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September 27, 2017

Gleanings

A Monthly Chart Presentation and Discussion Pulling Together the Disciplines of Economics, Fundamentals, Technical Analysis, and Quantitative Analysis

"When Smart People Talk, We Listen"

(We got such a tremendous response from this report we scribed recently, we thought we would repost it in this month's Gleanings report)

Over the years, we have learned to listen aggressively rather than talking too much in an attempt to show people how smart we might be. This is a trait more folks in our business should practice. Accordingly, when smart people speak, we listen. Such an occasion presented itself last week. The person speaking was none other than the legendary investor Jim Rogers who co-founded the Quantum fund with George Soros. The fund subsequently went on to gain an eye-popping 4200% in the first 10 years of their collaboration. In the *Investiv* quip, Jim was discussing his 15 rules for successful investing. To wit:

1. Invest in something when people say they never want to invest in it again, when they are throwing it out the window.
   Think about that. We know people that liquidated their portfolios around the March 2009 lows vowing to never buy a stock again. The same can be said about tech stocks as they were bottoming between November 2002 and May 2003. Currently, the same thing is being said now about energy stocks, especially the midstream MLPs.
2. Investing is both qualitative and quantitative.
   There is room for both disciplines (qualitative and quantitative) in one's portfolio just like there is room for both passive and active investment management, although currently we favor active.
3. The more people ridicule and question you, the more likely you are probably onto a good thing no matter what it is.
   This was like us buying oil sands stocks in the late 1990s when everyone was buying tech. Or like when we bought tech stocks near the end of 2002; and, what we are doing now in buying the out of favor energy stocks.
4. Don't invest in an area just because it is depressed, find and wait for the change and invest just before it happens while still unrecognized by the market.
   My father use to tell me, "Good things happen to cheap stocks," but stocks can stay cheap for a really long time if other investors do not recognize their cheap valuations. The charts will tell you when other investors will recognize them too.

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Jeffrey Saut

"When Smart People Talk, We Listen"

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5. Be ready to hold the cheap investments for a longer time as timing changes is very difficult but the patience usually pays off.
   The rarest commodity on Wall Street is "patience."

6. When you buy something cheap, even if you are wrong, you are probably not going to lose a lot of money.
   This reminds us currently of some of the midstream MLPs that have 8% - 10% yields, are just plain cheap, have very little sensitivity to oil prices, and a decent hedge against the inflation that is coming. These stocks can decline 8% - 10% in a year and you still have not lost any money because of the dividend.

7. Global capital flows are shifting, adjust accordingly.
   This has been one of our mantras for a very long time. Investing is very much about capital flows not just in stocks, but in all markets.

8. Pick any year in history. What everyone believed that year is no longer relevant 15 years later.
   As *Investiv*'s Sven Carlin writes, "When I heard the sentence above, it really blew my mind. 99% of what you hear and read about investing is focused on the short term, but it's unbelievable how things change in 15 years."

9. We've had economic problems every 5 to 10 years since the beginning of time, no matter what people say.
   That's true, but the equity markets do not always "dance" to economic problems. There were such problems in the 1949 – 1966 secular bull market, and again in the 1982 – 2000 secular bull market, but those problems did not derail the secular bull market.

10. Central banks will always fail to control whatever they try to control.
    We are not sure that is true all of the time, but it is certainly true on occasions.

11. Learn the Chinese word "Weiji" which means both disaster and opportunity.
    We have often written about the Japanese Kanji symbol for "crisis," which consists of two characters; one means danger and the other opportunity.

12. Do nothing most of the time.
    Warren Buffett has often stated, "Our investment philosophy, 'Is lethargy bordering on sloth remains the cornerstone of our investment style.'"

Jeffrey Saut

"When Smart People Talk, We Listen"

13. Cash is the perfect hedge.
As my father taught me, "Cash is indeed an asset class. To assume the investment opportunity 'sets' that are available to you today are as good or better than those that will present themselves next week, next month, next quarter is naive. You have to have cash to take advantage of them."

14. It is easier to figure out commodities than it is to figure out stocks.
We are not sure if this is true either because we donated a lot of money to the commodity markets in our misbegotten youth attempting to get rich quickly. We did manage to get rich slowly through a disciplined investment approach, which is why you need a good financial advisor.

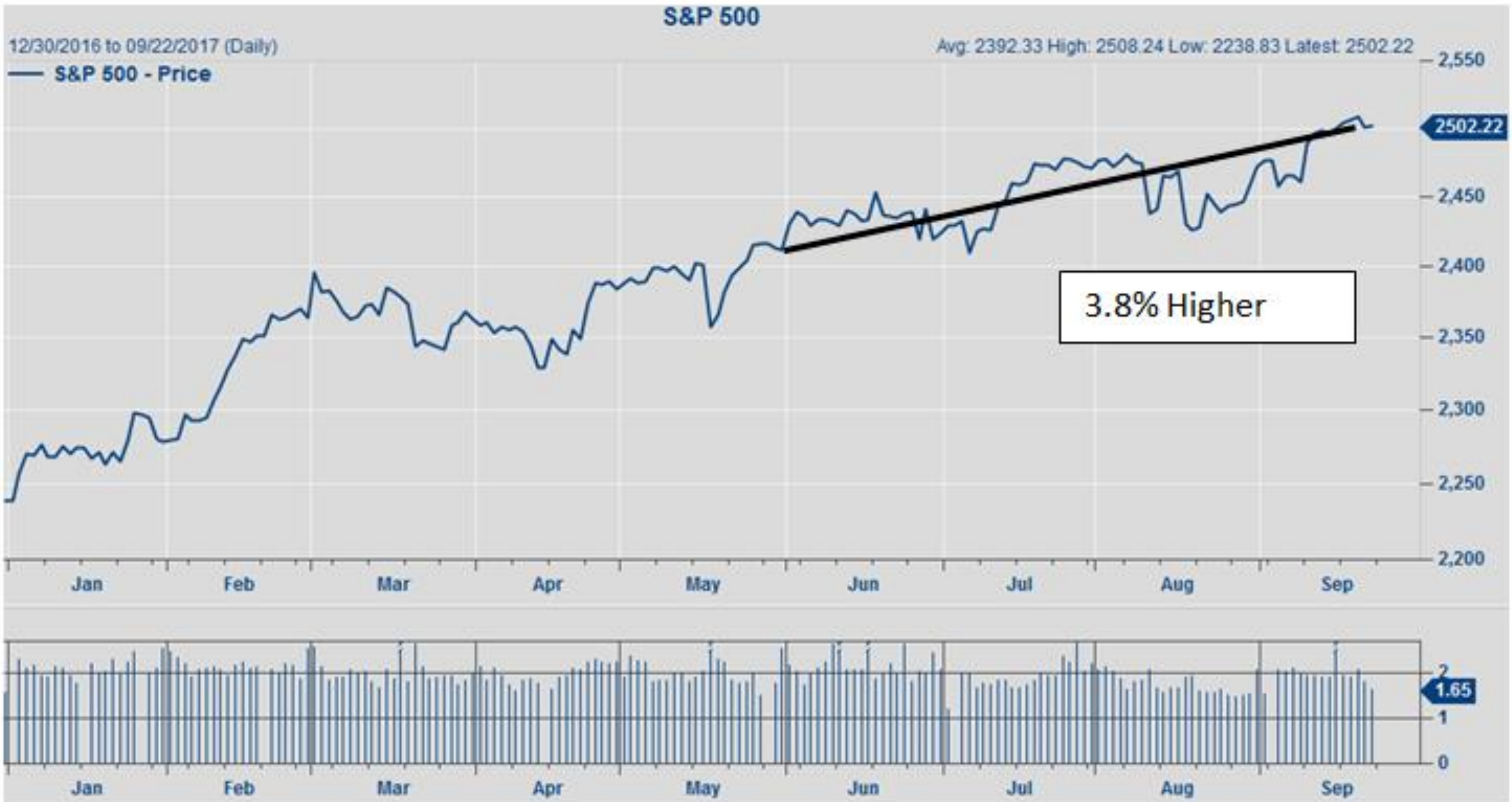
15. Don't listen to investment gurus, or even to Jim Rogers himself, do what you know.
This is Peter Lynch incarnate who always told us "Invest in what you know!" If early adopters of Facebook bought the stock, well you know how that turned out. The same can be said for Apple when the iPhone was introduced, or for that matter Apple on its first version of the Mac.

