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HERE COMES THE GROWTH SCARE

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EXECUTIVE SUMMARY

We were recently asked to clarify our market views, as they appear to have been contradictory. Let us make this clear, we are both bullish and bearish, but over different time horizons.

We expect the U.S. equity market should perform well into the end of 2019. The recent Zweig Breadth Thrust signal on January 7 (see *A Rare "What's My Credit Card Limit" Buy Signal*) has historically seen higher prices over longer time frames. Exhibitions of powerful price momentum have historically been very bullish.

However, we do have some concerns about the possibility of stock price weakness over the next few months. As we pointed out last week (see *Recession Ahead? Fuggedaboutit!*), the market is likely to be spooked by growth slowdown as we approach Q2. Evidence of a growth scare is already emerging.

Should a growth scare spark a stock price pullback, we have assembled a series of bullish tripwires. If these tripwires were to flash the all-clear sign should stock prices correct, that would be the signal to step up and buy.

Bullish and Bearish Over Different Time Frames

We were recently asked to clarify our market views, as they appear to have been contradictory. Let us make this clear, we are both bullish and bearish, but over different time horizons.

We expect that the U.S. equity market should perform well into the end of 2019. The recent Zweig Breadth Thrust signal on January 7 (see *A Rare "What's My Credit Card Limit" Buy Signal*) has historically seen higher prices over longer time frames. Exhibitions of powerful price momentum have historically been very bullish.

Troy Bombardia recently pointed out that the NYSE McClellan Summation Index (NYSI) recently exceeded 850, and past episodes have resolved bullishly. My own shorter-term study shows that the market was higher 75% of the time after one month with an average return of 1.8%, and higher 83.3% of the time after three months with an average return of 3.9%.

Exhibit 1: Breadth Thrusts Are Bullish

What happens next to the S&P 500 when: BullMarkets.co
NYSE McClellan Summation Index exceeds 850 (first case in 3 months)

	6 months later	9 months later	1 year later
2/6/2019			
10/3/2017	5.06%	7.97%	15.42%
3/17/2016	5.23%	10.42%	16.55%
2/27/2014	7.86%	11.47%	13.49%
1/18/2013	14.10%	17.40%	24.08%
9/17/2012	5.79%	8.69%	17.87%
1/23/2012	2.62%	8.91%	13.59%
10/8/2010	13.99%	13.25%	-0.83%
4/29/2009	21.72%	24.14%	38.13%
10/16/2006	7.43%	13.44%	12.58%
7/12/2005	5.52%	5.27%	2.98%
9/13/2004	7.20%	6.66%	10.19%
5/2/2003	12.56%	22.06%	20.15%
2/6/2001	-10.93%	-17.15%	-18.10%
Average returns	7.55%	10.19%	12.78%
% of cases that are positive	92%	92%	85%

Source: Troy Bombardia

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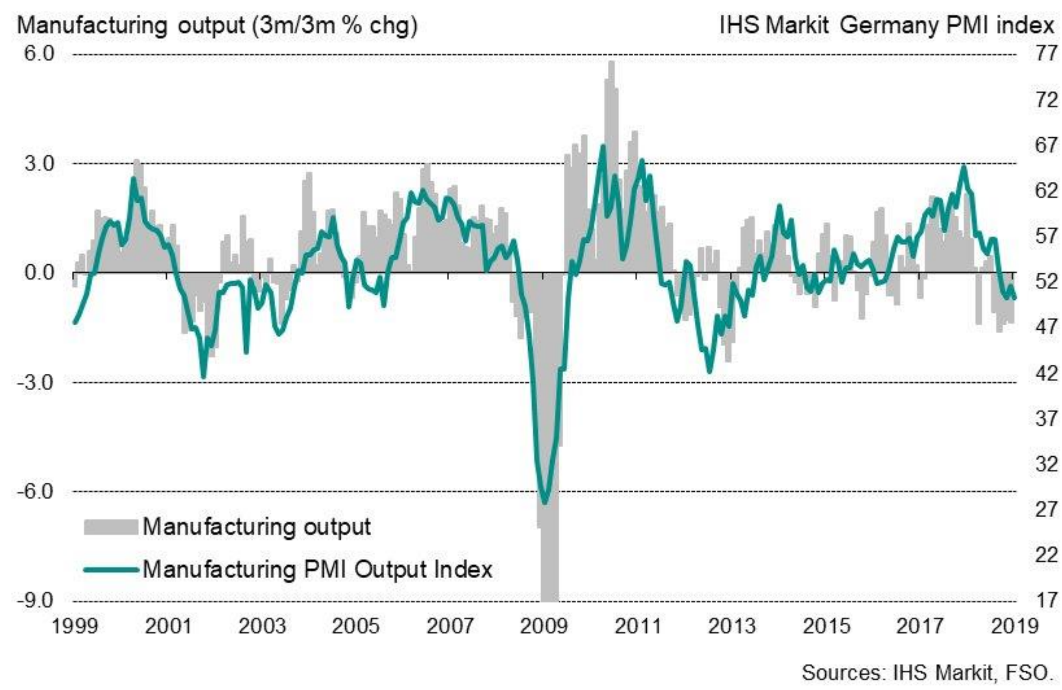
The Growth Scare in Europe

The most visible portion of the growth scare is appearing in Europe. German industrial production is tanking, and the country is in a technical recession. In addition, the European Commission cut its 2019 eurozone growth forecast from 1.9% to 1.3%.

