CORNERSTONE MACRO

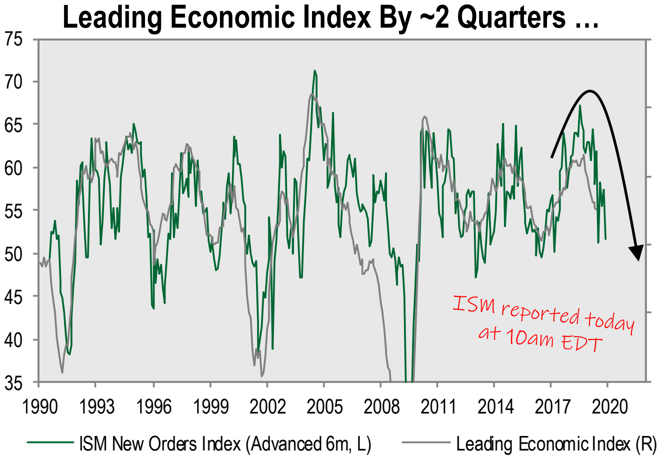
Economics, Policy, Strategy & Technicals

Portfolio Strategy

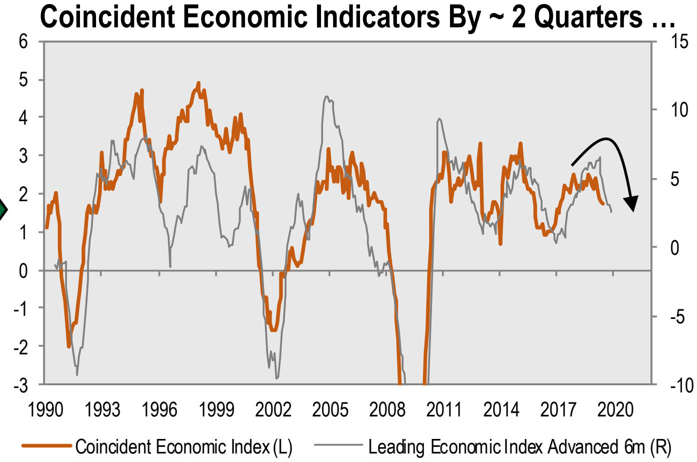
WALL STREET JUST PLAYING A LITTLE GAME OF FOLLOW THE LEADER

The slowdown in the global economy that we've been concerned about in 2019 is becoming more evident to most investors for three reasons: 1) the global manufacturing PMI has declined for a record 12 consecutive months and is now set to break below 50 (reported today at 11am EDT); 2) we're at a point in the cyclical slowdown where leading, coincident, and even now some lagging economic indicators are weakening; and 3) renewed tariff risks have refocused investors on the downside risks to the global-growth outlook. While we didn't intend to include a pun in the report title, the markets are certainly following President Trump's every tweet nowadays too. While tariffs are adding downside risks, the slowdown story has been in place for a long time and is about to become even clearer. In today's report, we highlight how stocks are likely to respond, or not, to the softer data in the coming months.

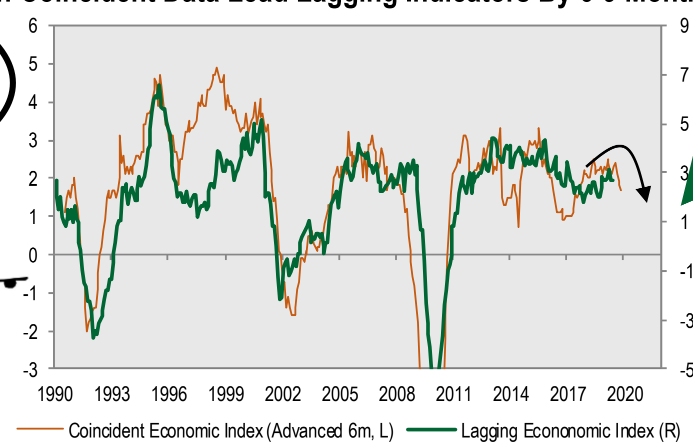
The ISM Leads The Conference Board's Leading Economic Index By ~2 Quarters ...



... Leading Economic Indicators Lead Coincident Economic Indicators By ~ 2 Quarters ...



... Coincident Data Lead Lagging Indicators By 6-9 Months



Lagging economic indicators set to decline in the second half of 2019 (i.e. rate cuts ahead?)