In June, the three major indices traded out to new all-time highs, and we noted that every time those indices simultaneously trade to new all-time highs the S&P 500 had an average 3.8% gain within the next three months nearly 100% of the time. Well, it is nearly three months later and the SPX is better by nearly 3.8%. Regrettably, we have underplayed that 3.6% rally because our models went into cautionary mode at the beginning of August. Most recently, our stock market internal energy model telegraphed there just is not a whole lot of upside energy available right here. Then too, the momentum indicator theorizes the odds of a trend reversal are high on a short-term basis, the breadth indicator is neutral (no trend reversal), and the sentiment indicator is flashing extreme complacency (high degree for a trend reversal). To be sure, our indicators/models are not always right, but they are right a lot more than they are wrong. Sometimes they are early (September 1999 – bear signal, November 2002 – bull signal, November 2007 – bear signal, October 2008 – bull signal, well you get the idea). But just like when flying an airplane in a blackout, you have to trust your instruments. Our "instruments" continue to counsel for caution on a near-term trading basis and we are titling portfolios accordingly. Longer-term, we remain in a secular bull market that has years left to run.

Jeffrey Saut

S&P 500 Gains After Three Major Indices Trade to New All-Time Highs

In June the three major indices traded out to new all-time highs, and we noted that every time those indices simultaneously trade to new all-time highs, the S&P 500 (SPX/2496.66) had an average 3.8% gain within the next three months nearly 100% of the time.



Source: FactSet, Raymond James research.

Economic & Market Update

Equity Markets/Technical Analysis

- **Market Outlook** – After losing nearly 3% in the past 30 days, the S&P 500 is once again creating new all-time highs. Participation has broadened from a capitalization perspective. Markets will turn their attention to 3Q earnings and a Republican tax reform (cut) effort. Barring any (negative) surprises on the earnings front and assuming headway on the tax reform front, a favorable setup points to generally higher equity values on the horizon.
- **S&P 500 Earnings**
  The **3Q17 estimated earnings growth rate** for the S&P 500 is now 4.2%.
  Thus far, 43 companies in the S&P 500 have issued positive EPS guidance; well above the 5-year average of 27. Technology, Health Care, and the Consumer Discretionary sectors make up 39 of the 43 companies. Even more companies (54) have issued positive *revenue* guidance for 3Q17. This number is more than double the 5-year average (25).
  The continued weakening U.S. dollar (relative to major currencies) is expected to continue to boost earnings of companies with substantial overseas operations.

  S&P 500 Earnings estimates*
  2017 - $127.04, **2018** - $144.71
  Current P/E: 2017 – 19.6x, 2018 – 17.2x
  Both earnings estimates and valuations are little changed since July

  S&P 500
  Key support: 2490, 2480, 2467-2474, 2450, 2438, 2417, 2406
  Key resistance: 2511
- **Sector weightings**
  Overweight: Technology, Health Care, Financials, Industrials, Energy

  Equal Weight: Materials

  Underweight: Consumer Discretionary, Consumer Staples, Utilities, Real Estate, Telecom

Monetary Policy, Inflation, FX

- **FOMC Policy Statement** (Sept. 20) - No surprise on rates (steady) or the start of the balance sheet run-off (October). Dot plot shows 11 of 16 senior Fed officials expecting one more rate increase this year. December rate hike odds now well above 50%.
- **Yellen Press Conference –** Fed Chair Yellen emphasized that balance sheet reduction (or "normalization") is not "active" policy, and that the federal funds target rate will remain the main policy lever. The Fed could alter the pace of the balance sheet run-off if the economy were to experience a significant negative shock.
- **Consumer Prices** (CPI – Bureau of Labor Statistics Sept. 14) - The CPI was up 1.9% from a year ago. Ex-food& energy, the CPI rose 1.7% y/y. Note, December Fed rate hike odds have increased significantly since the CPI report (the Fed uses the PCE Price Index as official target).
- **Exchange rates** (September 26)

  EUR/USD $1.180
  GBP/USD $1.345
  USD/JPY...... ¥112.17
  USD/CAD $1.234

U.S. Economy

- **Real GDP** (Bureau of Economic Analysis) - GDP growth rose more than expected in the first revision to 2Q17 growth (3.0% vs. 2.6%). Improvement concentrated in consumer spending and business fixed investment. Consumer spending rebounded from a soft 1Q; business investment boosted largely by the rebound in energy exploration. **Please note: 3rd estimate expected Sept. 28 – Hurricanes Harvey & Irma will have negative impact.**
- **Jobless Claims (Labor Dept. Sept. 21) -** The impact of Hurricane Harvey on claims appears likely to be of much shorter duration than that of Katrina. Irma will also distort, first with downward pressure (as individuals are unable to file) and then with a spike higher. Prior to the hurricanes, the underlying trend in jobless claims was low.
- **August Employment Report** (Bureau of Labor Statistics) – The headline figures were on the soft side of expectations, but well within the usual range of noise for these data, consistent with further improvement in overall labor market conditions.

