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Weekly Update: Main Street is calmer than Wall Street for a change

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I spent most of the week in San Diego, where I wasn't prepared for the 80-degree temperatures and blinding sunshine, leaving my sunglasses at home (living in cold and cloudy Pittsburgh, I only associate sunglasses with summertime). Well, a chill adviser gave me hers! It's all chill here. Walking along the water, there is a young man practicing tai chi—be calm, find your center. He's not worried. Further along my walk is a tarot card reader having an intense discussion with a couple—I'm not eavesdropping but I think the discussion is personal and not about the markets. And a little further down is a vendor selling dream catchers—ever heard of them? Off to meetings with advisers, one lamented, "What do you tell clients?! They look at the screens and say 'blankety blank blank.' " Indeed, despite very good fundamental data (*see below*), markets are behaving as if the global economy is sleepwalking into a low-intensity recession. No systemically important economy is contracting, but many sectors are experiencing recession-like conditions—manufacturing in the U.S., where today's data show inventories to sales still out of whack—and some markets are delivering recession-like returns. JP Morgan notes that what isn't recession-like is volatility, which has risen less than the trough-to-peak moves typical of major economic downturns—hence the concept of a low-intensity recession, i.e., the same dismal returns without the economic distress and extreme market volatility.

Deteriorating financial conditions reflect concerns about the health of European and Japanese banks, the effects of negative interest-rate policies and the contagion effects on U.S. banks, Ned Davis Research says. It thinks the Fed should be more focused on shoring up confidence in U.S. banks than on its primary monetary policy objectives (i.e., employment and inflation). Fed Chair Yellen's congressional testimony this week didn't touch on such or much new, though she did discuss negative interest rates (oh great, something new for my nightmares). Renaissance Macro thinks financial-crisis worries starting with European banks are overdone. It notes the Portuguese central bank's handling of a problem bank relied on a "bail-in'' solution that put the burden on senior debt holders, not a counterparty. This suggests that while European banks may face multiple hurdles with compressed margins and a slowing global economy, counterparty risk does not appear to be among them. And without counterparty risk, it's difficult to have contagion risk. At the end of the day, the market trades on earnings, and the news there doesn't seem to be as bad as the market is taking it. With more than four-fifths of the S&P 500's market cap having reported, earnings are beating by 4.4% while revenues have met expectations. Ex-energy, earnings-per-share (EPS) is on pace to rise 4.1%. In Q4 2015, EPS for the core of the S&P (i.e., excluding commodity businesses and the financials) was up about 4% on a top-line gain of 3% adjusted for currency translations, and margins were up slightly. In past periods when top-line growth was in the low-single digits, margins usually came down, so any increase is an achievement of sorts. The debt coverage problems of some energy and metals producers don't look generalizable to the rest of the market, Empirical Research says, noting the rise in the debt-to-equity ratio for other sectors isn't that much and is largely attributable to debt-financed acquisitions and the effects of buybacks on shareholder's equity. The bottom line: profits are less likely to crumble in a downturn than they were in those of the past.

The drama is in the emerging world, not in Corporate America. It will take a demand shock considerably bigger than what we've witnessed thus far to undermine profitability. (I am Team USA.) At a fascinating meeting in San Diego, advisers wanted to first discuss negatives and then positives. Their view that energy is a huge percentage of our economy has them very worried about economic and earnings growth prospects. On the other hand, these Californians were very well versed in the unbelievable technological advances that will continue to change/remove/create new industries. Well, isn't progress bullish? "Yes!" Millennials—115 million people, many of whom will marry and buy homes (people don't change)—isn't that bullish? "Yes!" A U.S. economy in which the labor market and household finances continue to improve does not fit with an economy about to head into a recession. Even the typically cautious Atlanta Fed has raised its 2016 GDP forecast to 2.5%. Lower recession odds should reduce worries about more significant downside risk in the short term, though increasing wage pressure and still-weak top-line growth aren't positives for profits. In

short, this environment is better for Main Street than Wall Street, a common theme in my travels around San Diego. I was asked what I'm seeing along this country's Main Streets and I told them outside of the secular decline in shopping malls, I see packed restaurants and relaxed consumers. Sitting in the airport, waiting for my flight back home (to subzero wind chills!), a man walks down the hall, singing at the top of his lungs and no one is looking up! This place is quickly rising to my top two destinations.

Positives

Global Recession Watch The OECD composite leading indicator slipped in December by the smallest amount in 16 months as the trend remained positive, indicative of stabilization. Breadth measures also exhibited tentative signs of broadening growth, as the share of individual country indicators above the long-term and monthly averages rose, the latter to a 2-year high. Meanwhile, the global composite PMI (manufacturing and services) remained in the expansionary range where it's been for almost 3 years.

The consumer is fine Bureau of Economic Analysis data show inflation-adjusted consumer spending in 2015 was *the strongest since 2005,* rising 3.1%. While retail sales at stores remained weak but better in January, core control group sales that take out volatile autos, gasoline and such jumped 0.6%, with almost half of the advance driven by surging non-store sales. This reflects the growing impact of online sales and purchases of "experiences'' and other "services" that don't make it into the much-cited retail sales metric, which only counts physical merchandise and thus misses a lot of activity in an economy that's predominately services. Also this week, the weekly Bloomberg Consumer Comfort Index hit a 4-month high on falling gas prices and a stronger jobs market, with the buying climate component advancing to a 10-month high. Michigan's preliminary sentiment for February slipped, but remained solid, with the current conditions component well above 100.