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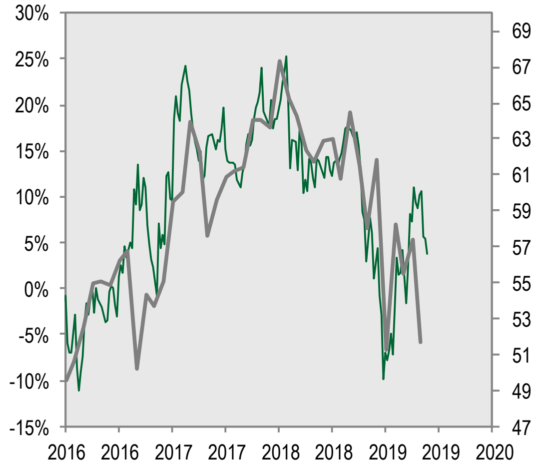
When Do Stocks "Price In" Leading, Coincident, And Lagging Indicators?

S&P 500 YoY vs. ISM New Orders



Stocks Discount These:

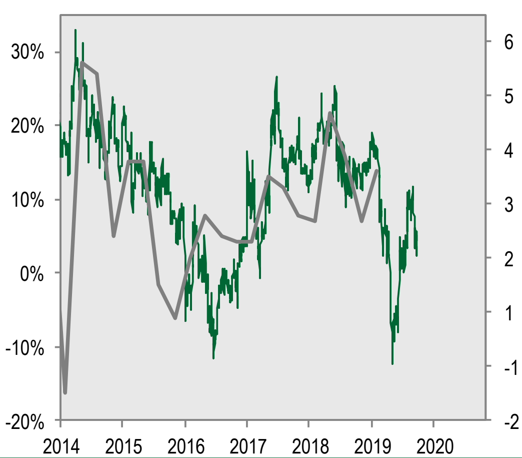
In Real Time

Stocks' performance in May is consistent with weaker LEIs.

Leading Indicators

- **Stock prices - S&P 500**
- Mfg weekly hours
- Initial claims
- Manufacturers' new orders, consumer goods,
- **ISM Index of New Orders**
- New orders, nondefense capital goods ex. air
- Building permits
- Leading Credit Index
- Yield Curve
- Consumer Sentiment

S&P 500 YoY Advanced 6m vs. Real GDP



Stocks Discount These:

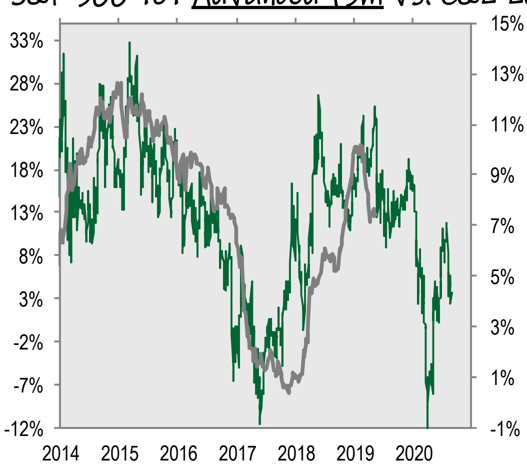
6-12 Months Before Data Is Released

Stocks are now discounting weaker GDP growth the back half of 2019.

Coincident Indicators

- Personal income less transfer payments
- Manufacturing and trade sales
- Industrial production
- Employee payrolls
- **GDP**

S&P 500 YoY Advanced 15m vs. C&L Loans



Stocks Discount These:

12-24 Months Before Data Is Released

Equities discounting slower loan growth in '20.

Lagging Indicators

- C&I loans
- Change in CPI for services
- Average duration of unemployment
- Change in labor cost
- Ratio of consumer installment credit to personal income
- Ratio of mfg and trade inventories to sales
- Average prime rate

