

# So much for the death of the bull market. Now what?

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1. While the equity market has had one heck of a rally year-to-date, sentiment indicators remain less bullish than one would expect given the magnitude of the rally. As much as the market is due for a retrenchment, the lack of capitulation by the bears keeps the market from fading. Positioning is simply not bullish enough yet.
2. The dramatic reversal in Federal Reserve policies implies the Fed “put” is back on the table. This encourages increased “risk-on” positioning, much of which is already reflected in higher P/E multiples.
3. We do not expect, nor have we expected, a retest of the lows, primarily because we believe the December selloff was the retest of the October low. Extenuating circumstances caused the December retest to go much lower than the October low.
4. 2019 U.S. earnings estimates are dropping. Never a good thing. We are believers in “follow the numbers”, and weakening fundamentals are a reason for caution. The case for an earnings recession later this spring has increased.
5. Emerging Markets, Europe and Japan all had horrible performance in 2018. They appear cheap from a valuation basis. Earnings revisions are bottoming out in Emerging Markets. No sign yet in Europe or Japan.

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Now for the details:

- 1) If there were ever a period of time that highlighted the importance of having an asset allocation plan and sticking to it (in my opinion, one of the key purposes of employing a financial advisor), it's the saga of fund flows in December and January.

Consider: in December, more money was pulled from equity mutual funds/ETFs than any other month: an estimated -\$89 billion.<sup>1</sup>

But the net outflows continued in early January *only to modestly reverse in the past couple of weeks.*

In my opinion, this is the textbook example of framing one's investment allocation decision based on current market prices versus having a targeted asset allocation plan. Pure emotion. Sell low (December) and buy back higher (now). That is no plan.

Cumulatively, investors sold the lows and reversed course only once the market moved higher. And while I have no hard evidence yet, I suspect self-directed flows were the primary drivers of this poor timing. Purely my opinion at this juncture, but in time that data will come out, and I doubt this time is different. *Self-directed trading tends to be the most reactionary.*

Certainly institutional pension plans with targeted asset allocations are looking pretty smart considering they stepped up in very late December and bought an estimated \$60 billion in equities to adjust their allocations.

*Institutional investors with large holdings in stocks and bonds use the end of the quarter to balance out holdings, adding to losers and cutting winners. **This time they went big on US large and small cap.** (Fortune Magazine, December 28th, 2018)*

Yet again, this reinforces the view that establishing and sticking with an asset allocation forces buying low when it feels crummy, not high when it feels great. Antithesis of the masses.

Now I understand there was a ton of tax loss selling at the end of the year, but if it was only swapping one loser for another, then the fund flow data would not have been nearly so negative as it was.

It's a simple lesson that we all know. *But if it's so simple, why does it happen over and over?* And if it happened to someone you know, then I would

encourage them to turn off the TV, not watch their portfolio daily and *pursue a less emotionally-driven targeted asset allocation strategy.*

What does this have to do with the market continuing to levitate higher despite an already inspiring rally?

A majority of the panicked money that left the market in December has not returned yet. Remember, the fund flows are barely positive YTD.<sup>2</sup> If we experienced classic investor panic/fear, why won't we once again experience classic investor greed?

In short, we need to convert those new bears fully back into bulls before the market runs out of steam. The AAll consensus bull index which dropped to 20% in December has only just this week risen to 40%, versus 60% in early 2018. Put/call ratios remain elevated. Hedge funds have remained on the sidelines after getting badly burned in Q4. *Each of these is a short-term indicator and could turn quickly,* but as of this date, there remains an elevated level of skepticism about the rally.

- 2) 2018 was the story of rising earnings with declining P/Es. 2019 just might be the reverse. I will get to the earnings part in #3, but the reversal in the market P/E has ALL to do with the reversal of the Fed. The 2018 move to normalize rates is over. Given January's pronouncements by the Fed regarding future rate increases and adjustments to the rate of balance sheet reduction, my view is that the equity market perceives that the Fed "put" is back on the table. The Fed's willingness to reverse direction when things get rocky encourages investors to take more risk. And that tends to result in higher P/E's.

