It never rains in California

There's a lot of pessimism as earnings season is set to go full bore. That may be a good thing.

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But it did the whole of my visit this week. My trip took me through Southern California, with stops in Los Angeles, Orange County and San Diego. At nearly every meeting, our hosts apologized for the extended terrible weather—"Very rare." Strong opinions were voiced, but unlike most of my travels, they were at opposite ends of the spectrum. At a lively dinner meeting in Newport Beach, the savvy group of advisors shared a bearish economic outlook. One worries about an "implosion of Europe," while another suggests "recession worries at both coasts," noting that Google searches for the word "recession" are the highest since November '09. On the opposite end of the spectrum, an advisor in Irvine complained about how negative people are. "The inflation bogeyman from the '70s doesn't exist!" "The massive millennial generation is bullish. With the most common age in the U.S. at 28, they're just entering the big consumption time of their lives." (A sentiment with which I wholeheartedly agree.) Still, the front page of the business section of the San Diego Union-Tribune earlier this week suggested that investors move into cash. And in

wealthy La Jolla, an advisor reported that many of his recent client calls required him to soothe their nerves.

This may be the most negative analysts have been entering an earnings season in nearly four years. Deutsche Bank estimates that underlying earnings-per-share (EPS) growth, which strips out the impact of the cut in the corporate tax rate and market variables such as oil prices and the dollar, will slow from a steady 11% in 2018's first three quarters to about 7.5%. While some of the deceleration is being driven by idiosyncratic factors, the main drags are coming from lower oil prices, a higher dollar and ,with over a third of S&P 500 earnings coming from abroad, slowing global growth. Across sectors, there is a broad-based slowing with the exception of Health Care, which is expected to see a modest increase. For 2019, the magnitude of the downward revision is now tracking a little bit worse than the median and average downward revisions that occurred from 2000 to 2017, with the bottom-up EPS growth rate now expected to be 5.7% ($171 in dollar terms), down from 6.8% as of Dec. 31 and 10% last summer. This new, lower threshold implies earnings growth far lower than the 23% posted in 2018. On a quarterly basis, S&P EPS growth is expected to slow to 3.5% in both this year's first and second quarters. At around 15, the forward P/E for the S&P is at its lowest level since September 2013, while the deterioration in retail sentiment as bad as it tends to get outside of financial crises. All of this is bullish. We want to see skepticism persist while momentum starts to build—that's the point where returns tend to be highest.

The rally since Christmas Eve may be reaching levels that suggest caution. A more precise tell than levels of resistance that the market is running out of gas would be weakness in styles that have led off the lows, i.e., high volatility, low quality and small-caps. Market structure is a concern. JP Morgan research shows an increase in volatility typically leads to an increase in systematic selling, which in an environment of reduced liquidity, tends to produce an outsized impact. This negative relationship between volatility and liquidity is

its worst in a *decade*. Put another way, by pumping liquidity into the market, global quantitative easing's rising tide arguably lifted all boats, pushing returns attributable to the market (systemic) to *all-time highs* and returns to stocks (non-systemic) to *all-time lows*. Passive investors were massive beneficiaries. But with liquidity now shrinking via quantitative tapering, there's potential role reversal, with 1-way systemic trades working against investors. Amid signs the global and U.S. economies are rapidly slowing—a big topic among the very worried Newport Beach advisors—there are offsets. In the past week, China's central bank pumped $83 billion of liquidity into the market overnight, the latest in a series of "record" injections about which many are dubious, and Chinese policymakers pledged more fiscal stimulus, too. Contrary to consensus, U.S. fiscal stimulus will be bigger this year than last, with individual and corporate tax cuts that are larger, 2/3 of last year's federal spending package yet to be spent and tax refunds that are projected to be massive. On top of this, the Energy Information Administration estimates gasoline prices at 2-year lows will goose disposable income by $89 billion. Then there were the 10 minutes yesterday when the S&P went vertical on news of significant China trade progress, before settling a bit as the news became fuzzier. This suggests the risk markets have yet to price a good outcome, another potential tailwind if it comes to be. Today's forecast for Southern California is sunny, but I'm leaving early with fond memories of rain, as I head to the dreaded Polar Vortex!