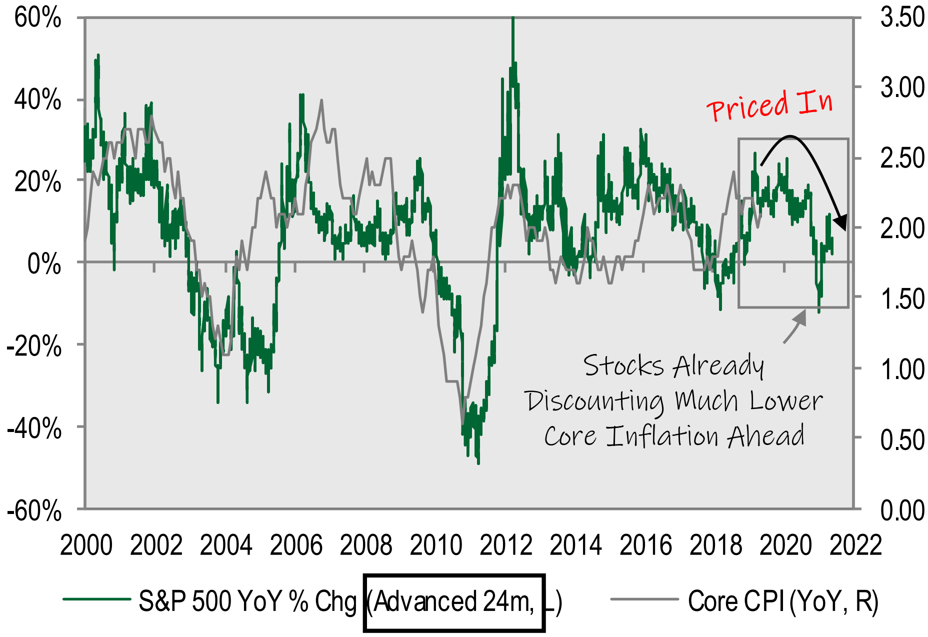
STOCKS DISCOUNT LAGGING INDICATORS WITH A LEAD TIME OF 12-24 MONTHS!

We are going to start this report by showing you how stocks trade well in advanced of lagging economic indicators. When it comes to lagging indicators, core inflation and loan growth are two series that investors often discuss given their importance to monetary policy. Well, today's market action gives insight as to what these two series are going to look like ahead. Core inflation likely has some upside and is set to peak in the coming quarters whereas loan growth is poised to slow imminently. Stocks don't change because of this data when it is reported as it is to stocks old news.

Lagging Indicators

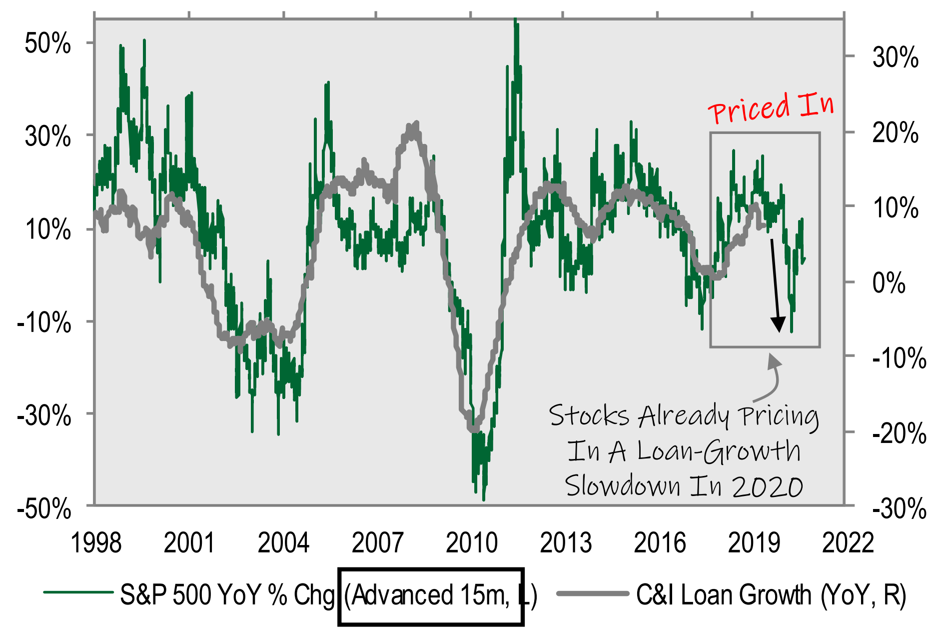
- **C&I loans**
- **Change in CPI for services**
- Average duration of unemployment
- Change in labor cost
- Ratio of consumer installment credit to personal income
- Ratio of mfg and trade inventories to sales
- Average prime rate (The Fed!)

Stocks Discount Core Inflation By 8 Quarters



Stocks Can Help Investors Forecast Core Inflation Trends With A VERY LONG Lead Time (~ 2 Years)

Stocks Discount Commercial Loans By 5 Quarters



Markets Don't React To Changes In Loan Growth, And Other Lagging Economic Data, Because They've Priced Them In Long Ago!

