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QUARTERLY INVESTMENT OUTLOOK

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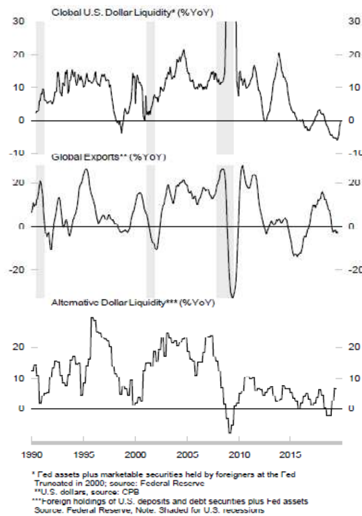
SUMMARY

- The Fed, ECB and PBOC are all following easy money policies. This is finally contributing to an increase in global liquidity, a condition needed for stocks to outperform bonds into 2020.
- M2 money supply is growing at 7% yoy, accelerating to a 13% annual rate since September. This could cause general price level inflation to move above 3% in 2020.
- Both oil and gas prices should move higher. Oil is benefitting from both an increase in the base decline rate coupled with slowing productivity, despite a 10% increase in well completions.
- A solid expansion in the Leading Economic Indicators along with a steepening in the Treasury yield curve, suggest a U.S. recession is not probable next year. Weakness in manufacturing is being offset by firm consumer/services sector. Consumer confidence at high level.
- A weak dollar is the key to our stagflation thesis. U.S./German yield spreads are already trending lower, a necessary condition for a dollar bear market.
- China is poised to lead the global recovery. We expect an S&P earnings recovery into 2020, but stretched valuations could limit gains in the S&P 500, a growth dominant index.

RECOVERY SUPPORTED BY AN INCREASE IN GLOBAL LIQUIDITY

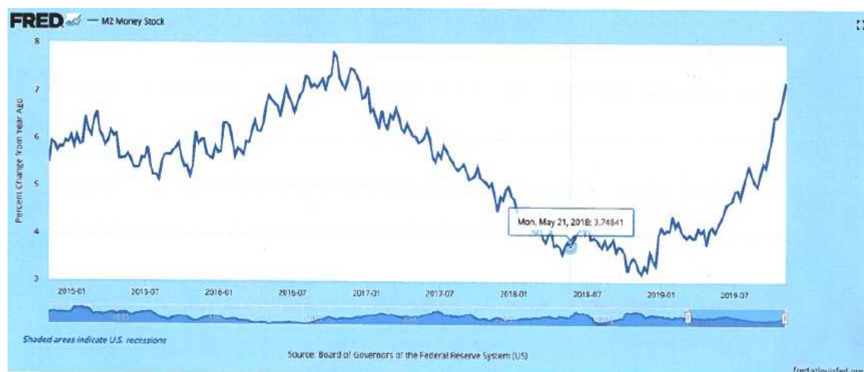
Accommodative monetary policies by the major central banks should stimulate a modest recovery in global growth in 2020. The Fed has lowered rates three times this year and the ECB is preparing another round of QE. China has recently lowered its short-term lending rate for the first time in four years, signaling the start of a new easing cycle. The PBOC said it lowered the seven-day repo rate from 2.55% to 2.5%. It also recently injected $28.5 bln. of one-year loans into the banking system. **The increase in global liquidity, along with a reduction in policy uncertainty, primarily through some form of trade dispute mitigation, should serve to bolster commodity demand.**



