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Conference Call

January 2019

Can the Fed's Dovish Tone Outweigh Bearish Market Factors

January 25, 2019 Conference Call
(This transcript has been edited)

Jim Bianco, President, Bianco Research: Good morning, everybody. This is Jim Bianco. Welcome to the conference call.

Summary

Let's see, what are we going to talk about today. Can the dovish tone from the Fed, and there was even more dovish tone from the Fed today outweigh some of the bearish tones in the market. The Federal Reserve has talked about this idea of they're going to be patient and they're going to be flexible. Today in the Wall Street Journal there was a story by some Fed staffers, but no one official other than the Kansas City Fed said that they might back off of reducing the balance sheet earlier than most people think.

Call me skeptical. The reason I say call me skeptical is the Fed spent 18 months telling us markets don't matter for policy, markets don't matter for policies. Then the market dives in December and they're trying to tell us that they're going to tear all this up and now they're just going to let the market dictate policy. I do believe they're going to let the market dictate policy for now, but if it stays at these levels or lower the answer is yes they're going to talk very dovish. If the market rallies, I suspect the Fed is going to go right back to some of their hawkish talk about wanting to raise rates. They're not going to sit there and watch the economy continue to advance and not think that they need to raise rates and reduce
the balance sheet, like they did a month ago, before the markets declined.

After that, there are a number of bearish factors we need to address starting with the big two. The U.S. economy and especially the European economy are slowing quite a bit. This is a big problem, especially in Europe. There's a lot of uncertainty. I'll show you some charts on the uncertainty stuff that is slowing everything down.

The next thing that we'll need to look at is earnings. Earnings are really decelerating quite quickly. Now this could be a little deceiving because what we're talking about is 2019 earnings, first quarter, second quarter, all of 2019. 2018 earnings is still benefiting from the year over year comparison of 35% tax rate to 22% tax rate, but 2019 is put on the same tax rate. Q1 estimates are now under 2%, and that is below the inflation rate. And so earnings are really just decelerating.

Predicting a recession, I did want to talk about the big problem with predicting recessions. This was the topic of my last call, but I do think it's worth mentioning again. No recession has ever been predicted by the consensus, ever. I'll show you some charts on that. Don't expect this one to be predicted as well either. They never are as well.

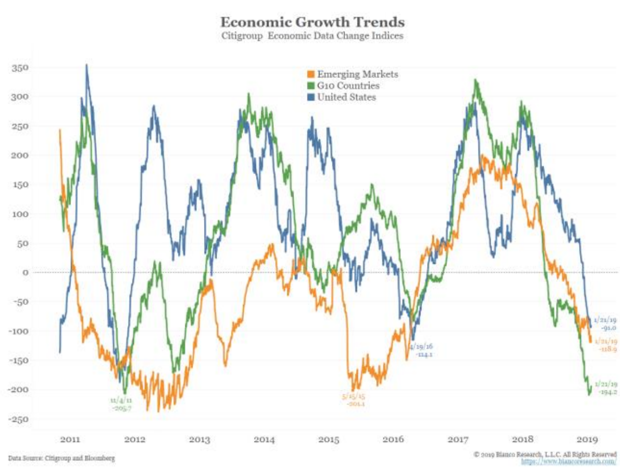
The shutdown, I think we're at a very important moment with the shutdown right now. My fear is that the shutdown is going to become a much bigger deal. Just as this call was starting there was stuff, a news flash on my computer screen, that said that LaGuardia airport has been closed because of a lack of FAA staffing. Here we go with the blue flu out because they're not being paid. This is going to one, either force the shutdown to end here soon, or it's going to continue for a while. Now why would it continue for a while, because the polling data, as I'll show you in a second, is not showing any one side or the other is being punished. Let me blunt about this, the media is anti-Trump, they highlight the data this is down for Trump, but the reality is it really isn't moving either way.

Now the point about this is the American public needs to make up their mind. Either punish Trump and he'll cave, or punish or have Trump's approval rating go up punish the Democrats and they'll cave. But if you don't punish either both sides will dig in, both sides will say good the FAA is going to shut down LaGuardia, that's going to force the other side to capitulate and we continue to go. I think we're at a moment now in the shutdown where we're either going to get a deal now, now being the next few days to several days, or I have a feeling or my fear is this bleeds into the debt ceiling. March 2nd we hit the debt ceiling. I'll explain that when I get there. When we hit the debt ceiling then all of a sudden the shutdown becomes part of the debt ceiling, becomes rolled up into one big ball of wax, and then the stakes go up quite a bit as well too.

Finally, I want to talk a little bit about the balance sheet and the outlook for interest rates. I still don't think that there's a lot of upside in interest rates. That would also suggest a bear flattening might be coming.

Economic Growth Trends

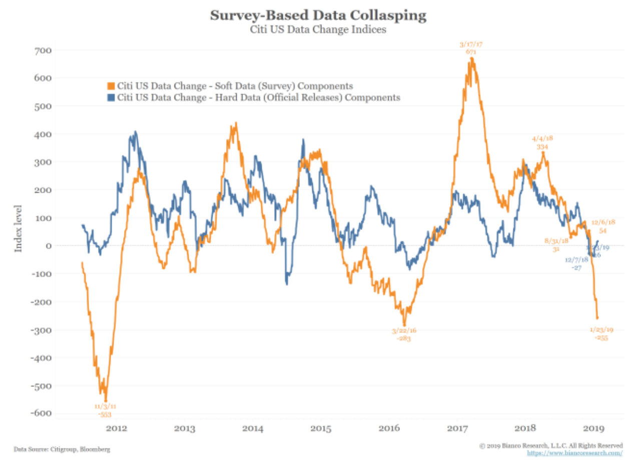
Okay with that said as a backdrop, let me turn us to the second page here on our handout at here, I want to talk about the economy and I want to talk about the slowing of the economy. My favorite Powell quote, which I'm going to use quite a bit as we go forward from here over time, "There really is no reason to think that this cycle can't continue for quite some time, effectively indefinitely," Jay Powell said on October 4th. I'll get back this quote a little bit later, but I do think that this was part of that October 4th speech when he also said that rates could go up a lot more that really bothered the market quite a bit. But within that, if you look at the data, you'll see that what we've got is we've got the data all moving much lower over the period.



Now this is the CitiGroup economic change data. What is the CitiGroup economic change data? That is that one half of the surprise index. All you need to know about this is that zero on the chart is your one year average. It measures economic data coming in versus its one year average. Below zero means that the U.S. in blue, the G10 countries in green, and emerging markets in red are all below zero and they're all heading lower. They're below their one year average and they're heading much lower as we go forward from here. The data is weakening.

U.S. Economic Data Is Weakening

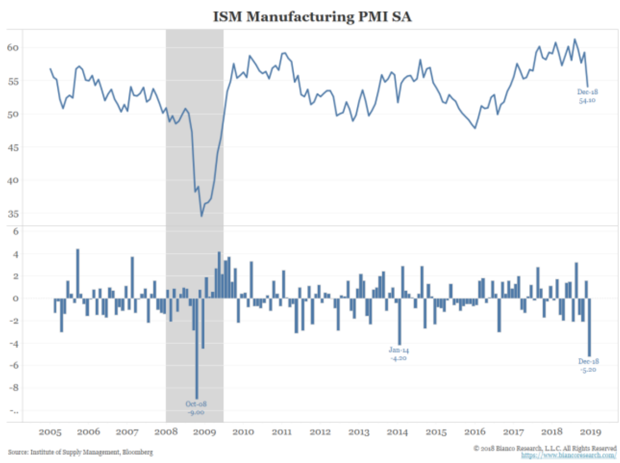
Let's look at the U.S. data and how it's weakening. Now you can break down this data change into two categories: the hard data or the official components in blue, and the soft data, or the surveys in orange. What jumps out at the chart is two things. First of all, there's been a big dive down in the soft data where the hard data has been moving sideways. What has been weakening in terms of the economic data over the last several weeks or so has been the survey data. That's what's been the big weakening.



Now what is causing the survey data to weaken? If you read the stories they'll say the shutdown is causing it, trade is causing it. Let me violently disagree with that. The survey data has always been, and I've written about this for many years, driven by the stock market. When you ask purchasing managers their question, because remember the purchasing managers is a survey, when you ask business confidence, when you ask consumer confidence, and any other survey in between, whether it's the regional Fed surveys as well, these are abstract questions. How is your business doing, well I can answer that. How is the general outlook for business. That is a question the NFIB asks. The general outlook for business, no one knows how to answer that question. What's the weather like in the United States? It's minus three degrees as I speak here in Chicago. If you're watching the golf tournament, it's 75 degrees. It's everywhere.