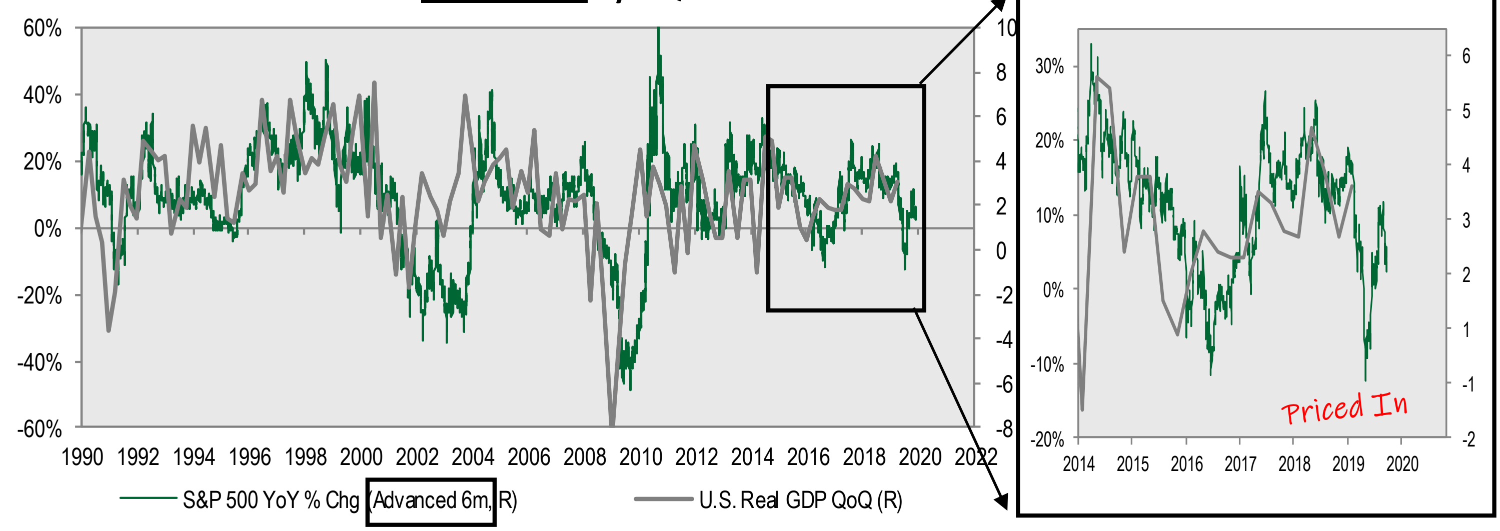
STOCKS DISCOUNT COINCIDENT INDICATORS WITH A LEAD TIME OF 6-12 MONTHS

Next, we will illustrate stocks' discounting of coincident economic indicators like industrial production, GDP, and employment trends. On balance, stocks' performance today is laying the path for GDP data two quarters from now. Therefore, investors should interpret recent weakness in equities as a sign of slower growth in mid-2019, rather than a sign of economic activity in the current quarter. This is why we rarely see investors react very much to GDP reports – they have already been discounted long ago.

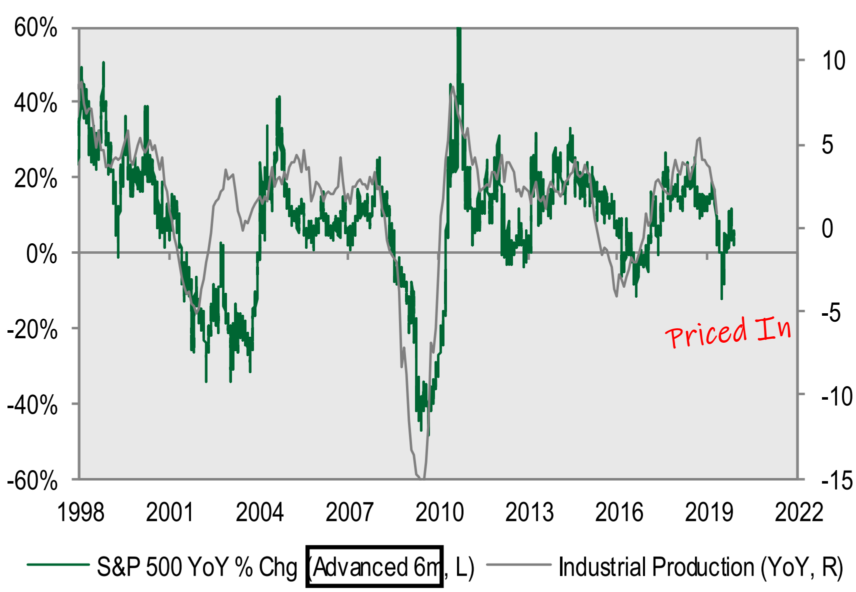
Coincident Indicators

- Personal income less transfer payments
- Manufacturing and trade sales
- **Industrial production**
- Employee payrolls
- **GDP**

Stocks Discount GDP Growth By 2 Quarters



Stocks Discount Industrial Production By 2 Quarters



Stocks' performance over the past six months suggests that industrial production is likely to decelerate.