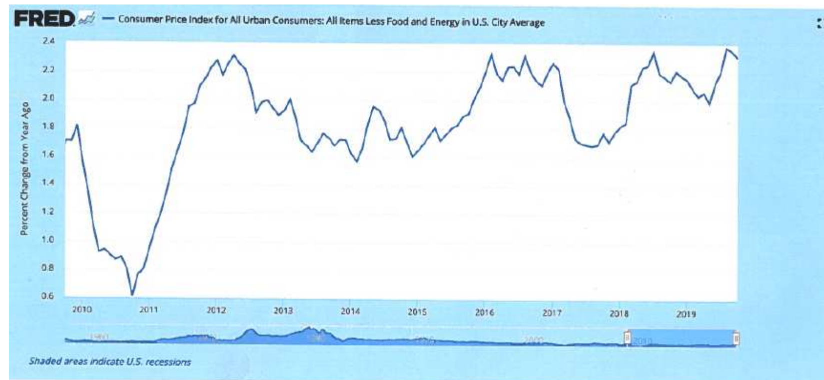
The chart above, courtesy of MRB Partners, shows three measures of global liquidity. The top window features the "conventional metric," which includes the size of the Fed's balance sheet plus foreign holdings of treasuries held at the Fed. The "alternative measure" shown in the bottom window includes foreign holdings of securities whether held at the Fed or not. Also shown is a measure of global exports. While not a direct measure of liquidity, the ability of foreign economies to earn dollars is ultimately the optimal way to obtain dollar liquidity. Moreover, the supply of financial liquidity tends to be pro-cyclical, which often correlates with the trade cycle. The fact that the conventional measure of global liquidity is hooking up, and approaching zero, after shrinking sharply as the Fed was contracting its balance sheet, is a positive for future growth. A favorable resolution to the U.S.-China trade dispute would also be positive for future global activity.

INFLATION COULD BREAK HIGHER IN 2020

As the late Nobel Prize winning economist, Dr. Milton Friedman, use to say "inflation is always and everywhere a monetary phenomenon." The chart to follow shows the yoy change in the M2 money supply. It grew at a 7.2% rate over the previous twelve months. Since September 25, 2019 M2 has increased at a 13% annual rate.



The essence of Friedman's thesis is that changes in M2 effect changes in both the real economy, and ultimately the general price level, the latter with a lag of roughly eighteen months. Noteworthy, as depicted in the chart below, showing the yoy changes in core consumer prices (less food and energy), the current yoy rate of 2.3% is at the upper end of an eight year channel.

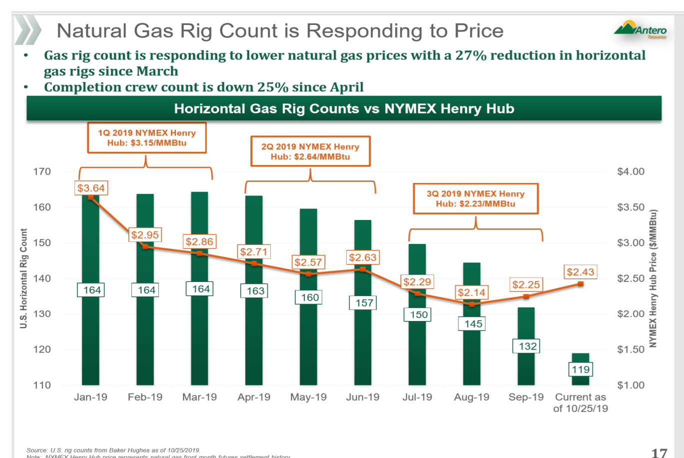


As discussed in the previous section on global liquidity, the central banks of the world, led by the Fed, are following accommodative monetary policies. Ultimately the Fed's easy money policy will lead to higher inflation, as money velocity turns higher. The initial impact should be to weaken the dollar, causing import prices to rise. The U.S. imports roughly $2.9 trillion of goods and services. A secondary effect should be a rise in commodity prices. Gold, being the most sensitive to changes in real interest rates, has already broken out of a six-year base, and is in a strong uptrend. As noted in our update on energy markets, we anticipate higher oil prices into 2020. We also remain bullish on copper, a key industrial commodity, which according to recent data published by the International Copper Study Group is estimated to be in a supply deficit of 400K tons.

