PCM
PEAK CAPITAL MANAGEMENT

Who Murdered the Economy?

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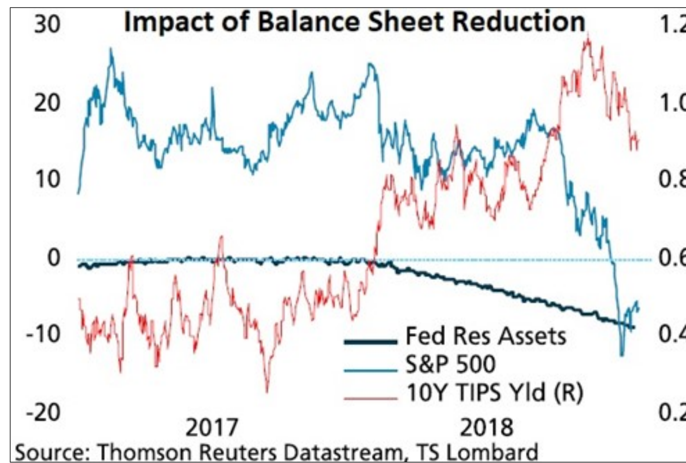
> **"What seems certain, however, is the need for a tactical, rather than a passive, approach to portfolio allocation."**

What happened? It was not long ago that the global economy was experiencing synchronous growth that made policy makers look like geniuses as markets priced in future prosperity. Economic nirvana appeared to be achieved until the 4th quarter of 2018 occurred. The economic predictions of 4% real GDP growth, rarified air for decades, evaporated in an instant and the markets began to re-price the risk of recession.

Clearly something dramatic happened that would be beyond the natural changes in the business cycle. Yes, we experienced a murder before our eyes with the impact of this heinous act just beginning. As investors and portfolio managers, we must solve this mystery in order to properly position assets for the future.

I had the benefit of discussing this crime and its impact with some of the greatest economic detectives alive today at the World Economic Forum in Davos, Switzerland. The opinions were wide-ranging with some suggesting there was no crime, the economy is dying a natural death, to the guilty party being the dramatic rise in nationalism. I challenged the later notion, suggesting that "economic nationalism" has been practiced by virtually every economy for centuries. So why is the risk of recession today the highest since 2007 as the economy struggles for breath?



Source: Thomson Reuters Datastream, TS Lombard

It has been said that bad things come in threes and we have seen a series of policy missteps that are likely the guilty parties in this unfolding tragedy. Some policies, like the trade dispute with China, may be the right action in the long-term but will have a short-term negative impact on the economy. Bloomberg data shows profits from China as the largest percentage of foreign earnings for S&P 500 companies. As the tariff war continues and China's economy slows, so do profits for U.S. firms that changes capex and hiring plans.

The pace of balance sheet reductions by the Fed also negatively impacts the economy. When history looks back at this period it is likely the Fed's fingerprints will be on the murder weapon; Quantitative Tightening. As the chart indicates, the correlation between the Fed's QT and yields and the S&P 500 is unmistakable. The Fed's commitment to shrink its balance sheet at the same time the deficit has nearly doubled has shifted the burden of financing the debt solely to the private sector. This has stripped the economy and markets of the liquidity necessary to keep the delicate balance of fiscal and monetary policy favorable.

In Davos, leaders discussed other suspects in the global economic slowdown. The greatest concern seemed to be corporate leverage and the low return on investment of the debt. A close second, global political dysfunction was espoused by giants of commerce like Jack Ma, Michael Dell, and Ray Dalio. Topping the list is the trade dispute between the U.S. and China but most believe a solution will be soon forthcoming. Uncertainty about Brexit remains a key concern for Europe as do the protests that have turned violent in France.

It was certainly not all doom and gloom in Davos. Optimism about the impact artificial intelligence (AI) will have in everyday decision-making was highlighted. Crypto-currencies, the focus of the 2018 gathering, were almost invisible but the role that block chain technology will play is forefront in most leaders' plans. Also discussed was the utilization of low-earth satellites capable of providing broadband to every global citizen in less than two years and its implications for e-commerce.

