Federated

Weekly Update: March Madness

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This was a meeting-packed 5-day mad race crisscrossing North Carolina, with visits in Charlotte, Winston-Salem, Greensboro, Raleigh, Wilmington…back to Raleigh…then Winston-Salem and finishing in Lake Norman. Everywhere we went the weather was perfect, the food was fabulous and the advisers and end clients were so welcoming. We were there on Tuesday's primary election date. People were mostly amused by this madcap political season. An adviser in Greensboro suggested that once the nominees are selected, their debate should be pay per view. "It would be unbelievable…huge!" Certainly over the weekend the political rhetoric and menace reached a fever pitch and yet, somehow investors are not concerned. Trump is to blame, MoveOn is to blame, Congress is to blame…take a number. How this isn't a bigger overhang on stocks is beyond me. As Strategas points out, while the S&P is rallying, internals were tepid with 3 to 1 declining stocks vs. advancing stocks. Small-caps were particularly weak, underperforming by more than 150 basis points on poor breadth. Over the last week, small-caps have failed to keep pace and have already given back roughly half of their recent outperformance since the February lows. The 200-day moving average for the S&P is 1999, and because we are above that the technicians are all bullish now. But we still see the market stalling around 2000.

Tuesday was also March 15—the Ides of March—best known as the date on which Julius Caesar was assassinated in 44 B.C. Now, the biographer Suetonius wrote that Caesar suffered from a receding hairline, about which he was very sensitive. His enemies were said to have made the most of this, constantly making fun of his baldness. He was said to enjoy wearing the laurel wreath (no baseball caps at that time, obv) because it hid his hair loss, and he also combed the thin strands of his hair forward (no hairspray in those days, obv). A seer had warned Caesar that harm would come no later than the Ides of March. On his way to the Theatre of Pompey, where he would be assassinated, Caesar passed the seer and joked, "The Ides of March are come," implying that the prophecy had not been fulfilled, to which the seer replied "Aye, Caesar; but not gone." "Et tu, Brute?" a Latin phrase meaning "You too, Brutus?" purportedly were the last words of Caesar to his friend Marcus Brutus. The quotation is widely used to signify the utmost unexpected betrayal by a person, especially a friend. Although the U.S. Supreme Court has designated corporations as individuals, it's still not a great idea to think of them as friends. If you did, you might be looking out for Brutus, too, with their massive buybacks to boost their stock prices, because households have $17.9 trillion of equity holdings. The main reason stocks have done so well this cycle is that corporations continue to be huge buyers, says Ned Davis. This cannot be emphasized too much. Historically, the market rewarded companies that bought back their own stock near the bottom of the cycle and once that had passed the interest turned toward organic growth. That's not been the case this time around and the payoff from buybacks has held up, as it's seen as the least of the capital allocation evils. Someday the era of bountiful free cash flow will end, it just doesn't look like it's going to be any time soon. Et tu, S&P?

We cautioned advisers the market likely will be volatile through the spring and that perhaps we will reach the 20% decline from the May 2015 high that would be a cyclical bear, but still within a long-term secular bull. "If we go down 20%, my clients will call and say 'go to cash'," said a successful veteran Charlotte adviser. More than a few nodded when I said that my nightmare is deflation. "The Fed is out of bullets," an adviser agreed. Well, Janet Yellen and co. didn't add any ammunition in their policy meeting this week. In fact, it was more dovish than anticipated. The committee tried to have it both ways, seeing improving economic activity and a strengthening labor market, but reducing the likelihood of rate hikes to just two 0.25% range increases this year instead of four in its last "dot plot" in December. It cited "global economic and financial developments [that] continue to pose risks" and, if anything, sees risks to its overall outlook as tilted to the downside. Well, maybe that's a good thing. As Ned Davis points out, the Fed's record of forecasting future economic activity and inflation has been less than stellar. For the better part of the past decade, it's been overly optimistic. Since 2005, real GDP growth has been below the midpoint of the Fed's latest projected range more than 75% of the time. This was also true in Q4 2015. But predicting is hard. Just ask anyone who filled out a bracket for the NCAA men's basketball tournament. We hurried to get some good meetings in on Thursday before offices vacated for St. Patrick's Day green beers and that March Madness. I'm not Irish nor a beer drinker, so I have nothing to say about that, nor do I follow sports or have been invited to fill out a bracket. But I do know that my husband's alma mater Michigan State and my daughter's UVA are heavily favored. So, who should I root for—Sparty or the Hoos? A house divided…Wahoowa!!!!