UPDATE ON OIL & GAS PRICE OUTLOOK

According to the natural resource research firm of Goehring & Rozencwajg U.S. shale growth is on the verge of a multi-year slowdown. Since December, U.S. shale production growth has grown only 57,000 b/d per month, 65% less than rate achieved in 2018. This slowdown occurred even though the industry well completion rate increased by 10%. Drilling productivity growth has grown at 2% during the first eight months of 2019, a slowdown from 10% growth in the same period in 2018. The major reason contributing to the slowdown was an increase in the base decline rate. The base decline measures the output of legacy wells, drilled and completed prior to 2019. While the contribution from new wells increased by a massive 60% over the past two years, so did the base decline. **In other words, the shale industry now needs 60% more wells, each of which is 11% more productive to reach the same level of growth as it did in 2017.** Meanwhile this is highly unlikely to occur with the oil rig count

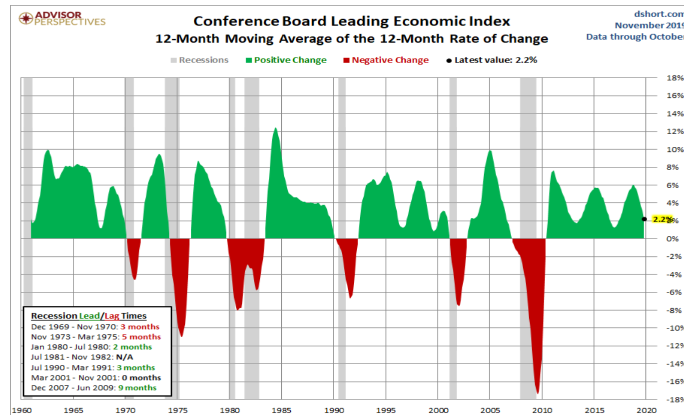
having declined by 25% over the past twelve months to 713 rigs. Shale companies are set to spend 13% less on drilling and completion in 2020 according to a recent Cowen & Co. survey. The bottom line is 2020 shale production may only grow by 600,000 bbl/day, well below industry estimates which forecast average growth of 1.5 million bbl/day for 2020. With non-OPEC ex U.S. growth estimated to decline by 400,000 bbl/day next year, and OPEC likely to hold production steady at a reduced rate of 1.2 million bbl/day from 2018 levels, and demand forecast to rise by 1.1 million bbl/day in 2020, the industry will likely continue to operate in a supply deficit. This is validated by both WTI & Brent crude which currently trade in backwardation, meaning front month futures prices trade at a premium, indicative of inventory tightness.



Shown above is a chart depicting the Natural Gas Rig Count (bars on the chart), which has declined from 164 in January 2019 to 119, a decrease of 27 percent in ten months. The NYMEX Henry Hub gas price has begun trending higher, having hit a low of $2.14/mm btu in August 2019. Currently prices are above $2.50/mm btu. We believe the ytd reduction in gas rigs may finally be having a positive impact on prices.

LEADING ECONOMIC INDICATORS SIGNAL CONTINUING GROWTH

Shown in the chart to follow, courtesy of dshort.com, is a smoothed trend of the momentum of the Conference Board's Leading Economic Indicators (12-month moving average of the 12-month rate of change). The LEI shows a +2.6% change suggesting that the current business cycle recovery is not at any imminent risk of reversing. An historical analysis of the smoothed LEI, shows it has an average lead time of 3.5 months in four previous recessions since 1980, and has a lag time of 4 months in two recessions i.e. 1970 and 1973-5.



THE TREASURY YIELD CURVE IS STEEPENING

The Fed has reduced the policy rate on three separate meeting dates since March 2019. More recently it has announced it will purchase $60 bn. of treasury bills on a monthly basis through the second quarter 2020 to provide additional liquidity to the repo markets. The combination of lower policy rates coupled with an increase in their balance sheet, has steepened the treasury yield curve. The 2/10 yr. treasury spread is at 17 basis points (bp); the 5/30 yr. spread is at 54 bp and the 10/30 yr. spread is at 46 bp. A steepening of the yield curve incentivizes lenders to make additional loans which investors (risk takers) are encouraged to spend/invest in new projects.