Exhibit 2: Germany in Technical Recession



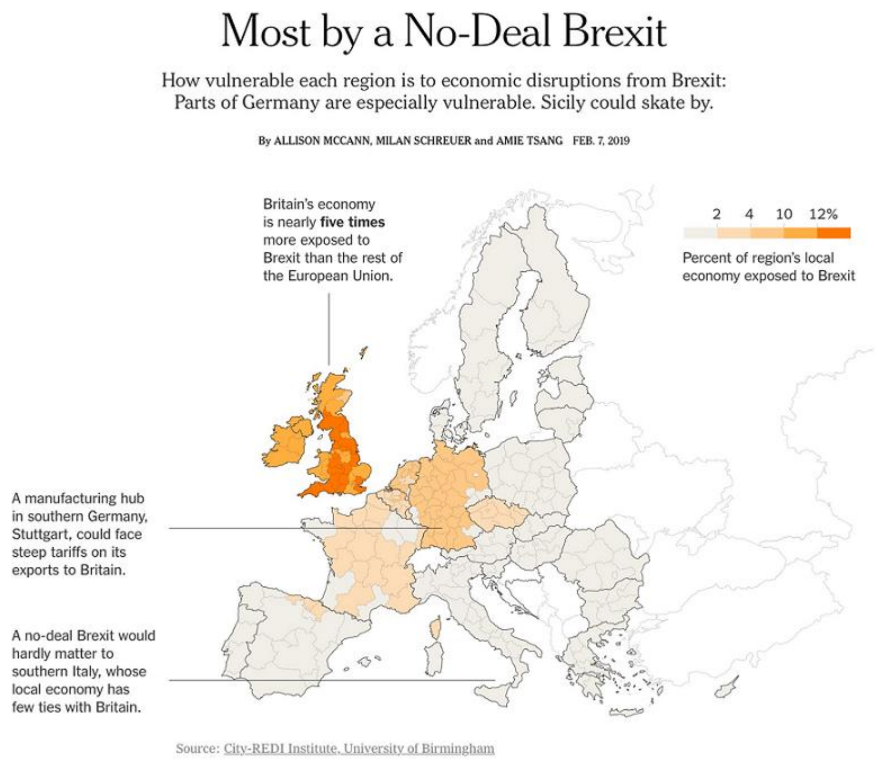
Source: HIS Markit

As Germany has been the growth locomotive of the eurozone, worries are spreading. Even The Economist published an article entitled, *It is Time to Worry About Germany's Economy — A Sputtering Engine".*

> *Germany is getting both the short and the long term wrong. Start with the business cycle. Many policymakers think the economy is close to overheating, pointing to accelerating wages and forecasts of higher inflation. In their view, slower growth was expected, necessary even. That is complacent. Even before the slowdown, the IMF predicted that in 2023 core inflation will be only 2.5%—hardly a sign of runaway prices. In any case, higher German inflation would be welcome, as a way to resolve imbalances in competitiveness within the euro zone that would elsewhere adjust through exchange rates. The risk is not of overheating but of Europe slipping into a low-growth trap as countries that need to gain competitiveness face an inflation ceiling set too low by Germany.*
>
> *The slowdown also portends deeper problems for Germany's globalized economic model. Weakness in part reflects the fallout from the trade war between China and America, two of Germany's biggest trading partners. Both are increasingly keen on bringing supply chains home. America is due soon to decide whether to raise tariffs on European cars. Trade is already becoming more regionalised as uncertainty grows. If global commerce splits into separate trading and regulatory blocs, Germany will find it harder to sell its goods to customers around the world.*

The possibility of a no-deal and disorderly Brexit is also worrisome. This New York Times graphic shows that while the British economy will bear most of the pain of a no-deal Brexit, both the French and German economies will also be vulnerable too. In addition, [Bloomberg](#) reported that a study by Halle IWH concluded that 100,000 German jobs would be at risk in the event of a no-deal Brexit.

Exhibit 3: Who Gets Hurt in a No-Deal Brexit?



Source: New York Times

Another possible but less noticed development is bearish implications of a U.S.-China trade agreement. China has promised to import more from the U.S. in order to reduce or eliminate the trade deficit over time. However, if China were to import more American goods in the short run, demand will have to be shifted from somewhere else. More imports from America such as Boeing aircraft, and fewer from Airbus. Europe would bear the brunt of falling Chinese demand under such a scenario.

A U.S. Slowdown Ahead?

Over on this side of the Atlantic, slowdown fears are also rising. Yelp recently unveiled a business survey called the Yelp Economic Average (YEA), and it is uncovering broad-based signs of a business downturn.

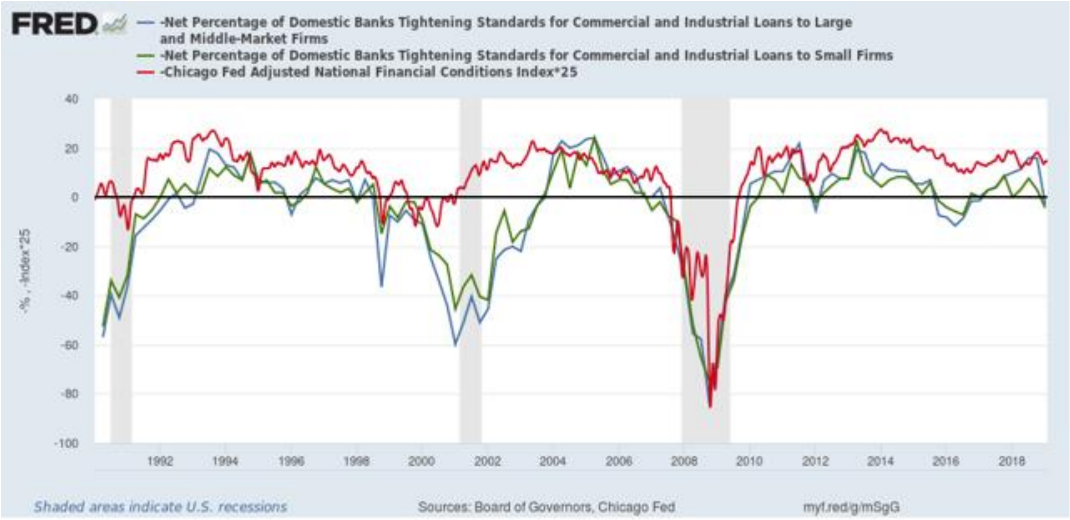
> *Over the past quarter, YEA fell by more than two points, due in large part to declines in the professional services, shopping, and other categories. Slumps in core business sectors may be early signs of an economic downturn. A second successive fourth-quarter slump isn't a result of seasonality; we've normalized the data so that it is seasonally adjusted.*
>
> *Of the 30 business sectors represented by the Yelp Economic Average (YEA), only one—gas stations—saw an increase in the fourth quarter of 2018, resulting in a national decline to 98.5 from 100.7 in the third quarter. All YEA scores are calculated relative to the fourth quarter of 2016, for which the score was set to 100.*
>
> *The downturn left few business sectors untouched. Everything from high-end retail such as jewelry stores and antique shops to pricey professional services such as private eyes and architects were hit hard in the fourth quarter, in a trend extending to sectors beyond our core 30. So were more routine discretionary offerings, such as burger places, bars, and coffee shops.*