This is why stocks don't react much when the data is reported – it's old news by that point.

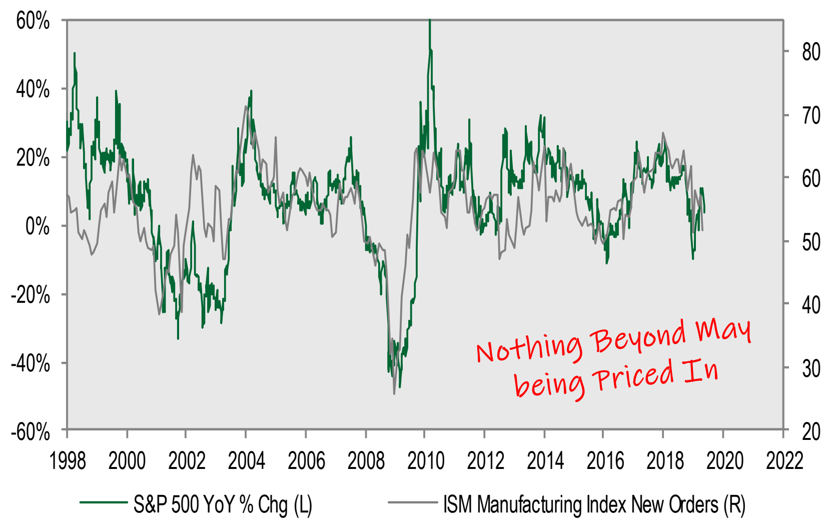
STOCKS DISCOUNT LEADING INDICATORS IN REAL TIME

The only data which stocks do not discount with much of a lead are leading economic indicators such as ISM New Orders or Consumer Confidence. As we show below, there is essentially no lead time between equity performance and the ISM or Consumer Confidence. A weak or strong month for equities is usually indicative of a weak or strong month for PMIs and sentiment data. Even though it is widely taught and believed that markets are "forward looking," we believe that the charts below clearly make the case otherwise … markets do not anticipate future trends in leading economic indicators. When it comes to GDP, profits and job growth, yes, stocks look ahead.

Leading Indicators

- **Stock prices - S&P 500**
- Average mfg weekly hours
- Initial claims
- Manufacturers' new orders, consumer goods, and materials
- **ISM Index of New Orders**
- Manufacturers' new orders, nondefense capital goods excluding aircraft orders
- Building permits
- Leading Credit Index
- Interest rate spread (10-year vs Fed Funds Rate)
- **Average consumer expectations for business conditions**

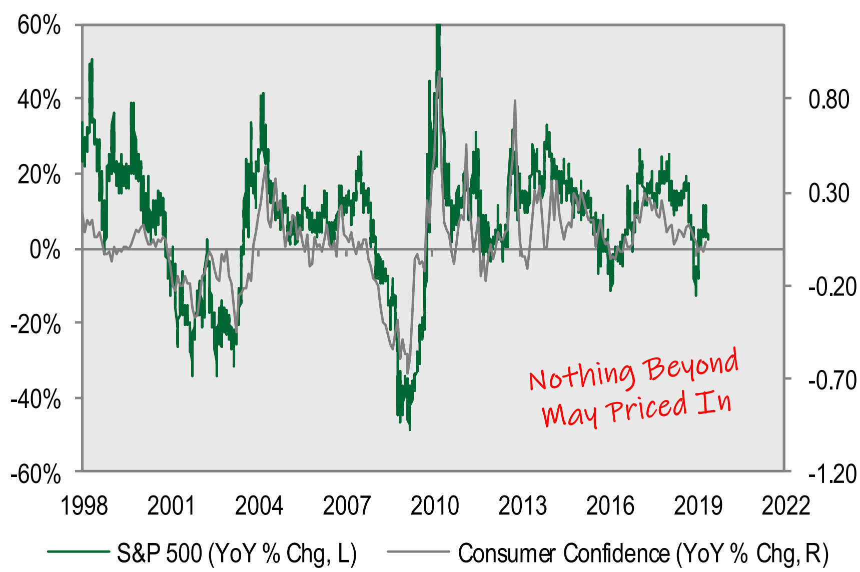
Stocks Trade With Coincident With ISM New Orders



Stock Prices Today Reflect ISM Readings Today.

