%	-3%	Mild
Jan-53	Sep-53	-11%	-12%	Mild
Jul-56	Dec-57	-17%	-22%	Deep
Jan-60	Oct-60	-13%	-12%	Mild
Dec-68	Jul-70	-34%	-13%	Mild
Jan-73	Dec-74	-46%	-15%	Deep
Feb-80	Apr-80	-15%	-5%	Mild
Nov-80	Aug-82	-27%	-19%	Deep
Dec-89	Oct-90	-16%	-26%	Deep
Mar-00	Sep-01	-37%	-23%	Deep
Oct-07	Mar-09	-56%	-45%	Deep
Average		-26%	-18%	
Median		-17%	-15%	
Average in Deep		-33%	-25%	
Average in Mild		-18%	-9%	

Source: Bloomberg, J.P. Morgan.

Source: JP Morgan

How bad can expectations get? In order to be bearish, you would have to be betting on a deep recession and a catastrophic outcome. The latest update from FactSet shows that the market is trading at a forward P/E of 15x, which is slightly above its 10-year average.

Exhibit 4: Forward P/E Ratio Below 10-year Average



Source: FactSet Information Systems

Our set of long leading indicators designed to spot a recession in advance were deteriorating for most of 2018, but bottomed out just short of a recession reading in Q4 2018. While the recession warning panel is still flickering, it did not turn red and it has begun to improve marginally.

In short, the stock market has valuation support. The market is moderately cheap and it is already discounting a mild recession.

Bullish Breadth Thrusts

The technical picture for stock prices is also constructive. The market has exhibited a number of breadth thrusts which indicate strong upward price momentum indicator bullish conviction. The Zweig Breadth Thrust is only one of many ways the strong price momentum is showing up. SentimenTrader also observed that two strong 90% up volume days within two weeks following 52-week lows have been strongly bullish.

Exhibit 5: Breadth Thrusts Are Bullish

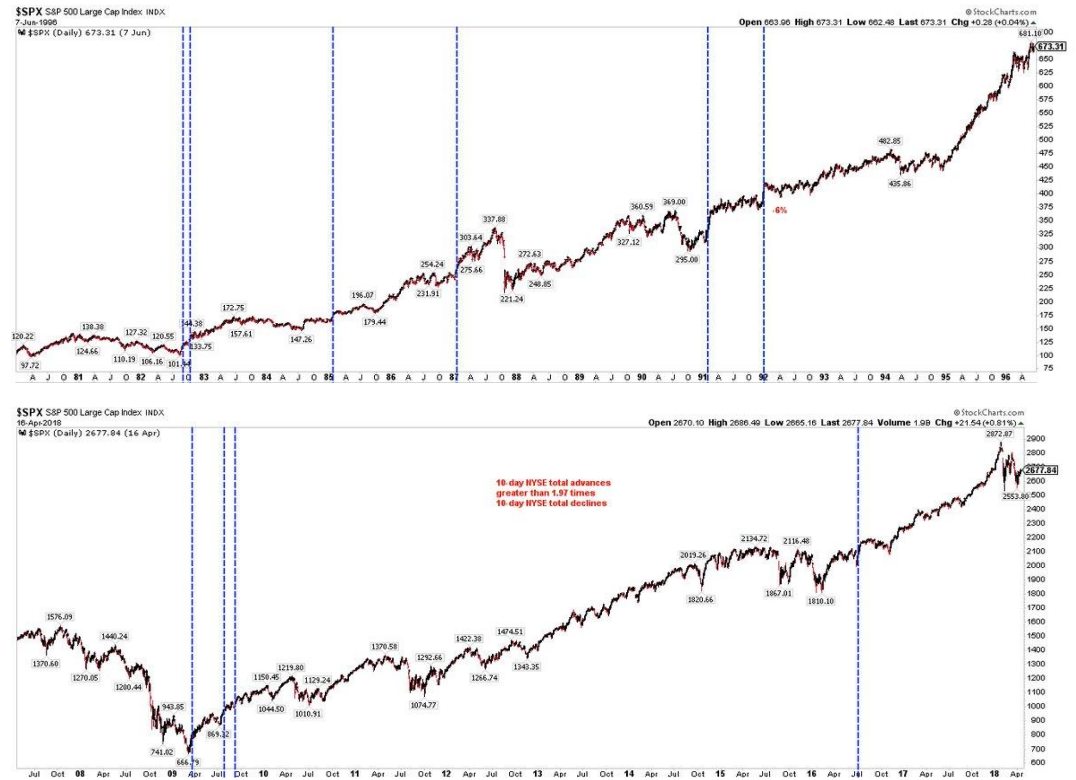
Over the past 50 years, when the S&P 500 sunk to a 52-week low, then there were two 90% up volume days within two weeks, the S&P continued higher over the next 3 months 7 out of 7 times, averaging 3.5%.

9:30 AM - 4 Jan 2019

Source: Twitter

Technical analyst Wally Deemer also pointed out that the market recently experienced an episode of breakaway momentum. There have only been 11 such episodes in the last 40 years, and they have tended to be bullish.