In addition, Georg Vrba's unemployment rate recession model is on the cusp of a recession call (see *The Unemployment Rate May Soon Signal A Recession: Update – February 1, 2018*): "If unemployment rate rises to 4.1% in the coming months the model would then signal recession".

We are skeptical that a recession is in the cards. The recession model is based on a rising unemployment rate, which has signaled slowdowns in the past. However, the rise in unemployment is the result of the labour force participation rate rising faster than job growth, which are signs of a strong economy not a weak one.

As well, the blogger New Deal democrat went on "Recession Watch" for Q4 last week because of tightening credit conditions from the Senior Loan Officer survey. Credit has tightened across the board for firms of all sizes.

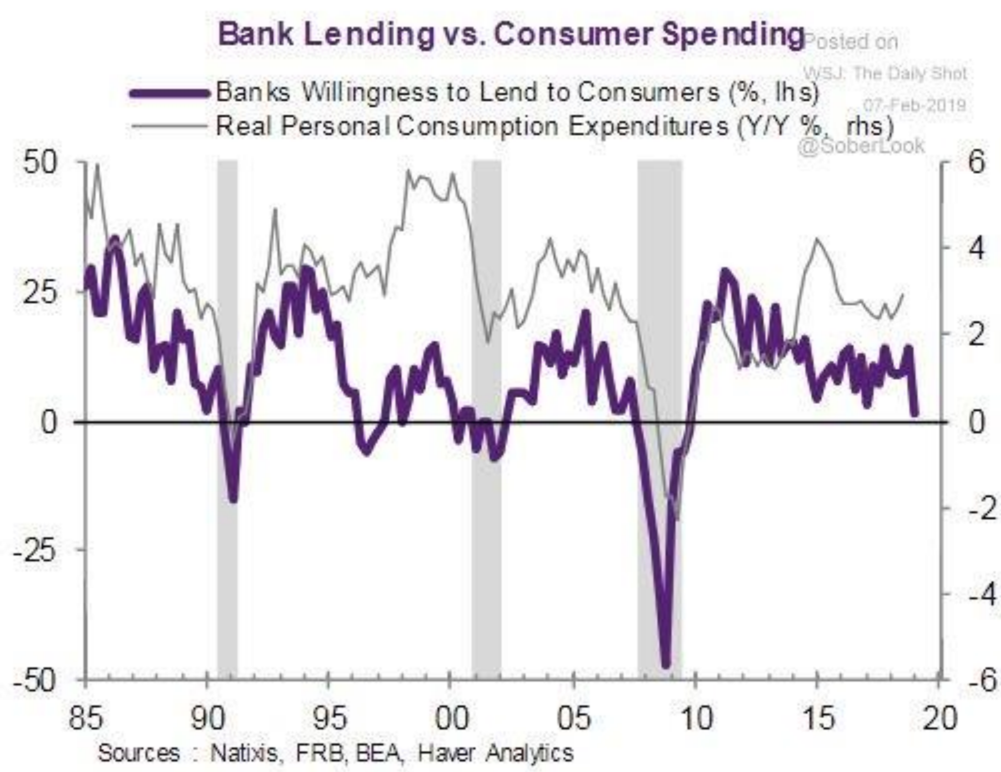
Exhibit 4: Credit Conditions Are Tightening



Source: FRED, Federal Reserve Bank of St. Louis

We would also add that credit conditions have also tightened on the consumer side as well.

Exhibit 5: Consumer Credit Conditions Are Tightening



Source: Wall Street Journal

The deterioration in credit conditions was enough to put NDD on "Recession Watch":

> *We have 3 negatives: interest rates, housing, and credit conditions*
>
> *We have 2 positives: corporate profits and real retail sales per capita*
>
> *We have 2 mixed indicators: money supply and the yield curve*
>
> *There has been enough further deterioration in the long leading indicators — metrics I have followed and updated over and over again for years — during the second half of 2018 that a plurality are negative. It had already appeared that the more likely outcome would be that in the second half of 2019, left to its own devices, the economy would just barely escape recession, although poor government policy choices this year could easily tip the balance. The further deterioration described above warrants going on Recession Watch one year out — i.e., beginning Q4 2019.*