As the economy went on a respirator the markets reacted sharply in the 4th quarter posting the worst results in 80 years. I would not be surprised, however, to see a sharp rebound before the next recession starts. The initial "dovish shift" when the Fed has been in a tightening cycle has often resulted in a sharp rise in stocks. The Fed hiked from 1% to 5.25% between 2004-2006 before they announced a pause. The markets jumped 20% in six months after the announcement but that only led to the recession of 2007-2009.

The economy may fall victim to policy missteps but the timing of the market impact remains unknown. What seems certain, however, is the need for a tactical, rather than a passive, approach to portfolio allocation.

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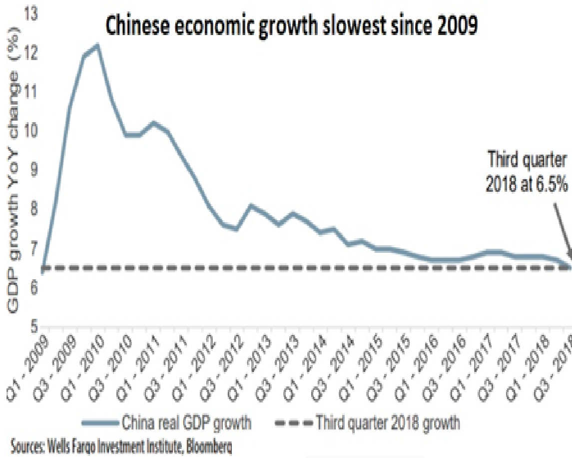

The slowdown of economic growth in China has more than just the Communist Party in the largest Asian economy concerned. Analysts are sounding an alarm that if the trade dispute is not resolved quickly, China's growth will sputter even further, leaving U.S. companies who do business there vulnerable. The latest results from the second largest economy in the world shows growth has slowed to levels last seen in early 2009 when the global economy was emerging from the Great Recession. China has ambitious plans to overtake the U.S. and become the world's largest economy, but will need to navigate deflating the debt bubble that has formed without destroying growth. Global growth will continue to suffer as China has contributed a large share of growth for a decade.

- According to FactSet, China accounts for nearly 5% of all revenues for the S&P 500, double the contribution from Japan (2.6%), the U.K. (2.5%), and Canada (2.1%), making slower growth a global concern.
- Goldman Sachs data shows the Information Technology sector has the greatest exposure to slower growth in China with 25% linked to China. Industrials are second to IT with nearly 10% of revenue exposure.
- China exports approximately $2.2 trillion annually according to The Economist, with 18% being sent to the U.S., and imports $1.7 trillion annually, including roughly 50% of global industrial metals demand.

Housing Slowdown?

We've talked about housing in recent PCM reports, but we felt it was worth mentioning again. The slowdown we've seen has made recent headlines. Certain data, such as new construction, existing home sales and building permits, points to a meaningful slowdown in the housing market. Perhaps the recent weakness is due to cyclical factors, but given that housing tends to be a leading economic indicator, we felt the current weakness is noteworthy. In particular, the number of existing homes sold in December dropped roughly 10% compared to a year ago, according to the National Association of Realtors.

- Housing prices have a tremendous impact on economic activity. Appreciating home prices (i.e. strong sales) creates a wealth effect, that, in turn, can spur economic growth. Consumers tend to spend more when their home equity value rises. This consumption can flow through to corporate earnings and ultimately lead to elevated asset prices.
- While the recent slowdown is concerning, the decline we've seen isn't necessarily problematic. We've seen the biggest drawdown in several years in terms of new housing starts. The prospect of higher interest rates (i.e. higher financing costs) is a headwind. But the economy isn't careening off the rails. Overall, the recent pull back is more likely due to cyclical factors.