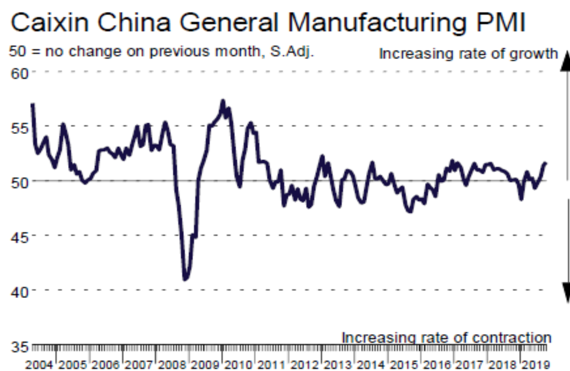
U.S. DOLLAR TREND - A MAJOR DETERMINING FACTOR

The chart to follow shows the relationship between the U.S. dollar (bottom window) and the spread between the U.S./German 10-year bonds. Both series bottomed in 2011 and trended together for seven years (2012-2018). In 2019 the interest rate spread reversed and is trending lower (top window), while the trade weighted dollar has gained 4%. We believe as long as the differential spread narrows, favoring German yields, that will exert downward pressure on the USD. As long as this trend is sustained, along with narrowing economic growth rates favoring Germany vis a vis the U.S., and portfolio flows into German equities and bonds, the euro should gain relative to the USD.

U.S. German Yield Spread Narrowing Is Dollar Bearish

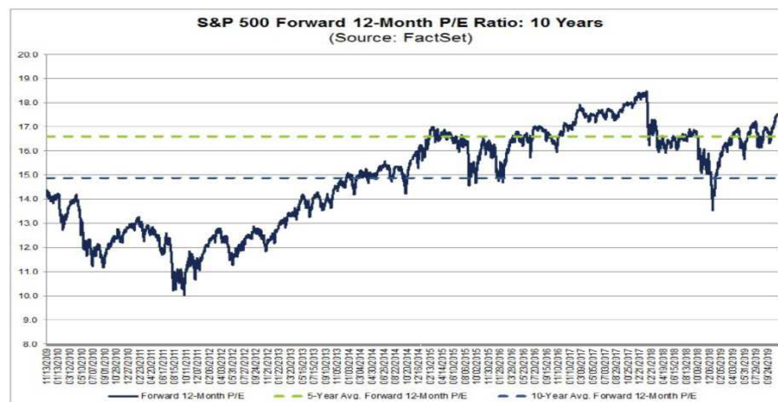
CHINA POISED TO LEAD THE GLOBAL RECOVERY

China October manufacturing data, taken from the Caixin General Manufacturing PMI Survey, showed operating activity at quickest pace since Feb. 2017. Both output and new orders accelerated higher, paced by stronger export business. Moreover, business confidence regarding the 12-month outlook improved to its highest level in six months. The headline PMI at 51.7 for October signaled the third straight month of improvement. New orders outpaced growth in inventories of finished goods. The Caixin report on manufacturing is considered the broadest measure of industrial activity as it covers over 500 companies. As we go to press, China reported the Caixin PMI for November at 51.8 extending its recent gains. This was the strongest gain since December 2016. China's non-manufacturing also ticked higher to 54.4.



MODEST EARNINGS GROWTH SHOULD ENABLE STOCKS TO OUTPERFORM BONDS

According to Factset, bottom-up analysts expect earnings on the S&P 500 to gain 10% to 179.9 in 2020. With profit margins peaking and real economic growth slowing to 1.5%-2% next year, this outlook may be somewhat aggressive. However, interest rates should remain low as the Fed will likely be on hold during the election year. This should keep pressure on the dollar, especially as foreign rates continue to outpace those in the U.S. We expect inflation forces to slowly emerge during the year, holding down real interest rates. A 17.5x price/earnings multiple is in line with an estimated inflation rate of 2.5% for 2020. At 3130, the S&P 500 appears to be at roughly "fair value," but as long as global liquidity expands, equities can trade higher and offer good relative value to bonds. A gradual steepening of the yield curve should pressure long-term yields, which may trend up to 2.5% by mid-year 2020. A run-up to 3% should inflation trends surprise on the upside, would cap the advance in equities. As shown in the chart below, courtesy of Factset, the S&P 500 forward 12-month p/e ratio is trading above its 5-year average (upper horizontal dashed line) and 12% above its 10-year average p/e (lower horizontal dashed line). Valuations are clearly stretched, but as long as the Fed keeps rates down, and the yield curve steepens, valuations can grind higher.



RISK FACTORS

- Inflation rebounds faster than expected
- Portfolio flows exit dollar based risk assets
- Oil producers increase production

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January 2020

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