“Does Powell Trump Trump?”

trump:
noun – a valuable resource that may be used, especially as a surprise, in order to gain an advantage

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The US equity markets have had a strong early part of the year even though most Q4 2018 and early Q1 2019 economic numbers have not followed suit. The bulls on Wall Street would say the economic numbers don’t matter because an easy Fed trumps the fundamentals. That may turn out to be correct, but in my opinion, it is too early to tell.

Fact is, the markets are on the 8th week of uninterrupted gains since the December lows and as of this writing, we are now just above their 200-day moving average. The pervasive belief is that the Fed will be able to engineer a soft landing (because they have been so good at it before…insert sarcasm here).

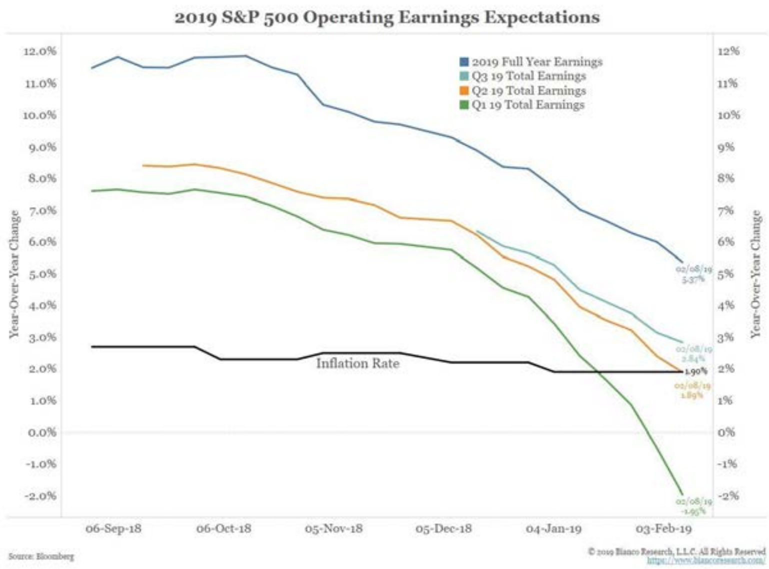
What’s changed since the December lows other than Jay Powell’s (Fed) speeches? Absolutely nothing. The economic numbers looked mixed at best and the outlook for the S&P 500 earnings for Q1 has fallen deeper into the red (which would be the first negative showing in three years if it holds).

So, this month I am going to do my version of “show and tell” in which I have found some interesting charts that highlight the division between the markets, corporate earnings, and relevant economic data.

Enjoy!

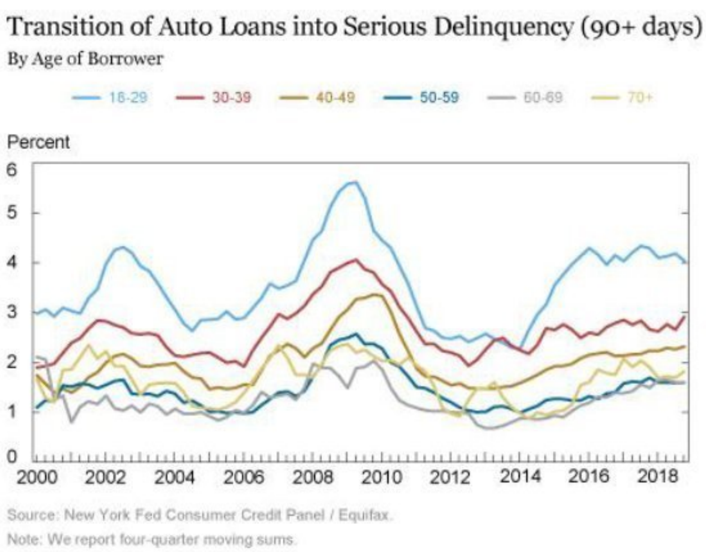
The first chart highlights 2019's S&P 500 Operating Earnings Expectations. This is forward guidance on earnings as well as the inflation rate.

This chart would look great if it was the topography of the ski slope, but if you're looking for higher valuations on the market, it's hard to get excited when looking at 2019.