Positives

Signs of life in manufacturing Total industrial production continues to be down, falling 0.5% month over month (m/m) in February driven by utilities and mining output. But manufacturing production, about three-quarters of total industrial output, rose 0.2% m/m (previous: 0.5%) in line with expectations. Several important categories of the U.S. manufacturing sector appear to have stabilized over the past two months including machinery, primary metals and petroleum refining. Just as you need to look beyond the headline industrial production numbers to individual sectors, you also need to consider the difference in different regions. The Empire State manufacturing index rose to 0.6 in March (previous: -16.6), well above consensus expectations of a decline of 10.5. New orders and shipments rose sharply into positive territory, to provide some tentative signs of stabilization for Northeast manufacturing activity. Not to be outdone, the Philadelphia Fed manufacturing index rose to 12.4 in March, well above consensus of -1.5 and a return to positive territory after six months of contraction. New orders surged to 15.7 (previous: -5.3) and shipments rose to 22.1 (previous: 2.5), the strongest readings on both indices since late 2014. The Philly Fed Index has historically been a bellwether for national trends and, with the Empire State survey results, adds to a growing list of data that point to signs of stabilization in the U.S. manufacturing sector.

Welcome mats out for housing activity The NAHB/Wells Fargo Housing Market Index was unchanged at 58 in March, below consensus for a one-point gain to 59. While this was the lowest level since May 2015, it also shows that builder confidence is stabilizing. Supporting this, housing starts and permits remain on an uptrend. Starts climbed 5.2% m/m in February to an annualized rate of 1.18 million units, beating consensus of 1.15 million. The solid gain was driven by single-family construction, which grew 7.2% m/m (previous number was -0.3%). Multifamily starts grew 0.9% m/m (previously -9.5%), while building permits were down 3.1% m/m but remain in an uptrend. The traffic of prospective buyers rebounded. This is bolstered by the Labor Department’s Job Openings and Labor Turnover Survey (JOLTS), which climbed to 5.54 million in January. Month-on-month, the January increase in openings was broad based across industries. Despite this increase in labor demand, hires fell rather sharply in January (5.03 million vs 5.40 million previously). Quits also fell at the beginning of this year, returning to 2.0% from a temporary December rise to 2.2%. Layoffs and discharges remained low through January. The number of unemployed job seekers per job openings fell to 1.4 (previous: 1.5), consistent with low levels of labor market slack. While these data point to a bit of a step back in labor market confidence in January, payroll growth rebounded strongly in February and continues to suggest that U.S. labor markets are solid.

Not excited about apparel prices going up, but inflation *is* needed In the February’s CPI report, headline inflation fell 0.2% m/m, pulling the year over year (y/y) rate down to 1.0%, both numbers in line with consensus expectations (-0.2% m/m, 0.9% y/y). Core inflation, however, rose 0.3% m/m and 2.3% y/y, driven by an outsized increase in apparel prices (1.6%) and a large rise in the prices of medical care commodities (0.6% m/m). Overall, core services inflation continues to firm, and the pace of inflation increase for most categories of goods accelerated relative to their already-strong January pace. All of this suggests that reduced slack in the U.S. economy will continue to put upward pressure on prices.

Negatives

Too much of a good thing, or at least things Retail sales were down 0.1% (m/m) in February. The decline in headline sales was led by gasoline station sales, which posted a 4.4% m/m decline, owing to lower retail prices. Motor vehicle sales were reported at -0.2% m/m (previous: -0.2%), consistent with manufacturers’ reports of unit sales. The most informative number in this report is the revision to January sales: core sales growth was marked significantly lower, to 0.17% m/m from the initial estimate of 0.62%. This revision suggests consumption growth posted a softer bounce in January than estimated. The downward revisions were broad-based and paint a less favorable picture of consumption at the start of Q1. In February, softness at furniture stores, general merchandisers, grocery stores, and non-store retailers held back core sales growth. The retail inventory to sales ratio (I/S) rose to 1.50 from 1.49, its highest mark since May 2009. Such high level of inventory accumulation relative to sales has been a headwind to output growth this year and looks to stay that way as retail inventories rose 0.3% in January, led by vehicles and apparel, but business sales fell 0.4%, led by wholesalers.