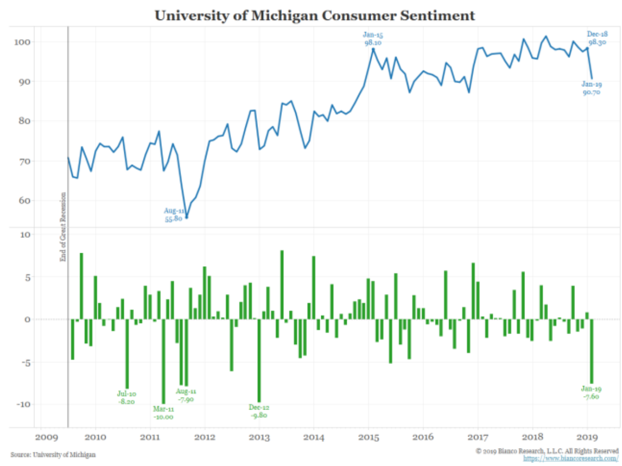
So what do you do to answer that question, the general outlook in business, you describe the stock market. What I think this big dive down in the last month was December stock market, was the damage that the stock market did on the psyche. That's where I think that we are. What will it take to get confidence to go back up would be a massive stock market rebound. Maybe that's underway now, we'll see if it is. We've roughly retraced 50% of it as well.

One other word about these surveys. Recall that with these surveys I've not been a big fan of surveys. I think we way over read the meaning of surveys except when they make jarring moves. When the surveys shot up right after Trump was elected into March of 2017, they were right, we were about to have a year of very strong growth. When they dove down into the $26 crude oil collapse and stock market collapse in March of 2016 and November of 2011, they were right, we went through a period of weaker growth. But everything in between, if you're not sitting at some kind of an extreme in these surveys, I think we tend to way over read what they mean. What's happening in the U.S. is we're seeing a slowing in the economy. The official data is not slowing as much, but the sentiment data is hard on its low. Now if it rebounds strongly, then that would be something good, otherwise not.

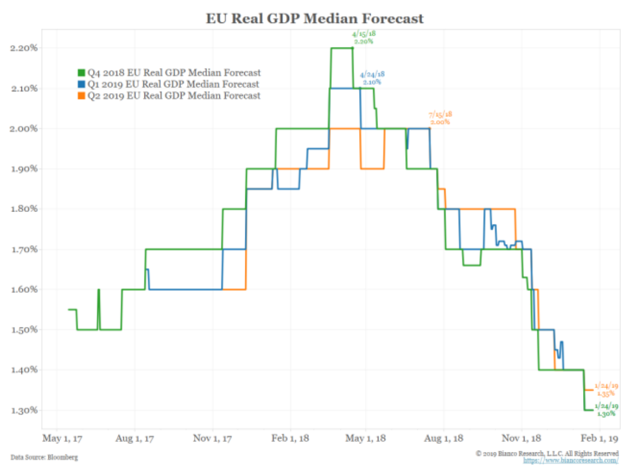


Now just a quick word about how the sentiment data works. Here's the ISM purchasing manager's index. December's number fell 5.2%. You've got to go back to the great recession to find something like that. Did purchasing manager's business change that much in December, or was that inspired by the stock market? I think that that was inspired by the stock market is what we saw there.

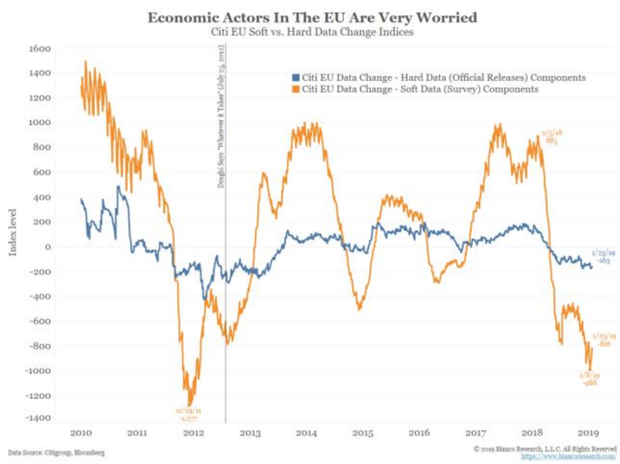
Similarly, on the next chart if you look at consumer confidence, the January number in consumer confidence fell 7.6% from 98.3 to 90.7. That is one of the four or five largest one-month declines in consumer confidence we've seen in the post-crisis era. July 10, March 11, August 11, and December 12th were also big stock market decline months. What's got sentiment down? I think what's got sentiment down here is the stock market.



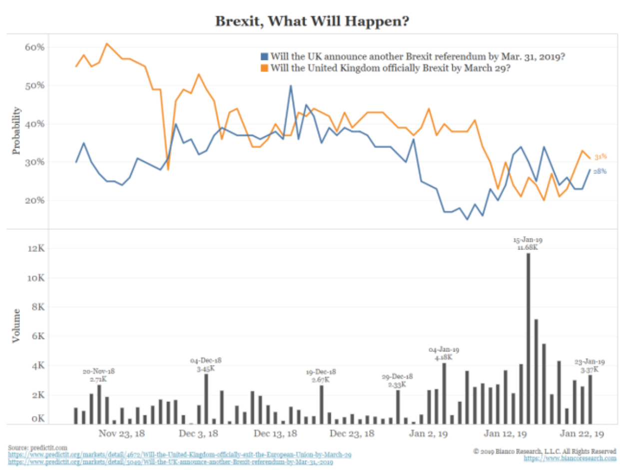
Europe's Slowing Economy



Let's stick with economies and let's talk about Europe. Europe's economy is slowing. There's GDP for the Euro zone. It's down to .2. You can see that pretty much in the post-crisis era you've got to go back, this is about the slowest growth we've seen in the last five years out of Europe right now. You can see here this chart shows you the median forecast. The red line is for Q4 for Euro zone GDP, the blue line is for Q1 of 2019, and the orange line is for Q2. All you need to see here is that we've got a big down trend going, and we are at some of the lowest numbers we've seen for European growth over the next couple of years.



The orange line is the soft survey data. Europe's data is as bad as it's been on the soft survey data that we've seen for the last six or seven years. Their hard data is slightly below zero. But is definitely the case in Europe that the survey data is very bad right now. Now that could be driven a lot by yellow vest protests, political instability out of Italy, and of course Brexit.

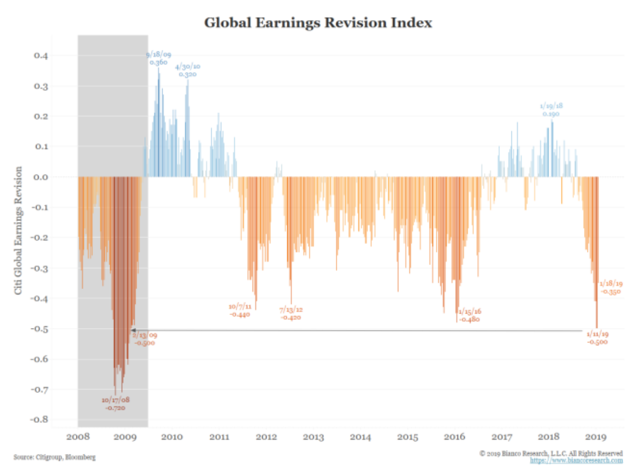


Here what we're looking at on the chart on slide nine is the betting for Brexit. I highlighted two outcomes for Brexit. One is that there's an official exit of Brexit by March 29th in orange. That is 31%. The other one is that there will be a second referendum announced by March 31st. That is 28%. If you add that together that is 59%. That means that there's 41% other. What is that 41% other? I think it's a combination of two things. I think it's a combination of one it is that there could be a hard Brexit that they just leave without any deal, and two it could be that there's great uncertainty as to what's going to happen with Brexit.

One of the things I've talked about with politics that I personally detest is some of the theater of politics. I'll use the Kavanaugh hearing. We had the Kavanaugh hearing, then comes the Kavanaugh vote. The media goes and asks all the 100 Senators how are you going to vote, and the 100 Senators tell them how they're going to vote and they announce it. It's written in the paper exactly what the vote is going to be, but you should tune in, stop what you're doing, watch the vote because it's very important. Well they already told, yeah the vote's important, but they already told us what they're going to vote. The act of voting is that, and that is a metaphor for all of politics. A lot of politics we already know what the outcome is going to be, we just have to get there.

Brexit is an exception and so is the shut down. We do not know, what the shut down less so, Brexit we do not know what the outcome is going to be. The reason Theresa May put the vote up to the parliament last week and intentionally let it fail was the thinking was if it failed by less than 100 votes they could maybe tweak the deal and get 100 people to switch. But because it failed by 230, they don't think they could have tweaked the original deal to get it to switch. The point is they don't know what to do. No one knows what to do.

