November 12, 2019

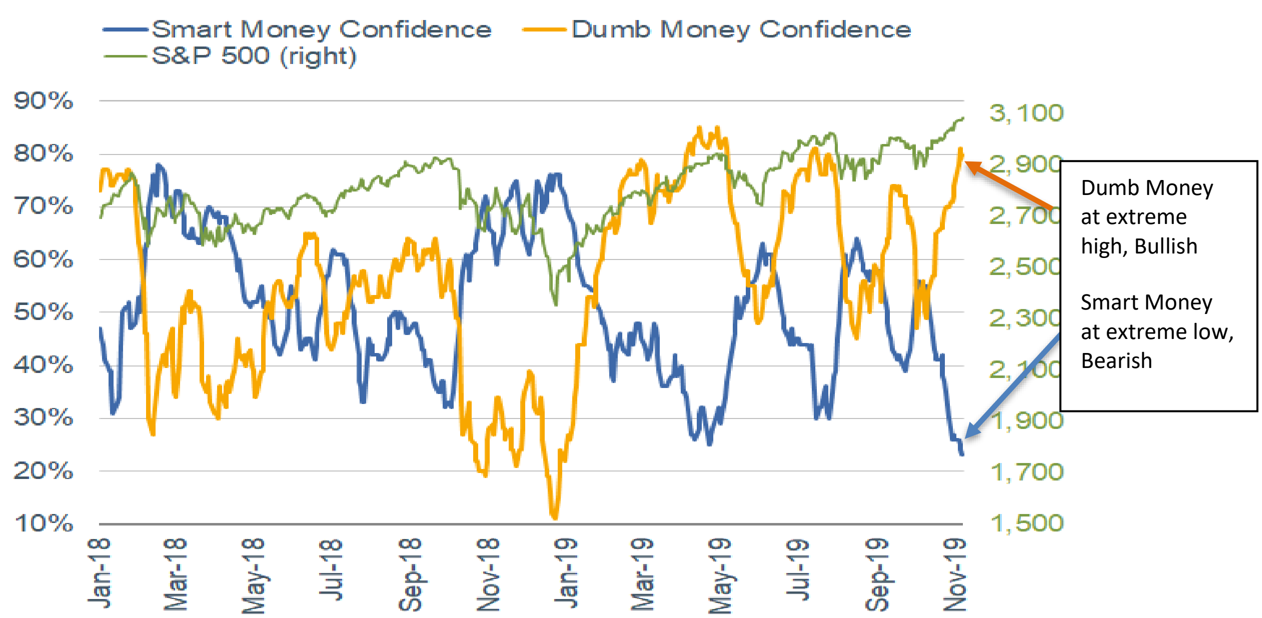
Is the Market Wearing Blinders?

Horse **blinders** are firm leather squares or plastic cups that attach to a horse's bridle or hood and prevent a horse from seeing behind and beside him.

Conflicting Data Grows

It is indeed an interesting time in the global markets. Depending on where you look or what you look at, a quick assessment would either be 'good' or 'not so good'. For stocks, it seems as though investors may have blinders on, as the focus has been solely on the 'good'. Hope of a signed US-China phase one deal and the Fed's recent accommodative rate cut have given investors a new appetite for risk and the result has been a push to all-time highs in many stock sectors. Out of sight to the stock market are the 'not so good' factors, namely negative earnings and weakening economic growth. It is these factors the bond market is focusing on and explains why global interest rates remain near their all-time low. The dichotomy of the data and reaction of the stock and bond market has been remarkable. At this juncture, wearing blinders has been the winning strategy for stocks. Seasonality favors the stock bulls, as strength is likely to continue through year end. However, there are some key leading indicators that are flashing warning signs that should not be ignored.

"Risk-On" Mode Back in Vogue: Since the middle of September market leadership has made a noticeable shift from Defensive sectors (Utilities and Consumer Staples) to Cyclical sectors (Financials, Industrials, and Tech). Coinciding with the recent risk-on behavior has been a surge in optimism among various measures of investor sentiment, one of which is SentimenTrader's "Smart Money and Dumb Money Confidence" index. The 'Smart Money' part captures the sentiment of institutional and professional traders while the 'Dumb Money' part reads the sentiment of small traders and individual investors. Currently each index is at extreme opposites, where the Smart Money is bearish, and the Dumb Money is very bullish. <u>In the past, this divergent has signaled a market pullback is coming</u>. The chart below shows the extreme divergence (Blue & Orange line) and the rising S&P500.