Global Economy

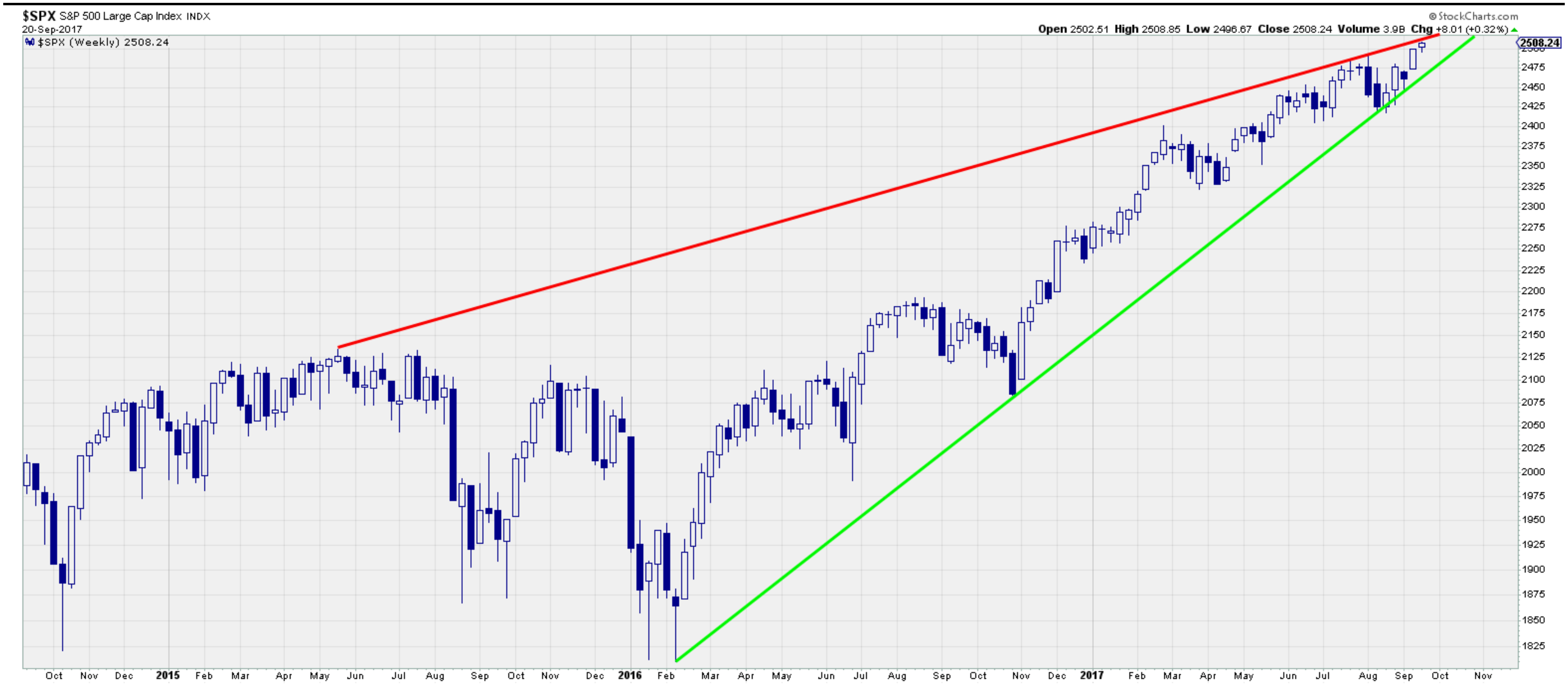
- **German Election** (Sept. 24) – While German Chancellor Angela Merkel was elected to a fourth term, her center-right Christian Democrats were weakened, including the far right nationalist Alternative for Germany (AfD) party garnering 13% of the vote, signaling that recent defeats of similar candidates/parties in the Netherlands and France have not extinguished anxieties about security and national identity.
- With recent data coming in stronger than expected, the **Bank of Canada** (BOC) again raised its target for the overnight rate to 1.0%, this after raising the overnight rate by 25 bp in July. Consumer spending remains robust, underpinned by continued solid employment and income growth.
- **ECB Policy Decision** (Sept. 7) – No change in rates or in the asset purchase program. No signal that tighter monetary policy will arrive anytime soon. In fact, the ECB is still prepared for more QE if needed. Draghi states, "a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up and support headline inflation developments in the medium term."

Source: FactSet, Raymond James Research. S&P 500 earnings estimates are bottom-up operating earnings as of 9/22/17 market close, provided by Standard & Poor's.

Andrew Adams

S&P 500

The S&P 500 continues to surprise to the upside and make new all-time highs, but there does exist likely resistance just above 2500 that could force at least another pause (resistance line drawn from the May 2015 high through the August 2017 high). The index has now gone more than 300 calendar days without a 3% correction on a closing price basis, and we have to assume the dips will keep getting bought until they no longer are. The trend clearly remains up.