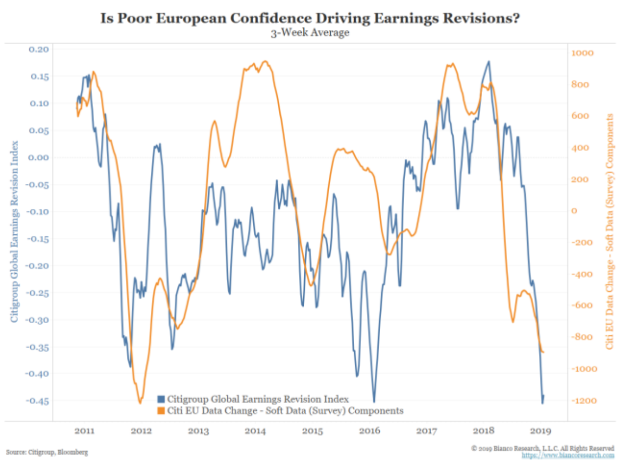
Why is the UK economy not collapsing, because there's this great hope that will sort it out. That might not be misplaced, but this is definitely a problem with uncertainty in the economy is that no one is really quite sure what's going to happen next. There's just a hope that it will work out. This is usually not the case. In the case of the shut down, we don't know exactly when or how, but we know that the shut down will end. It will end at some point. There will be a deal. The government is not permanently shut down. We're still trying to work out some of the deals. But Brexit's a little bit different.



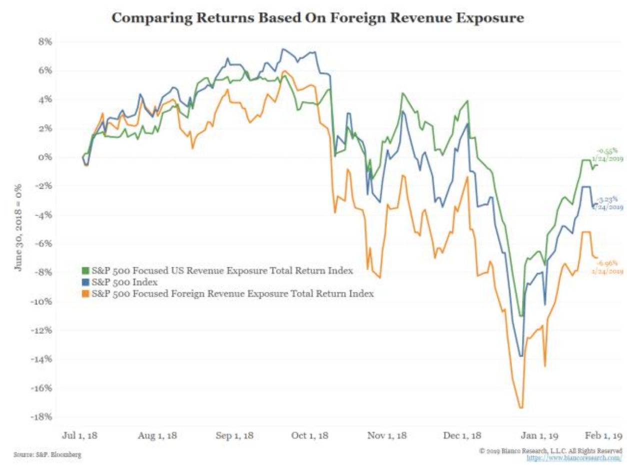
How is this manifesting itself in the global economy? Here is a chart from CitiGroup called the global earnings revisions index. They look at the consensus of all of the global companies and have the analysts track global stocks. They look at their revisions and they put it together as an index, how they're changing their earnings outlooks. You can see that by early January we were at the lowest level in 10 years, or thereabouts. You needed to go back to the great recession to find a time that earnings were being cut this much. The analysts are hacking earnings, and they're hacking earnings quite aggressively right now across the globe.

Is Poor European Confidence Driving Earnings Revisions?

Europe plays into this in a big way. How so? Let me take the next chart. The next chart here, the orange line on this chart is that soft data survey I showed you a couple of charts before out of Europe, and the blue line is the earnings revision index. They're essentially the same thing. They go up and down together. The bad sentiment in Europe is showing up in analysts forecasts and analyst outlooks that they're very worried about the global economy.

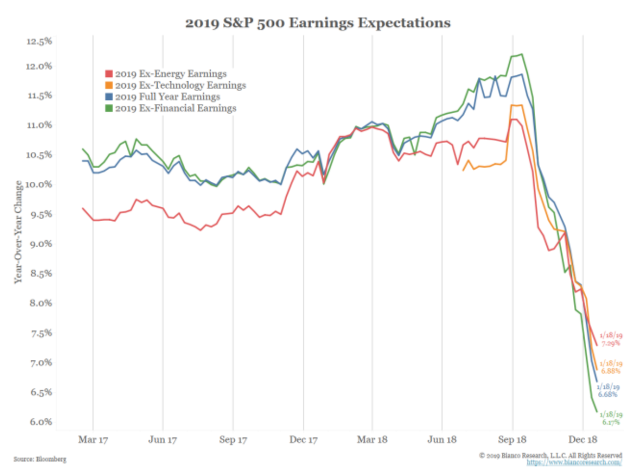


It also might be showing up in the way that the stock market is trading. The S&P 500, here we're looking at returns from June 30th, June 30th equals zero on this chart, is the change in the S&P 500 is in the blue line. Then the green line is the 125 companies with the largest U.S. revenue exposure or the smallest foreign exposure to revenues. The orange line is the 125 companies with the biggest foreign exposure to revenue. The foreign exposure to revenue companies have been underperforming rather to the U.S. ones. Now this is a combination of I think that the global earnings numbers are going down and the European economy is not doing well, overseas is doing poorly, and a fear about trade. This is showing up in the way that the markets are trading right now. The way that the markets are trading is they're suggesting to you that you should be more focused on the U.S. than you should be on global economies.

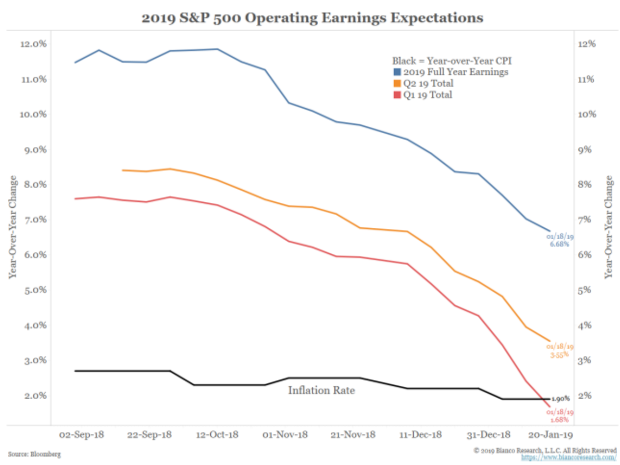


Slowing Earnings Expectations

Speaking of the U.S., let me jump to the next chart, earnings expectations in the U.S. I looked at the global numbers and I talked about how they're going down. Here's 2019 earnings expectations. The blue line on the chart is the year over year growth for the S&P 500 for the full year. This is the year end, so this is in 11 months. What are the analysts expecting for earnings, it is 6.68%. Then if you look at some of the other lines, if you want to know what ex-energy is in red, ex-technology is in orange, ex-financials is in green. We're under 7%, but notice that right at the stock market peak earnings expectations have been going down and they have been going down quite hard.



But if we were to detail that, this chart here, what we show is the black line is the inflation rate on the chart. You can see where the inflation rate has been relative to what is expected for earnings growth. Remember this is a median of the 500 companies, this is all the analysts' estimates, median for the analysts' estimates for each individual company, all 500 averaged together. For the first quarter, which is in red, we are under the inflation rate. We're at 1.68.



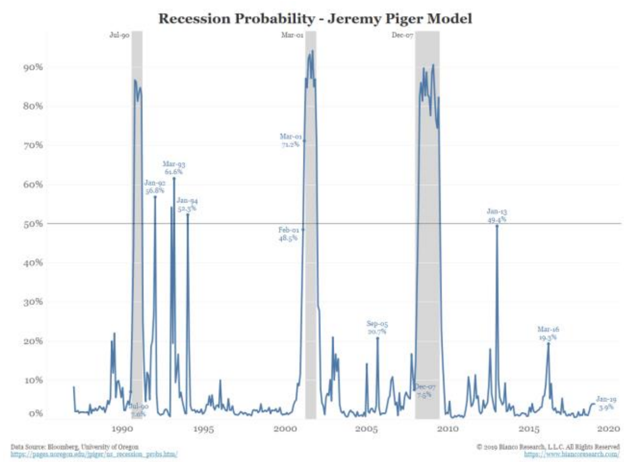
A little bit later this morning we'll get the update to this, but we're at essentially, let's just call it essentially zero real growth on earnings for the first quarter. That is a problem. The second quarter is not much better. It is under 4%, 2% real. Notice its trend is straight down. It's still got another three months so that it can be cut before it winds up becoming an actual as well too. Then the blue line on the chart is the 2019 that I showed you on the previous chart as well too. Earnings in the U.S. are not doing very well.

What have we talked about so far? The economy is slowing, especially out of Europe. What's driving it lower is the sentiment. It's very poor right now. You've got great uncertainties going on out of Brexit, out of unrest in Europe, and a general slow down going on in Europe, which is scaring them. It is also showing up in the U.S., but the slow down in the soft data I think is more stock market driven from December. That's manifesting itself in the global earnings revision, and the U.S. earnings data is all looking not good. The fourth quarter will be okay. Remember that the fourth quarter will be okay because the fourth quarter will largely be a function of the tax cuts for the U.S., but it's really about guidance and it's really about looking forward into the first quarter and the second quarter, and that's where we see some issues.

Probability Of A Recession

Let's talk about recessions. I do want to emphasize this. This is a little bit of what I talked about in the last call. I want to emphasize this because I think it's important, the way that recessions come, because I think people have missed or forgotten what they are. Janet Yellen was on stage with Jay Powell on January 4th. "I don't think expansions die of old age. Two things usually end them. One is financial imbalances," that's the Fed speak for a crash in financial markets, "and the other is the Fed." Thank you Janet for admitting that the Fed kills expansions. "... And usually the Fed ends an expansion," she corrected herself, "because inflation has gotten out of control the Fed needs to tighten to bring it down." I'll disagree with that.