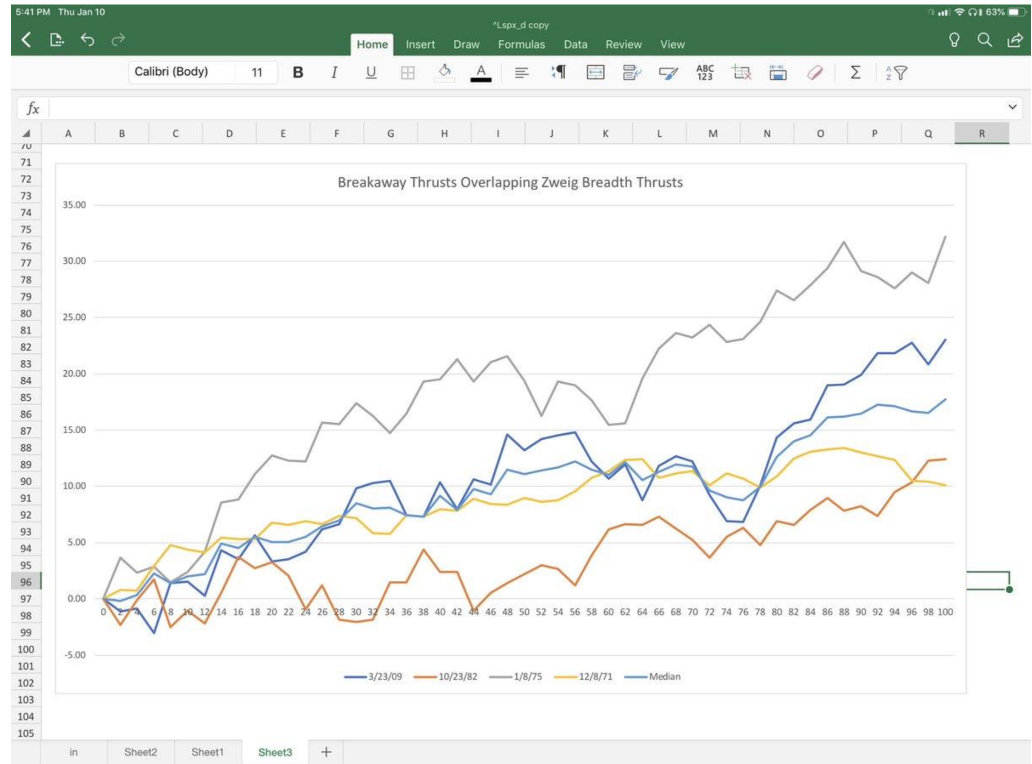
Exhibit 6: Breakaway Momentum Signals



Source: Stockcharts

While the market never goes up in a straight line, the historical experience of the intersection of breakaway momentum and ZBTs have resolved themselves bullishly (x-axis = trading days, y-axis=% gains).

Exhibit 7: Breakaway Momentum + Zweig Breadth Thrusts



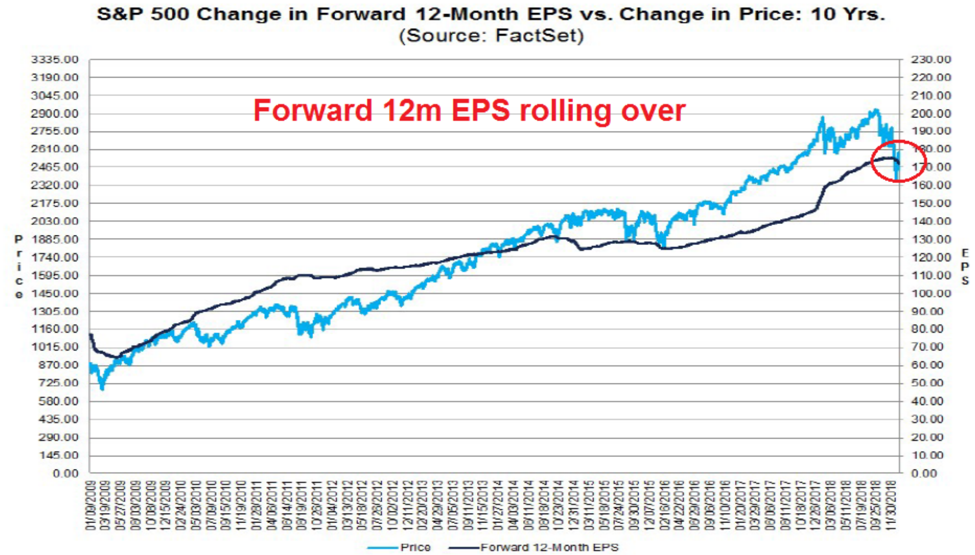
Source: Jonathan Robinson

In short, the market is enjoying valuation support and positive price momentum, which has historically been a bullish sign. What more could a bull ask for?

Negative Fundamental Momentum Risk

However, some near-term risks remain. As we enter earnings season, estimate revisions have been falling, and stock prices have tended to move coincidentally with forward 12-month estimates.

Exhibit 8: Forward 12-month EPS Correlated with Stock Prices



Source: FactSet Information Systems

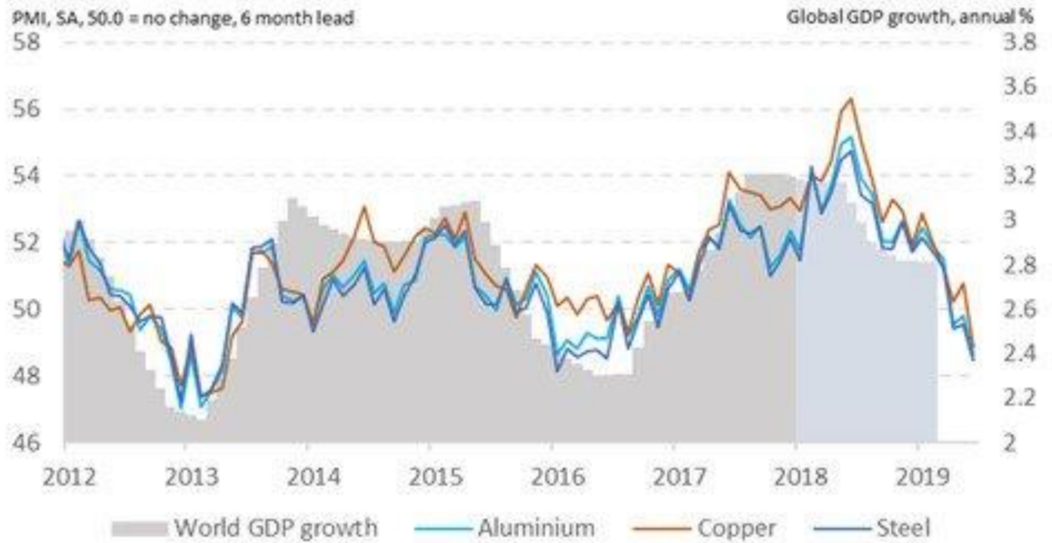
In addition, top-down data has been missing expectations, as evidenced by the falling Citigroup U.S. Economic Surprise Index (ESI), as well as global non-U.S. ESI.