Economic Impact from Shutdown

S&P 500 Performance Before, During And After Government Shutdowns

Study period: 1970 - 2013 — *sentimenTrader.com*

Shutdown Start	Shutdown End	# Of Days	AIM Model	Week Before	During Shutdown	1 Day After	1 Week After	1 Month After
09/30/76	10/11/76	10	64%	-1.6%	-3.4%	-0.8%	-0.2%	-2.8%
09/30/77	10/13/77	12	20%	1.6%	-3.2%	0.1%	-0.8%	2.7%
10/31/77	11/09/77	8	0%	0.8%	0.7%	1.9%	2.7%	0.7%
11/30/77	12/09/77	8	17%	-1.3%	-1.2%	0.0%	-0.3%	-4.2%
09/30/78	10/18/78	17	36%	0.7%	-2.0%	-1.2%	-3.2%	-6.7%
09/30/79	10/12/79	11	0%	-1.0%	-4.4%	-1.1%	-2.8%	-0.9%
11/20/81	11/23/81	2	74%	0.0%	-0.1%	1.6%	3.7%	0.6%
09/30/82	10/02/82	1	62%	-2.7%	1.3%	-0.4%	7.4%	11.1%
12/17/82	12/21/82	3	65%	-1.5%	0.8%	0.2%	1.9%	5.5%
11/10/83	11/14/83	3	28%	0.6%	1.3%	-0.7%	-0.3%	-2.0%
09/30/84	10/03/84	2	34%	0.3%	-2.2%	0.3%	-0.2%	3.1%
10/03/84	10/05/84	1	10%	-2.3%	0.1%	-0.3%	0.9%	3.6%
10/16/86	10/18/86	1	8%	1.6%	-0.3%	-1.2%	-0.2%	1.8%
12/18/87	12/20/87	1	43%	5.9%	0.0%	0.2%	-1.4%	-2.6%
10/05/90	10/09/90	3	23%	1.8%	-2.1%	-1.5%	-2.0%	0.3%
11/13/95	11/19/95	5	60%	0.7%	1.3%	-0.5%	0.2%	2.0%
12/15/95	01/06/96	21	50%	-0.2%	0.1%	0.3%	-2.4%	4.0%
10/01/13	-	-	40%	-	-	-	-	-
Median		3	35%	0.3%	-0.1%	-0.3%	-0.2%	0.7%
% Pos				59%	47%	41%	35%	65%

Source: sentimenTrader.

The government shutdown proved to be the longest in history. The market seemed to ignore the impact the shutdown may have on companies and the economy as the market marched upward and onward from the travails of fourth quarter 2018. The government shutdown in 1995 resulted in a cost to the government of $2.1BB, adjusted for inflation (Office of Management and Budget). S&P Global Ratings estimates that the economy lost $6BB as a result of the shutdown relative to the $19 trillion dollar U.S. economy. Certainly, the shutdown impacts consumption by government workers, but it is noted that this has a limited impact given that government workers do not make up the majority of consumers. Mark Zandi, Chief Economist at Moody's Analytics, points out that a prolonged shutdown will ultimately impact overall consumer confidence.

- The worst market decline during a shutdown was in 1976. A 10-day shutdown resulted in a 3.4% drop in the S&P 500 (LPL).
- The most recent government shutdown in 2013 lasted for 16 days and resulted in the S&P 500 appreciating 3.1% (LPL).
- From the 1976 shutdown through the 2013 shutdown, there were a total of 18 shutdowns. Across the 18 shutdowns, the S&P averaged a decline of .1% (LPL).
- The Congressional Budget Office is estimating that the recent shutdown cost the economy $11BB including a permanent $3BB loss.

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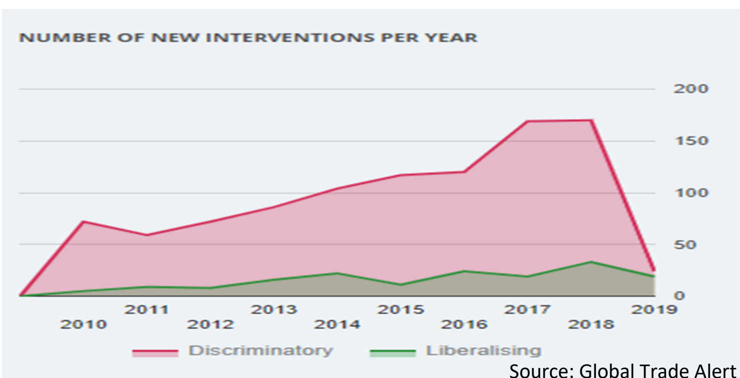
Macro View – Flashing Yellow Lights for Global Growth