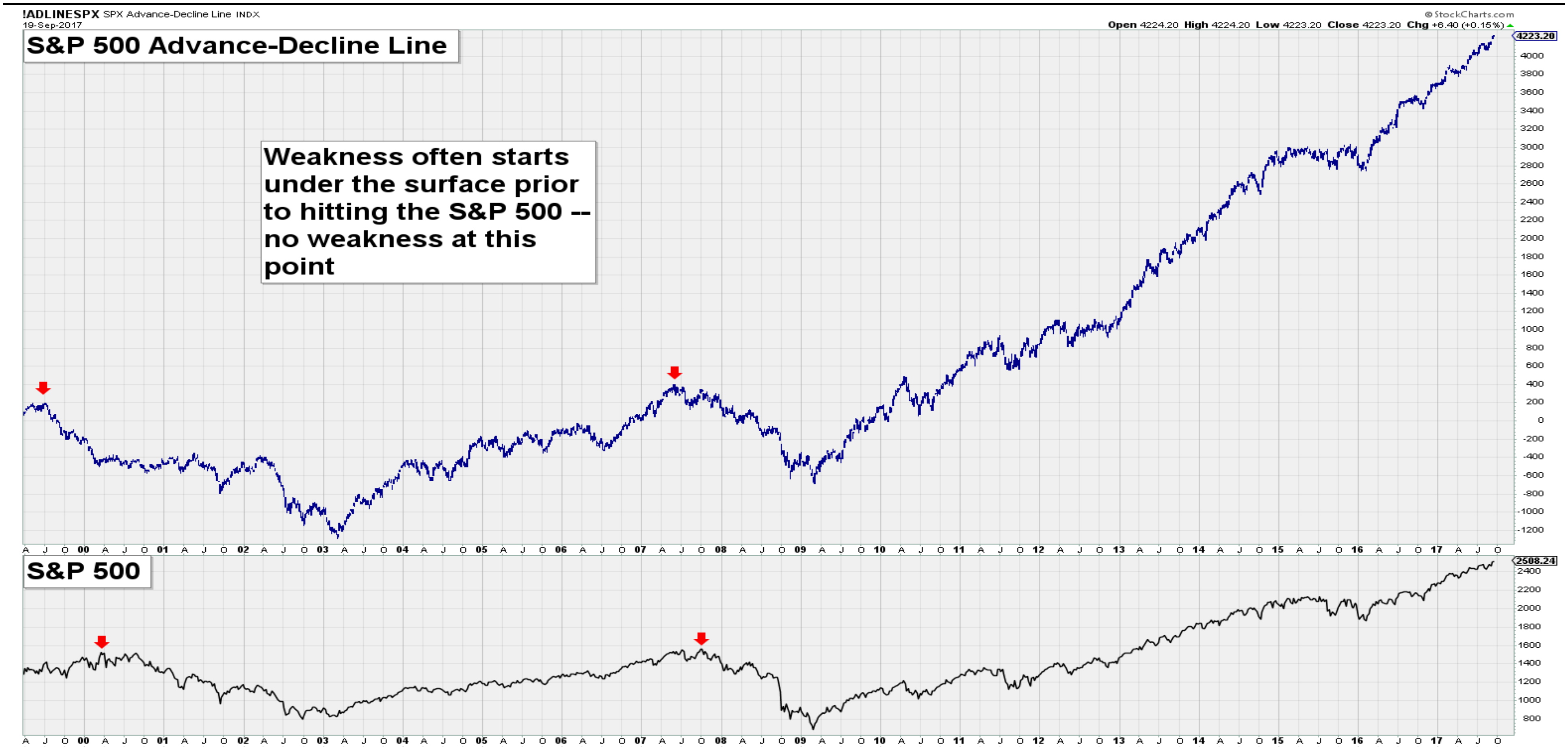


Source: Stockcharts.com.

Andrew Adams

S&P 500 Breadth Update

While we did see a noticeable drop in market breadth in July/August, the wider stock market has largely recovered and the S&P 500 Advance-Decline Line and the S&P 500 itself have recently made new all-time highs. This is important because the S&P 500 Advance-Decline Line often tops out prior to the S&P 500 topping out, so the fact that both are still rising helps support our view that the market remains healthy and downside is hopefully limited.



Source: Stockcharts.com.

Andrew Adams

Russell 2000

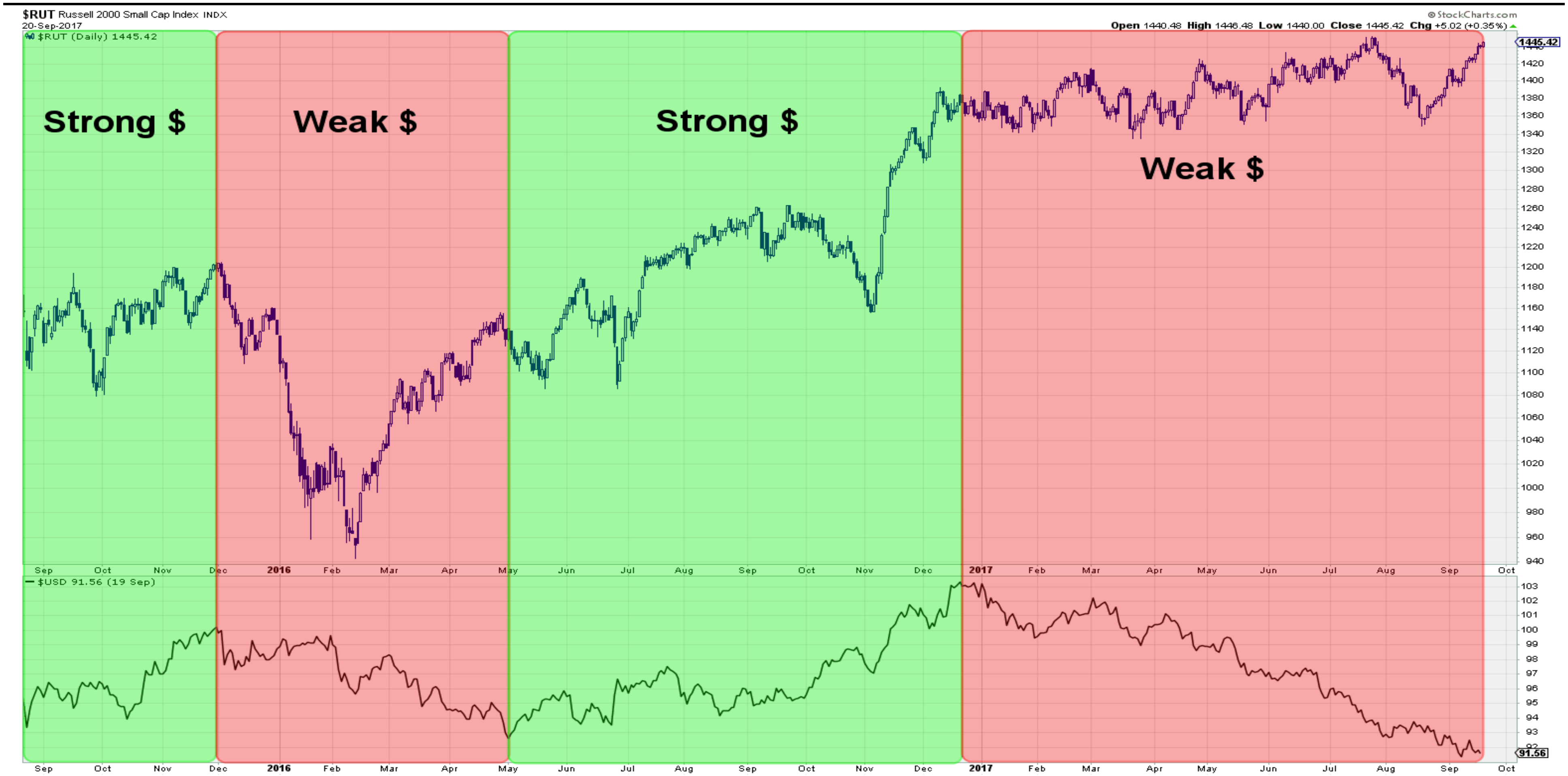
The small cap space, represented by the Russell 2000, has struggled to really break out this year, with very heavy resistance continuing to provide a ceiling to how high the index will go. We have heard much discussion about the underperformance of the small caps being a red flag for the broad market, but we believe it is really just a function of the weaker U.S. dollar leading to asset flows going into the stocks with the most foreign exposure. Larger companies are generally more likely to do more business abroad and so have been able to benefit from the weaker U.S. dollar in ways that smaller companies have not. Investors have recognized this fact and thus chosen to favor larger companies.

