02/04/20

Quarter in Review

The Markets

Q4 was less turbulent from a market standpoint with US equities up above 9% for the broad market, with foreign securities up just over 8%. The majority of equities were up over 20% and some over 30% for the year. Since the US-China trade agreement mid-December emerging market equities rallying 7.5% for the month and close to 12% for the quarter. Fixed income generally underperformed equity in the quarter but Long-Term bonds were still up over 19% for the year, high yield up over 15% and intermediate bonds up over 8%. Real Estate didn't have a good quarter but was up over 25% for the year right up there with equities. Commodities had a good Q4 up over 7% but was up just over 6% for the year. The only sector Commodities beat was cash earning just over 2% for the year.

National Observations

In early October After the WTO ruling against the EU for their support of Airbus, the US announced tariffs on 7.5 billion of EU goods. France and other countries vowed retaliation and with their economies already in the doldrums this won't help. The Fed, due to large fluctuations in repo rate, launch a new wave of quantitative easing but they aren't calling it that. In fact, by the end of the quarter the **Fed had increased its balance sheet by over 400 billion in T-Bill** purchases, injecting a massive amount of liquidity into the market. Many are associating the equity rally in Q4 and early 2020 with this action. If that weren't enough the Fed also cut rates for a third time at the end of October. Corporate earnings in Q3 were very good, albeit WeWork received a 9.5 billion rescue package from Softbank and Adam Nuemann was shown the door. There were a multitude of mergers and acquisitions during the quarter, with LVHM's 16 billion offer for Tiffany, Charles Schwabs agreement to acquire TD Ameritrade in an all-stock transaction valued at 26 billion. However, all was not good for **Boeing with the decision to halt 737 Max production** coming days before it fired its CEO on Christmas Eve. Many economists are calling for a 50-bps reduction in Q1 2020 GDP because of it. Boeings suppliers number the thousands and although Boeing itself said there will be no reduction in staff, many expect a reduction in employees to come in the next several months. On the regulation side the SEC pushed back the MiFID, Europe's investment research rules, requirement for US firm for another 3 years until July 2023. Most firms have been running dual books, but it still gives companies more time for full compliance. On the data side Barclay's put out a very interesting piece comparing the two most widely used purchasing managers indexes, ISM vs Markit PMIs. What the report showed was that ISM hasn't been tracking the current manufacturing slow down as well as Markit's PMI, in fact they are several points off each other, with ISM being more pessimistic. ISM is an extremely important indicator used across the street and is one of the first data points out, typically coming on the first business day of the month. I typically take statements like "this time is different" with a grain of salt, but knowing that it is now popping up in well regarded data sets is a bit worrisome. Also, on the data front, which is somewhat alarming, but sort of expected, is the **rise in medical insurance cost, up over 20% annually**. All you have to do is look at your rise in health insurance year over year (many of us don't) and you will see it for yourselves. This increase coincides with the start (Q3 2018) of the new source of data for the Bureau of Labor statistics and has contribution an additional 20 to 30 bps to CPI. Congress was busy this quarter finally passing the USMCA trade accord, and very significant changes to the retirements system. Although features like allowing small companies to join together to spread 401-K costs is a positive, allowing 401-Ks to add annuities, a product fraught historically with high expense and opaqueness, isn't a good thing. Secondly it limits the period of time inherited non-spousal IRAs can "stretch" payments to only ten years, from the beneficiaries expected lifetime. This essentially front loads tax revenues for congress when the beneficiary may not need the money. As the deficit continues to climb be sure that more policies like this will be put in place. Lastly and most certainly not least the important the **President of the United States was impeached**, making him the third in history. The trial has started at the time of this write up, and so far, the markets have generally ignored it focusing more on the trade deal with China and US/Iran saber rattling.

International Observations

In early October the US said it would not stop a Turkish advance into Syria which was seen as abandoning its Kurdish allies. Then a week later the White House was set to sanction Turkey for its military offensive. During that time an Iranian tanker was struck by missiles off the coast of Jeddah, while Saudi Aramco returned to pre-attack oil production levels, putting its IPO back on target. In November the Aramco IPO's value was reduced by both OPEC and the IEA saying that oil demand would plateau somewhere between 10 and 20 years. Eventually the IPO did go off well in December with Aramco raising close to 25.6 billion dollars, and after a jump in price on the first day of trading the company's value was close to 1.9 trillion.

