Ivory's Economic Outlook

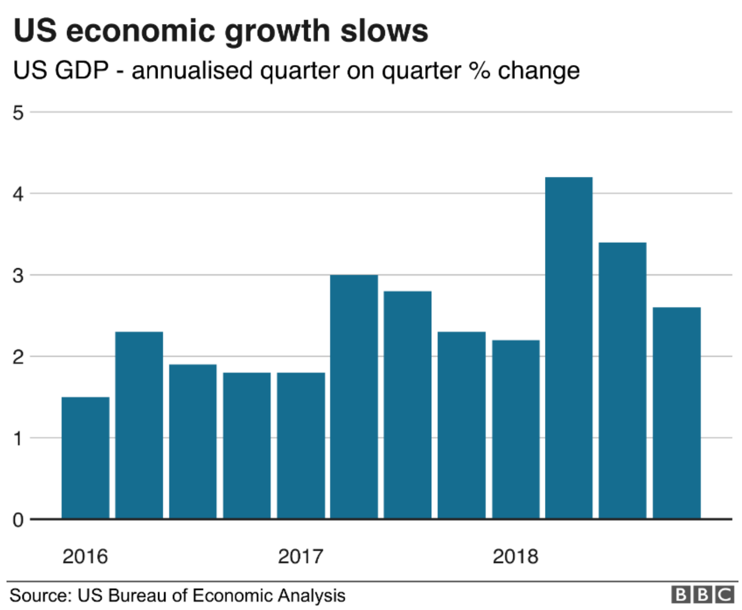
FALL 2019 • IVORY JOHNSON; CFP®, CHFC; FOUNDER; DELANCEY WEALTH MANAGEMENT, LLC

"When you come to a fork in the road, take it."
Yogi Berra, Hall of Fame Baseball Player

The Washington Nationals play less than a mile away from my house, and having captured the 2019 World Series trophy, friends and neighbors naturally assume I'm as stoked as the rest of the city for their recent success. The truth is I was raised on Yogi Berra logic, spoon fed Babe Ruth statistics, and had scotch tape scars on lead paint walls when I left for college to remind me that Reggie Jackson's picture once lived there. I can't help it; I'm still a Yankees' fan.

It's only fitting that baseball is America's pastime. Batting averages, RBI's and earned run averages are all embedded into America's pageantry, not just for their ability to measure precision and predict future outcomes, but also the nostalgia and strategy of it all. If there's a right-handed pitcher and a left-handed batter hitting 5th with a righty on deck who's in a slump in a one run game with a man on 2nd and two outs in the 6th inning with a 3-1 count, what pitch do you throw? Certainly not a fast ball down the middle.

The game is a symphony in an age when everyone prefers the remix. Its once revered beauty consolidated into singular events - bunting a runner over exchanged for the long ball, stolen bases kidnapped by analytics. What once boasted a process now highlights outcomes. Now the financial markets are following suit. Gone are the days when healthy balance sheets marked a solid company with strong fundamentals. In today's environment bad news isn't bad, just another reason for the Fed to hit the ball out of the park or a chance to react to yet another remarkable headline.



Investors have witnessed 18 months of a decelerating economy that enjoyed a growth rate of 4.2 percent in the 2nd quarter of last year, 3.4 percent in the 3rd quarter and here we are with a 1.9 percent GDP growth rate for the 3rd quarter of 2019. The same can be said for earnings growth, which went from increasing by 14 percent in the 4th quarter of last year to less than one percent in the 3rd quarter of 2019[i].

The market, much like a man who lost his hair far earlier than he expected, isn't quite sure what to make of it. While 75 percent of the S&P 500 companies that have reported topped analyst expectations, a third of the companies issued lower earnings guidance[ii]. They're literally telling us it's going to get worse.