Source: Charles Schwab, Sentiment Trader, as of 11/7/2019. Confidence Indexes are presented on a scale of 0% to 100%.

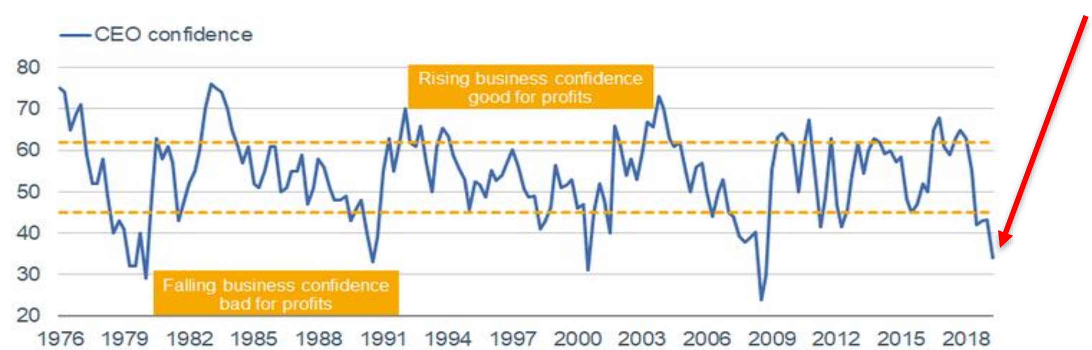
Components of GDP Weakening: The preliminary release of 3rd quarter GDP showed growth at only 1.9%, down from 2% in Q2, and 3% in Q1. While the current growth rate is moderate, the components of growth show a deep divide in areas of strength verses weakness. Specifically, consumer spending, which accounts for 69% of GDP, is still fairly robust with 2.9% growth, however it is significantly weaker than the 2nd quarter. Keep in mind, much of the strength from the consumer is due to a very tight labor market. So, as long as employment remains strong, the consumer should keep spending. At the same time, the business sector, specifically non-residential or commercial fixed investment, is telling a much different story. This component of the economy continues to weaken, now falling -3.1% in the 3rd quarter. Though business investment accounts for only 17% of GDP, it is view as a leading indicator of future growth and the continual decline in spending is signaling a potential recession ahead. The chart below shows the components of GDP by quarter, and the weakening in trend of both the consumer and businesses.

	% of real GDP	3Q19 real GDP	2Q19 real GDP	1Q19 real GDP	4Q18 real GDP
▪ Consumer spending	69.8%	2.9%	4.6%	1.1%	1.4%
▪ Government spending	17.3%	2.0%	4.8%	2.9%	-0.4%
-Federal: 6.7%		3.4%	8.3%	2.2%	1.1%
-State/local: 10.6%		1.1%	2.7%	3.3%	-1.2%
▪ Net exports of goods and services	(5.2%)	-0.1*	-0.7*	0.7*	-0.4*
-Exports: 13.2%		0.7%	-5.7%	4.1%	1.5%
-Imports: (18.4%)		1.2%	0.0%	-1.5%	3.5%
▪ Fixed investment	17.4%	-1.3%	-1.4%	3.2%	2.7%
-Nonresidential: 14.3%		-3.0%	-1.0%	4.4%	4.8%
-Residential: 3.1%		5.1%	-3.0%	-1.0%	-4.7%
▪ Change in private inventories	--	-0.1*	-0.9*	0.5*	0.1*
	Real GDP	**1.9%**	**2.0%**	**3.1%**	**1.1%**

Source: Charles Schwab

CEOs vs. Consumer Confidence Divide: Spending plans, both at the consumer and corporate level, are driven by expectations (confidence) about the future and hence, following various confidence indices can give us a look into the future. Today, there is a stark difference in confidence between business leaders and consumers. The first chart shows CEO confidence, and how now it is at the lowest reading since the Global Financial Crisis. The chart immediately below it shows that when confidence is this low, the growth rate of corporate profits fall. And suffice to say, falling profits augurs poorly for future capital spending and employment. Clearly a warning sign of slowing growth.