Moving to Asia Hong Kong protests continued and became more violent, with the Hong Kong university standoff where over 100 students were trapped inside. Hong Kong's government invoked emergency powers (the first in over 50 years) to ban the wearing of facemasks. This was later found by a local court to be unconstitutional, however China's top legislature said the court had no power in its ruling. On the economic side the US blacklisted 8 Chinese tech firms, while China's GDP in October was close to 6% the slowest since the 1990s. Hong Kong's growth was even slower down 1.3%. During the trade negotiations in October where China agreed to buy more US agricultural products while the US was going to delay increasing tariffs, the House of Representatives passed a package of measures supporting the prodemocracy movement in Hong Kong. Although this didn't derail the trade talks, it didn't help matters. In the end of November Pro-democracy forces won a landslide victory in Hong Kong's local elections taking 85% of the 452 district council seats. But since the functional constituencies (around 3% of the population) votes for the executive committee (1200 people), which in turn selects the Chief Executive, only then to be approved by the Central Peoples Government in Beijing, the local election victory will probably not lead to much real change. Back in the US a trade deal with China seemed more and more elusive but on December 13th the US President signed off on a phase one deal just days before tariffs where to increase.

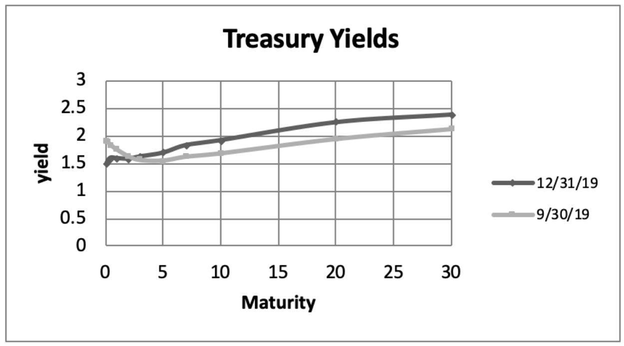
In Europe the two main topics of consequence where Brexit and slowing economies. After getting his Brexit deal approved by the EU and extending to 01/31/20 but rejected by Parliament, Boris Johnson's gambit for new elections paid off. On December 12th the conservatives won the majority capturing 364 seats (gaining 47 while Labour lost 59), and then on 12/21/19 the Parliament finally backed the deal. However just like other economies in Europe the UK had almost no growth in the third quarter as new orders and manufacturing continues to disappoint. On the Merger front in late December PSA Group (Peugeot and Citroën) and Fiat Chrysler agreed to merge, creating the fourth biggest auto manufacturer in the world.

Interest Rates

As previously mentioned, the Fed cut rates again to a range of 1.5 to 1.75% at the end of October. This seems to be the last rate cut and the Fed is comfortable with stopping there for now as it doesn't want to grow the ranks of those voting against the policy. The Feds main focus this quarter was quelling the spikes in the repo rate. It added over 400 billion in T-bills to its balance sheet, retracing over half of the reduction in 2018 and 2019. We are not living in a functioning market where the Fed has to do this. In the 12/18/19 Barclays pod cast call the Flip Side, Jeff Meli argued that once again the Fed is ignoring the moral hazard of injecting billions of dollars into the market. Now some can argue this was where the 2008 recession started with Bear and Lehman failing to obtain liquidity in that market. I believe that the reduction in the balance sheet would remove liquidity from almost every market and make price volatility increase. But bankruptcies for over levered entities need to happen. Our banking sector and their balance sheets are multiples better than where they were over a decade ago. Low interest rates have made those same entities which have been precluded from prop trading look for other avenues to make money, many simply lending overnight to leveraged hedge funds buying equities.

The inversion of the yield curve reversed in Q4 with everything from the 2-year on in rallying while back of the curve sold off, making an almost parallel shift upwards from 7 to 30 years. All this while interest rates were cut another 25 bps. The rallying in the front end may also be due to increase in the Fed buying T-Bills in their repo program.

Years	12/31/19	9/30/19	Difference
0.08	1.48	1.91	-0.43
0.24	1.55	1.88	-0.33
0.5	1.6	1.83	-0.23
1	1.59	1.75	-0.16
2	1.58	1.63	-0.05
3	1.62	1.56	0.06
5	1.69	1.55	0.14
7	1.83	1.62	0.21
10	1.92	1.68	0.24
20	2.25	1.94	0.31
30	2.39	2.12	0.27



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage has reversed its decline climbing from 3.64 back to 3.74%. 15-year conforming balance essentially did the exact same thing moving back from 3.16 to 3.19% for the quarter.