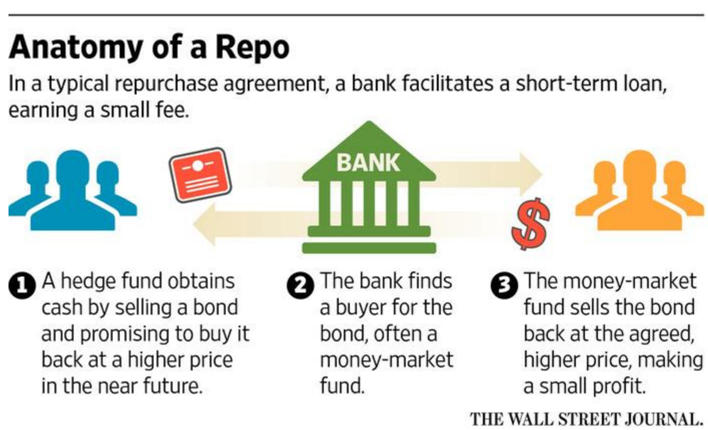
These matters shouldn't keep anyone up at night. You're thrilled if you owned securities that do well when growth and inflation slow, but not if you loaded up in energy stocks that have a different experience at the end of a business cycle. The victory is not choosing one option over another, but doing so based on a repeatable process.

Fool's Gold is a term used to describe an investment believed to be valuable that later ends up near worthless. It stems from one of three minerals being mistaken for actual gold. The most common mineral mistaken for gold is pyrite. Chalcopyrite may also appear gold-like, and weathered mica can mimic gold as well. Sometimes the fear of missing out will have you reaching for anything that looks like the precious metal, and in the process, you stop using one.

Suffice it to say the Chinese trade deal is pyrite in a sense that it's not that important to the market. In my opinion the Chinese have been taking us to cleaners for decades and our economy responded by lapping the rest of the world. An on and off again romance is exciting, but it certainly won't kill the golden goose. After all, U.S. exports to China are down $14.5 billion over the first nine months of the year in a $22 trillion economy[iii]. Striking a deal with China will not spark a reversal of the business cycle as much as it might end the whirlwind affair with Twitter.

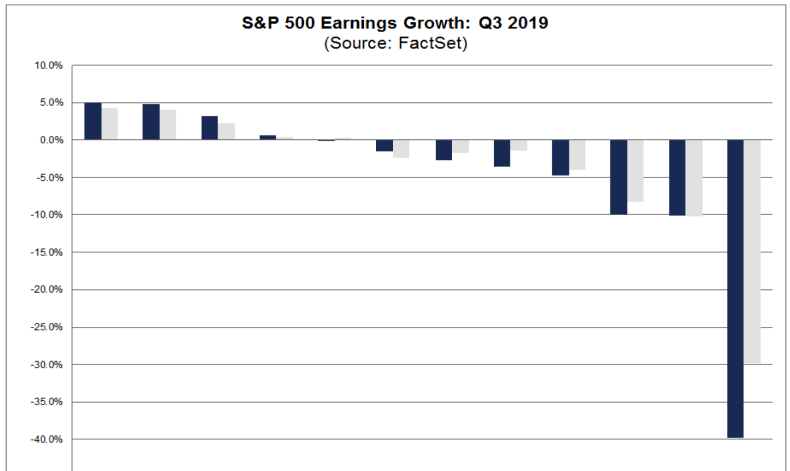
On the other hand, the repo market is a term few investors have ever heard of, and why would you. I'm guessing not a lot of drivers know what camshaft is either. Without it, however, there's nothing to make the valves open and close. Once that part fails it's time to go car shopping. The repo market is where borrowers seeking cash are prone to offer lenders collateral, typically in the form of Treasury bonds. Repo rates are the interest paid to borrow cash in exchange for treasuries for 24 hours.

Overnight lending seems plain vanilla, but those rates spiked to 10 percent in September, sparking the Federal Reserve to spend $60 billion a month to provide the necessary liquidity[iv]. Rather than looking to goose the economy back to health, the Fed is now using its balance sheet to make sure banks have enough reserves and that an adequate amount of capital is flowing through the system to keep things running efficiently.



John Smoltz is a Hall of Fame pitcher who announces baseball games. He said during a broadcast that hitters with the most compact swings and the fewest moving parts perform the best in the playoffs. In a high-pressure environment when every at-bat counts, when hitless streaks are magnified, the more moving parts you have the easier it is to break down and underperform when the stakes are high.