Source Bloomberg

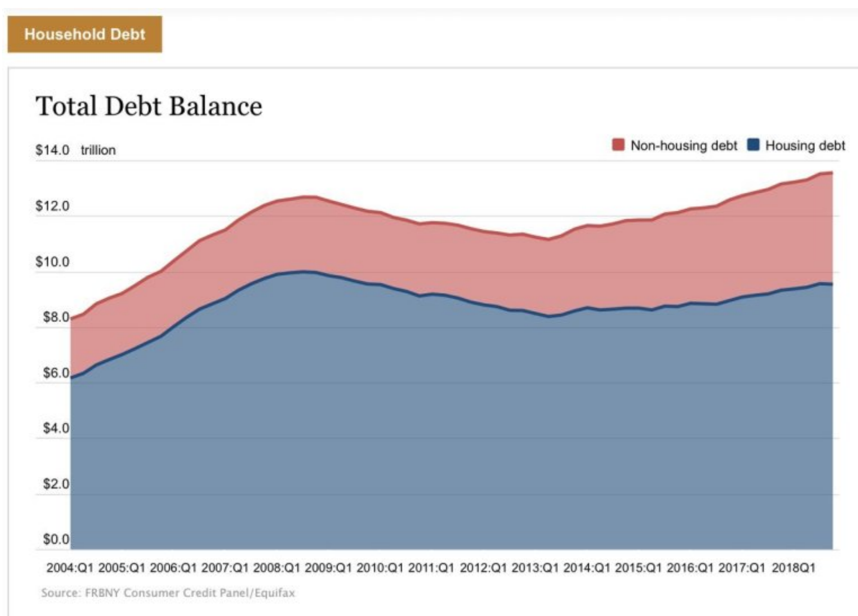
This chart below is (in my opinion) very interesting. This chart shows delinquency in auto loans by age group. Since cars are the last thing that people want to allow to go delinquent, this gives a good indication of the underlying strength of various demographics. As you can see, since 2014 rates have started to go up modestly, and is something that should be watched.



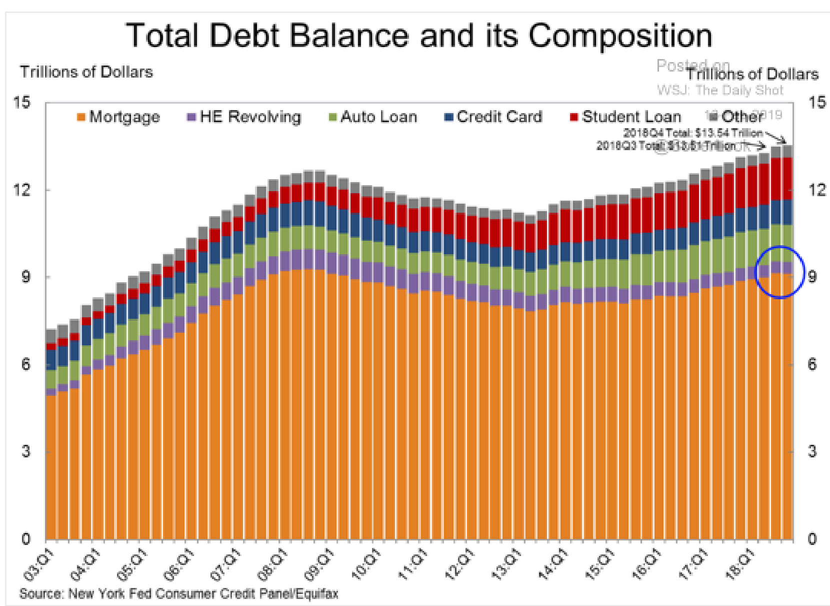
Source: New York Fed Consumer Credit Panel

The two charts below illustrate a topic that I have referenced in past papers, the total amount of household debt. This includes; real estate (the largest portion), auto loans, credit cards, and student debt. As you can see, the spread between real estate (blue) and all other debt (red) has widened and (underlined for emphasis), we are well above 2008 levels.

If you refer to the previous chart, you'll notice that both delinquency and debt started to rise in 2014. In my opinion, this was caused by the real cost of living increases (not what is seen on CPI) outpacing wage growth. As such, consumers used and continue to use debt to supplement the relative decrease in real income. Those frustrations were played out in the 2016 election and could happen again (in the opposite direction) in 2020.