The Fed thinks inflation has gotten out of control, murders the economy, and I use that word specifically because look at what Bernanke said in the next one. "But as Janet says, "expansions don't die of old age. I'd like to say they get murdered." The leading murderer for an economy is the Federal Reserve. They do it on the guise that they think inflation is coming back. That's why they murder it. They then tell themselves it was necessary because if they didn't do it we would have had inflation and that would have been worse.

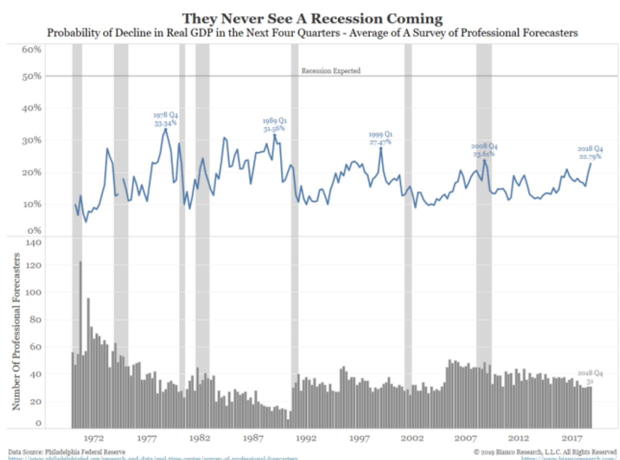


A model put together by Jeremy Piger. He is an economist at the University of Oregon. He works with Tim Duy who's a lot more higher profile. He uses the four indicators that the MBE or the recession dating committee uses to determine when a recession begins. It's a very good contemporary model. I'm using this model for one reason and one reason only. I think it's a good contemporaneous model. That's what I wanted to say. I don't think it necessarily gives you any insight.

In January, we're at 3.9%. Oh, okay. So we've got no worries about a recession. Well, in July of 1990, we were at 7%. That was the month that the recession started. Three months later we were at 85%. We went from 7% to 85% in a heartbeat. In January of 2001, we were at 10%. In February we were at 48%. In March, the month the recession started we were at 70%. For the Great Recession, in December we were at 7.5%. That was the month it started. By March, we got to 85%.

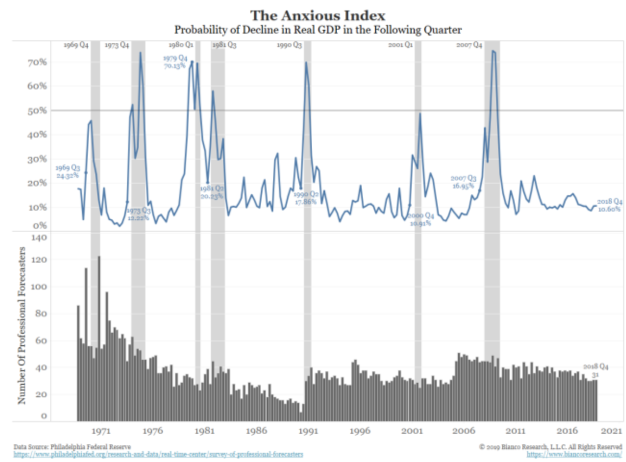
What I want to show you is, yes we're 3.9%. Yes, we're not looking at a recession, but what this model shows you is when we go into recession, it moves up 70 or 80 points in 60 days. That's the way it works. You go from 3.9% to 80, recession. What just happened? That's the way it works on how we get a recession. Now why do recessions work that way? Because the mistake that everybody makes when it comes to a recession is, I use this analogy and I'll use it again. If I'm in this situation we're watching a fire fight, I could see the biometrics of the soldiers. I'm kind of using a sci-fi Hollywood version of this. I see their heart rate, I see their blood pressure and I see their temperature. Hey, they're all fine. There's no problem. They're all healthy and they're engaged. Then one of them gets hit by a bullet and they're dead. That's exactly the same mistake we make with the economy.

You hear economists say, "There's no chance of a recession because employment is doing this and GDP is doing this and retail sales are doing this, industrial production is doing that. That's not the way you predict the recession. That's never going to tell you recession. What you want to be worried about is, if somebody's murder the recession to use Bernanke's term. December I think was about that. To kind of highlight this a little bit more, the Philadelphia Federal Reserve does a survey of professional forecasters. You can see in the bottom chart, they ask how many forecasters they answered a particular question.



So for the fourth quarter, 31 of the forecasters asked the question what is the probability of a decline in real GDP in the next four quarters? So, over the next four quarters, what is the probability that we'll see a negative print on real GDP? This chart goes back to 1970. That's when they first started asking this question. So you've got almost 50 years of data. I highlight on this chart 50% no one has ever predicted a recession. They're all shaded. This chart has never been above 50% in 50 years, 0 for 6. If you're waiting for the GDP data and you're waiting for the industrial production data and the payroll data to tell you a recession, then you know what you need to do is you need to go back to Piger's model and remember, it will go from 4% chance of recession to 85 in 60 days.

And in those 60 days, the recession has started and you've missed it. So do not listen to those that say look at GDP, look at payrolls. I don't see recession. Wrong metrics. Look at your soldiers. Their heart rates are fine, their blood pressures are fine and then they get hit by a bullet and were killed. That's what you have to worry about is if the Federal Reserve or a financial imbalance and I throw one other in there, a spike in crude oil, is going to murder the economy. That's the fear. Now, there's another index that they look at too is the anxious index. That's their term for it. The probability of a decline in the next quarter and what you see here is a couple of instances that they've looked at as a possibility of a decline in GDP in the next quarter.



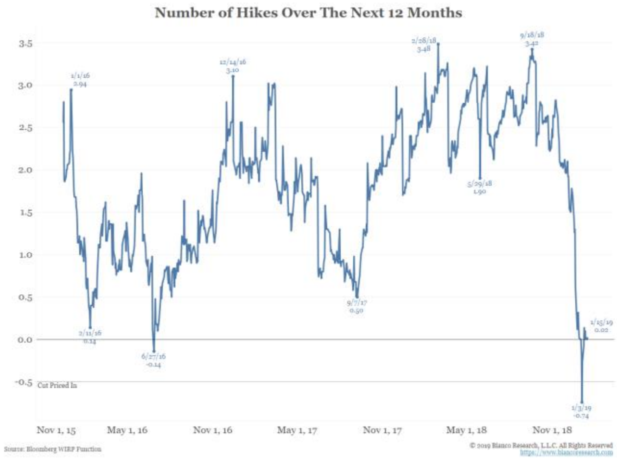
But typically, it's right when the recession starts. So they're basically announcing to you that the recession started that morning. They're not giving you any lead time in terms of what to expect out of the recession that's coming. I go to the next page here, slide 19 on the chart. I get a picture on this slide here of Jay Powell. And I've got some of his quotes here that he spoke that turned the market around with his January 4th speech, particularly with inflation muted, meetings that we've seen, we can be patient as we watch and see how the economy evolves. We will prepare to adjust policy quickly and flexibly. He said that.

What I want to point out about this is just a little funny thing. Jay's got a piece of paper in his hand. When he was asked about what was going on with the economy, he pulled out that sheet of paper in his hand and was actually shaking if you see me on the screen. His hand was shaking. He read his words. His words were very well picked. This was not a guy speaking off the cuff here. He was trying to tell the market that he was backing off as far as what they were looking at. And why is that? Because if we were to go to the next chart, this shows you the number of hikes over the next 12 months. You can see that in December, it collapsed all the way down to the day before Powell spoke, January 3. It was pricing in three quarters of a cut by the next 12 months.

In other words, it was pricing in the first ease that we've seen, although in '16, it had never gotten down to more than 50% greater since the Great Recession. We had not seen it pricing. Why was it? Because on December 19, Jay, when you said that the balance sheet is on automatic pilot and then you also said that there would be two more rate hikes, the market thought to themselves, this is too much. You're going to cause a recession so we're going to price in a recession. The stock market declined 20% and we priced in an ease by the day before. Or to stick with Bernanke's metaphor, "Jay Powell pulled the gun out of it's holster and waved it around and he scared the hell out of everybody."

You're going to do that, we're going to have a recession. You're going to murder this economy. So I might as well price in that you're going to murder it. Then you pulled out your sheet of paper on the fourth with your hand shaking and you told me I'm putting the gun back in it's holster. I am not going to murder this economy. And you can see that we've rebounded back to somewhere around zero.

No Rate Hike Is Priced In



This chart's a couple days old, but we're still somewhere around zero, so there's no rate hike or rate ease priced in. A quick word about this. I've heard a number of people say, "Well the market overreacted in December." I'll disagree with that. I don't think the market overreacted in December. I think it was necessary for the market to do that to get the Fed to back off.