The Mortgage Bankers Association information as of 01/29/20 showed the 30-year conforming balance FRM down from 3.87% with .27 in points to 3.81% with .28 points. Jumbos loans were barely down from 4.01% with .28 pts to 3.97% with .24. 15-year conforming balance FRMs were also down slightly from 3.25% with .22 in points to 3.24% with the same points. S&P Case Shiller National average was up 50 bps in November, or 3.52%. Since 1988 the average has been about 3.81%. This was a pickup and the year over year average is back where it was in May of 2019. Looks like low mortgage rates are helped.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 111.2 still off July's adjust peak of 112. Since all but two of the underlying indicators have come out and not been computed, this a pretty good number. The biggest detractors were the recent rise in claims but that has since reverted back in January. ISM new orders were the second worst performer in the LEI and it has been in contraction mode since August. Building permits were definitely slower in December but still better than the 2019 average, as it was the last contractor to the LEI. The three largest contributors were stock prices, the credit index and consumer expectations… all of which are not GDP contributors. Although the index hung around 112 for latter half of the year, December was lower and in all the wrong places. These number can help the Fed to pretend to be on hold again this quarter while it continues to inflate its balance sheet. But I don't see this as a strong LEI going into 2020.

Jobs

At the time of this write up, **nonfarm payrolls** posted an **increase of 145,000 jobs for December.** Remember anything less than 150k could also be zero or negative. But November and October were 256k and a revised 152k up from 128k. For the year we are averaging about 176k jobs per month, down from 2018's 223k, and more in line with 2016 and 2017 and 187k and 182k respectively. These are NOT bad numbers, especially while the household unemployment rate is still at 3.5% down from 4% in January. The median duration of unemployment is 9 months, the exact same place we started the year. Aggregate weekly hours index settled at 111.7 up from 110.9 at the beginning of the year while **temporary services recovered slightly, but still down 16.5k jobs for the year**. Hopefully those turned into permanent positions. This canary is still alive and kicking. The Civilian Labor force participation rate has been at 63.2 for the better half of a year, slightly above the long run average of 62.88. The ISM employment survey number has been below 50, in contraction, since August of 2019. Manufacturing employment for the same time period eked out a whopping 5k jobs. **For the year manufacturing jobs were up about 46k which pales in comparison to 2018's 264k jobs gained**. The GM strike was disruptive during October and November, but the net over those two months was a positive 13k. With Boeing halting 737 Max production I don't believe we will see a bounce back in January or even Q1 2020 for that matter. My view is still for jobs to start slipping is in 2020.

Industrial production

Q4 IP was essentially flat returning a -0.01%. Since 2018 IP has been down 1.00%. December was unseasonably warm causing a 5.65% drop in utilities. The positive 0.2% in manufacturing and 1.3% in mining wasn't enough to counteract the loss. 2019 paled in comparison to the industrial recession of 2015, but I believe it was instrumental, along with the trade issues with China, in pushing the Fed into insurance mode this year. In addition to utilities, motor vehicles, consumer durables, transit equipment and durable goods materials also declined. The groups that had gains were information processing equipment, defense and space equipment, construction supplies and nondurable goods materials. On a side note **manufacturing capacity utilization (MCU) has been in decline in our country since the first recording in 1967.** More recently since the Great Recession it has struggled to reach prerecession levels, as noted by Dr. Daniel Bachman in his 2016 article for Deloitte entitled (*The curious case of manufacturing capacity utilization: Why hasn't it recovered from the Great Recession?)*. In the article he spoke about certain obvious MCU declines in printing and wood products. Since that article, capacity utilization has approached its post-recession peak near 80% at the end of 2014, but in 2019 we have slid back down across all sectors. Now although this bodes well for decreased bottlenecks and less inflationary pressure, it seems like the US continues to have excess manufacturing capacity, and probably in the wrong production groups.

Housing

New home sales for September were 694k per year, while November was 697k and October was 705k. Q3 was better but 2019 was marked improvement over 2018. Mortgage rates rose in early October (still under 4%) and stayed put until the beginning of the 2020, where they have started their march south again. **Existing home sales were 5.540mm annually ending December.** This was above the past two years average of 5.340mm for both 2018 and 2019. Although December showed a bit of slow down private housing building permits have been steadily rising since 2011. The outlier for December though was **New Housing Starts up 1.608mm**, a number not seen since 2006! I think this number will probably get revised and I would like to understand more on what demographic is ordering these new houses. I am still pessimistic about the next generations desire/ability to save for housing. The student debt issue is still one of the main forces against home purchases, but so is waiting to get married and have a family. I will wait till January's number to see if this is a trend.