Source: Stockcharts.com.

Andrew Adams

Russell 2000 vs. U.S. Dollar Index

To continue the point on the previous page, the correlation between the Russell 2000 (top) and the U.S. Dollar Index (bottom) becomes clear once we chart them together. Over the last couple of years, the small caps have often struggled when the U.S. dollar is going down, but rallied when the dollar is showing strength.



Source: Stockcharts.com.

Andrew Adams

U.S. Dollar Index

The U.S. Dollar Index has hit what looks to be fairly important support level around 91, but this area has not been able to boost the dollar back up so far. If 91 breaks, there really isn't another level of obvious support close by, which only increases the significance of the zone where it currently sits. The index has broken down through some key support levels during its fall, too, which means those same levels may now act as additional resistance to any rise in the value of the dollar.

Source: Stockcharts.com.

Andrew Adams

Dow Jones Transportation Average

The Transports have been back and forth for all of 2017, but are now approaching the upper end of their range from the last several months. The fact that the DJTA made a much higher low in August (compared to the May low) hopefully means the index is ready to take a shot at bettering its all-time high set in July, but resistance in the 9750 area should be watched closely.

Source: Stockcharts.com.

Andrew Adams

10-Year U.S. Treasury Rate

The 10-Year U.S. Treasury rate threatened to accelerate to the downside around the start of September once it broke 2.10%, but that has turned out to be a false breakdown to this point. Like many false moves, the quick reversal has quickly continued in the opposite direction to now once again close in on 2.30%. The rate may be hitting some resistance right now from a line drawn from the March and July highs, but should it break above there, it's looking at a fairly clear path to 2.40% where further resistance resides.

Source: Stockcharts.com.

Andrew Adams

Crude Oil

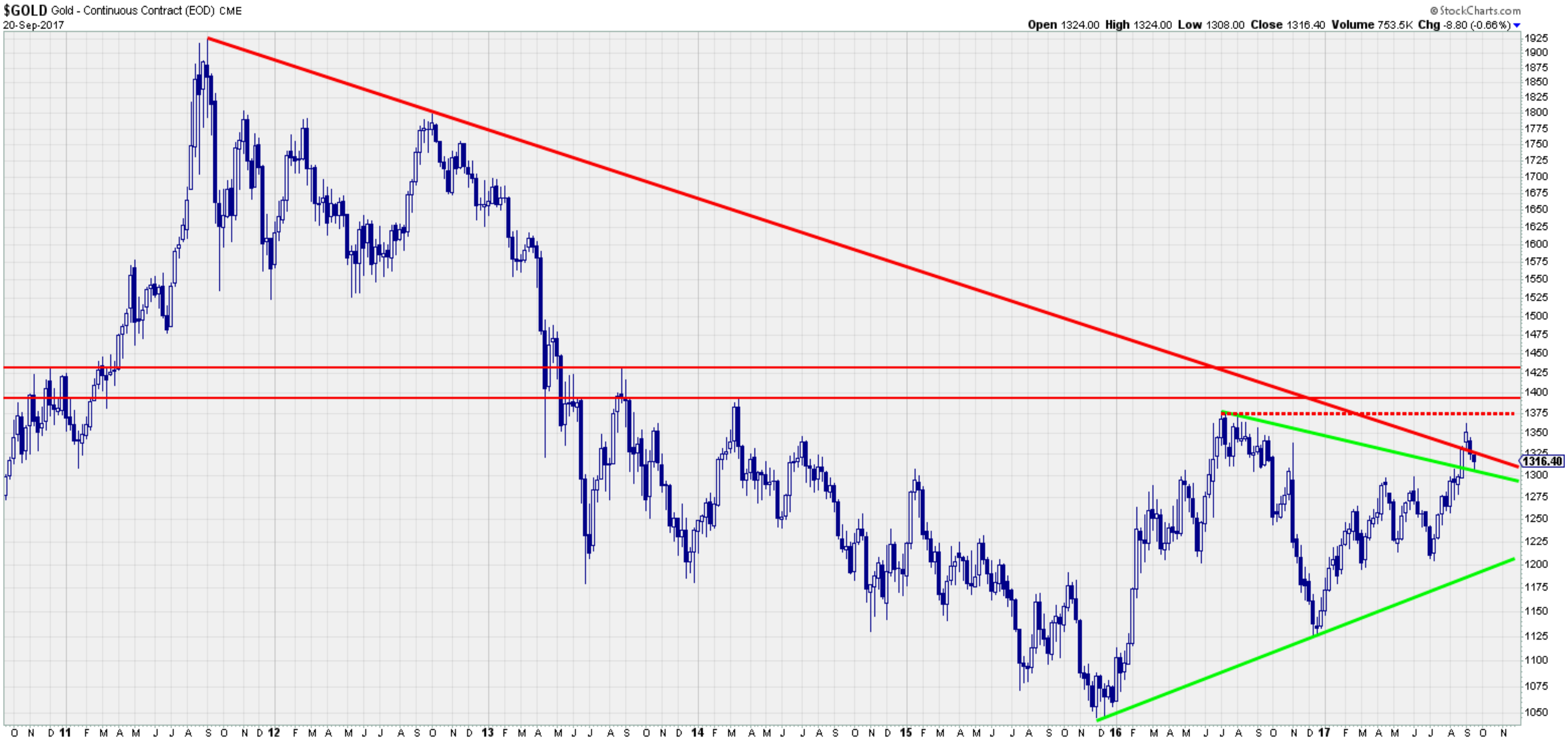
Crude oil has been behaving much better recently and the Energy sector has benefitted from that price action. Oil looks to have broken one measure of the long-term downtrend (diagonal green line connecting the June 2014 and February 2017 highs) and now looks like it could once again threaten the crucially important $55 level. $55 remains the key overhead resistance price, and if it is able to break out above there, it wouldn't be surprising to see it quickly challenge $60 again like it did in 2015.

Source: Stockcharts.com.