They needed to slap the Fed on the side of the head and said, "You're going to do what Yellen said and you're going to do what Bernanke said. You're going to murder this economy with that policy you announced on the 19th. Stop it." Well, we don't believe we need to. All right. Watch what we're going to price in. We're going to price in a recession. All right. Now, we'll back off. So the question then becomes, as I go to the next slide, has Powell figured this out?

Has Powell Learned The Lesson?

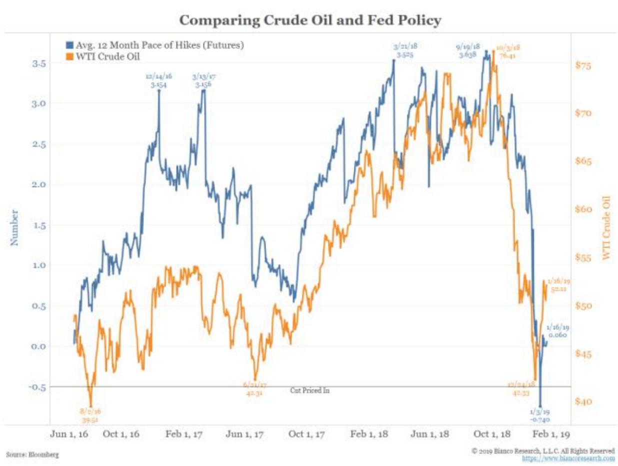
Has Powell learned the lesson? Now, this is the real issue when it comes to the Fed. They tried to do too much in December 19th. The market rioted. They heard the message of the market. They backed off.

Is it over with? I had a number of debates with people. Yes, the Fed's got it's message. They're not going to raise rates this year. They're done. Or, are they just saying this now to let the market recover because Bernanke said this. We had the paper tantrum. We backed of it. The market recovered and then we went right back to what we were going to do. So that's all we're doing. We're just mouthing some words to get the market to recover. Then when it recovers enough, we'll go right back to what we wanted to d. That's the real question. Are they serious about it? Now the problem with Powell is he's all over the lot in October. The funds rate is a long way from neutral.

That was hawkish. In November, the funds rate is just below the range of estimates. That was dovish. In December, balance sheet reductions, that December 19th, are on automatic pilot. That was hawkish. January 4, the Fed can be patient and flexible. Dovish. January 10th, the balance sheet will be substantially smaller. Hawkish. That's the last time he spoke, January 10th. Jay make up your mind. Which one are you?

The problem with this is, Powell is not consistent with anything that he says right now. He's all over the lot with it and therefore I still think there's a risk that if the markets recover, they really do want to pull the balance sheet back by $600 billion, they'd like to do two rate hikes. If anything, they'd really like to do three, but they'll settle for two. They still want to do it. They just won't say it in this environment right now, because they're so worried about what they saw out of markets. But I still think the Fed wants to do it and I still think that's going to be an issue.

Inflation



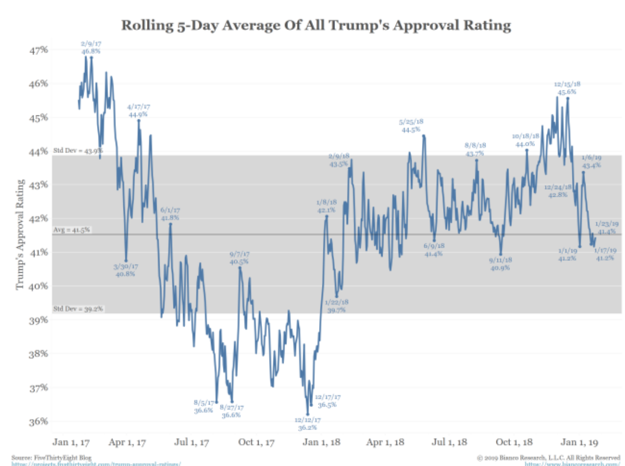
Regarding inflation expectations, this seems to be the big driver of what the Fed is looking at right now, is inflation expectations. We'll have to see where this goes. The blue line on this chart you're looking at is the same chart you just saw before. It's the number of rate hikes priced in over the next 12 months. The orange line is WTI crude oil notice that they move down together. They move up together. So the real question is, what happens if crude oil prices go to $60 or $65? Does that really put the pressure on the Fed to start hiking rates some more? Or does the Fed back off of that? We'll have to see if crude oil prices stay down in the $45 to $40 range, do we still continue to talk about the Fed maybe cutting rates?

One of the problems with Fed policy is that it is dictated by inflation expectations. And inflation expectations we're going to be looking at TIPS break evens, the inflation swaps, whether you're looking at some of the surveys. ISM prices paid, or anything else that the Fed looks at for inflation expectations. So much of inflation is influenced by the price of energy which is measured by the price of crude oil because it's 8% of CPI and it's very volatile. Look at it. We had $75 to $40 dollars in a quarter on crude oil prices. And it's so volatile that it shows up in all these numbers that it's, in essence, the driver of Fed policy is energy prices.

So tell me the next direction in energy prices and I'll tell you what the Fed's going to do next. I'm thinking that the next price movement is going to be up in crude oil, maybe $55-$60 dollars in crude oil. Then that will in kind show up as higher tax break evens, higher measures of inflation expectations and then this dovish talk might turn a little bit. Then we can be back to some version of December.

The Government Shutdown and Trump's Approval Rating

Let me turn to a different topic now as a risk. The shut down. Here's Trump's approval rating since he's been President. This is a rolling five day average of all Trump's approval ratings. There's about 50 services that we aggregate together, just do it on a rolling five day basis. A couple of points about his approval rating. One, he's never been above 50%. He's the only President who's ever done that. The first 365 days you see on this chart is the lowest approval ratings that a President has ever had. Two, if you look at his range, the plus minus one standard deviation from 39% to 43.9%, a 4% range, far and away the tightest range we've ever seen. That's kind of what's really interesting about Trump is his approval rating really doesn't move. He's got a base. His base is with him. And that's a little bit of what goes on.



Three about his approval rating, this was the tax cuts, that going into the tax cuts, the press on the tax cuts was absolutely awful. It was a giveaway to the rich. It was a terrible idea. But yet, they still forged ahead with the tax cuts and you remember everybody got their $1000 bonuses right after it because they signed them at the end of 2017. Then his approval rating bounced. So here's what I want to point out about his approval rating right now. On December 24th, which is right here, his approval rating was 42.8%. On January 23rd, the last day I updated this, he was at 41.4%. His approval rating is down a whopping 1.4%. That's after 32 days of government shutdown. His approval rating went down 1%. All these surveys are plus or minus 3% standard error.

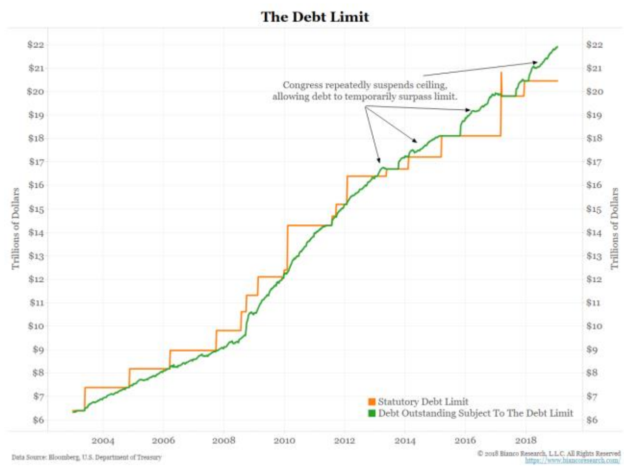
So you can't even say that it's moved statistically significant is what we're looking at here. He's really not being punished for the approval rating. Now, I didn't put Pelosi approval rating in here. Her approval rating by the way is at the highest it's been in several years and it's 32%. Remember all members of congress are awful. They've been this low, Congress approval rating has been as low as 12 or 13%. Everybody hates Congress. But her approval rating is not moving either. What pressure does Trump feel to end the shutdown? Is he being punished by his base? Is he being punished in approval ratings? Too soon to tell. We've already had 32 days of shutdown and he's only moved 1%. I'm not seeing any real evidence. Yeah, the media will say, but the polls say that the American public blames Trump for the shutdown.

That's true, they do. But then the next question they usually ask is are in favor of border security? And the answer is yes. So now what? Usually with the polls, you always get those mixed messages. It's Trump's fault the government shut down, but we agree with him we want more border security. So it's like both sides are right and wrong. So they're both dug in. They're not even negotiating with each other because both sides I think are looking for total surrender. Trump is offering proposals he knows that the Democrats won't take. Maybe trying to get them to the table, maybe just trying to give the appearance of looking reasonable. The Democrats don't even go to the table, giving the appearance that they look unreasonable and that's why my fear is that this shutdown could go on for a long time.