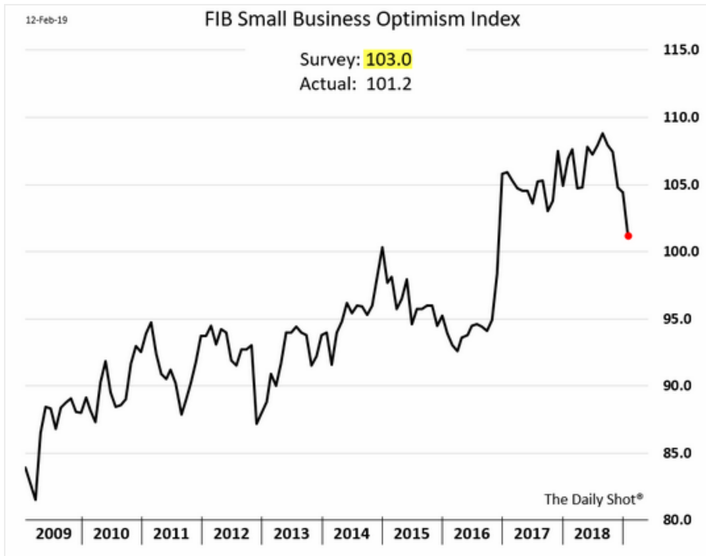


Source: Consumer Credit Panel/Equifax



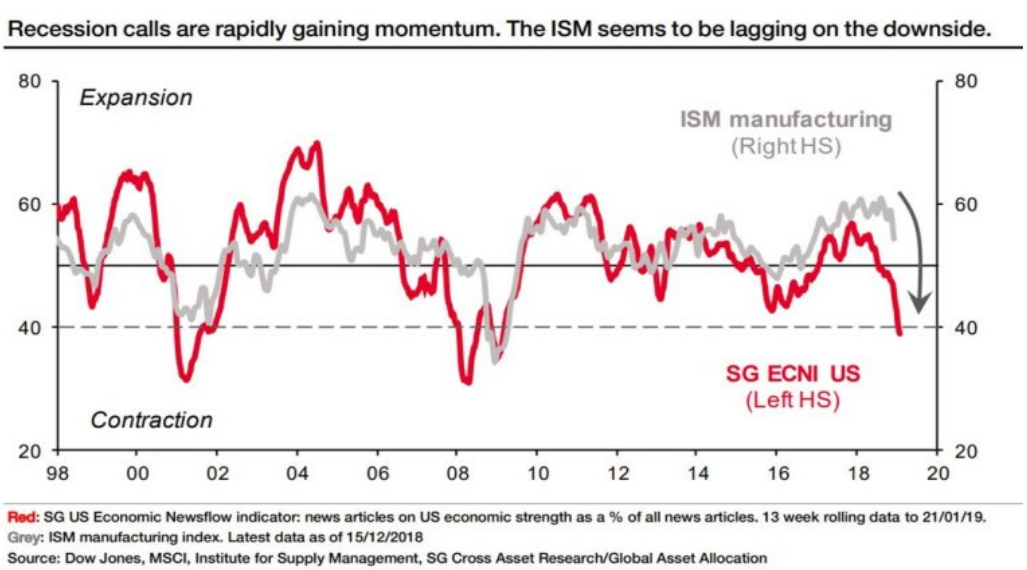
Source: NY Fed/Equifax

So, what is happening with the "Mom and Pop Shops" that drives much of the US economy? The chart below is the FIB Small Business Optimism Index. Once again, the chart shows that business optimism is declining. For the most part, these are not companies that would be adversely affected by trade deals (or lack thereof). This chart generally will correlate with how consumers feel between the coast (Heartland). If our current President hopes to be reelected, I suspect this optimism downtrend would have to reverse course.