Andrew Adams

Gold

Gold has benefitted this year from the weaker U.S. dollar and the geopolitical noise, and actually managed to break above the most conservative interpretation of its downtrend since 2011 a couple of weeks ago (that long, falling red line). It has since pulled back to support near $1300, but as long as the metal stays above that $1300 level, it looks interesting and may be about as attractive as it's been in several years.



Source: Stockcharts.com.

Andrew Adams

STOXX Europe 600 Index

While we are still bullish on the U.S. stock market over the long term, we have also recommended looking outside the U.S. this year for investment ideas. The STOXX Euro 600 index has been in a fairly clear downtrend since May, but it is now very close to breaking above that dotted red resistance line and ending that downtrend. The index looks to have some support underneath it, as well, so a clear breakout may offer a good signal to add exposure to Europe.

Source: Stockcharts.com.

Scott Brown

The Economy in Brief

Real GDP rose at a 2.1% annual rate in 1H17 and the moderate trend is expected to continue into 2018. Hurricanes Harvey and Irma will have a negative impact on 3Q17 GDP growth, but we should see a rebound in 4Q17 and early 2018. Monthly economic figures are expected to be distorted. However, the pre-hurricane data were spotty, suggesting softer growth in consumer spending and manufacturing. Core inflation has been low, with a continued deflationary trend in consumer goods and some moderation in non-energy services (including shelter costs).

Federal Reserve officials continue to expect gradual increases in short-term interest rates over the next few years (most expect a mid-December hike). The Federal Reserve has announced the start of the balance sheet unwinding, which begins at a modest pace ($10 billion per month) and picks up each quarter (to $50 billion per month on October 2018). Long-term interest rates are expected to drift higher.

Lawmakers have avoided a budget and debt ceiling showdown, delaying these issues until December 8. Significant tax reform will be difficult, but we may still see lower tax rates at some point.

Washington Developments

FY18 Budget/Debt Ceiling: President Trump and Democratic leaders reached an agreement to fund the government and waive the debt ceiling until mid-December (that is, they kicked the can down the road).

Tax Reform: To gain a lot, one has to give up a lot. Many firms pay a lower effective tax rate than what is being proposed (thanks to deductions and subsidies) and they don't want to give that up.

Trade Policy: A misstep here has been viewed as one of the biggest risks to the economic outlook. The hope is that NAFTA renegotiations will be done around the edges and not disrupt supply chains.

Fed Personnel: President Trump has nominated Randal Quarles to be the Fed's Vice Chair of Supervision (cleared committee, now awaiting a Senate vote). There are three other vacancies and the president has not decided on whether Yellen will be replaced as Fed chair.

The Russia Thing: Special Counsel Mueller's investigation is reported to be progressing, but will still take time. Financial market participants haven't expressed much concern, but that may change at some point.

Scott Brown

Economic Outlook – Key Themes

Moderate Growth

Domestic economy

- Consumer fundamentals remain strong (jobs, wages)
  - A temporary rise in gasoline prices is a restraint
  - Rents have been outpacing overall inflation, but pace appears to be moderating
  - Still only minor signs of credit stress in the aggregate
  - Sentiment remains divided sharply by political affiliation
    - But what people are saying and doing are different things
- Housing fundamentals are strong, but affordability and supply issues will continue
  - Some choppiness month-to-month, but a strong year-over-year trend
  - Higher building costs
- Business fixed investment improved in 1H17
  - Rebound in energy exploration, strength in exports
  - Business sentiment remains elevated

Long-term demographic restraints

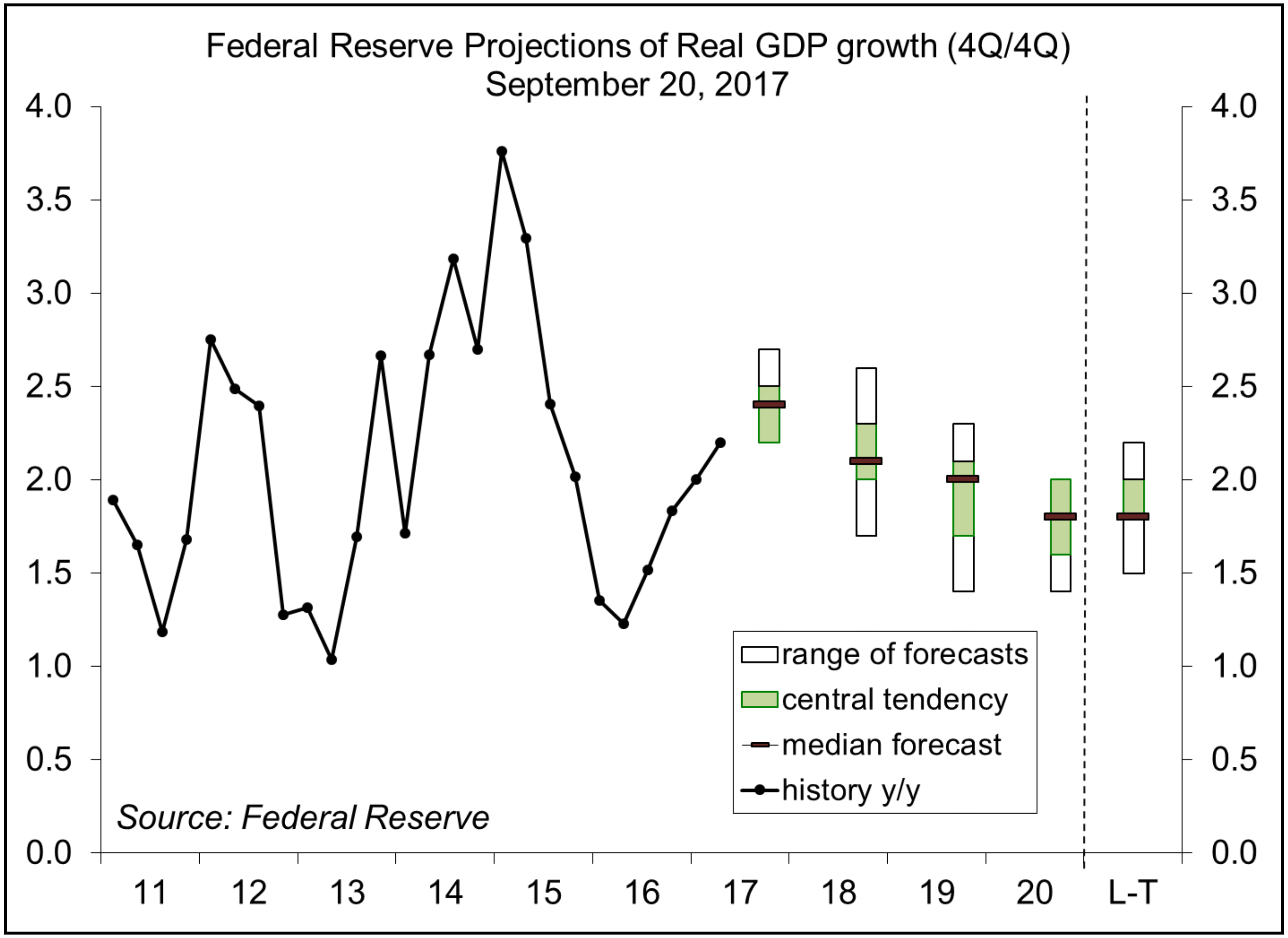
- Slower labor force growth than in previous decades (+0.5% / year over next 10 years)
  - And 40% of that is projected to be immigration (could be slower)
- Fed notes some signs that labor market constraints are restraining economic growth
- Better trend economic growth depends on stronger growth in productivity