All eyes were on the World Economic Forum in Davos, Switzerland in January. The gathering of top asset managers, economists, central banks, and financial luminaries agreed on slowing global economic growth. Countries and regions continue to seek protectionist political leanings and policies. This resistance to globalization begins to create headwinds for trade and economies, and corporations heavily reliant on exports or whose growth initiatives revolved around global trade. The World Trade Organization (WTO) recently lowered its outlook for global trade growth in 2019 to 3.7%. 2017 demonstrated global trade growth of 4.7%. Further, the chart below from the Global Trade Alert shows the number of interventions nations have taken affecting trade, be it discriminatory in the red line or liberalizing in the green line, dating back to 2009. There is a clear spike in actions that restricted in 2017 and followed up in 2018.



Source: Global Trade Alert

Fixed Income - Searching for a Bid

If money is the mother's milk of politics, debt would play the same role for any economy that is growing and expanding. The access to credit at competitive yields is critical to economic growth. To deliver a stable fixed income environment you need to have multiple parties willing to support transactions, something that has been evaporating since the passage of Dodd-Frank in 2010. As the chart indicates, after peaking prior to the last recession at 17%, the share of debt instruments held by Broker/Dealers has fallen back to 1985 levels - around 6%. The absence of B/D participation will not impact risk-free assets like Treasuries, but is impacting less liquid fixed income categories like high yield and Muni's. Massive levels of debt will be rolled over in 2019 and 2020 causing some to question whom the buyers are and at what yields.

Source: Thomson Reuters Datastream, TS Lombard

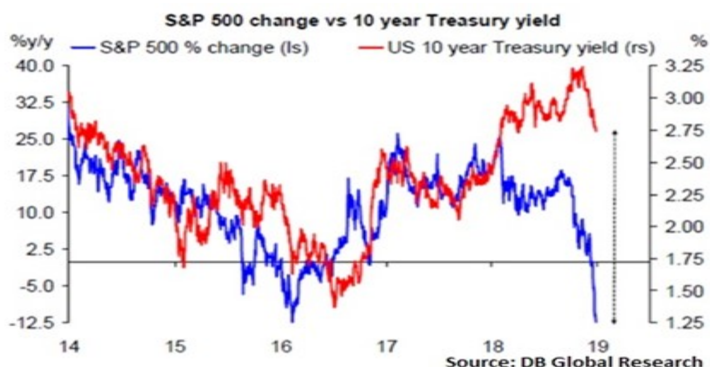
Taking Stock – Getting Paid to Wait

There is much discussion on equity exposure during a recession. More often than not, the discussion leads to dividend paying stocks and ETFs with a dividend focus. The dividend yield certainly pays the investor until the pending recession occurs. This is critical as the top of the market and the rate of decline or volatility as the recession approaches eludes most if not all investors. The most recognized among Dividend Indexes is the Dividend Aristocrat Index. Each holding is part of the S&P 500 and must demonstrate over 25 years of consecutive dividend increases with specific market capitalization and liquidity minimums. As an example, the Dividend Aristocrats were down 21.9% in 2008. The chart below shows the corresponding ETF, SDY. The ETF reflects 50 companies that have increased their dividend every year for 20 years. The chart makes it clear that there is volatility appropriately reflected consistent with holding equities. Dividends may offer an opportunity to mitigate volatility while capturing dividend income.

Source: ETF.com

Technical - The Ultimate Tell?

Great poker players have similarities to great traders - both have the ability to see a "tell" that guides them in their decision-making. The twitch of an eye reveals to the astute player whether another player is bluffing or has the goods. Similarly, great traders have markers they look for that consistently allow them to be on the right side of the trade. The correlation between the annual growth of the S&P 500 and the yield on the 10-year Treasury remained above 90% from 2014 through 2017 but de-coupled since the beginning of 2018. The gap between the data points has hit the highest level in nearly two decades. The Fed is at a critical point in its tightening cycle if the chart is predicting the future. It looks likely that the Fed might not simply pause in their rate hiking but begin to lower rates back to the 2% level of 2017 if stocks are going to rebound.