CEOs' Confidence Nosedived

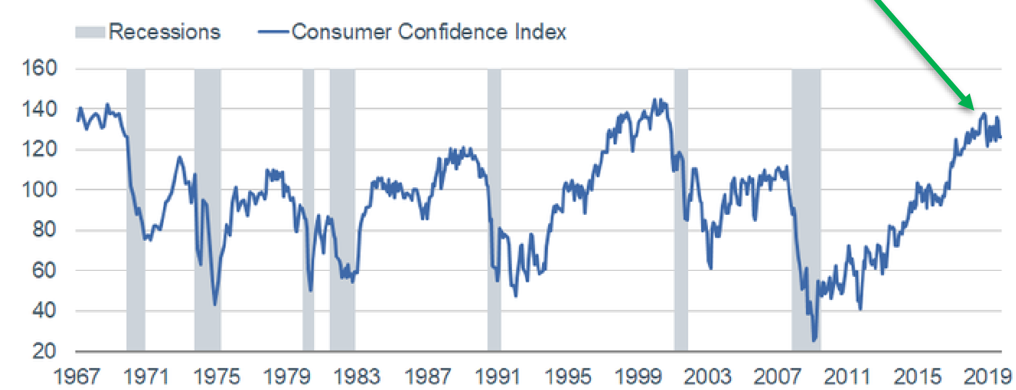


CEO (business) confidence	Corporate profits annualized gain (6/30/1976-6/30/2019)
> 61.9	14.0%
45 – 61.9	5.2%
< 45	-1.7%

Source: Charles Schwab, FactSet, Copyright 2019 Ned Davis Research, Inc.

In sharp contrast, the consumer remains quite confident. As mentioned above, a strong employment market is a huge support to consumers outlook and spending patterns. The first chart below shows consumer confidence holding near the high of this 10-year recovery.

Resilient Consumer Confidence

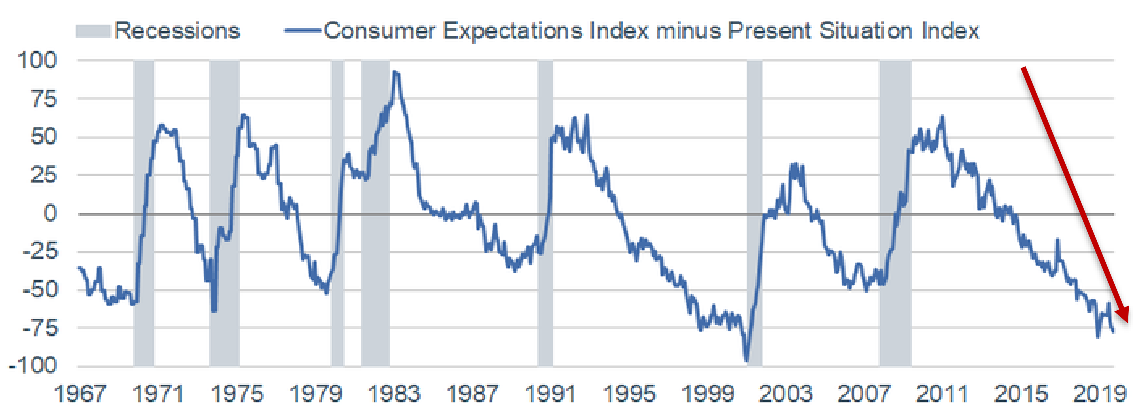


Source: Charles Schwab, Bloomberg, The Conference Board, as of 10/31/2019.

Unemployment rate since 1950. Currently level of 3.6% indicates a very healthy labor market.

But Wait…The Future is Not So Bright: Consumers are not as confident about the future as they once were. According to the Conference Board, consumers' expectations have fallen to a level that in the past has been a recession warning.

Consumers Much More Confident About "Today" Relative to "Tomorrow"



Source: Charles Schwab, Bloomberg, The Conference Board, as of 10/31/2019.

In sum, deep divisions lay between the professional and individual investor. The same can be said about businesses and the consumers regarding what the future holds. For now, individual investors and consumers are leading the charge, albeit perhaps with blinders on. The recent market rally has been more based on a relief of uncertainty over the US-China deal and falling interest rates, than an endorsement of future strength. But seasonality is in favor of the market strength; however, caution is warranted as we move into 2020.

Investment Strategy: No change in the portfolio strategy. The stock/bond allocation remains in the 'Neutral' zone: overweighting in defensive and low volatility stock sectors; moderate duration and high credit quality in the bond sectors.

As always, please contact me with questions or concerns. These are my thoughts. Your feedback is always appreciated.

In remembrance of Veterans Day, I am truly thankful and blessed by the great sacrifice our soldiers have given.

May you and your family have a wonderful Thanksgiving!
Barbara

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