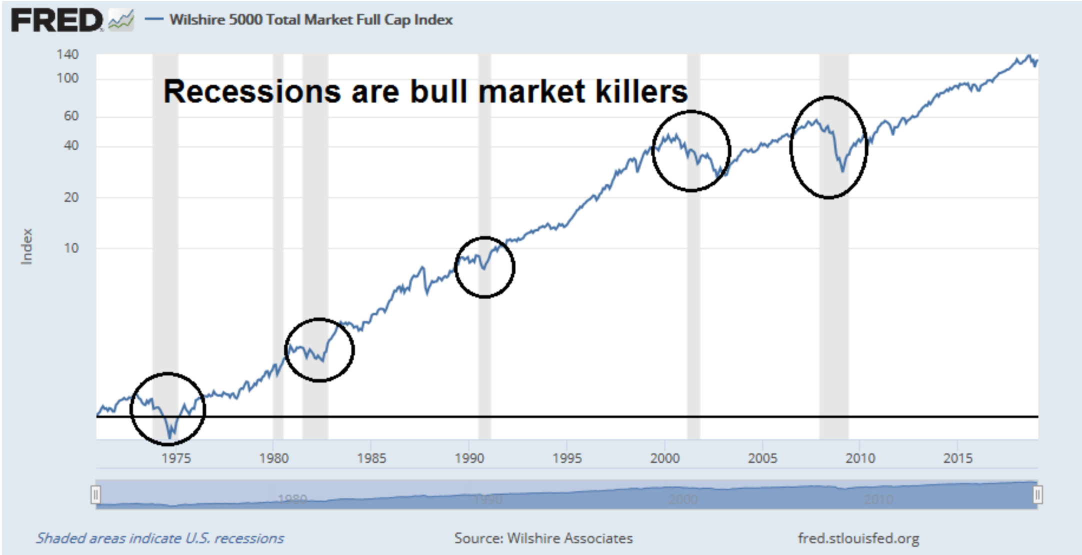
However, NDD was careful to distinguish this as a "Recession Watch" warning, and not an actual recession forecast.

> *It isn't a "Recession Warning," where a downturn looks certain, but more on the order of the warning given to Scrooge by the Ghost of Christmas Future: what is likely to happen if there is no intervening change for the good.*

Why We Are Bullish

Here is why we remain bullish on equities longer term. It is true that recessions are bull market killers, we are skeptical of these recession warnings.

Exhibit 6: Recessions Are Bull Market Killers, But…



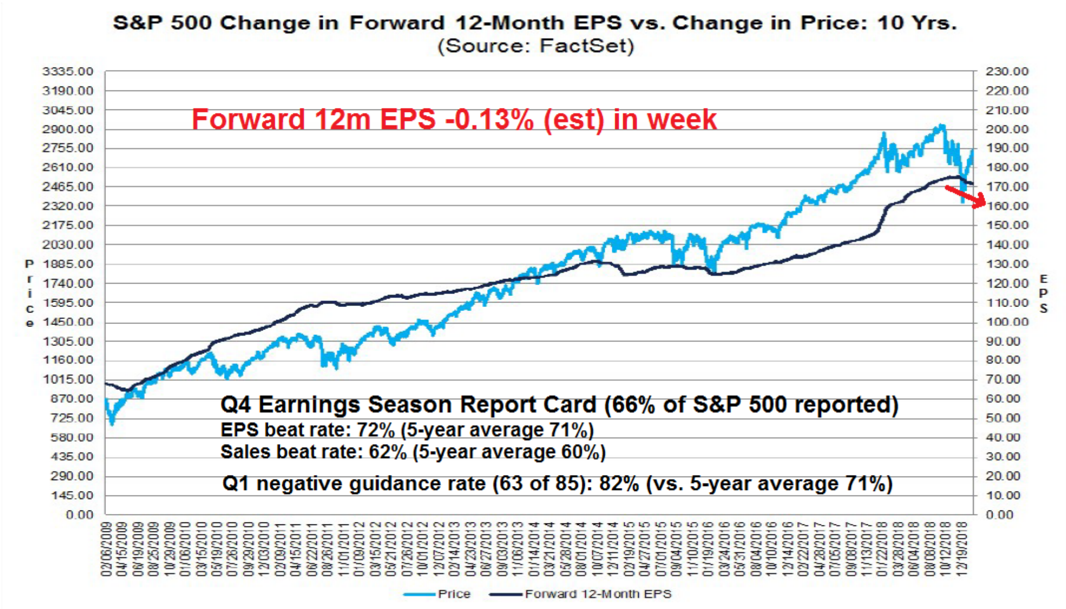
Source: FRED, Federal Reserve Bank of St. Louis

Recessions don't occur spontaneously, but occur as part of a process. Past recessions have been the result of either tight Fed policy cooling growth into recession (1973, 1980, 1982, 1990) or the unwinding of financial excesses that led to an accident (2000, 2008). The same conditions are not in place. Fed policy can hardly be described as overly hawkish. A financial accident is always possible (China, the European banking system), but the American economy is largely insulated from the worst of any implosion. Should a U.S. recession occur, we expect it to be mild.

Traversing the Valley of Weak Growth

Nevertheless, NDD's short leading indicators are pointing to Q2 weakness, and the market will have to traverse this valley of weak growth. The latest update from FactSet shows that while Q4 earnings season beat rates are slightly ahead of historical averages, Estimate revisions are falling and the Q1 negative guidance rate is above average, but stock prices haven't responded to the downgrades.

Exhibit 7: EPS Estimates Are Falling



Source: FactSet Information Systems

In addition, the old market leaders of 2018 have not stepped up in the reflex rally off the December 24 bottom, and many of the old FAANG stocks are likely to face regulatory headwinds in 2019. Business Insider reported that Facebook is facing an existential threat to its business model in Europe. Other companies that rely on Big Data like Google and Amazon are likely to get caught up in the dragnet soon.