The almighty pump It took a while for the effects of lower gasoline prices to spur spending, yet just a modest bump up to spook consumer confidence declined. It shows the caution of today’s consumer, still stung by the Great Recession and the slow rebound, seen most recently in today’s preliminary look at sentiment in March as measured by the University of Michigan. It fell to a five-month low of 90 from 91.7 in February. Still, the survey is in solid territory, as is the Conference Board’s Leading Economic Index even though it rose only 0.1% m/m in February, one-tenth below consensus expectations. Lower initial jobless claims and interest rate spreads were the primary positive contributors on the month. The headline index is up 2.3% y/y as of February, consistent with slow but positive real economic growth in the U.S.

China fables China’s official unemployment rate is 4%, and has been amazingly steady at 4% for the past 13 years. That’s literally unbelievable. Monthly measures published by non-government agencies indicate that, on balance, Chinese employment is, and has been, declining for almost two years. China is experiencing one of the biggest deflationary busts ever, with its credit and investment bubbles both unwinding at the same time. Piling on is that its industrial production for

January/February came in 5.4%, the slowest since 2009. Retail sales also missed and marked an eight-month low. Fixed Urban Asset Investment did beat consensus (+10.2% y/y versus 9.3%), but it was driven largely by government pumping up construction +13.7%.

What else

Political Watch Much has changed since President Obama ran on a platform of “Hope” eight years ago. This election cycle, Anger is the new Hope. This shift in voter attitudes is in direct response to the U.S. experiencing its slowest continuous period of economic growth going back to the late 1940s/early 1950s. After repeatedly changing the configuration of government over the past decade and still seeing disappointing growth, voters are looking for candidates with less ties to traditional political parties and less political experience. The next president will likely get a fiscal policy mandate from voters, says Strategas.

Political Watch Exit polls indicate that many Republican voters in the primaries feel betrayed by Republicans in Congress. That’s certainly part of what is fueling Trump’s success, in addition to the aforementioned reaction to the slow domestic growth. The intense protests against Trump and angry responses by his supporters lead us to think the general election could be 2016’s black swan for markets. Certainly Tuesday’s results essentially ensured the Republican race will go into June as many of the delegate-rich states needed to put Trump into a majority, such as California and New Jersey, are late primaries. Betting odds are now suggesting a greater than 50% chance that will happen. Trump would need to gain 60% of the delegates moving forward and in recent primaries his numbers are lower than that run rate. But just 5% of the delegates have been awarded in a winner-take-all primary and 65% of the future delegates will be awarded through winner-take-all states. Also, many of the upcoming primaries are closed and Trump has not performed well in Republican-only contests. Historically, the candidate with the most votes going into a contested convention usually is not the winner.

Think how cool Pittsburgh would be if Phil Orlando also moved here! Zagat recently named Pittsburgh the No. 1 food city in America. The New York Times Food section just led with an article on how Pittsburgh is drawing millennials with innovative new restaurants and bars. Recent census data shows that Allegheny County’s millennial population is on the rise. The median age in Pittsburgh is 32.8, well below the national figure, 37.7. Vogue recently went live with a piece that proclaimed, “Pittsburgh is not just a happening place to visit—increasingly, people, especially New Yorkers, are toying with the idea of moving here.” What do you say, Phil?

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The Conference Board's Composite Index of Leading Economic Indicators is published monthly and is used to predict the direction of the economy's movements in the months to come.

Consumer Price Index (CPI): A measure of inflation at the retail level.

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

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

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

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

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.

Price-Earnings Ratio is a valuation ratio of a company's current share price compared to its per-share earnings.

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 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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