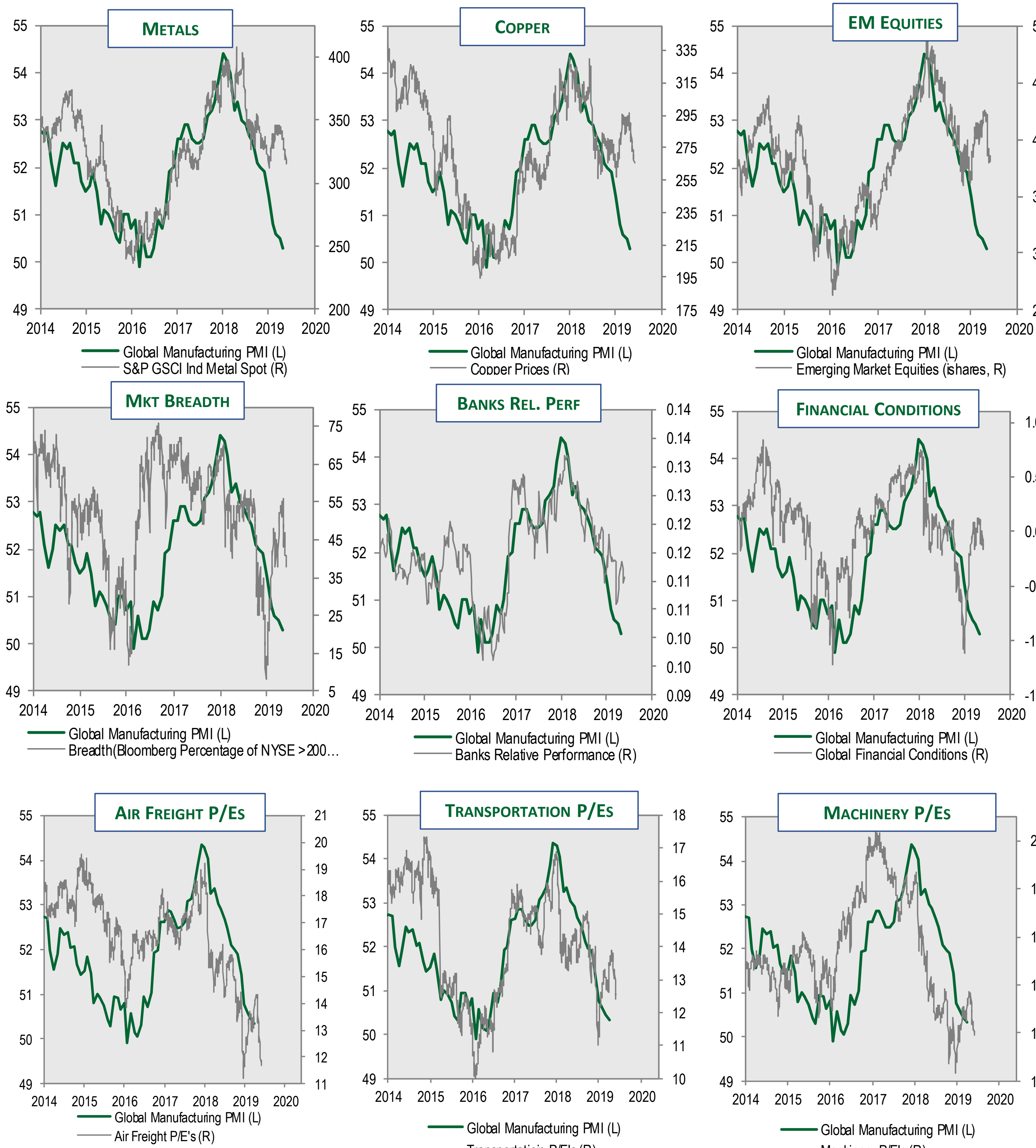
PMI Data Are NOT Forward-Looking Data Points For Future Equity-Market Performance, They Are Coincident With Equities.

Stocks Are Coincident With Consumer Sentiment



Consumer Sentiment Is Mainly A Reflection Of What Stocks Prices Have ALREADY done, not what they WILL do.

