Feb 20-18

WHAT HAPPENS AFTER MARKET "MINI CRASHES"?

Good Evening To All

Thus far, 2018 is proving to be a record year for equity and bond markets! After one of the best January market starts on record we next had to deal with the fastest -10% correction since WW2—a breath taking plunge over just 9 days!

My take is that this is just the beginning of the many "RARE EVENTS" that we could see in 2018:

RARE EVENTS THUS FAR:

#1 The recent 10% plunge on the S&P 500 from Jan 26 to Feb 8 was a 4+ Standard deviation event! This was the fastest 10% correction since WW2 and also the fastest one EVER outside recessionary times!

#2 The famous "VIX Fear Index" had its biggest one day move in history—up 116% over that time frame!

#3 The next rare event--contrary to the normal "flight to safety" towards bonds that we typically see when stocks plunge, with this equity retreat we did not see this rush into bonds and instead we saw 10 year bond yields rise (and bond prices drop) which is very unusual. The last two times we saw this positive correlation between equity and bonds was 1987 and 1994….which were very bad years for equities…

#4 YEAR 9 Bull Markets are Rare Events—this is a repeat from prior notes but deserves mention again because of the possible negative market outcome…it is a rare event when we see significant Tax Cuts (at year 9) requiring massive serial deficits at a time of record low unemployment! Even rarer is that this is happening at a time when the FED is raising rates because we are ALREADY 9 YEARS INTO A CYCLE…uncharted and inflationary for sure!!!

How this will play out is what finally spooked markets just 12 days ago…and I expect more of this to come in 2018 as this rare scenario becomes more obvious to investors…

THE ECONOMIC BACKDROP

#1 Surprised Inflation is a Worry

-the recent surprised increase in inflation (CPI was 2.1% and Core was 1.9%--both higher than expected) and wages (the 2.9% increase in hourly wages was highest since 2009) is an indication of what is coming in 2018….equity markets worry about inflation as that means more rate hikes and lower profit margins…

-additionally, the worry is that the declining US dollar will bring more inflation home to the US (import inflation) in mid-2018

#2 The US Consumer is Not Doing Well

-retail sales fell 0.3% in Jan and the prior two months were revised down…a sign of consumer fatigue and this spooked markets last week

-savings rate in the US fell to 2.6% in Q4— last seen this low in the 1920s—Rosenberg says US savings are only this low 1% of the time in history…so where will the future spending come from I ask myself??

-on the credit side things look equally bleak—credit card delinquencies now at a 5 year high…then we add in massive auto loan debt and student debt and we see a troubled consumer going forward

-weak spending will be a surprise to the markets in 2018 I believe

#3 Rising IR and Bond Yields are a Worry

-if we see a rate hike in March that will be the 6th in this cycle which historically is a red flag for equities as the negative effects of the rate hikes are delayed for consumers and equities…but by the 6th increase is when market5s take notice historically

-and we now have the 2 year T bill yielding over 2.2% vs the dividend yield on S&P 500 at 1.8% --so we no longer have TINA—investors now have an option besides equities which will challenge equity money flow in 2018

-the biggest concern for the equity markets is the GLUT of US gov bonds that will be coming to market starting in 2018 because of the tax revenue short fall (i.e. Trump Tax cuts) AND at the same time the FED is rolling its massive bond accumulation (QE now into QT)…

-simple supply and demand dictate that bond prices MUST fall and rates MUST increase (in the short term anyways) and equity markets are now starting to worry about how consumers and corporations will deal with higher rates when they roll their bond portfolios (and mortgages) at much higher rates…

#4 The Sliding US Dollar

-the US dollar is down 12% over the last year against a basket of other currencies—exporters love this BUT it sends a poor message about the US economy

-why would the US $ be declining at a time that the FED is raising rates and "supposedly" the economy and markets are booming????...hmm…maybe Trump talking down the dollar is working or maybe Foreign investors see problems ahead for the US economy and its currency (e.g. massive deficits which will require ++ bond issuances, a weakening economy and inflation to just name a few)

-history tells us that a "weak currency equates to a weak economy" says Felix Zulauf and I agree

#5 Surprised Weakening Economy in 2018?

-well respected ECRI just reported that the US economy will surprise on the weak side in 2018—markets are NOT expecting this and ECRI has an excellent track record on cycles and turns…

-additionally and supporting this is that the Citi Group Economic Surprise Index for the major G10 economies is now weakening which is a MAJOR concern for frothy markets

#6 Valuations Extreme (Still)

-although valuations improved briefly with the 10% correction they are now again EXTREME—history tells me that going all in when markets are this expensive is a big mistake.