Exhibit 9: U.S. and Global Economic Surprise Index Are Falling

Source: Arbor Research & Trading

Commodity prices comprise a key input to our global trend model. IHS Markit reports that its Global Metal Users PMI, which is a leading indicator of World GDP growth, is falling.

Exhibit 10: Metal Users PMI in Decline



Source: HIS Markit

In addition, the relative returns of global industrial stocks relative to MSCI All-Country World Index (ACWI) are tracing out a rounding top, indicating cyclical deceleration.

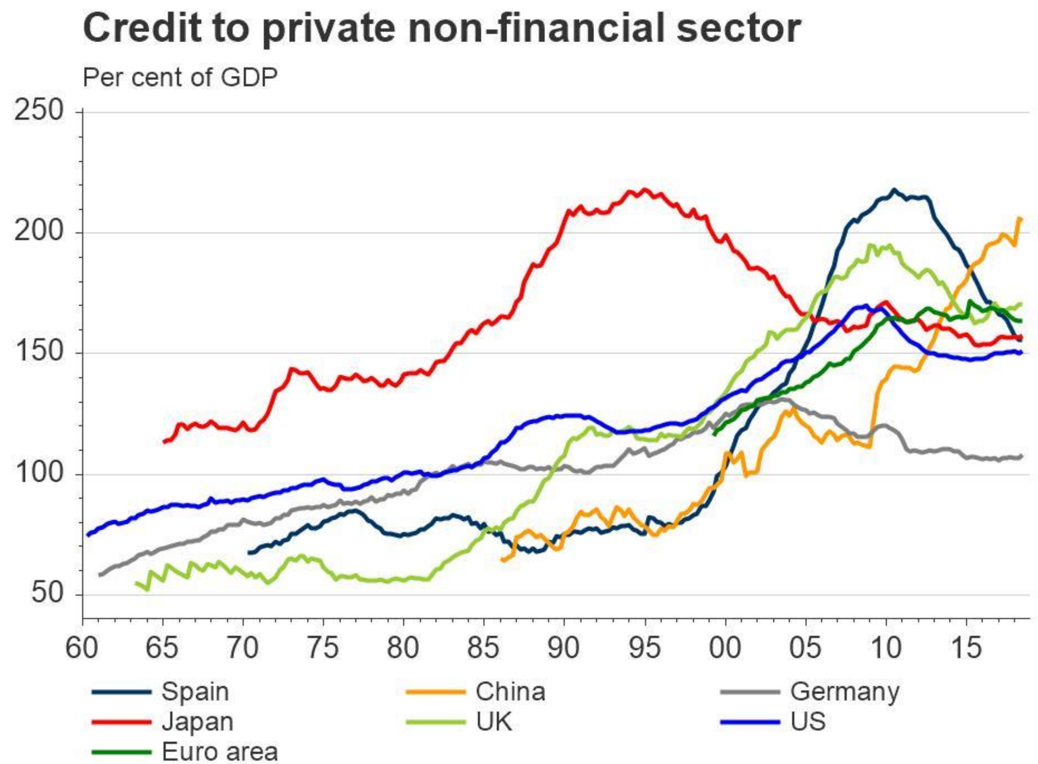
Exhibit 11: Global Industrials Relative Performance Rolling Over

Source: Stockcharts

China Risk

China also poses a high degree of tail-risk for investors. The Chinese economy accounted for roughly one-third of global growth and about one-half of global capital expenditures. This is the China bear's favourite chart, which indicates the precarious nature of her over-leveraged economy.

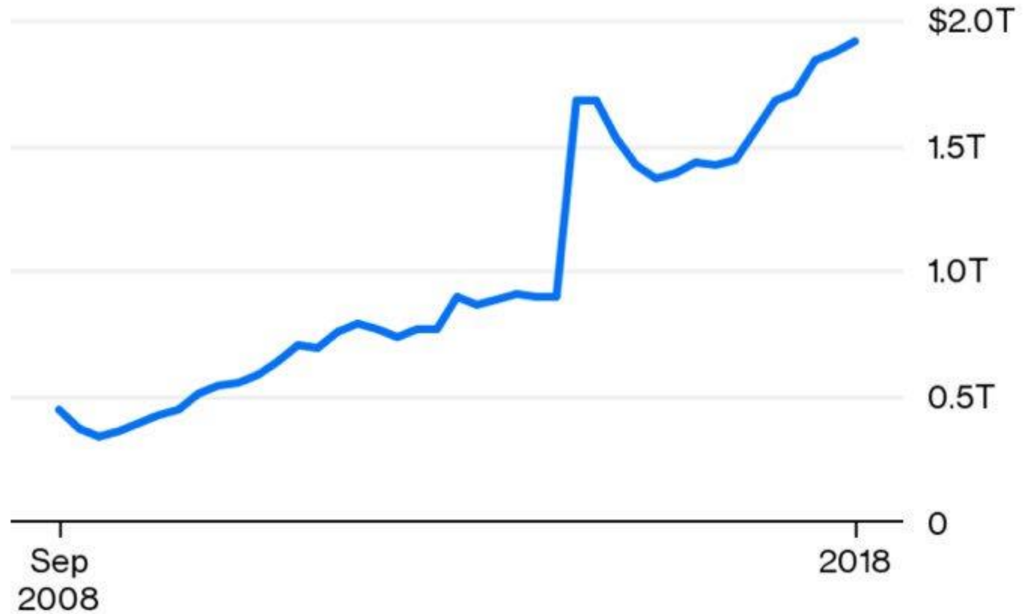
Exhibit 12: The China Bears' Favourite Chart