Source: DB Global Research

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Investing for Recession

Clint Pekrul, CFA

The likelihood of a recession in the next year is over 50% in our view. While we can't time the beginning of a recession, we can observe how various asset classes have performed over prior economic contractions. The past isn't necessarily a perfect guide, but it can be informative. We can draw some conclusions about how asset prices might behave in a recession, and set expectations about performance.

Technically, a recession is a period when economic growth (GDP) contracts over two consecutive quarters. Recessions tend to be few and far between. That's to say, the economy generally expands, and asset prices rise. But when the economy contracts, investors tend to shun risk assets, such as equities, in favor of safer assets, such as cash or high quality, short term Treasuries.

For equities, a recession can be problematic for high flying momentum names (at least initially). Given their higher valuations, momentum stocks have further room to fall when economic conditions deteriorate. Eventually, a momentum strategy will buy down-trodden stocks on the way back to recovery, but the initial drawdown can be painful. Conversely, low volatility stocks (i.e. equities that exhibit less than average price variability) tend to hold up better in a recession than momentum stocks. However, low volatility stocks can lag the major averages in an expanding economy. From a geographic standpoint, emerging markets tend to underperform developed markets during a recession. But longer-term, the risk of investing overseas can pay off in the form of above-average returns.

During a recession, dividend paying stocks can provide a cushion against declining equity prices. In general, dividend paying stocks tend to have better than average balance sheets, and can withstand an economic slowdown better than companies that can't sustain a dividend.

For fixed income, a recession can be problematic for corporate bonds, specifically higher yielding debt issued by companies with below average credit ratings (so called "junk bonds"). At a high level, the fixed income market is divided into investment grade bonds (e.g. mortgage backed securities, highly rated corporate debt and U.S. Treasuries), and lower-rated corporate debt. In a recession, cash flows tend to come under pressure, which makes paying debt service a challenge. As a result, the market can discount high yield bond prices. But, longer-term, the risk of default can be offset by higher than average yields.

The question we face is how to allocate capital, given that we don't know precisely when the next recession will occur. Some readers might be familiar with the world's largest hedge fund – Bridgewater's All Weather Portfolio. The fund is technically a global macro strategy that invests in various asset classes across the globe. The fund's premise is to balance risk (i.e. Investment uncertainty) across multiple markets to take advantage of broad trends. The methodology does not necessarily try to time the market, but remain invested for the simple reason that it's incredibly difficult to know precisely where we are in the business cycle (e.g. contraction or expansion).

By remaining fully invested and balancing portfolio risk, the fund can participate in market gains while not being too susceptible to a decline in any single market. At Peak, we follow a similar strategy whereby we seek to balance risk across multiple asset classes in such a way that we're not overly concentrated in any single market (from a risk standpoint), while at the same time maintaining positive exposures to broad asset classes. While we might not hit the proverbial "home run" in a strong, upward trending market, we are positioned defensively to not "strike out" at the wrong time.

In summary, it's difficult to know when we are officially in a recession (hindsight is always 20/20). Based on historical observations, we have some idea of which asset classes might hold up better in a recession. The challenge is knowing when to effectively rebalance into these asset classes. Our approach is to remain fully invested and balance portfolio risk across multiple markets.

Relative Performance During a Recession	
Defensive Exposures (Outperform)	Susceptible Exposures (Underperform)
-Low Volatility Stocks	-Momentum Stocks (Initially)
-Investment Grade Bonds	-High Yield (Junk) Bonds
-US Sovereign Debt (Treasuries)	-Emerging Markets (Both Equity and Fixed Income)

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Q: Was December an anomaly?

History will shed light on whether or not the historic selloff was overdone, or simply the presage of what is to come. The numbers were ugly. Last year was the worst year for stocks since 2008 and only the second year the markets were lower since the Great Recession. The 9% drop in December was the largest since 1931 as the Great Depression was devastating the U.S. economy.

Whether trading at the end of the month was an anomaly will largely depend on what the Fed does next in my opinion. As previously noted, the first dovish move by the Fed at the end of a rate hiking cycle often leads to a strong rally in stocks. If Chairman Powell and others at the Fed signal that they believe rate hikes are over for this cycle I would expect to see the markets rally and recover the losses from December. However, if the market believes the Fed is likely to hike one or two more times in 2019 as has been suggested, and the Fed remains committed to reducing its balance sheet on schedule, I would not expect markets to rally but to continue deteriorating.