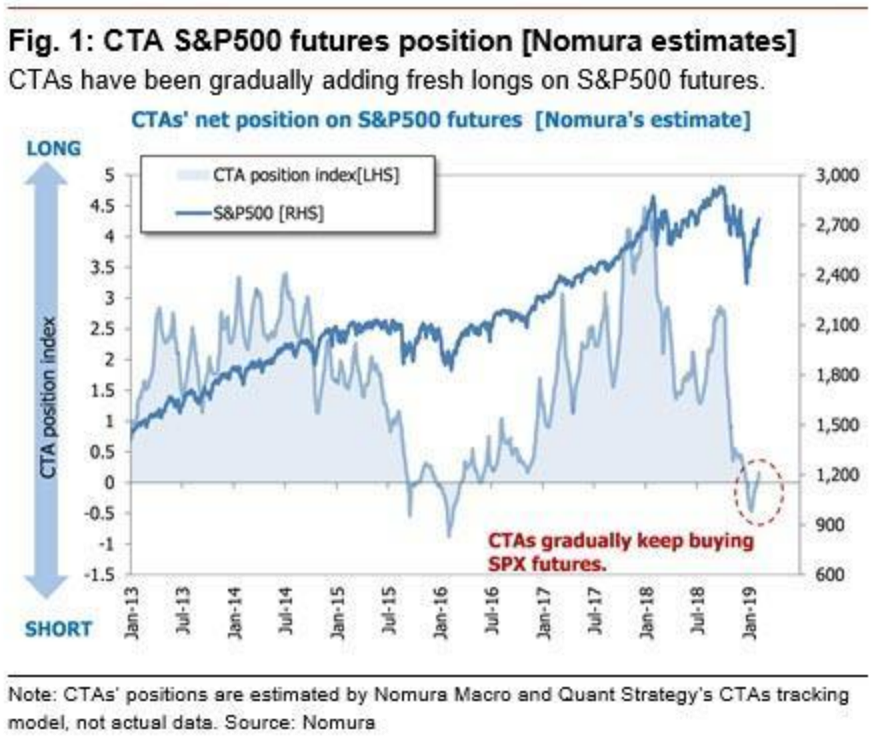
> *Germany's antitrust regulator, the Bundeskartellamt, or Federal Cartel Office, on Thursday issued Facebook with an ultimatum: Stop hoarding people's data.*
>
> *Following an unprecedented three-year investigation involving extensive conversations with Facebook, the Bundeskartellamt issued a press statement declaring that it had "imposed on Facebook far-reaching restrictions in the processing of user data."*
>
> *It demands that Facebook — which has 32 million monthly users in Germany — change its terms and conditions so that people can explicitly stop it from hoarding data from different sources, including Facebook-owned apps like WhatsApp and Instagram as well as third-party websites with embedded Facebook tools such as "like" or "share" buttons.*

If FAANG falters, where's the leadership? The market will have to spend a little time to sort these issues out before it can rise further.

What Could Go Right

Still, there are some silver linings in the dark cloud of bearish factors. Even the perennially bearish Zero Hedge conceded that market positioning is supportive of stock prices in the short run. Analysis from Nomura shows that Commodity Trading Advisors are responding to the change in price trend and adding to their equity positions.

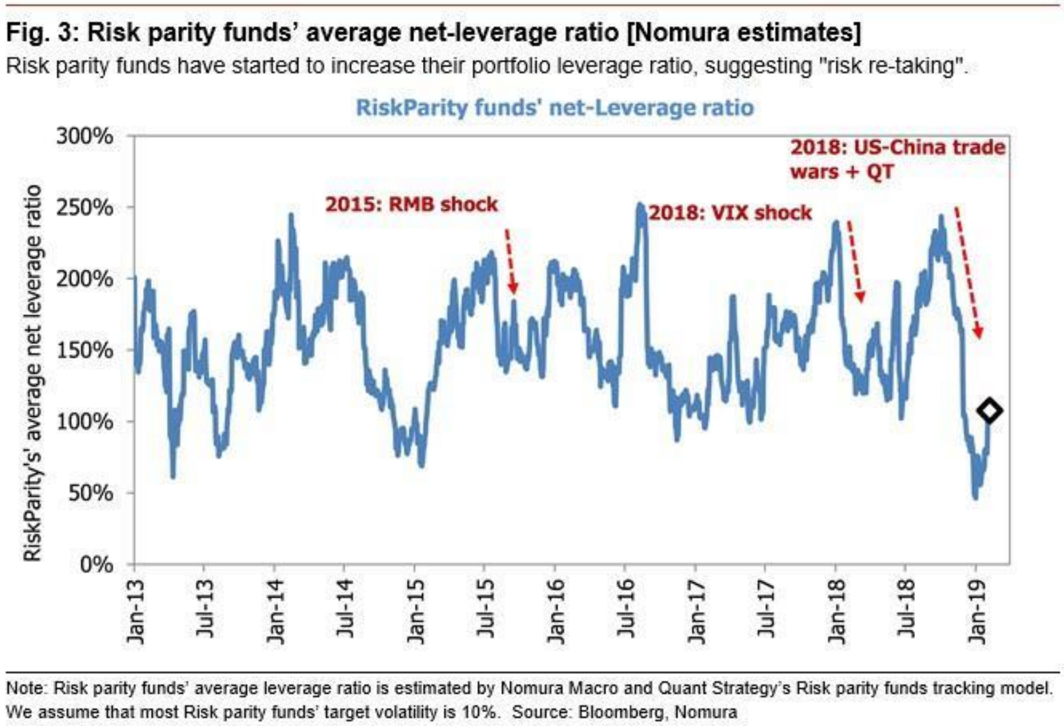
Exhibit 8: CTAs Are Buying



Source: Zero Hedge, Nomura

As well, risk parity funds are unwinding their underweight position in equities and they are starting to buy again.