Source: Datastream

In the past, Chinese debt has been less of a concern for global investors as most of it has been denominated in RMB; therefore, financial contagion risk is low. However, a [Bloomberg] article pointed out that external debt has ballooned to about US$ 2 trillion, which is a significant level even in the context of China's large foreign exchange reserves.

Exhibit 13: China's Ballooning External Debt



Source: Bloomberg

China's economy is now showing signs of weakness, and the trade war is making things worse. Caixin reported that a UBS survey indicated that a considerable number of export manufacturers have either moved or considered moving their production out of China:

> *Most export manufacturers in China have already moved or plan to shift some production outside the Chinese mainland, as the Sino-U.S. trade dispute adds to existing headwinds for businesses, a survey by Swiss investment bank UBS has showed.*
>
> *Thirty-seven percent of the respondents said they have moved some production out of the mainland in the past year, the bank said in a report released on Friday about the poll. Another 33% of respondents said they plan to do so in the next six to 12 months.*

The trade war also creates uncertainties. A mid-level American delegation arrived and concluded a round of constructive talks last week, and the issues are becoming clear for both sides. Here is what the outline of an "easy" trade deal would look like (via NY Times):

> *China is buying American soybeans again and has cut tariffs on American cars. It is offering to keep its hands off valuable corporate secrets, while also allowing foreign investors into more industries than ever before.*

In addition, Beijing would roll back its retaliation for the first round of American tariffs. In addition, China has offered some liberalization on investment in the auto and financial services sectors, and loosening of the JV requirement of forced technology transfers, though Beijing has long maintained it never forced technology transfer in the first place, and all deals were voluntary.

In return, the U.S. may or may not roll back tariffs on the tariffs levied on Chinese goods since the start of the trade war.

That's the easy deal. The difficult issue is an agreement on China's industrial policy and IP transfer. U.S. chief negotiator Robert Lightizer has pressed for a verification process of China's commitments to Chinese concessions on these issues.

Leland Miller of China Beige Book appeared on CNBC to state that he believes there is tremendous economic pressure on China to reach a deal, but it will be a deal in name only. In effect, the trade deal will amount to the "easy" deal (my words, not his), and possibly some provisions of the "difficult" deal, but the enforcement of the agreement will be a function of future U.S.-China relations. In a past CNBC appearance, Miller explained that U.S.-China trade frictions will rise in 2020. There is a growing consensus in Washington that China is a challenge for the U.S., and presidential candidates will all posture to show how tough they are on China. Even if we were to see a trade truce in 2019, friction is likely to rise next year.

Political Risk

As the Democrats take control of the House of Representatives, the chairs of the various committees are expect to investigate Trump, his family and his cabinet. White House staff are preparing for a deluge of subpoenas as Democrats settle into their seats. In addition, the results of the Mueller probe are likely to become public some time in 2019. The combination of all of these events are likely to put tremendous political pressure on Trump and how he governs.

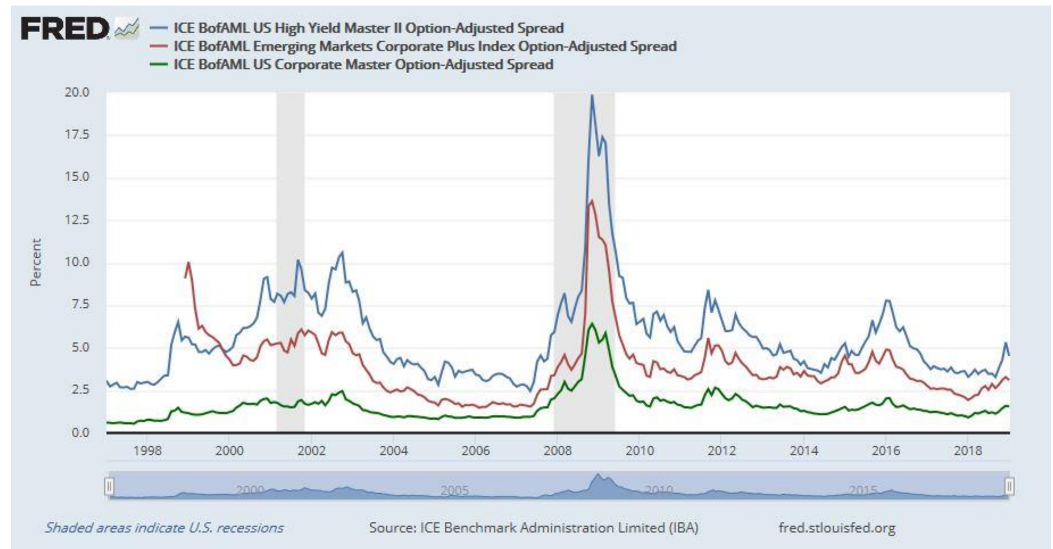
We have already seen a brief taste of the conflict between Trump and the Democrats during the latest government shutdown impasse. Trump has threatened to declare a State of Emergency in order to get funding for the border Wall. A decision like that is well outside constitutional norms, and it will likely be challenged in the courts. (Even if you support Trump's potential declaration of a State of Emergency, would you also support President Hillary Clinton's declaration under similar circumstances?)