Now maybe if the headline I saw right at the start of this is LaGuardia is closed because enough FAA officers didn't show up and we get more of that, the fear I have with that is that could even backfire. Oh look, the airports are closing and we can't do anything right now. Both sides are going to wake up and say, "Good! This means the other side has got to cave in." Maybe the stock market takes a big hit. Good. The other side's got to cave in. Not that I'm in trouble, it's that they're in trouble. And what I'm really worried about with this is, is that while this is more political theater, it gets serious. Let me get there. Here. It gets serious on March 2nd.

The Debt Ceiling

So here's the debt ceiling. The orange line on the chart is the statutory debt ceiling limit and the green line on the chart is the current level of debt.



And you'll notice, wait a minute. Why are we above the debt ceiling? Because last Fall when we hit the debt ceiling right there, we passed a rule that said we're going to ignore the debt ceiling limit until March 2nd. On March 2nd the debt ceiling limit will rise to whatever the level of debt is, around $22 trillion. Then they can go through the whole extraordinary means where they borrow from all the pension funds and stuff and push this thing out into the Summer before it becomes a real issue. But, this is about four or five weeks away. If we don't solve the government shutdown soon, then the discussion of ending the shutdown rolls into a simultaneous discussion of lifting the debt ceiling. That's a big deal because there's the probably of default with the debt ceiling. Remember that the Federal Government cannot prioritize payments, cannot prioritize payments.

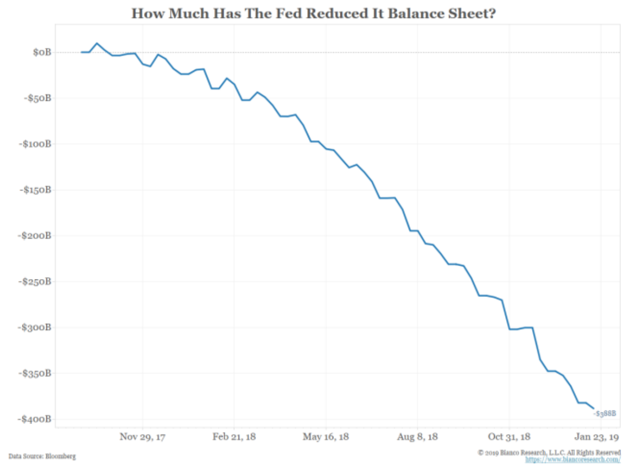
So even with the debt ceiling, they might have 90% of the money they need to pay for everything. That means that 10% doesn't get paid and in order to do that, you'd have to prioritize what you pay and what you don't pay. They're not allowed to do that because it would be a violation of the separations of power. Because otherwise, Congress can pass whatever bill they want and the President can decide what bills he's going to pay and what bills he's not going to pay and therefore it gives him too much power. So if you cannot pay 100% of your bills, you cannot pay any of your bills and the big bill we're talking about here is debt repayment. So if a treasury security comes due and you don't have enough money to pay your bills, you cannot repay principle.

And if you cannot repay principle, by the way the headline is now saying that there's also a big slowdown now in Philadelphia and Newark as far as FAA staffing issues slowing down the airport. So maybe this will force a shutdown resolution here very, very soon. Otherwise, this could get very ugly very fast. And the reason it would get ugly again is, Trump doesn't think he's losing. And Pelosi doesn't think she's losing. So therefore, they're just like just sit on my hands and watch the other side cave. And it could get a lot worse before it gets better. The other problem is the bases of both parties are such that if Trump doesn't get his wall funding, his base will eviscerate him. If Pelosi gives him any wall funding, her base will eviscerate her.

So it is a big debt struggle. We'll see how this plays out, but my fear is, if this goes on for much longer, it rolls in the debt limit and then it becomes a much, much bigger issue for everybody. And the debt limit becomes a bigger issue because of payment prioritization and you wind up having a real problem on your hands with payment prioritization because you can't pay your debt. You can't pay 100% of your bills, you pay none of your bills. You can't repay securities and then they're in technical default. The big one is for money market funds. If treasury bills go into technical default, there's been rulings that you have to value them at zero. You could break the buck, have your money market fund and we all know that's not a good scenario for them.

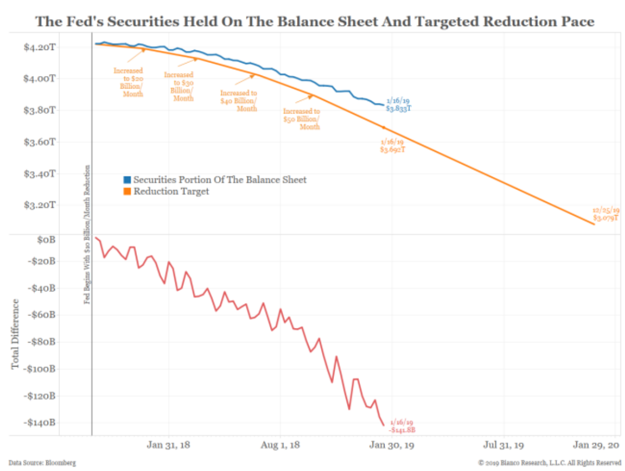
The Fed's Balance Sheet

The balance sheet, another risk. I just want to run through this one real quick. So we thought about, this is what Powell said on the 19th of December that got everybody worried. We thought about this carefully and how to normalize policy. We came to the view that we would effectively have the balance sheet run off on automatic pilot and use monetary policy to adjust rates. Now the problem with this statement is if we look at the next chart here, how much has the balance sheet been reduced? Since the Fed started, the balance sheet has been reduced by $388 billion dollars is what we've seen for the total balance sheet reduction right now. So they're down by about $400 billion.



And, they are moving at a pace of about $50 billion a month on the balance sheet. Going to the next chart, you can see here this is, the orange line is the projected reduction in the balance sheet. You can see how much it's projected to reduce in the next year and the red line is how far short they are of their goal. The reason they're short of their goal is rates went up and the roll off of mortgages was much smaller than they thought. That accounts for most of it.

But, what is the big issue here that everybody seems to be dancing around is what does this mean? What does it mean? Again, the Fed likes to believe that there's no monetary or monetary effect from the balance sheet reduction.



The market disagrees. The market thinks, and I talked about this in the last conference call, that a $600 billion dollar reduction in the balance sheet, the market thinks could be two, maybe three rate hikes. And you put those on automatic pilot. This doesn't get discussed. I asked the Fed, I do talk to the Fed a little bit, mainly here in Chicago. I said, "Look, you've got to address this issue. What does $600 billion mean? You guys at the Fed thinks it's paint drying.

You don't think it means anything. The market thinks it means a couple of rate hikes. Then you want to do a couple more and that's why we had December."

This is a big issue. This is a form of tightening. It's a form or tightening in loss of liquidity and no one seems to want to address it. I've really been at a loss to see any street research, or any questions about what does this mean? And this is why we think the balance sheet is a much bigger issue, than everybody has, because we're not dealing with it.

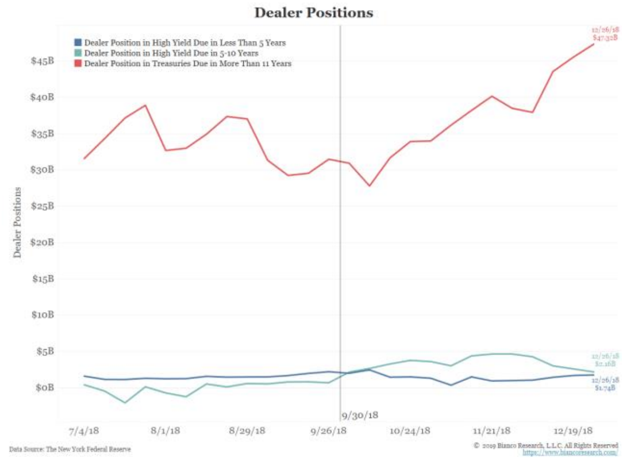
Q4 2018 Total Returns

All right. A couple other issues I want to run through here, real quick. Fourth quarter. I want to talk about, what is the paying trade in the buying market? So, here's the fourth quarter total returns. Here's zero on the chart on the total returns, and you'll notice that most of the indexes, for the fourth quarter, had positive total returns. Long treasuries were up four percent for the quarter. The overall treasury index was up two and a half. The aggregate index was up 1.64% for the quarter, and then the laggard on the bottom was high yield. High yield lag, it was down 4.63$. Investment grade was only down 18 basis points for the quarter.

So, in general, the quarter was a very good quarter, but in general, what did we hear from the banks, and the big brokerage firms, about their FICCT, Fixed Income Commodity Currency Trading. It was awful. It was the worst quarter they had, in 10 years, or post crisis, it was one of the worst quarters that they had, and what is worrisome about that is while, remember that most of the returns of a big bank's trading operation is that they hold inventory. Their inventory went up in price, and yet, they still had a bad quarter, and actually, it was a very decent quarter, that their inventory went up in price.