*The problem is much of this change has already been reflected in the market's valuation.*

Consider: On February 11, 2016, then Fed Chair Janet Yellen seemingly reversed direction when she stated that, "Financial conditions in the US have recently become less supportive of growth." It was a message that the Fed was turning more dovish, at least temporarily. The forward S&P 500 P/E went from 14.8x the day before her pronouncement to 16.8x by the end of 2016<sup>3</sup>, a full 2 P/E turns higher.

Likewise, on January 4th, 2019, Jerome Powell first indicated an alteration in Fed policy. Since then, the forward P/E multiple on the S&P has risen from 14.1x to 15.9x today. A 1.8 P/E turn.<sup>4</sup>

*Our conclusion is that the change in Fed policy is good for equities, but at least for now, much of the change has been priced in.*

- 3) Lately, “retest” has replaced “recession” as the most used “r” word in the market! Lots of chatter about “when is the December retest?” A question: if the April 2018 correction was the retest of the February 2018 correction, then what happened to the retest of the October 2018 correction? Where was that?

In the November 2018 commentary that was published shortly after the late October selloff, we wrote:

*With the recent low on October 29th, a more consistent retest would not come until just before Christmas. Not last Friday. **Bah-Humbug!***

Well, I guess the date was right. But to call the 2351 low on the SPX on December 24th simply a “retest” is understating the pain.

*But hear me out on this one.* On December 13th, 2018 the SPX was back to the October lows. I thought we were a week early but more or less proving our point.

And then, as we all know, it became worse. Over those next seven days of trading, the market dropped yet another -11%.

Sitting at my desk (and sometimes under my desk) and watching what happened that week leading up to Christmas, it was clear to me that mutual fund liquidation, tax loss selling, hedge fund liquidation, etc. with no bids, further accentuated the declines. Anyone that scoffs at that notion was probably already on vacation!

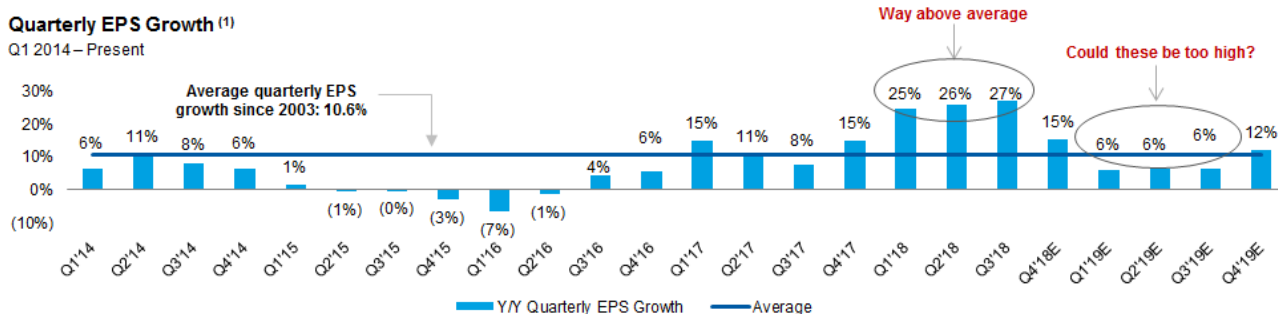
Could the December decline have been the October retest, albeit with some unique circumstances? If that’s the case, the retest that everyone is expecting should not emerge. Enough said. That was last year’s story.

- 4) In our 2019 January outlook piece, we discussed the “better than 50/50 chance of an earnings recession in the US in 2019.” Since then, the likelihood of such a scenario occurring has only increased. *Recent 2019 earnings revisions are just terrible – even post-earnings announcements.* Yes, companies might be meeting revised guidance, but the 2019 estimates continue to drop.