GLOBAL MARKET TRENDS ARE DISCOUNTING GLOBAL LEIS IN REAL TIME

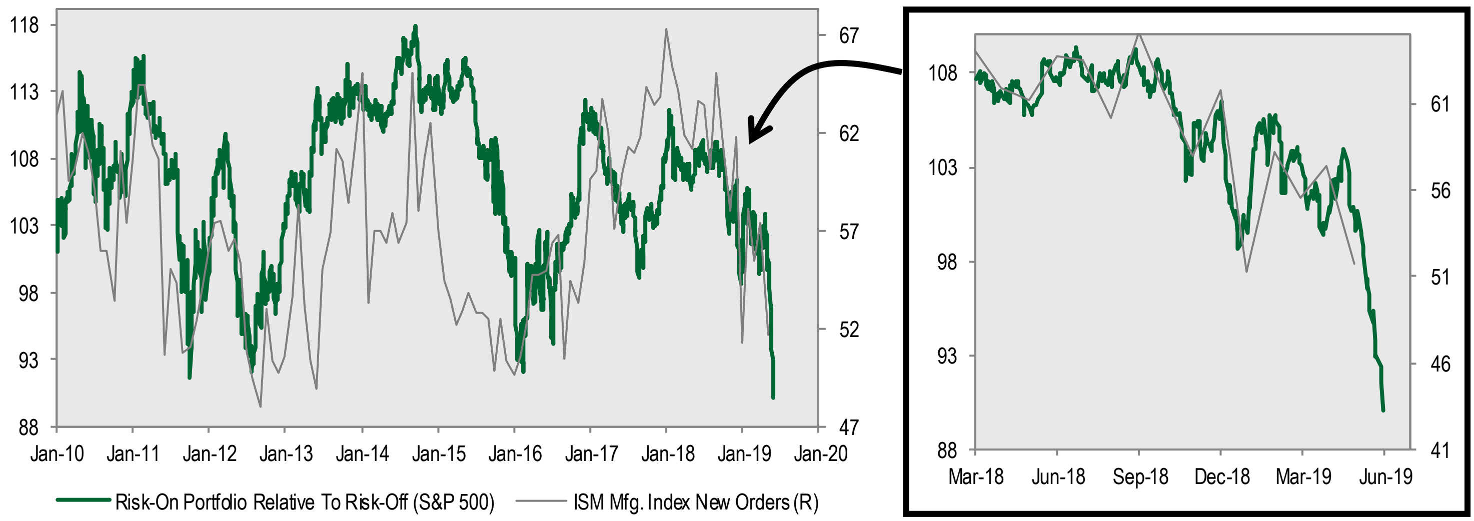


FACTORS MOVE WITH LEADING ECONOMIC INDICATORS IN REAL TIME TOO …

OUR RISK ON VS. RISK OFF PORTFOLIOS POINT TO WEAKER MAY PMIS, WEAKER Q3 GDP

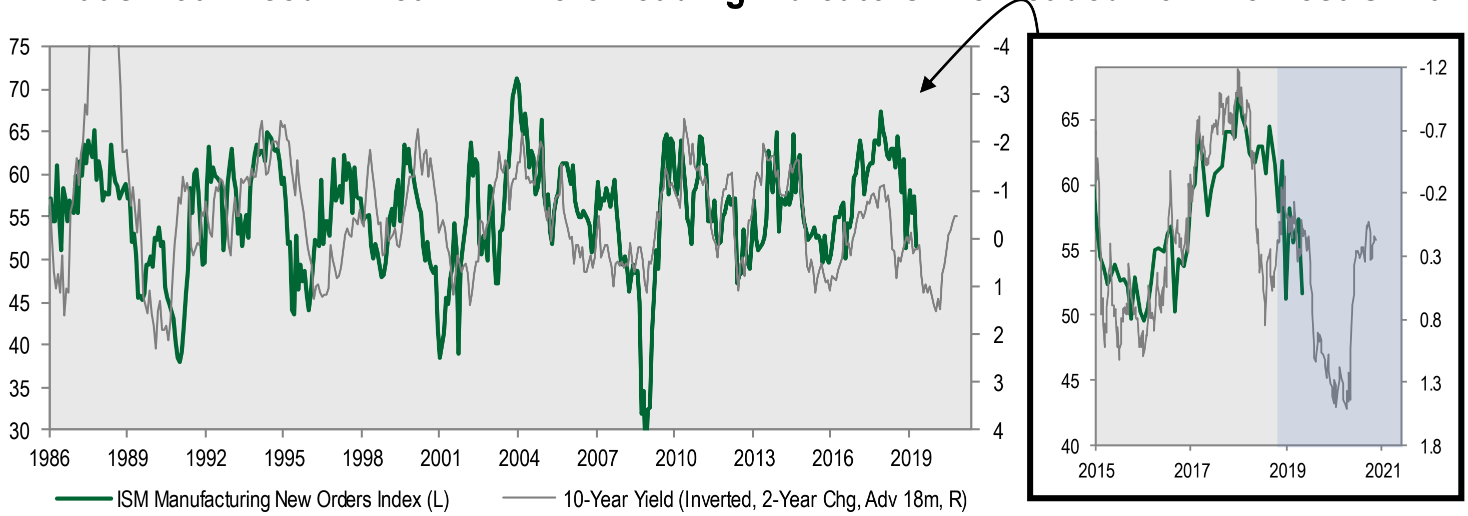
Factor performance is another way to see the markets' discounting mechanism of leading indicators in real time. We have been proponents of risk-off (growth, stability, and defense) this year as we expected PMIs to moderate throughout the year. In the past few weeks, risk-off has performed very strongly, indicating that the ISM index is likely to fall again in the month of May. That said, it's not yet telling us anything yet about June or July's leading economic data.