Unilateral declarations of emergency and martial law are what happens in emerging market countries under strongman rule. Most of these markets trade at single-digit P/E ratios. U.S. equities trade at a forward P/E of 14. Should Trump provoke such a constitutional crisis, expect the markets to begin pricing in a political risk premium to the U.S. equity market.

Credit Market Stress

Another source of risk is comes from possible stress in the credit market. On the surface, conditions appear benign. Credit spreads have widened and begun to normalize after the December risk-off episode, and levels are nowhere near the high stress readings seen in past recessions.

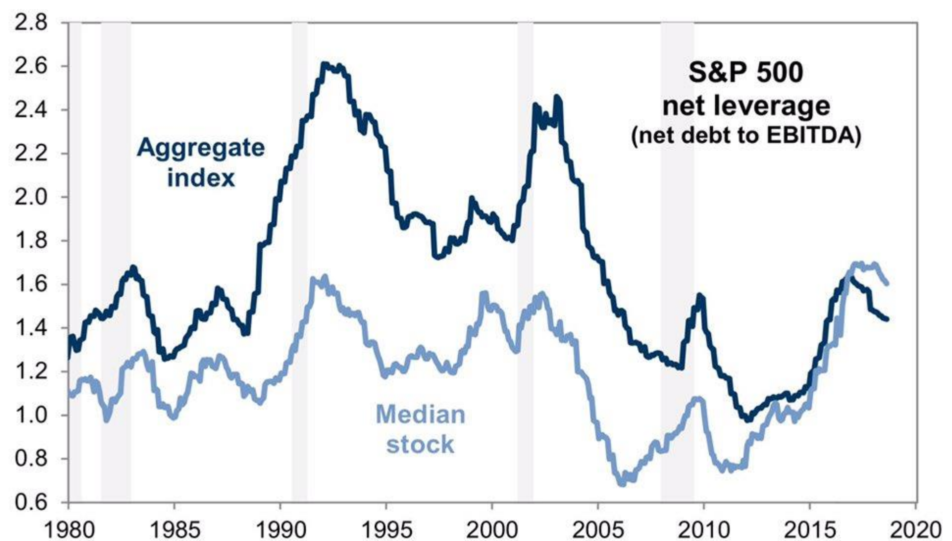
Exhibit 14: Credit Spreads



Source: FRED, Federal Reserve Bank of St. Louis

Beneath the surface, however, the internals appear ominous. Median corporate leverage has returned to level equal to or above past market tops.

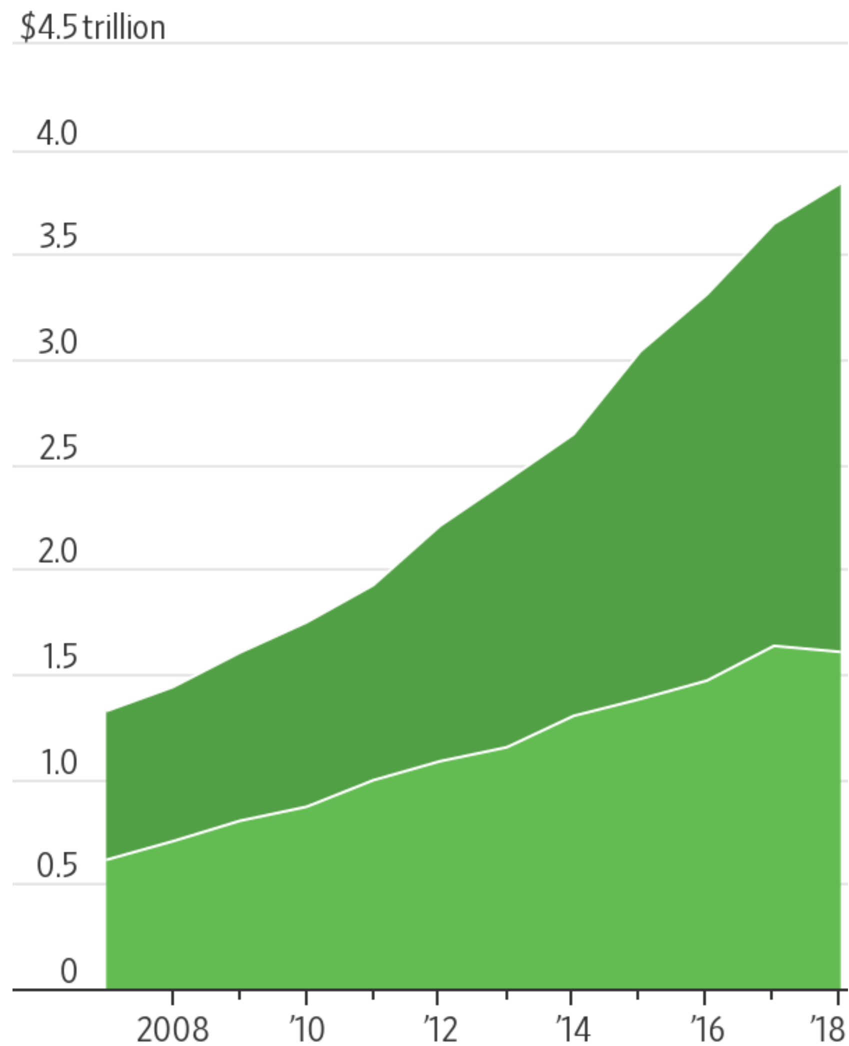
Exhibit 15: Corporate Leverage Rising



Source: Goldman Sachs Global Investment Research

BBB debt, which is the lowest level of investment grade credit, now dominates the IG bond universe. Should the economy weaken, expect many of the BBB credits to be downgraded to junk, which would flood the junk bond market with supply in an environment of uncertain demand.