Rest of the world

- Brexit negotiations expected to be difficult
- China economic restructuring likely to be uneven, concerns about high debt levels
- Near-term global economic outlook has continued to improve
- Demographic constraints will limit the long-term pace of global growth

Scott Brown

Fed Officials Expect Moderate GDP Growth



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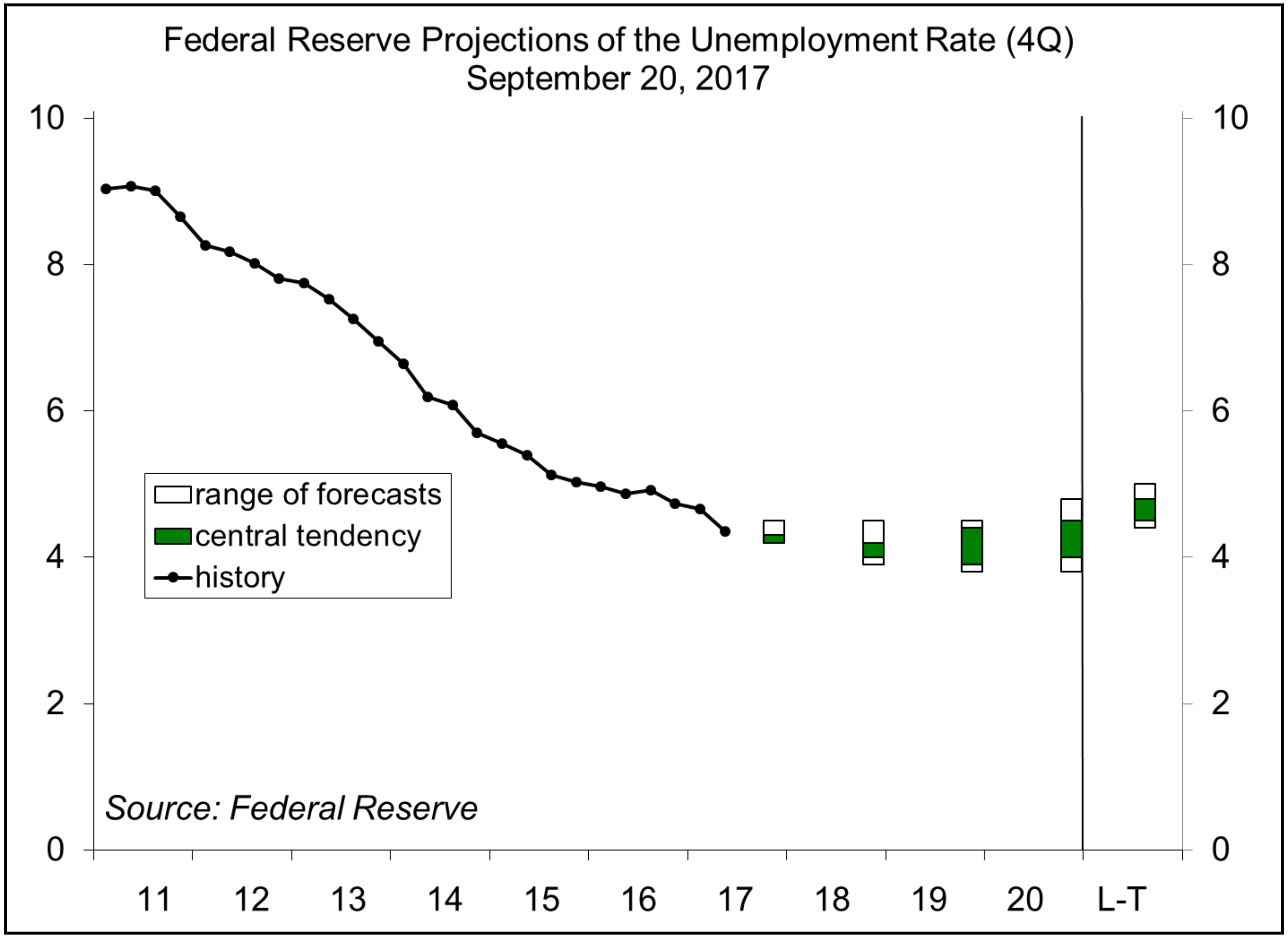
The Unemployment Rate Is Expected to Remain Low