Exhibit 9: Risk Parity Funds Are Normalizing Their Equity Weightings



Source: Zero Hedge, Nomura

In addition, the team of Steve Mnuchin and Robert Lighthizer are headed to China for another round of trade negotiations on February 14-14, though the timing of a Trump-Xi meeting has not been finalized yet. Asia Nikkei reported that while China is making trade concessions, it is also playing the North Korea card. A trade agreement, regardless of how incomplete the provisions are, combined with a de-escalation of tensions with North Korea, will be a positive surprise for the markets.

> *As things stand, Xi's side appears to be making concessions to Trump -- announcing increased purchases of American goods and hinting at some structural reforms -- in a bid to stabilize bilateral economic relations. China's economic slowdown has made it difficult for Xi to take a combative stance.*
>
> *But things are not that simple. What is also happening is that China is playing the "North Korea card" and shrewdly weighing in on the second U.S.-North Korean summit, as a way to gain leverage in the trade talks with Washington.*

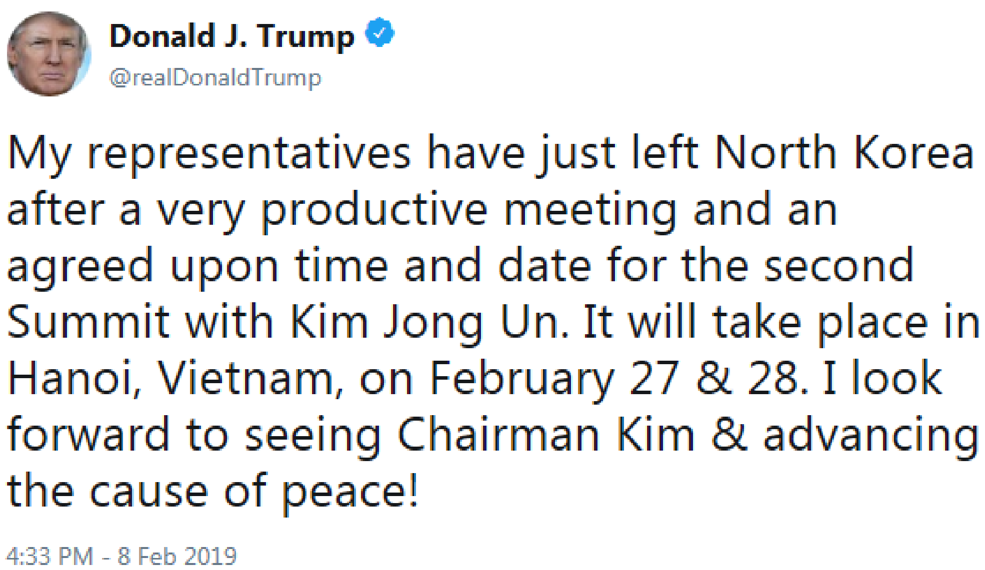
Xi was in effect offering a big win to Trump, not just on trade, but on North Korea as well:

> *China's strategy was clear from the composition of the delegation that accompanied Liu on his trip to Washington. Although labeled as "ministerial-level talks," Liu took no cabinet members with him. The only other high-profile figure on the delegation was Yi Gang, the governor of the People's Bank of China, the country's central bank.*
>
> *Sitting opposite a full line-up of Trump administration heavyweights such as U.S. Trade Representative Robert Lighthizer, Treasury Secretary Steven Mnuchin, Commerce Secretary Wilbur Ross was a group of Chinese vice-ministers.*

> *The unequal and bizarre lineup of the Chinese side said it all. The main purpose of Liu's U.S. trip was to meet Trump and personally convey in polite terms Xi's request for a summit.*
>
> *China knew that if it could arrange a meeting with Trump before the March 1 trade negotiation deadline, it could finalize the details of a possible deal in the days after this week's Chinese New Year holiday.*
>
> *This is where the North Korea issue comes into play. A source involved in Sino-North Korean relations says the really big issue between the U.S. and China is not trade, but national security.*

We believe that the recent statements on the American side about "a sizable difference" between the two sides and no Trump-Xi summit has been scheduled is posturing. Both sides desperately need a deal for their own domestic reasons. Negotiators on both sides will undoubtedly be closed-mouthed after the Beijing round of talks, but statements by both sides will offer some clues. Barring a complete breakdown, any decision to keep talking should be seen as a sign of progress. Expect negotiations to go right down to the wire, much like the NAFTA negotiations, which yielded only cosmetic changes, but all sides were able to claim victory. Trump's Friday night tweet about a meeting with Kim Jong-Un is a tantalizing clue that he has taken Xi's bait of a trade-North Korea linkage in the discussions.