Hindsight is always perfect vision, but given the rally in risk assets that we've seen in January, it seems that the December swoon was a bit overblown. I watch the markets every day and like clockwork, equity prices would fall precipitously late in the trading day for no apparent reason. Keep in mind that the fourth quarter pullback last year was from all-time highs for most major equity indexes, such as the S&P 500. A 15% to 20% correction is not unusual, based on historical observations. Equity investors have to keep this in mind. We tested several technical thresholds in December, and then bounced off the bottom and headed higher. Overall, the U.S. economy seems to be in decent shape, although the likelihood of a recession is elevated. The Federal Reserve's interest rate policy was a major unknown in 2018. The prospect of higher interest rates was a major headwind for equity valuations. But now we've got a bit more dovish tone from the Federal Reserve. I wouldn't call December an anomaly. The market's decline was a run-of-the-mill pullback. The bigger – and far more concerning – question is how fragile the markets seem to be at the prospect of interest rate normalization.

Q: Who were Winners and Losers in the Government Shutdown?

It is hard for me to believe there were any winners but all were losers in this latest government shutdown. I am sure there will be memes with Chuck and Nancy holding pitchforks with big smiles on their faces when Trump apparently caved in to re-open the government without any firm commitment on border funding. Some have suggested that Trump needed to take this step to re-open the government for 3 weeks just to document that Congress is incapable of dealing with immigration issues to strengthen his case for declaring a national emergency and reallocating funds from the DOD and Homeland Security.

It is exasperating that so much of the country's focus has been on what amounts to 0.1% of the government's budget for the current year. It is not difficult going through what the government spends money on each year for everyone to find something they would object to or call immoral. The idea that a wall/steel barrier/fence/force field would be included in that list is comical, especially when you are on record as recently as 2 years supporting such action.

Politics has become all about playing to one's base and I believe it is dividing the country and making governing much less civil. Before anyone rejoices over their side winning you might remember that the agreement was more of a pause in the shutdown than a solution. Three weeks is a very short period of time.

I'm having a hard time distinguishing between so-called winners and losers with respect to the government shutdown. I'm not a political hack, but it seems like Washington is out of touch. I was watching CNBC the other day and Wilber Ross, our commerce secretary, made some comments that seemed disingenuous with respect to the hardships that "non-essential" government workers were facing. But border security is not only important, it's a task mandated to Congress by the Constitution. The dollar amount in question for Trump's boarder wall is inconsequential. Our elected politicians (both Republican and Democrat) spend more in a day than the $5 billion proposed for the wall. So, who are the winners and losers? Well, the 800,000 plus government employees working without a paycheck will feel the brunt of the shutdown (obviously). The ultimate "winners" from this mess are the politicians who can effectively play the blame game come election time.

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Model Weights

All weights as of February 1, 2019

Income	
Mortgage Backed	39.00%
Investment Grade	17.00%
High Yield Bonds	14.00%
Preferred Stock	12.00%
US Dividend Equities	5.00%
US REITs	6.00%
Short (Inverse) Treasury Bond	5.00%

Balanced Income	
US Dividend Equities	12.00%
International Dividend Equities	11.00%
US REITs	12.00%
High Yield Bonds	30.00%
Long Term Treasuries	28.00%
Short (Inverse) US Equity	5.00%

US Growth	
Low Volatility Factor	20.00%
High Quality Factor	10.06%
Small Cap Factor	9.85%
Value Factor	21.00%
Momentum Factor	8.44%
Long Term Treasuries	23.00%
Short (Inverse) U.S. Equity	8.00%

Global Growth	
Low Volatility Factor	13.00%
High Quality Factor	8.00%
Small Cap Factor	6.00%
Value Factor	11.00%
Momentum Factor	5.00%
Developed Market Equity	17.00%
Emerging Market Equity	10.00%
Long Term Treasuries	25.00%
Short (Inverse) U.S. Equity	5.00%

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