The Consumer

The Conference Board's consumer confidence index stood at 128.2 as of December 2019. Since the September drop of close to 8 pts it has been on the rise driven by peoples view of the current and future job market. The **University of Michigan's Consumer Sentiment December number was 99.3**, also up for the quarter and the highest level since June. This was supported by personal income, disposable personal income and personal consumption expenditures all rising for December. With that said the year over year numbers dropped in personal income and disposable personal income below a rate of 4%, while consumption expenditures were close to 5%, the highest number since October 2018. Real Income less transfers (social security is a transfer), was also down a bit in December but up considerably for the year. The consumer is still in a good spot, income is rising, employment is holding, and sentiment is strengthening.

Inflation

As of December, **CPI was up 2.29% and PCE was up 1.61% year over year,** a considerable pick up from Q3. The Fed is starting to get its inflation target back near 2.00% but at what cost. Food items were up 1.8%, with five of the six major grocery categories up except for fresh fruits and vegetables. Food away from home was up 3.1% as well, while energy reversed it early year contraction and was up in each month of Q4. Nonfood and energy items like shelter were also up for the year, 3.2%, while the medical care index rose 4.6%, as mentioned above. Prescription drugs and hospital services both rose 3%. Auto insurance was flat while new vehicles rose 0.1%, but used cars and trucks declined 0.7% for the year. **The education index increased 2.1% in 2019 after a 2.6% increase in 2018.** Airline fares were up 1.7% with recreation up 1.5%. Tobacco increased 5.5% this past year, while alcohol rose 0.5%. Apparel declined for the sixth year in a row, down 1.2%.

In Closing

We are now **126 months** into an economic expansion, still hanging on. It might have helped that the Fed cut rates three times last year and injected 400 billion into the economy, but hey whose counting. The leading economic indicators are still pointing north but the strength is coming from stock prices, credit index, and expectations. Not the meat potatoes of new orders or claims. **Jobs were up 553k for the quarter, and about 176k per month for the year.** This was off from 2018 but more in line with the previous years and end of expansion gains. **Industrial production was down 1.00% for the year,** a far cry from the 2015 industrial recession but definitely off. As the phase one part of trade accord with China kicks in, we would normally see this pick up, but with Boeing halting production of the 737 max, Q1 2020 GDP isn't shaping up well. Housing had a substantial pick up in December with single family new home sales up 23% from a year ago, while new housing starts also had a jump to 1.6mm on an annual basis. Existing home sales had the same average yearly amount of 5.34mm as in 2018, while house prices across the country were up 3.52% year over year till November. The consumer looks fine, personal income, disposable personal income and personal consumption expenditures all rose in December. Real Personal Income Less Transfers was up close to 8% on the year. The savings rate is down a bit from last year but at 7.6% it is twice as much as we were saving prior to the great recession. Signs of recession are down, but the Fed can't seem to turn off the easy money, even at the risk of moral hazard, didn't we learn about this during Alan Greenspan's tenure…

As of this write up my model is still calling for a chance of a recession less than 20%, but we are in uncharted territory now. Modern monetary theory is being talked about in more than the economics faculty lounges at the London School of Economics and post Keynesian socialist poetry clubs. As the links between full employment and inflation are being tested in these times, government debt can be monetized in huge swaths, I am concerned that we are often forgetting the hyperinflation of the Weimar Republic and the resulting in the systematic destruction of wealth and the middle class of that country. Companies leverage levels are high, but their earnings are hiding this, and corporate debt hasn't seen the downgrade parade yet. Can we ever get off the easy money train?

Overall our allocation for 2020 hasn't changed that much. I have shifted back a large portion of the US small cap equity exposure to mid-cap, but the overall equity to fixed income allocation hasn't changed that much. I am back in intermediate term debt, but probably should have been in longer dated instruments as the Fed QE T-Bill program has a similar effect to cutting interest rates. The Coronavirus has taken emerging market stocks for a ride, a place I probably won't ever be comfortable investing my client's assets in. I have stayed away from real estate and commodities in my allocation but am currently looking at certain retail versions of private equity investments.