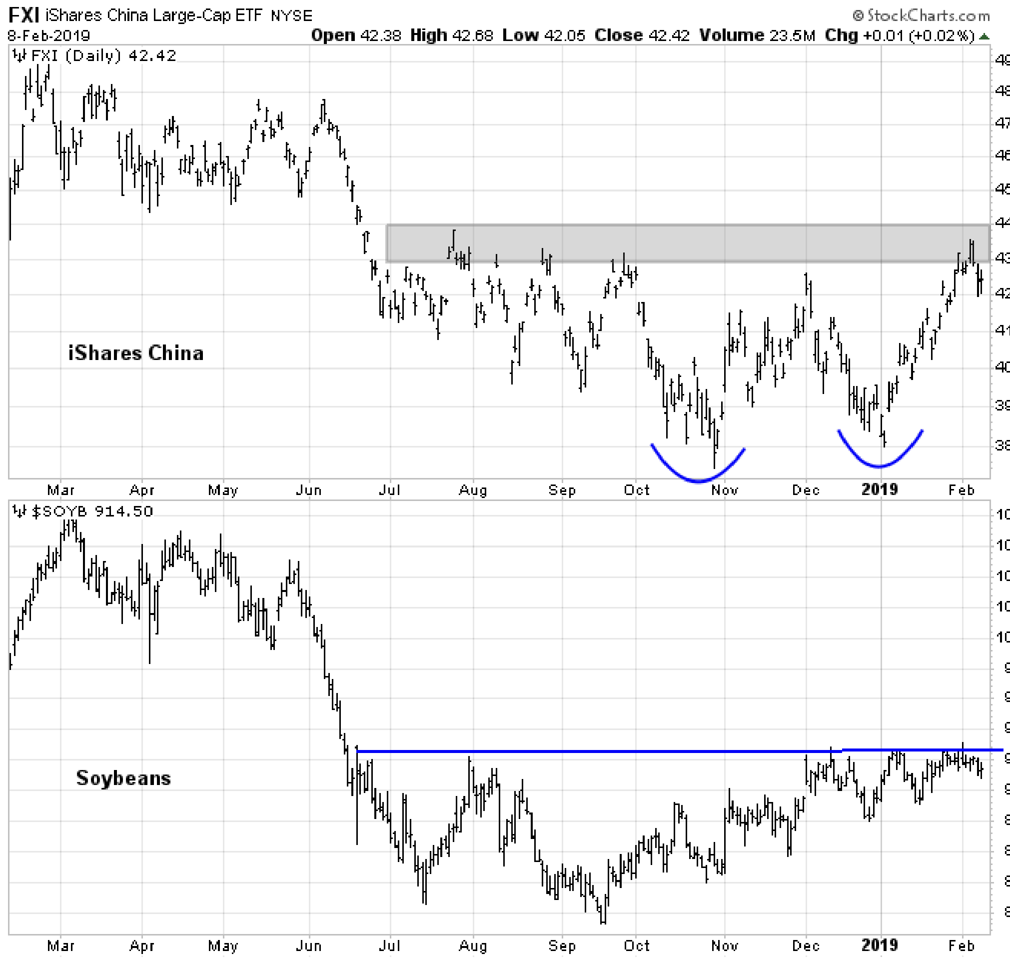
Exhibit 10: A Trump-Kim Summit Feb 27-28



Source: Twitter

The Chinese stock market was closed last week, but the U.S.-listed ETF was not. The U.S.-listed ETF (FXI) and soybean prices are exhibited constructive technical patterns that bear watching. FXI (top panel) made a double bottom and is now testing a key resistance zone. Soybean prices have been trending up and also testing key resistance.

Exhibit 11: China Sensitive Vehicles on the Verge of a Breakout



Source: Stockcharts

These will be key indicators to watch in the days to come.

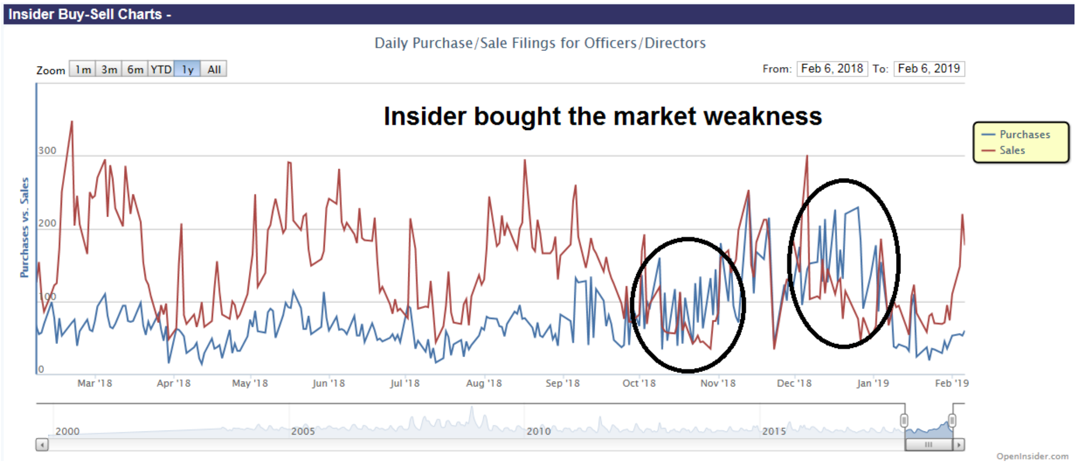
Bullish Tripwires

Should the market correct, or retrace and test the December lows, we stand by our belief that a re-test would represent a buying opportunity because the market was discounting a mild recession at the December 2018 year-end (see *Ursus Interruptus*).

Should stock prices weaken and re-test the previous lows, here are the signs we would watch to see if the same buying opportunity is still presenting itself.

How are insiders behaving? This group of "smart investors" bought the last two rounds of market weakness. Would they continue to do so if stock prices re-visit the December lows?