What the Repo Market events show us is that liquidity is substantially lower than what the Federal Reserve believes to be true and rising risks are evident in the weakest link of the financial machine - the overnight market. More importantly, liquidity providers probably have significantly more leverage than many expected. The repo market is something to keep in mind because it's complexity would make it difficult to remedy if things got too far out of balance.



	Real Estate	Utilities	Health Care	Comm. Services	Industrials	Consumer Staples	Financials	Consumer Disc.	S&P 500	Materials	Info. Technology	Energy
Today	5.1%	4.8%	3.2%	0.6%	-0.1%	-1.5%	-2.7%	-3.6%	-4.7%	-10.0%	-10.1%	-39.8%
30-Sep	4.3%	4.0%	2.2%	0.4%	0.3%	-2.4%	-1.7%	-1.5%	-4.0%	-8.3%	-10.2%	-29.8%

The same cannot be said for stock buybacks which are more or less straight forward. It's not too dissimilar to album sales when the studio would buy most of the records themselves and then claim it's a #1 hit. If you're spending over 100 percent of your free cash-flow to buy your own stock back[v], supply and demand being what they are, chances are the stock goes higher.

Lo and behold buybacks are beginning to slow after a decade of gaining speed. In the second quarter, S&P 500 share buybacks totaled $161 billion, still a lot of money, but 18 percent less than the first quarter[vi]. Moreover, the amount spent on buybacks this year is down 17 percent from a year earlier[vii], the sort of thing that happens when revenues decline.

With all of that said, the market is reacting positively to trade talk headlines, as if a deal will reverse economic gravity. Add a Fed rate cut to the table and you get a monetary banquet. Take those two dynamics away, however, and it's a dramatically different year. And while it's fine to sell the sizzle and not the steak, sooner or later investors will demand to eat real food.

What is more likely to happen in my opinion going forward is GDP growth will dip below one percent in the 4th quarter of 2019. Moreover, earnings growth is expected to do the same, and instead of flat to negative this quarter, may be in the red next go around and that won't bode well for stocks that benefit from a growth environment. One change on the horizon is inflation, which is showing signs of rebounding. That would be bad for consumer staples and good for energy stocks and commodities, or so says the process.

Some might find it hard to believe that the manager of the New York Yankees makes less money than the head football coach at Boise State, even though the Bronx bombers generate 100 times as much money. The reason is because baseball managers do a lot less managing these days, depending more on the math of matchups than experience and the feel of the game.

Nothing is more frustrating than when a starting pitcher who is coasting along with a lead, only to be taken out for a relief pitcher and (you already know what I'm about to say) the new pitcher gives up a home run. The next time it happens, don't blame the manager – the numbers man upstairs called the shots. That's why they don't get the big bucks; the computer makes all the decisions for them.

It sure would be nice to have one of those baseball computers tell me what to do when the economic conditions change. Some of the things that have been working, particularly in the 4th quarter of last year, are under pressure because the reasons we bought them are not as pronounced today. From the looks of things, we're in the 7th inning of decelerating growth and inflation and it's almost time to go to the bullpen and rotate asset classes. So you should expect a new pitcher, but they'll be careful not to throw a fastball down the middle of the plate.

We're still not out of the woods.

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[i] Stocks may be rallying to records, but the earnings outlook is darkening; CNBC; 11/6/19
[ii] Stocks may be rallying to records, but the earnings outlook is darkening; CNBC; 11/6/19
[iii] Trade war losses for the US and China grow into the tens of billions of dollars; CNBC; 11/4/19
[iv] The Fed is extending its overnight funding operations through January 2020; CNBC; 10/11/19
[v] S&P 500 buybacks are driving an unprecedented cash decline, says Goldman; MarketWatch; 7/30/19
[vi] S&P 500 buybacks are driving an unprecedented cash decline, says Goldman; MarketWatch; 7/30/19
[vii] Goldman warns that buybacks are 'plummeting,' ending a big source of buying power for the market; CNBC; 10/21/19