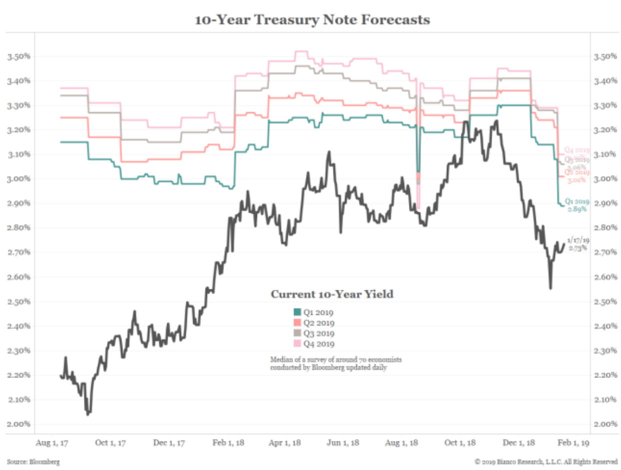
Dealer Positions

Now, could it be, let me go back to that chart, could it have been that 4% loss in high yield, that buried them? Well, the New York Fed puts out the net dealer positions, and the net positions are net of hedges. The dealers had a net exposure long treasuries, greater than 11 years of 47 billion dollars. They were up 4%. Forty-seven billion dollars, up 4%.

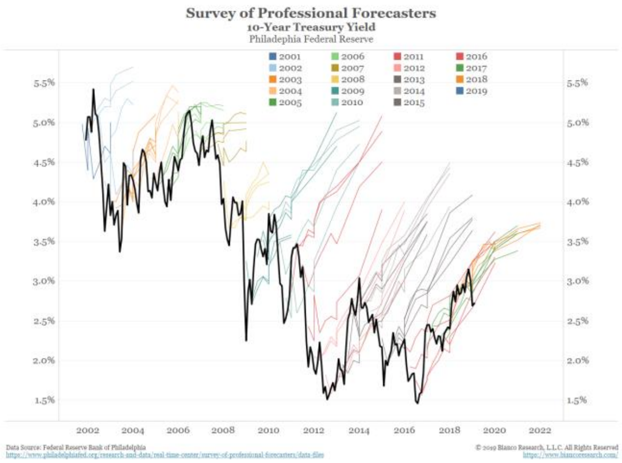


They had net positions in high yield, of about three billion dollars, that were down 4%. Well, their long treasury position should have way more than offset their loss, in inventory levels in high yield, but yet, they still had a bad quarter. What does the bad quarter tell us? I think it tells us that the pain trade in the market is lower, and I think the pain trade in the market is lower, is because of two things.

One, the dealer positions is just a sampling of what the big banks think. It's not their all encompassing position. It's just a sampling of it, and second of all, this chart here shows, a survey of economists on interest rates. So, the black line is the 10 year yield. The various colored lines here are, what we think or the meeting of what economists think is going to be the 10 year yield, at the end of the first quarter, second quarter, third quarter, fourth quarter. It's always above the black line.



I've always joked, whenever I go give public speeches, they're like, you're the bond guy, how high are rates going to go? … The direction is settled (up). We're just talking about the magnitude, because rates have to always go up, and so that mentality's in there. Not only that, if you look at the next chart, here's the survey of professional forecasters. This chart here shows you all the way back to 2001, with the next four quarters, all those colored lines is what they think interest rates are going to go. They always think they're going to go up. How much do you see under the chart, that they think rates are going to go down? Hardly anything is under the chart.



So, what we learned from Q4 2018, about interest rates is, you really want to put people in a bad place? 2.25% in the 10 year. That's going to put people in a bad place, 2.25%. You want to put them in a good place? 3.25% in the 10 year now, but here's two problems with this.

What happens if we go to 2.25% in the 10 year? We'd probably invert the yield curve. The Fed is not going to cut rates, at least until things deteriorate a lot more, because nobody predicts recession until it's too late, because they look at the wrong indicators. They should be looking at whether or not the Fed is going to murder it. Whether or not crude oil prices are going to spike. Whether or not we're going to have a financial imbalance.

So, if we go to 2.25%, we would probably invert the curve. Why would we go to 2.25%? Because all of the things of slowing economy, slowing earnings, slowest all the way down.

The problem with 3.25% on rates, is that we went there in September and October, and the financial markets fell apart, and there's a school of thought out there, which I'll subscribe to, is that, the market really can't handle, or the economy really can't handle north of three percent in the 10 year yield. We tried it and look what happened. Everything fell apart in the fourth quarter. Risk markets that is, fell apart, and safe markets, like treasuries, had a big rally.

Those guys that keep saying, fair value, we're on the ten year notice. 4.5%. Be careful. You may not like where everything is, when we go to four and a half, and the only way I've argued that we're going to 4.5%, is if we see serious inflation, or serious inflation expectations, and that would not be taken well, if you go back to our conversations about the stock bond relationship, in a state of flux as well too.

So, I'm going to skip the part about higher indexing. I've gone through that before. We've written about it a lot. If you want to ask me about it in the Q&A, I'll be more than happy to address it, but let me summarize what I've talked about so far.

Conclusion

The Fed is dovish. They're saying dovish words, even today, but the question is, should we believe them? We can believe them for now, but what do they ultimately really want to do? What they really want to do, is they want to go back to raising rates, and aggressively reducing the balance sheet. They just can't say it right now.

Now, some people argue no, they've gotten religion, and that they're not going to go back that way. I'm not convinced. I still think that if we continue to have another off 300 day, we'd solve the shut down, and stuff. The Fed's going to go back to being a little bit more hawkish. Oh, the coast is clear. Bernanke said that. Yeah, Bernanke said it. I've kind of suddenly said, that Bernanke treats the markets like they're little petulant children. Oh, they throw their little temper tantrums. We have to give them what they want for a little while, to get them to calm down, and then we can go back to going the way we were.

That's exactly what he said on January 4th, about the temper tantrum. Oh, we just, you know, we backed off on reducing the balance sheet, and then six months later, those stupid markets changed their mind, and then they let us reduce the balance sheet. Forgetting, of course then, that you increase the balance sheet by another $700 billion dollars, which is equivalent of two more rate cuts. So, you basically eased two more times, during the temper tantrum period, because increasing the balance sheet is effectively an ease of some form, and $700 billion could be up to as much as two rate cuts. Then, you start to taper from there.

So, you gave the market more stimulus, that's why it recovered. This is the catch 22, that I think we face. The market is not convinced yet though. We're beyond that. Beyond the Fed, and the ability of the Fed to motor the economy. Remember, the percentage of likelihood that we're going to have a recession can go from seven to 85 in 60 days, when the Fed shoots it, and a good sign the Fed has shot the economy is an inverted yield curve, which I've talked about many times, about that an inverted yield curve is just a signal of policy is too tight. We have a very flat curve now, down under 40 basis points on the 10yr/3mo, and 15 or 16 or so on the 10yr/2yr which means policy is not as easy as they think it is.

Beyond that, the economies are slowing, especially in Europe, driven by a sharp downturn in sentiment. That sharp sentiment downturn has been driven by, I think, the stock market here, and the instability in Europe. I'm not a fan of sentiment, except when it makes extreme moves, and then it can be self-fulfilling, and that's your risk. It is showing up in the earning estimates.

Global revisions of earnings are at the lowest levels in 10 years. We are under the inflation rate for the first quarter at earned growth. There is no earnings growth, to really respond to get the market back to the September 20th high at this point. The earnings growth was largely a function of cutting the tax rate. So yes, the bulls will come out and say, "Look at that fourth quarter earnings growth." Yes, because at 35% tax rate in the fourth quarter of ‘17. So, 22% tax rate, in the fourth quarter of '18, but the first quarter's going to be at 22% to 22% tax rate, and it's under the inflation rate right now

Looking beyond that a little bit, the balance sheet does need a form of tightening. The Fed has not really addressed that. I'm worried that the shutdown ... The shutdown is at it's moment of truth right now. If the stories I'm reading are right, and that we're shutting down airports, but the problem is, who gives? If Trump doesn't get his wall funding, his base will rip him apart. If Pelosi gives him any wall funding, then her base will rip her apart. Somebody's got to die here. It's basically, or they got to find something else that they can stomach.

The problem with all of the compromise is, welcome to politics in the U.S. You don't compromise. You accept total antihalation of the other side. So, either we're going to settle this shutdown in the next handful of days, or this thing's going to go, and it's going to get a lot worse, and it's going to get wrapped up in the debt ceiling, and it's going to become a big problem. So, we're at the moment of truth, with the debt ceiling right now, and the pain trade in bond meals is lower right now. If you want to know where it hurts, it hurts if it goes lower.