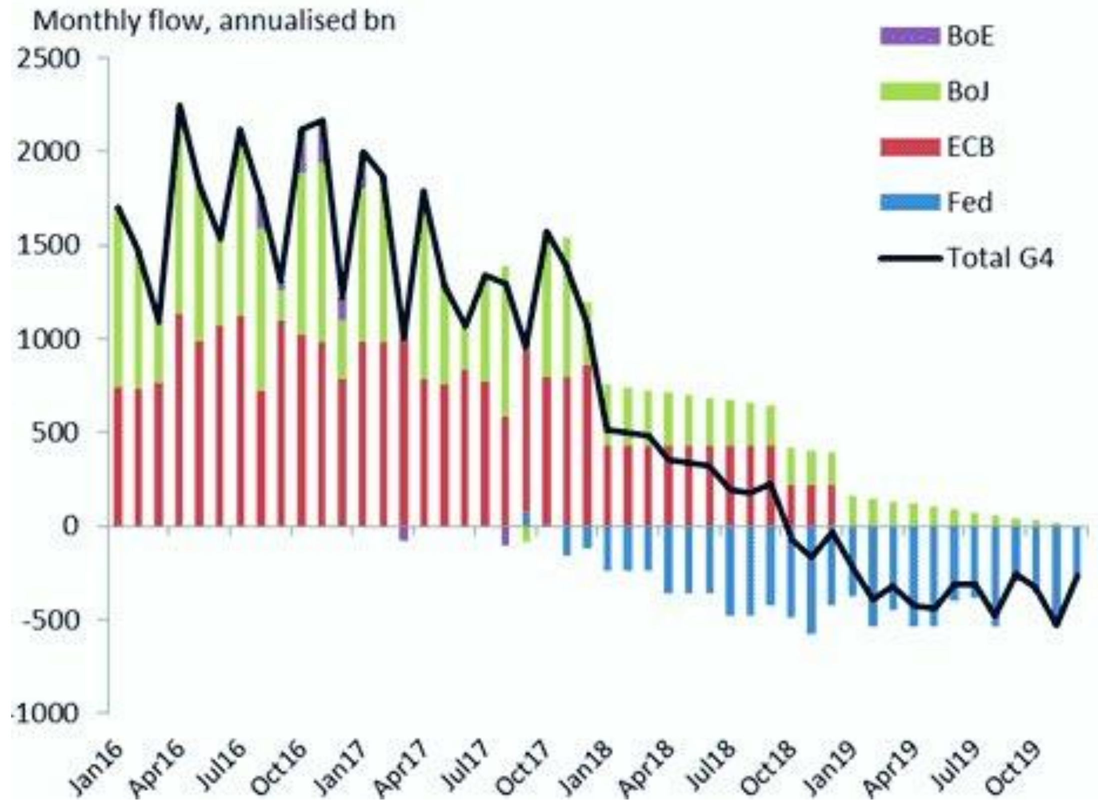
Exhibit 16: BBB Credits Now Dominate Investment Grade Bonds



Source: Fitch Ratings

At the same time, global central banks are tightening and withdrawing liquidity from the financial system.

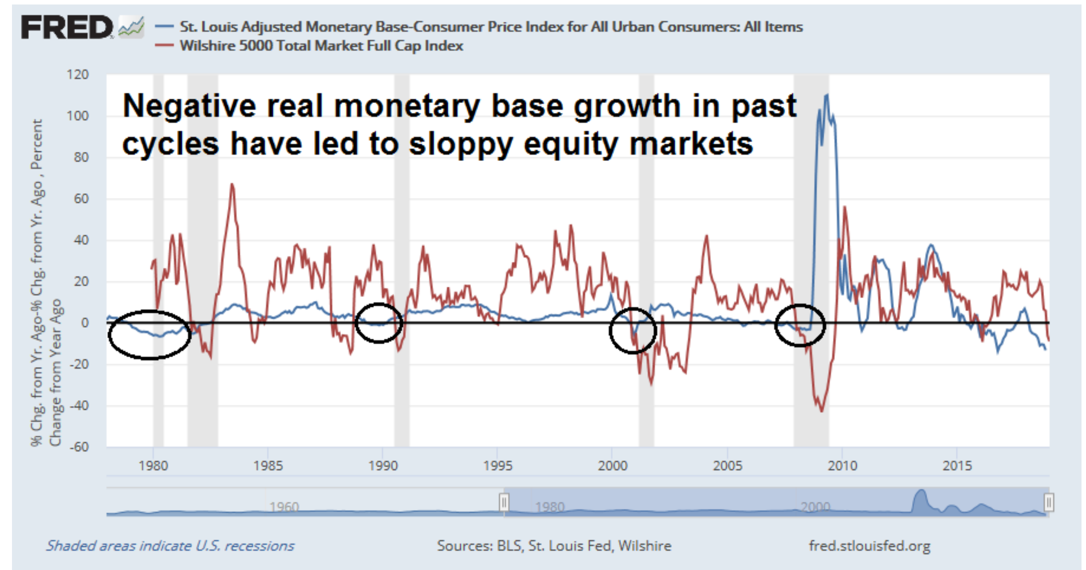
Exhibit 17: Global Central Banks Are Withdrawing Liquidity



Source: Financial Times

Notwithstanding the Fed's slightly more dovish tone, its tightening bias will have a negative effect on the growth of the monetary base. If history is any guide, negative growth in the monetary base has been a headwind to equity prices.