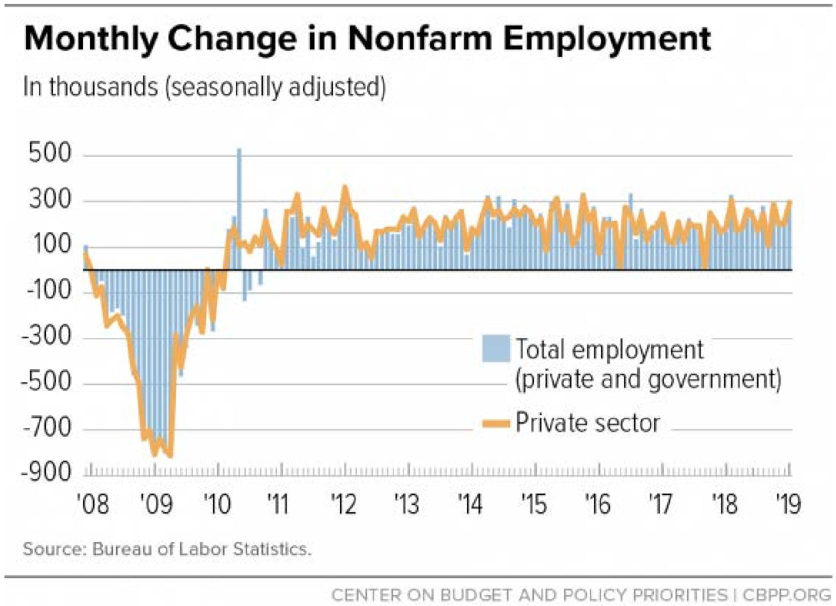
Source: The Wall Street Journal

OK, so I am giving you all the bad stuff first. The next chart below is comprised of data from Dow Jones, MSCI, and the Institute for Supply Management (ISM). The ISM numbers are showing a significant amount of slowing have historically lead to contractions in the economy. This theme piggybacks on the small business confidence numbers which have dropped 5 months in a row.



Source: Dow Jones, ISM, SG Cross

Not all economic data is bad, however, as you have seen on the news recently, employment in this country is very robust. The US has averaged 195,000 new jobs each month from March 2010 through January 2019. That is impressive over a 9-year period and through two administrations.



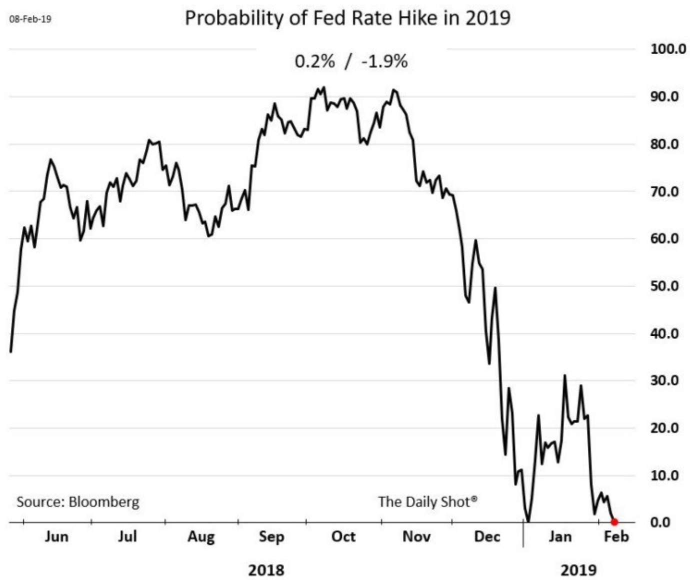
Source: BLS

The best news for employees in the US is that wages (which stagnated for the last 5 years) started to move higher in 2018. This is much needed good news for those in the workforce.

Source: CBPP from the LBS

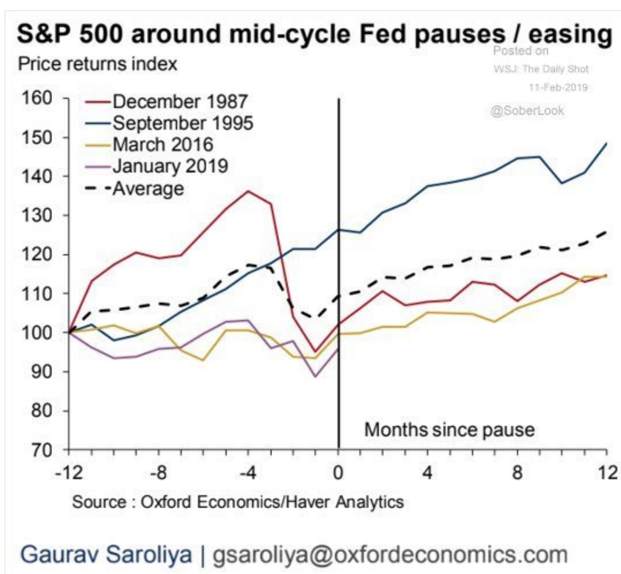
But if you really want to know why the bulls are in control, I believe it comes down to these next few charts. I like to think of it as the "Powell Trump Card."