Questions/Answers

Victoria asks: *What is your outlook, on the 10 year yield?*

Answer: I have been learning bullish on rates, bigger picture for a while now. I think that we're probably going to go back and retest 2.50%. I wouldn't be surprised if we made a slightly lower low. The yield curve goes back to zero. I also think within, if I was to expand this question a little bit more, I'm going to go pure technical analyst, because I am a CMT, a Chartered Market Technician. I was in the first class that got the Chartered Market Technicians in 1989. So, 30 years ago. It's a very worthwhile exercise. It's the CFA equivalent for a technical analyst.

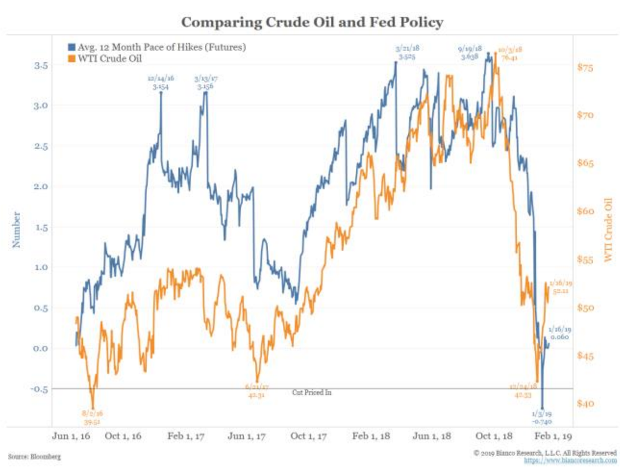
It would be surprising for risk markets, whether you're talking about crude oil, credit spreads, the stock market, to sell off as sell as they did, it's the end of December, and not retest. Now, the retest could come in the Summer, but a retest might be forthcoming, and with that retest, you could probably see 2.50% by year-end. I'll go that far. Whether or not we make a lower low, or the retest is successful, and then we go up, I'll hold that open for now.

Well, if you want a story for it, if the shutdown doesn't, it rolls in to the debt ceiling, Europe is a mess, Brexit goes from ... We don't know how it's going to be solved. Don't worry. It will work itself out too. We don't know how it's going to solve. Holy crap. This thing could be really messy. Throw all of that in to the caldron. There's your retest and maybe if you get some weak numbers.

Remember, that there's that seasonality quirk, with the economic data, that the first quarter's always the weakest. They've tried to do this double seasonality on GDP to offset it, and they really still haven't been able to figure out why. So, if you throw in some of the weak data. So, 2.50%. I still think the bigger risk is that we retest 2.50%. We retest it the December lows in the stock market, as opposed to that that was the low and we're just going higher. Now, that's always a possibility, but I'll still hold out, that those retests are coming in, and those are the stories for it too.

Todd asks:, *what about crude oil? You said 55 to 60 bucks. Could you explain a little bit more, why you think crude oil's going to go higher?*

Let me go back to my crude oil chart here, on the slide show as well too. Get to my chart here. So, the only thing on this chart is crude oil, and the only thing I'll say about crude oil right now, is that this decline in crude oil that you saw here, is big and meaningful, and I do think that part of that decline was largely, and I'll put the word D, demand driven, that there was an expected falloff in demand, that is recovered.



I also think that that decline in crude oil is, and I'm going to put the S word here, supply, affected it. It's supply will be affected by it, that the big fallen price is going to pull back supply a little bit, and maybe motivate oil peck to a cut, which we are sort of seeing. Maybe see some back-off in fracking in oil, because it's not as economic, and you could see a little bit of a pop-up, the $55 to $60 dollars in crude oil. More driven by the supply end of it, and a little bit of the recovery end of it.

That's my argument here, but more importantly, what I wanted to show with this chart is, the Fed is so focused on inflation expectations, and this is the driver, that $55- $60 crude oil, would eventually drag. Your TIPS breakevens, and your Swap Caps and floors, and your ISM prices paid, and all that stuff higher, and if it drags all that stuff higher, they start the noise again about having to raise rates, and $600 billion in the balance sheet, and we have a mini December all over again. Mini December, and that's your retest.

So, I'm trying to make the case for a retest, is what I'm making. I'm not going to make the case for a lower low. Let me get a retest. Let me get that part right. If I could get that part right, as opposed to the lows in in, we're on our way higher. Let's keep going. Let's keep going from here.

Alex asks: *Why do you think that a $600 billion dollar reduction balance sheet is worth two to three rate hikes?*

Answer: I talked about this on the last conference call. A couple of things there as well too. First of all, Jay Powell said, "If you take the QE models, and run them in reverse." Think about that for QT, but what Jay forgets, is that Bill Dudley, in 2010, when he was the head of the New York Feds, said that each 10 billion dollar increase in the balance sheet, is worth one basis point of cuts.

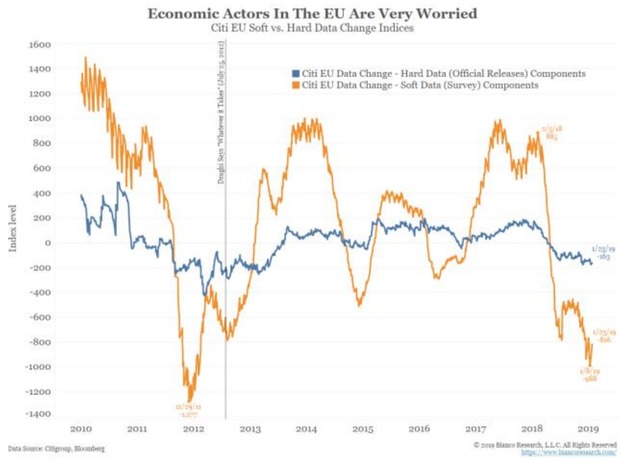
All right. Let's reverse that, Bill. A $600 billion, is worth three cuts." Okay, well 500 billion then, is two and a half plus, so you round that to three. So, that's one way that we've looked at it. Another way is, a couple of conference calls ago, we showed a survey done of market participants, asking what they think 600 billion dollars is worth, in terms of the equivalent of rate hikes, and the immediate answer was 35 basis points, so that's about one and a half hikes.

Now, I bring this up to say, no-one's talking about this. Where's the research, that they would say Kansas City Feds, sorry, but where's the research that says that the rate, the reduction in the balance sheet meets the equivalent of x rate hikes? The Fed wants you to believe it's zero. That's why they put it on automatic pilot. The market doesn't think that, that's why the market freaked out, and it took the Fed by surprise.

I still don't think the Fed gets it right now. They're just saying the words they need to say, because they don't want the market to fall apart as well, but I don't think that they get it from here, as we look forward.

Edward asks: *He's asking about the EU Chart here, and the question is about whether or not this is a sentiment low, in terms of EU soft data, because that's where we saw it in 2011.*

Answer: I get the argument. Looking at this from it's standard technical analysis viewpoint, and basically saying that, it's 2011 low. We're not close enough that it's hard to get much worse, but remember, as I highlight on this chart here, with the horizontal line, it was at this level here, when Draghi said, "whatever it takes." Which was July 25th, 2012, which was a seminal turnaround in the psyche in Europe right now. Draghi sort of said that yesterday, by just saying, "Don't worry. It won't be any rate hikes." Until the next guy takes in. Remember, Draghi has to leave in October. Until then, the next guy, if there's going to be rate hike, he's going to do it. Mario's going to go the full eight years, as the head of the ECB, without ever hiking rates, is what he said, but he didn't say anything about actively easing.



More importantly, this decline here, could damage the real data, as we move forward. As I said, I'm not a big fan of sentiment, except when it's at extremes, and when it's at an extreme, it could become self-fulfilling. If we've all scared the hell out of ourselves, because of Brexit or VilaVest, or Italy's going to leave, or all of the above, and a slow down in Germany. If we scared the hell out of ourselves, for those reasons, or others, we're going to act like we're scared, and then, the real data will eventually show up. Most of the time, it just meanders around zero, and there's much more noise than signal, but when you get an extreme, I think it's more signal than noise. So, that's why I'm worried that this will become self-fulfilling. It will drag it down.

Like I said with the U.S. data. The big jump up with Trump because he was business friendly, in cutting regulations, but a lot of people cried, Oh, that's just politics. It doesn't matter. Well, we did have a very good 2017, at least measured at a GDP level. Now, the problem is, you can only cut regulations once. I did put that chart and news clips a couple days ago, of the big giant flaw in 2017, of the Federal Register on Measure of Regulation. Well, 2018 was up just a smidge, but call it unchanged. You can only chop regulations big once, then all you can do is hold the line on them. So, you're delta on regulation change goes to zero, then after that, nets essentially, I think, what's happened.

All right. I'm at 65 minutes on the call. I will end it here. I'll thank everybody for joining us. We'll put out the transcript. We'll try and get the transcript out on Monday. Any other questions that come in, I will address them on the transcript. So, thank you all for joining us on this call, and we hope to talk to you again in this format, in the next couple of weeks. Bye-bye.

END

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