Exhibit 18: Monetary Base Growth and Equity Prices



Source: FRED, Federal Reserve Bank of St. Louis

Investment Implications

To sum up, what does this all mean?

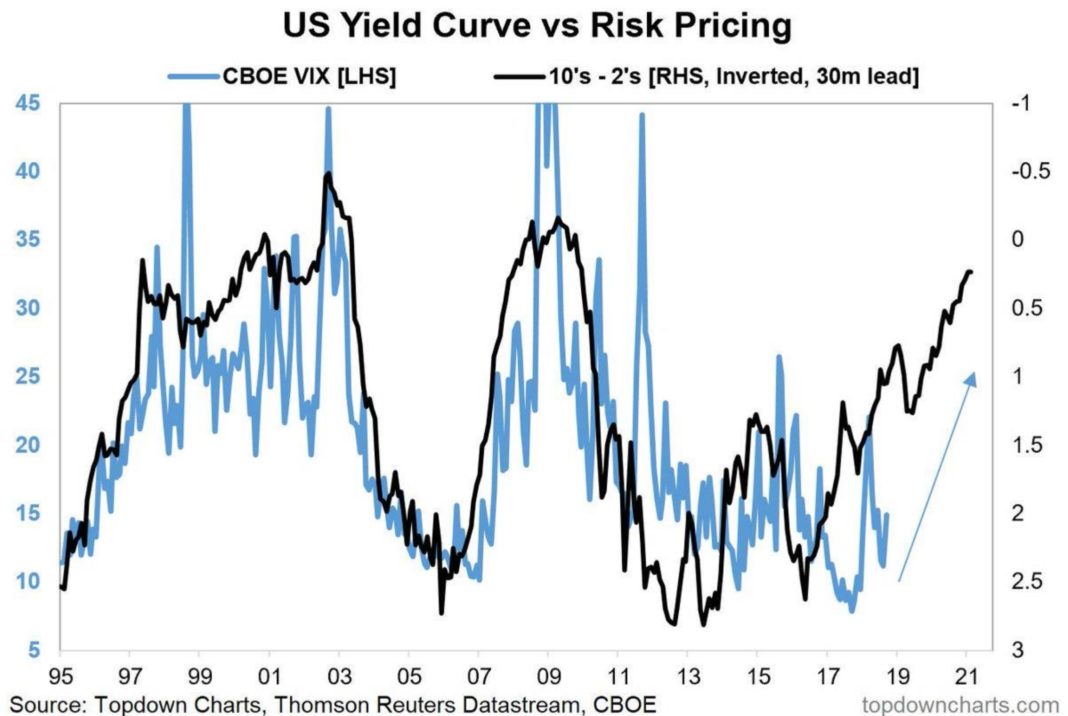
Our previous base-case scenario had been a recession in late 2019 or early 2020, with a slowdown that begins in early 2019. Stock prices would decline, first to discount the effects of a slowdown, and later a recession. The recession would serve to unwind the excesses of the previous expansion, notably high leverage in China, and the unresolved banking problems in Europe.

In reality, stock prices declined in Q4 2018 in a steep fashion, and the market is already discounting a mild recession. Technical conditions became washed out, and different measures of breadth thrusts are pointing to an intermediate-term bottom. While a number of risks remain, none of them, with the exception of a growth deceleration, will necessarily be realized in the next six months. It is also unclear how much of the growth slowdown is already discounted in the market. Real GDP growth fell from a 3–4% annualized pace in the latter half of 2018 to about 2% in 2019, which is well above recessionary conditions.

The other risks, namely China, trade war, political risk premium and credit deterioration from monetary tightening may not fully manifest themselves over the next six months. Undoubtedly, the market will respond to newsflow from these sources of risk in the future, but their near-term resolutions are unlikely to be catastrophic for stock prices.

To be sure, the global economy is undergoing a tightening cycle. Callum Thomas has shown that tightening cycles, as proxied by the slope of the yield curve, tends to lead equity market volatility by 2.5 years.

Exhibit 19: Yield Curve Leads Volatility



Source: Topdown Charts

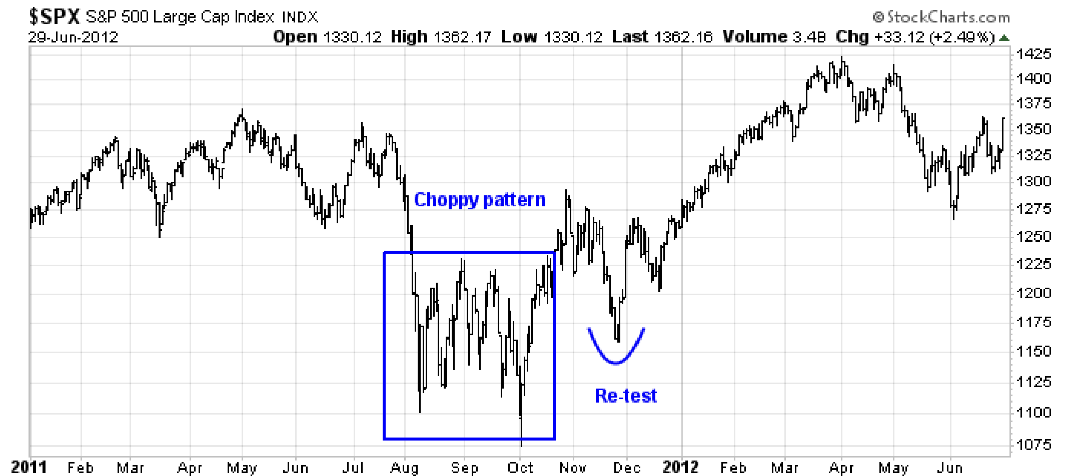
In conclusion, we had mainly focused on the risk conditions in the past, while ignoring valuation. Today, the combination of favourable valuation and positive momentum has changed my outlook. Based on these conditions, we would expect stock prices to grind upward for the remainder of 2019, but in a volatile manner.

