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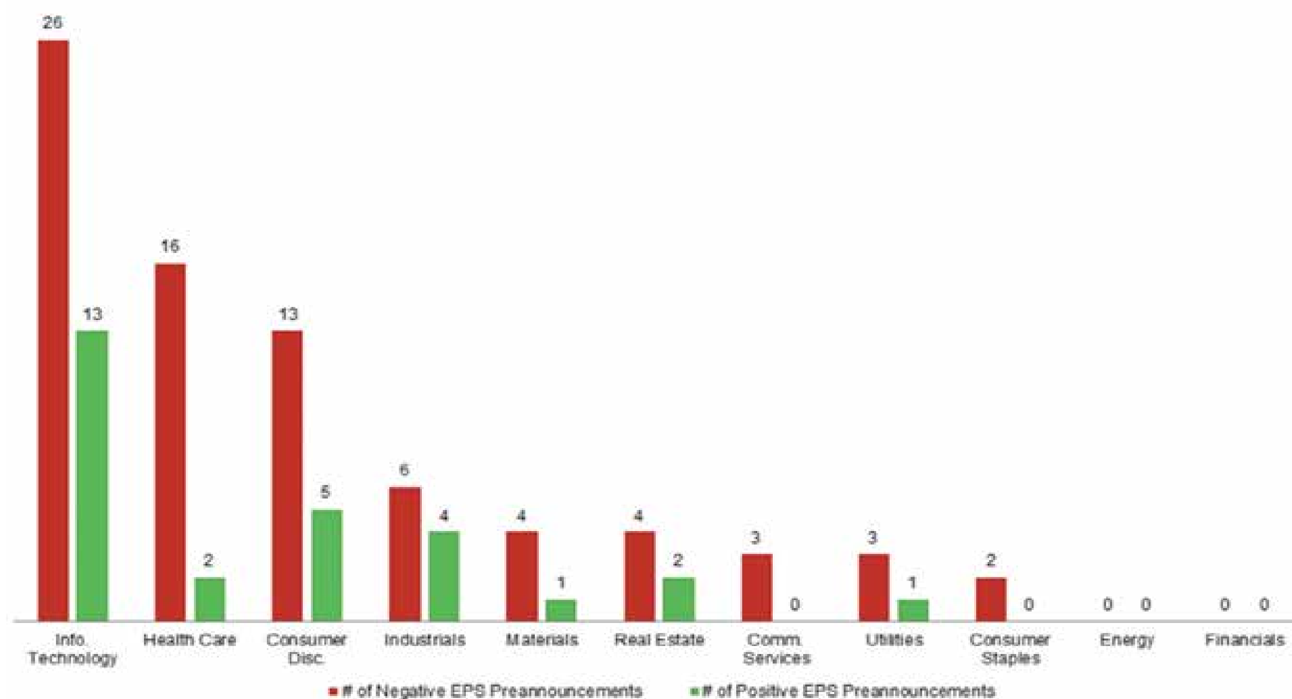
With roughly 80% of trades in the stock market now being executed by algorithms that react instantaneously to triggers ranging from earnings announcements to specific words used in 5am tweets from the president, the world of investing has certainly entered a new paradigm. In an environment where volatility begets more volatility, as we see today, one must be positioned for a turn in the market cycle before the tipping point becomes conventional wisdom. In this issue we'll explore the factors that lead us to believe that, despite the Federal Reserve's recent reversal towards accomodative monetary policy, we're near the end of the cyclical upswing that began in 2009. Across our portfolios our emphasis continues to shift towards income-generating, low-volatility securities with minimal sensitivity to a slowdown in the broad economy.

Following our call last year for increased caution (see 2Q18's Viewpoints: *An Inflection Point*), the equity market experienced a dramatic downdraft beginning in September, followed by an equally dramatic recovery to start 2019. In fact, it was the worst performing month of December for US equities since 1931, and the best month of January since 1987. The fourth quarter sell-off was driven by what the rate-of-change data made apparent: the period of globally synchronized growth in 2017 and early 2018 had come to an end; the Fed's tightening regime looked increasingly likely to destabilize saturated debt markets; and the Trump tax cuts would do little more than provide a temporary bump to GDP and corporate earnings. In 2019, all of these concerns remain in place, with one important development that has been enough

to reinvigorate equity markets. To the surprise of most, the Fed announced not only that its tightening regime has come to an end, but it has also suggested, with increasing confidence in subsequent meetings, that interest rate cuts are now back in the cards. Unlike today's bulls, who assume by extrapolation that easy money must always bring about greater risk appetites and higher asset prices, we don't see the Fed's new stance as a cause for celebration, but more likely a sign that economic conditions have declined more abruptly than expected.