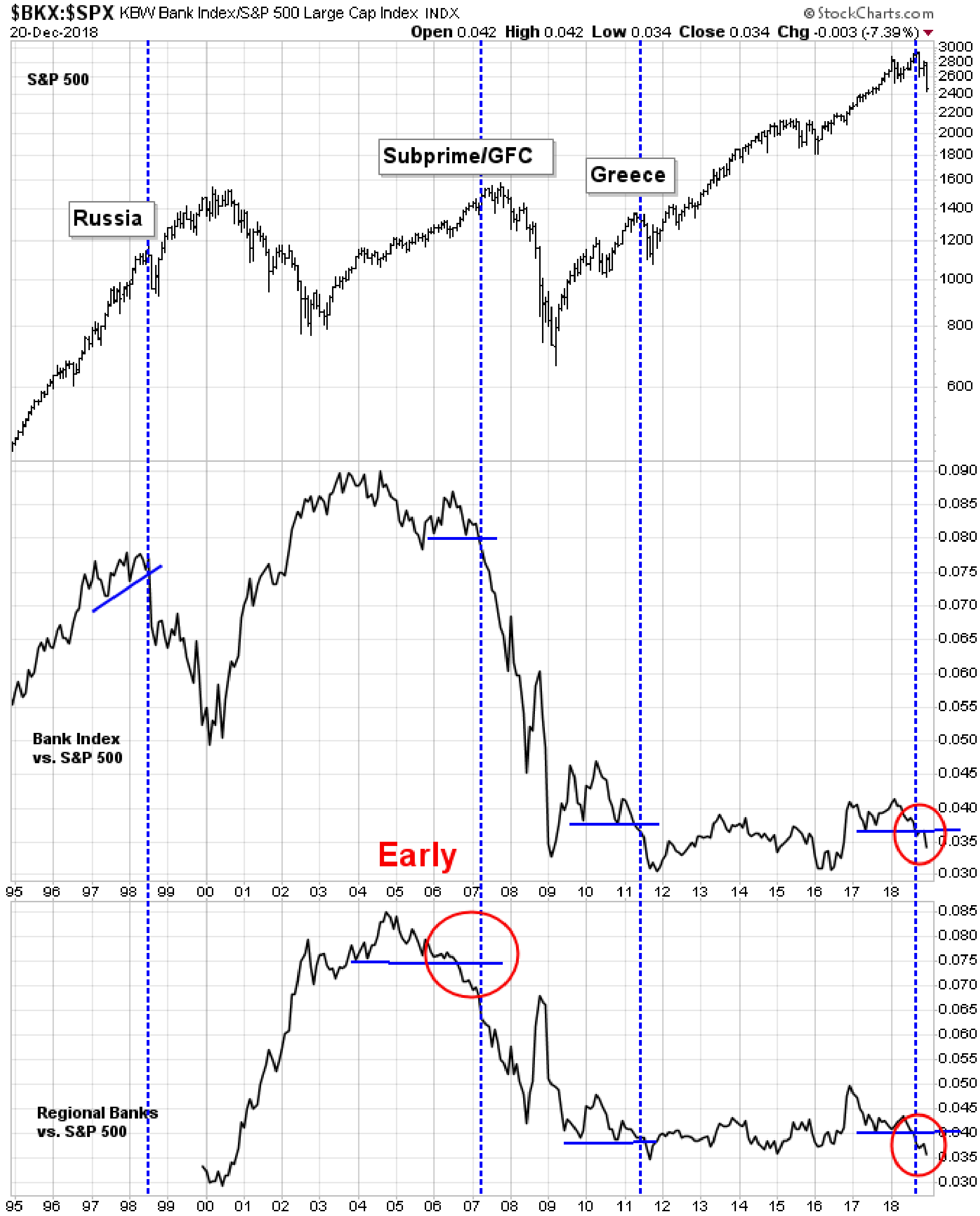
Exhibit 12: Watch Insider Activity If the Market Corrects



Source: Open Insiders

One concern that will undoubtedly face the markets in the event of a widespread growth scare is financial stress, and contagion risk from abroad. In the past, technical breakdowns of the relative performance of bank stocks have been warnings of equity bear markets.

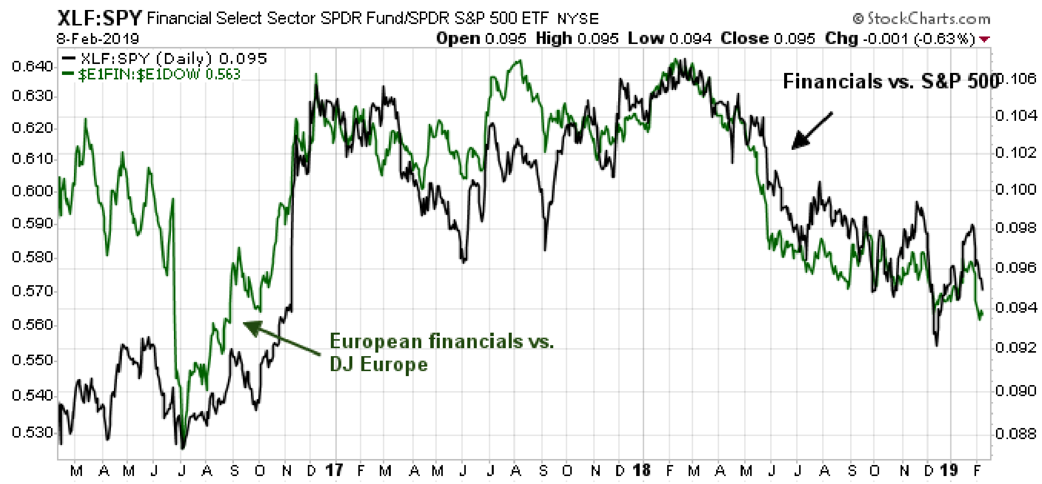
Exhibit 13: Technical Relative Breakdowns of Banks = Bear Market



Source: Stockcharts

Since a key stress point is the European banking system, how are the European financial stocks performing? Is the relative performance of the sector significantly worse than U.S. financials?

Exhibit 14: Watch U.S. and European Financials



Source: Stockcharts

As well, watch for signs of stress in the canaries in the Chinese coal mine. How are Chinese property developers like China Evergrande (3333.HK) behaving? Are they holding long-term support?

Exhibit 15: Are Chinese Property Developers Breaking Support?

Source: Yahoo Finance

What about the AUD/CAD exchange rate? Both Australia and Canada are commodity-sensitive economies, but Australia is more sensitive to China while Canada is more levered to American growth. Is AUD/CAD holding support?

Exhibit 16: Watch AUDCAD for Signs of China Weakness

Source: Yahoo Finance

If these tripwires were to flash the all-clear sign should stock prices correct, that would be the signal to step up and buy.

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