A balanced fund that was at target weight in its asset allocation would be underweight equities today. We suggest that accounts raise their equity risk profile by re-balancing back to target weight. Should the stock market weaken and re-test the old December lows, it would a signal to take a risk-on position and overweight equities.

As the economy is likely to sidestep a recession, here are some possible historical patterns that the market might follow. These episodes all involved some kind of scare, but the market ultimately avoided a recession.

2011 was the year of the Greek Crisis in Europe, and a budget impasse in Washington. The market dropped, stabilized and chopped around for a few months, rallied, weakened and corrected, and then went on rise into fresh highs.

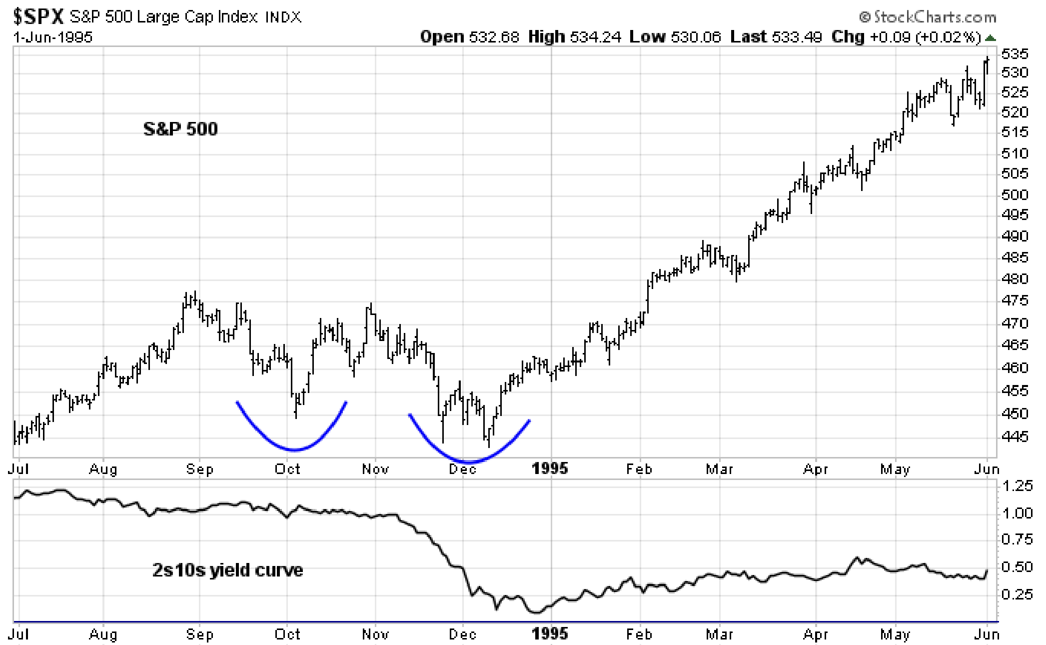
Exhibit 20: The Greek Crisis of 2011



Source: Stockcahrts

There was a growth scare at the end of 1994, when the yield curve neared inversion but did not do so. The market made a double bottom before going on to advance to new highs.

Exhibit 21: The Growth Scare of 1994



Source: Stockcabrts

1962 was the year of the "Kennedy Slide". There was no recession but it was accompanied by JFK's attack on the steel industry and a "businessman's panic". The market's final bottom coincided with the Cuban Missile Crisis.

Exhibit 22: The Kennedy Slide of 1962

Source: CNBC

From a technical perspective, the breadth thrusts were signals of the initial bottom is in, but to expect further volatility in the next few months. Don't be surprised if the stock prices were to weaken again to test or undercut the December lows in a double or multiple bottom. Looking out 6-12 months, history tells us that returns should be positive.

Disclaimer

I, Cam Hui, certify that the views expressed in this commentary accurately reflect my personal views about the subject company (ies). I am confident in my investment analysis skills, and I may buy or already own shares in those companies under discussion. I prepare and edit every report published under my name. I depend on my colleagues for constructive criticism on my research methods and conclusions but final responsibility is my own.

I also certify that I have not and will not be receiving direct or indirect compensation from the subject company(ies) in exchange for publishing this commentary.

This investment analysis excludes any target price, and is not a recommendation to buy or sell a stock. It is intended to provide a means for the author to share his experience and perspective exclusively for the benefit of the clients of Pennock Idea Hub (PIH). My articles may contain statements and projections that are forward-looking in nature, and therefore subject to numerous risks, uncertainties, and assumptions. The author does not assume any liability whatsoever for any direct or consequential loss arising from or relating to any use of the information contained in this note.

This information contained in this commentary has been compiled from sources believed to be reliable but no representation or warranty, express or implied, is made by the author or any other person as to its fairness, accuracy, completeness or correctness.

This article does not constitute an offer or solicitation in any jurisdiction.

Confidential — Do not duplicate or distribute without written permission from Pennock Idea Hub