A closer look at rates-of-change of key economic indicators tells us the driver of equities this year has been nothing more than a knee-jerk reaction to the Fed's pivot. After hitting an all-time high of 12.1% in the third quarter of 2018, S&P 500 profit margins fell to 10.1% in the fourth quarter, the lowest level since Q1 2017. Looking at estimates for the first quarter of 2019, consensus projections six months ago called for S&P 500 profit growth of +8.1%; three months ago that estimate fell to +5.3%, and today it stands at *negative* 3.8%. Pricing power and top-line growth are still non-existent in most sectors and wages are escalating following decades of stagnation. We believe an earnings recession is more likely than the optimistic 10+% bottom-line growth baked into consensus projections for the fourth quarter and 2020 as a whole, and thus we continue to tilt allocations toward non-cyclical equities with durable margins.

With respect to GDP, consensus forecasts immediately following last year's tax cuts reflected a prolonged period of 3+% growth spurred by what was expected to be a surge



in new capital investment. One year later we can look at the sequence of GDP numbers and observe this failed to happen: 4.2% growth in Q2 (the peak), 3.4% in Q3, 2.2% in Q4, and an estimated 1.0% for Q1 of 2019. The takeaway here is that providing corporations handouts does not necessarily give executive suites the confidence to pursue risky long-term projects needed for productivity growth and job creation. Instead of a burst in new capex plans, an incredible $806 billion of stock was repurchased in 2018, up 55% from 2017 and up 36% from the previous high watermark in 2007. With the national debt increasing $1.48 trillion last year, it begs the question of whether organic growth is happening at all.

Underlying these headline numbers is a more pessimistic US consumer, the driving force of the economy. In recent months consumer spending, consumer confidence and retail sales data have each turned sharply negative from a rate-of-change perspective, although absolute levels remain slightly positive and a point of emphasis for market cheerleaders. The casual reader of financial news is also likely unaware the US housing market has been in a recession for several quarters. Meanwhile, saving rates among wealthy households are on the rise while purchases of luxury and discretionary goods, such as cars, jewelry, watches, travel, and high-end Manhattan real estate (one of our favorite leading indicators) are falling steeply. We attribute this behavior to growing self-awareness among US households regarding their high levels of indebtedness, which are now at historic highs, as well as the psychological "wealth effect" from a range-bound equity market and softening housing prices.

Given the noticeably low trading volumes on up days compared to down days so far this year, the rally in US equity prices seems to us a demonstration of the old adage that "the public buys the most at the top and the least

at the bottom." While equities are pricing in an economic reacceleration, fixed income markets are revealing a set of entirely different expectations. Since October 2018, the yield of the behemoth Barclays Global Treasury Index, representing a composite of 37 investment grade countries, fell 27%. At the time of this writing nearly one-fifth of the global bond market is trading with negative yields. Not quite in negative territory, the belly of the US treasury yield curve has also been inverted for most of the year. The prevailing message domestically and abroad is that low growth and inflation

are here to stay. Inverted yield curves have historically been one of the best predictors of looming recessions, and the Fed's response to cut short rates when inversions do occur has almost always come too late.

All this is not to say we anticipate a financial calamity of similar scale to 2000 or 2008. Our base case assumes a recession in corporate earnings and a return to economic growth at just above stall-speed. US markets still look to us as the best house in a sketchy neighborhood largely because of our superior ability to transmit monetary policy in response to market shocks, as well as the global dependence on the US dollar. The recent strengthening of the greenback has once again highlighted its exclusive stature as the refuge of choice during economic turbulence, the primary currency all major commodity exchanges, and the most attractive repository for global savings.

Looking ahead, we'll require some visibility of a meaningful pick-up in capital expenditures, likely resulting from a massive government-backed infrastructure plan, in order to turn positive on economically-sensitive equities. In the meantime, we expect bonds and value stocks with reliable dividends will outperform growth-oriented assets.

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