Below is the current probability of a Fed Rate Hike as implied by the Fed Funds Futures market. As you can see, the markets are giving a zero percent chance the Fed will raise rates.



Source: Bloomberg

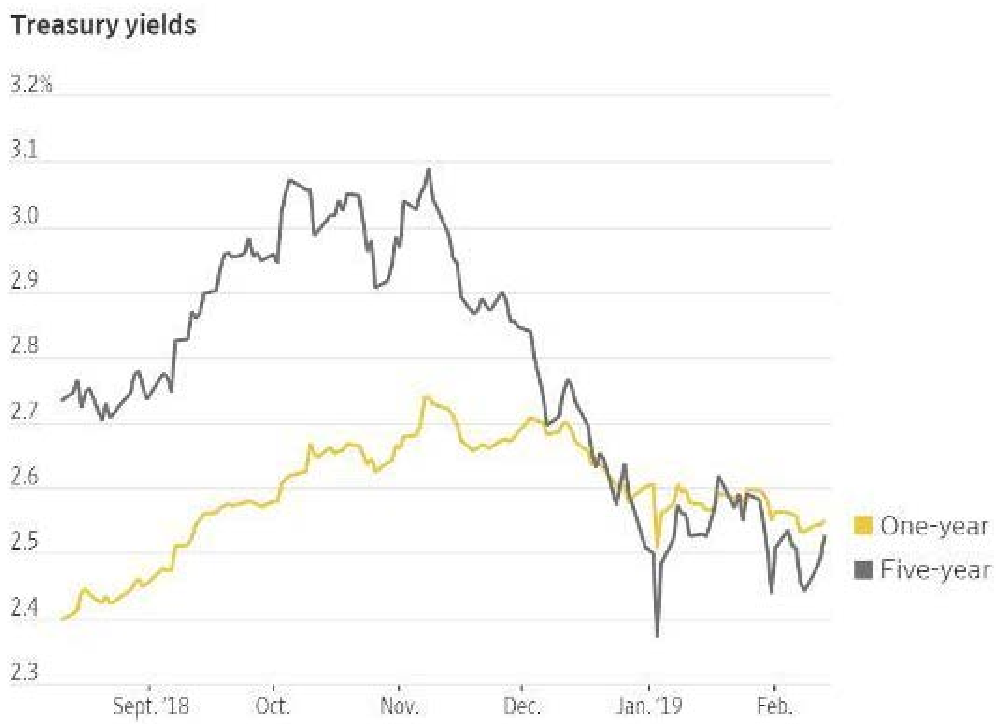
Since markets love to look at history as a guide, it becomes a little easier to understand the markets' enthusiasm for equities. As the chart below shows, doves may cry when the late artist formerly known as Prince sings, but a dovish Fed saves the day when it comes to the equity markets.



Source: Oxford Economics

People who assumed the Fed, along with the rest of the government, would cave the minute the financial market got a little choppy (at this time) look correct. I thought Chairman Powell, a former Wall Street executive, would have more “financial chops” to stay the course and put some arrows in the Fed’s quiver. That appears to be the wrong estimate of this Chairman as a few bad months in the market stopped cold the “normalization” of both interest rates and the Fed’s balance sheet. There is still a lot of time left in the year, but my call for two rate hikes (and the Fed dot plots are calling for the same), currently looks like a bit of an overestimate.

Lastly, the final chart of my “show and tell” this month is on treasury yields. The bond market (which I have spent a large part of my carrier) implies that the Fed may be done raising rates.



Source: Seeking Alpha

As the chart shows, rates on the 1- & 5-year UST have dropped since December, and there is an inversion (investors are paid more on the 1 year then the 5) on the 1/5 spread. This is an interesting sign by the bond market on their forward projections on the Fed’s next move.

So, while the market tries to decide what matters more, economic data or monetary policy, the market swings are likely to persist. We would always advise investors to stay on top of rebalancing their portfolios (at a minimum of quarterly) and keep all arms and legs inside of the roller coaster.

Until the next time.