-a few recent words from much wiser investors:

-Howard marks—"most valuation parameters are either the richest ever or among the highest in history. In the past, levels like these were followed by downturns. Thus a decision to invest today has to rely on the belief that "it is different this time'"! A reminder—in the investing world it is NEVER different…greed begets extreme valuations and then the Herd jumps in and then the cycle turns---we are very close to a turn in my humble opinion

-Dr Richard Thaler—Nobel Prize winner…"we seem to be living in the riskiest moment of our lives and yet the stock market seems to be napping. I admit to not understanding it"…his reference I think is why the equity markets have not yet corrected…

-GMO James Montier---the "US equity market is OBSCENELY over valued" and so we are under exposed as you all know

-GMO estimated real returns over the next 7 years if bought at today's levels—for US Large Caps is a crushing -4.6% per year!!!!! And remember that their very accurate estimates at July 2000 peak was for "only" -2.5 per year and Jan 2008 was for "only" -0.1% per year for the following 7 years which was SPOT on—so YES buying now is worse than before 2000 and 2008 crashes according to GMO….

-the "Buffett Indicator' of the Wilshire 5000 market cap: GDP is now 137% vs 2007 = 104% and 2000 =136%!! Again another example of just how expensive it is…

As stated many times before—these are EXTREMLY expensive markets folks and although "valuations alone are not a great timing device" it is wise to pay attention after a Mini Crash and record volatility.

MY EXPECTATIONS

#1 A retest of the 10% correction is very likely over the next 2-4 weeks!!!

-the average correction seen in a bull market is -13% and this process typically occurs over 4 months(to the bottom) and then another 4 months to correct (Goldman Sachs)…NOT DAYS like we are seeing so far!!!

-another Bloomberg report said that over the last 60 years the median time to recoup a 10% correction has been 153 day!! Not days…so odds are very high that we will see a retest of this recent 10% correction!!

-so while valuations did improve briefly (i.e. I started my buy list) over ½ of this -10% decline has already been recouped. Logic dictates that we will see another 10% retest over the next few weeks…so I will wait patiently once again…

-the real question is whether the next retest will be in the "usual mid-term" negative 10-16% range or can we expect something MUCH BIGGER...we will see shortly…

-I will remind readers that that -20% "severe corrections" or bear markets also happen every 5-6 years even when there is NO RECESSION (or yield curve inversion) …like we saw in 1987, 1994, 1998 and 2011 and I think this is also a very possible outcome later in 2018 !?

#2 Surprise Economic Weakness in 2018

-this is the view point of ECRI and also the Citi Economic Surprise Index which measures on average how much a data point deviates from the forecast—this index has slid from the Jan 4 high of 80 to a low 40 Feb 14 according to Fact set

-I also note that renowned BCA Research Bank Credit is forecasting a recession in 2019—one of the rare such bearish calls and remember that the market typically responds to this 6-12 months ahead of time…

-also of note is that the famed Ray Dalio has now changed his tune saying that "the risk of a recession in next 18-24 months is rising"

-from my perspective the consumer is in trouble in 2018 and the Trump Tax Reform does little to help the middle class. Additionally, rising inflation and interest rates will spell trouble for the US consumer (and corporations) resulting in weak GDP growth and the markets are not pricing this in. This will be a surprise for frothy markets and create more volatility in 2018.

(but I am aware that share buy backs could help EPS in the near term thanks to the Trump Tax Cuts but I think this will be short lived)

CONCLUSION

For now we remain in defensive mode in all client accounts. This "mini crash" is a RED flag for me and I expect more volatility AND opportunity as we move through 2018.

The odds of a 10-16% decline in the very near future is very high I feel (that is our Plan A) but the risk of a bear market (a -20% decline) and no recession is now my B Plan for 2018. This would also allow for a great buying opportunity!

A close Plan C outcome in 2018 (and my PREFERRED Plan) is a FED induced recession brought on by inappropriate rate hikes later in 2018…either way I see a very hostile environment for equities ahead and hopefully I will be updating my "Suggested Buy List" for all clients very soon.

Although I am the first to admit that I have ZERO crystal ball forecasting abilities in the short run, I am an avid reader of history and will finish with a Warren Buffett quote --"what we learn from history is that nobody learns from history".

My sense is that we are seeing history repeat here again where despite significant risk versus reward asymmetry (not unlike 2000 and 2007) investors are blinded by greed once again, willing to dance right to the very end despite a very narrow exit!

Consequently, I will continue our defensive investing strategy until we see a better entry point, especially for new clients and new money.

Terry