Recent Risk-Off Outperformance Reflects Weaker Leading Indicators In May



We can look to series that *anticipate* trends in leading indicators in order to forecast markets and positioning trends in the future. Proxies of monetary policy are the most consistent and accurate anticipatory series out there. These policy proxies are calling for a continued downtrend in leading indicators through the end of 2019. We are likely now facing the most dangerous phase of the business cycle for equities where PMIs are in a downtrend and approaching the 50-threshold. Avoid cyclicality and embrace stability & defense.

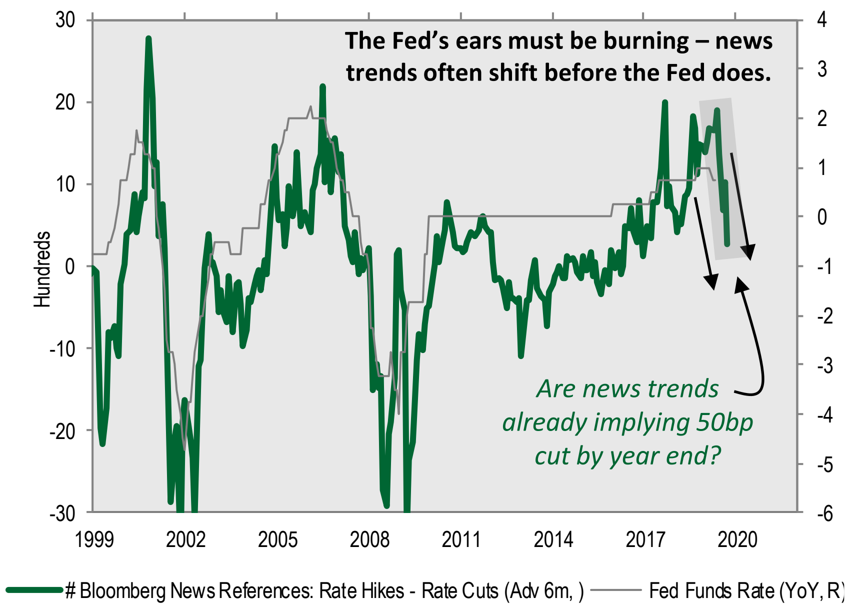
What's Not Priced In Yet??? Where Leading Indicators Are Headed For The Rest Of 2019



WHAT ARE MARKETS EXPECTING FROM THE FED?

Last week we hosted a conference call with Roberto Perli on "Positioning Your Portfolio For The Fed's Next Move". We talked about the various scenarios under which the Fed will cut and what that means for markets. While it is hard to determine exactly how big of a rate cut and when is being priced into equities, it is evident by the amount of news chatter of late, that it is being widely anticipated.

Policy-Action Chatter Typically Starts Six Months Before The Policy Action Occurs



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THE OUTLOOK FOR TREASURY RATES *CSM Policy

If the Fed is done tightening and if rate cuts don't happen any time soon, it means that the Fed is on hold and current market expectations are probably not too far from what will actually happen.

- Therefore, the average expected federal funds rate shouldn't change much for the foreseeable future, and Treasury rates will continue to be driven by the term premium (positioning, hedging, safe-haven flows, supply, foreign rates, etc.).
- If the Fed is done at 2.5% and if the term premium eventually settles to its average of the past several years (about -0.2%), then according to our framework:

Ten-Year Rate = 2.5% + (-0.2%) = 2.3%

That is, the current level of interest rates is not crazy – it's actually quite appropriate given the Fed policy outlook.

But what it the Fed cuts, say, 50 bps at some point this year? Then:

Ten-Year Rate = 2.0% + (-0.2%) = 1.8%

That is, if the Fed cuts, Treasury rates today are way too high and will go down more.

A ROADMAP FOR A "TYPICAL" SLOWDOWN AFTER THE FED HAS TIGHTENED

History may not repeat but it sure seems to rhyme. This proverbial rhyme is illustrated below in what we call the cycle roadmap. This roadmap is at the core of our framework and it all starts with changes in the Fed Funds rate. Changes in interest rates take a long time to flow through the system. We don't believe a Fed rate cut this year can cause an about-face in the global slowdown of 2019.