The labor market is fine Initial jobless claims fell back to mid-December lows, easing worries over January's jump. Meanwhile, December job openings were their *second-highest level on record*, with the job openings rate (the number of job openings as a percent of total employment + job openings) matching its *record high;* the quits rate hit a *post-recession high*, signaling workers are confident enough about prospects to leave one job for another; and the number of unemployed per job opening fell to *a 14½-year low*. Wage inflation caused by a tight jobs market was a big worry in my California trip. With such a worry unconfirmed for years, I'm waiting to see and would welcome the whites of inflation's eye vs. my personal deflation fears.

Negatives

Small business optimism wanes January's NFIB gauge dipped to near a 2-year low, led by a deteriorating outlook for business conditions as well as declining sales expectations, and tightening credit and labor-market conditions. While plans to hire slipped, a greater share of firms reported they were unable to fill positions while the share raising wages hit a new post-recession high—good for workers, not so much for profits, which also came under strain because of declining prices.

Advisers' biggest worry in 2015 was inflation—not me! Falling crude prices have pushed the average price for a gallon of gas below $1.70, feeding into the core PCE the Fed so closely watches, and this morning's report shows import prices continuing to fall. The Fed frequently states inflation's slowdown is "transitory," i.e., due to oil. But breakeven inflation rates as far out as 10 years have plunged, central banks are trying or discussing negative rates (*more below*) and sovereign yields are collapsing, with 10-year yields this week hitting -0.35% in Switzerland, 0.01% in Japan, 0.15% in Germany, 0.35% in Sweden, a record low 1.25% in the UK and touching 1.54% in the U.S. I have said many times to advisers that I find no one willing to voice that he/she is a bull on government bonds. "Will you be the first one?" And no one ever bites—a nagging worry at the back of my mind, is everyone on the same side of the boat? Isn't that usually a bad sign?

The risk-off trade has room to run With high momentum stocks roughly 30% of the S&P and low-momentum/value names only 6%, Cornerstone Macro says the current rotation from growth to quality means nearly a third of the market is being bid down vs. only 6% being bid up, making it difficult for the overall market to go higher. Moreover, in downtrends such as this, more extreme oversold conditions often are needed to produce a bounce and a market trading about 9% below its 200-day moving average isn't there yet; it was 14% below around the 2011 lows. Ned Davis says its criteria have been met for what it defines as a cyclical bear in a secular bull market and that, looking back at the 4 secular bulls since 1921, the median decline in the Dow in a cyclical bear has been 19%. At this writing, the Dow's off about 14% from its cycle high.

What else

Political Watch No GOP candidate since 1944 has won the nomination without winning Iowa or New Hampshire, clearly a positive for the Trump and Cruz camps and a negative for the other Republican candidates. Washington Analysis says it's difficult to envision how any establishment candidate could break into that top two so long as a plethora of his ilk (i.e. any one of Bush, Rubio or Kasich) remain in the race. Trump's success was across the board and fairly overwhelming in New Hampshire, while Clinton won just two demographic groups: voters 65 and older and those making over $200,000 a year. Investors can't dismiss the odds of an extreme election outcome that poses major risks to the stock market. Trump could spark a trade war, is breathtakingly uninformed on domestic and national security issues and is utterly unpredictable, Cornerstone Macro says. Sanders is calling for a political revolution to upend the existing economic order through massively higher taxes, crushing Wall Street, and a single-payer health-care system. Either would put downward pressure on multiples.

Technology is deflationary The pace of its use is accelerating—the Internet, 3D printing, robotic factories, Uber, Airbnb, Netflix and self-driving cars are cutting whole industries from existence in the blink of an eye, taking out centuries-old systems and delivering products and services faster and 10 times cheaper. The Institutional Strategist says our financial and monetary systems aren't structured to handle the rapidity of this change but they can print money faster than technology can create deflation—this appears to be the only way out at this point.

With age and experience comes wisdom The average person is said to spend $142.31 on Valentine's Day. But did you know those coupled longer than 5 years spend much less?

Linda A. Duessel, CFA, CPA, CFP
Senior Equity Strategist

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Dow Jones Industrial Average ("DJIA"): An unmanaged index which represents share prices of selected blue chip industrial corporations as well as public utility and transportation companies. The DJIA indicates daily changes in the average price of stocks in any of its categories. It also reports total sales for each group of industries. Because it represents the top corporations of America, the DJIA's index movements are leading economic indicators for the stock market as a whole. Indexes are unmanaged and investments cannot be made in an index.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed 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 Bloomberg Consumer Comfort Index is based on weekly telephone survey of consumers seeking their views on the economy, personal finances and buying climate.

The Global PMI is compiled by Markit Economics and is derived from surveys covering more than 11,000 purchasing executives in 26 countries.

The National Federation of Independent Business (NFIB) conducts surveys monthly to gauge how small businesses feel about the economy, their situation and their plans.

The OECD composite leading indicator is designed to provide early signals of turning points between expansions and slowdowns of economic activity in member countries.

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.

Federated Equity Management Co. of Pennsylvania

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Federated®
Federated Investors Tower
1001 Liberty Avenue
Pittsburgh, PA 15222-3779
Telephone: 412-288-1900

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