POSITIVES

- **Soft landing watch** Builder confidence unexpectedly rose, buoyed by lower mortgage rates that have boosted housing demand. The National Association of Home Builders estimates single-family starts rose 3% in 2018 and expects "low unemployment, solid job growth and favorable demographics" will support demand this year. Mortgage purchase applications have been surging and are now near 8-year highs. Still, the

incongruity of last year's soft housing market with strong fundamentals and consumption growth could be warning of weakness in underlying household demand, a potential risk worth keeping an eye on.

- **Soft landing watch** Manufacturing activity surged in December, led by motor vehicle production, construction supplies and business equipment. January data so far is mixed, as New York's Empire manufacturing index barely remained in expansion territory, posting its lowest reading in since May 2017, while the companion Philly Fed index surprised sharply to the upside, a clear sign of acceleration.
- **This argues for Fed patience** Led by energy, headline producer prices fell in December for the first time since February 2017 and core PPI (excluding food and energy) slipped for the first time in a year. The declines put year-over-year (y/y) PPI at its slowest pace since July 2017. Import prices also fell while, in its latest Beige Book review of conditions in its 12 districts, the Fed described wage growth as flat and overall prices pressures as moderate.

NEGATIVES

- **Soft landing watch** Consumer sentiment plunged in January to its lowest level since President Trump was elected, led by a big drop-off in the expectations component. The University of Michigan said the decline reflected a host of concerns: the partial government shutdown, the impact of tariffs, instabilities in financial markets, the global slowdown and a lack of clarity about monetary policies.
- **Global soft landing watch** China vehicle sales fell 3.1% y/y in December, the first decline in 18 years of data, and both imports and exports fell y/y, signaling weakening domestic and international demand. Furthermore, EU industrial production plunged more than expected to a 3-year low.

- **The holidays weren't *that* good** Retail sales ex-autos were unchanged December, according to Bank of America aggregated credit and debit card data that cast doubts on reports that it was the strongest holiday season in at least five years. Department, home goods and sporting stores posted the weakest activity, Bank of America said, while cruises and airlines had a good month, highlighting the trend toward experience-based spending.

WHAT ELSE

Shutdown watch An analysis of 18 episodes over the past 40 years shows the equity market drops about 2%, on average, during a shutdown. If the shutdown is accompanied by a need to raise the debt ceiling, the average decline is closer to 4%. Fitch recently warned that if the government shutdown persists through March 1 and the debt ceiling debate is protracted in nature, it may need to reconsider its AAA rating for the U.S.

FAANG's "odd year" phenomenon Fundstrat research finds that FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) have a nearly 100% win ratio relative to the broad market in "odd years" and only beats the S&P 33% of the time in even years.

Is China losing its edge? In the 1980s, companies could hire 50 manufacturing workers in China vs. one in the U.S. for the same amount of money. Because Chinese wages have risen much faster than in the U.S., that ratio is now just 5-to-1. And doing business in China comes with a host of burdens, from a regulatory environment that favors Chinese enterprises to political, environmental and national security concerns. The rub: we may be reaching a point at which U.S. companies are ready to lower their dependence on China and bring their supply chains back home, abetted by new advanced manufacturing technologies such as artificial intelligence and 3D printing.

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

Producer Price Index (PPI): A measure of inflation at the wholesale level.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The Empire State Manufacturing Index gauges the level of activity and expectations for the future among manufacturers in New York.

The Federal Reserve Bank of Philadelphia gauges the level of activity and expectations for the future among manufacturers in the Greater Philadelphia region every month.

The National Association of Home Builders/Wells Fargo Housing Market Index is a gauge of how well or poorly builders believe their business will do in coming months.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

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