The argument for an earnings recession was simply that the bar was just too high year-over-year.

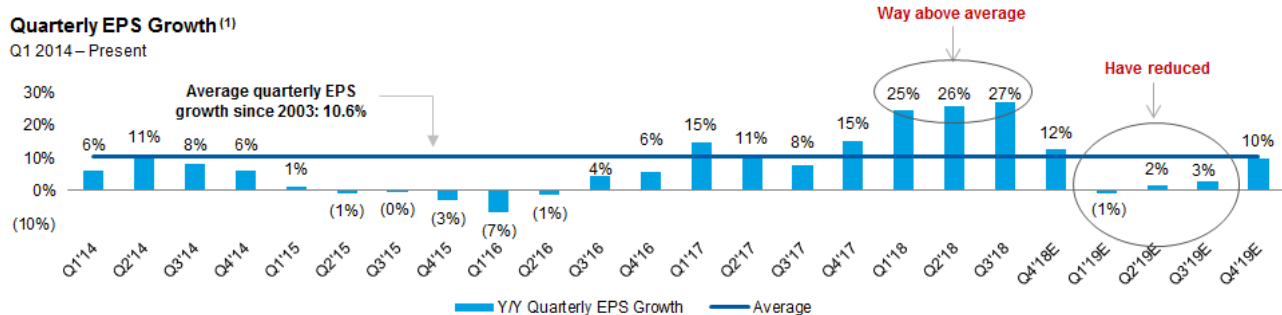
Here is the chart we used in January (Display 1):

**DISPLAY 1**



1. Refinitiv, S&P, Factset, Morgan Stanley Research, Full year EPS is sum of 4 quarters, Based on data available as of December 18, 2018 **Past performance is no guide to future performance and the value of investments and income from them can fall as well as rise.** Indices are unmanaged and not available for direct investment. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

DISPLAY 2



1. Refinitiv, S&P, Factset, Morgan Stanley Research, Full year EPS is sum of 4 quarters, Based on data available as of January 18, 2018 **Past performance is no guide to future performance and the value of investments and income from them can fall as well as rise.** Indices are unmanaged and not available for direct investment. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Now look at that same chart updated (Display 2). Note the changes in Q1, Q2 and Q3 for 2019.

If a recession is two consecutive quarters of negative growth, it looks to me like Q1 is already there and Q2 is teetering. *Shouldn't the market start worrying about an earnings recession?*

To review, there are many precedents of an earnings recession without an economic recession. The average decline in the market under those scenarios (6 since 1950) has been a -16% decline.<sup>5</sup> That's no big deal, given we saw a -19.8% peak to trough decline at the end of 2018. However, the more the market rallies, the more we must factor this in as a risk. At the very least, to us this seems to be a negative that is potentially looming in the spring. The bulls need estimate revisions to turn upward.

- 5) There is obviously a key difference between Value "Buys" and Value "Traps", encapsulating the key difference between Emerging Markets and Europe/Japan. Non-US markets collectively performed worse than the US last year. Additionally, each market has plenty of stocks that scream of being cheap. Check the "Value" box.

But stocks remain value traps until fundamentals turn up, at which point they become value buys. Positive revisions imply expectations are thoroughly washed out, which is happening in Emerging Markets. No sign yet for Europe/Japan. So for us, EM is a value buy, while Europe/Japan remain in value trap territory.

This does not mean we have no allocation to Europe/Japan. But the allocation has been static in these regions versus in EM where we have been increasing.

*In conclusion, given the magnitude of this recent rally, we are more cautious on the US. We are more optimistic on Emerging Markets and we are in a holding pattern on Europe/Japan.*

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<sup>1</sup> ICI Weekly data

<sup>2</sup> ICI Weekly data

<sup>3</sup> Factset

<sup>4</sup> Factset

<sup>5</sup> St.Louis Fed, U.S. Bureau of Economic Analysis, Bloomberg