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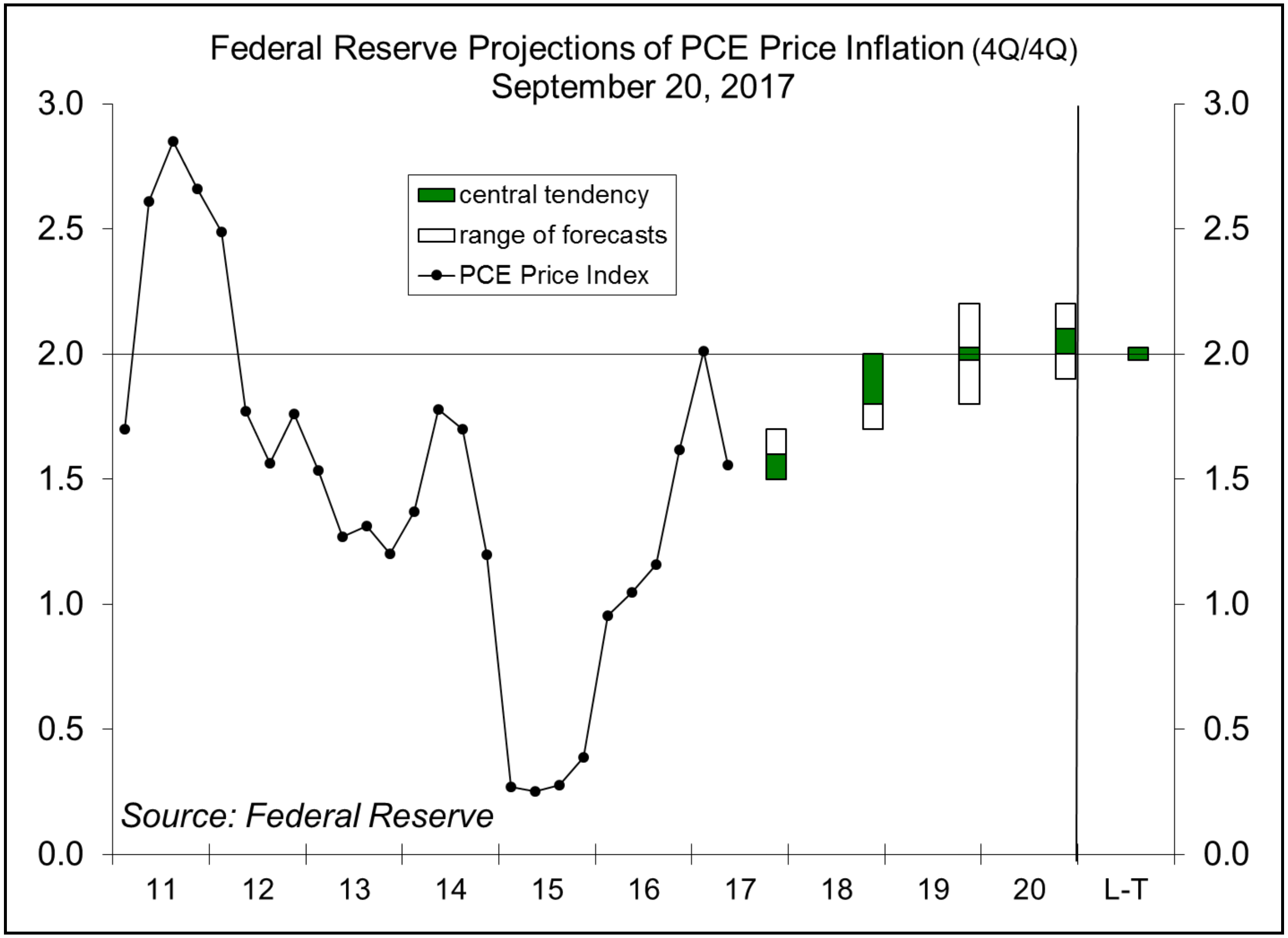
Inflation Is Expected to Move Toward the 2% Target



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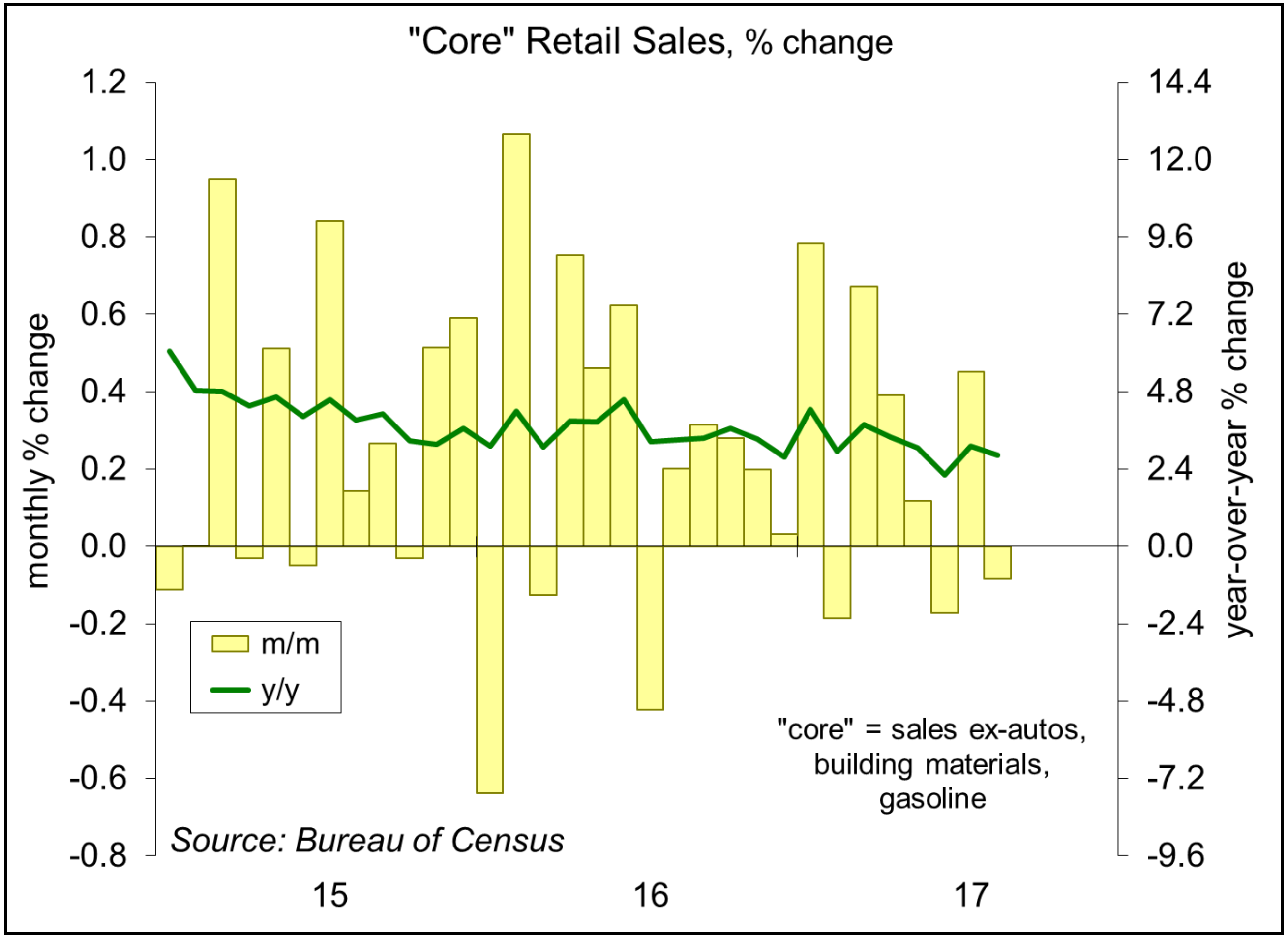
Retail Sales Growth Slowed into 3H17



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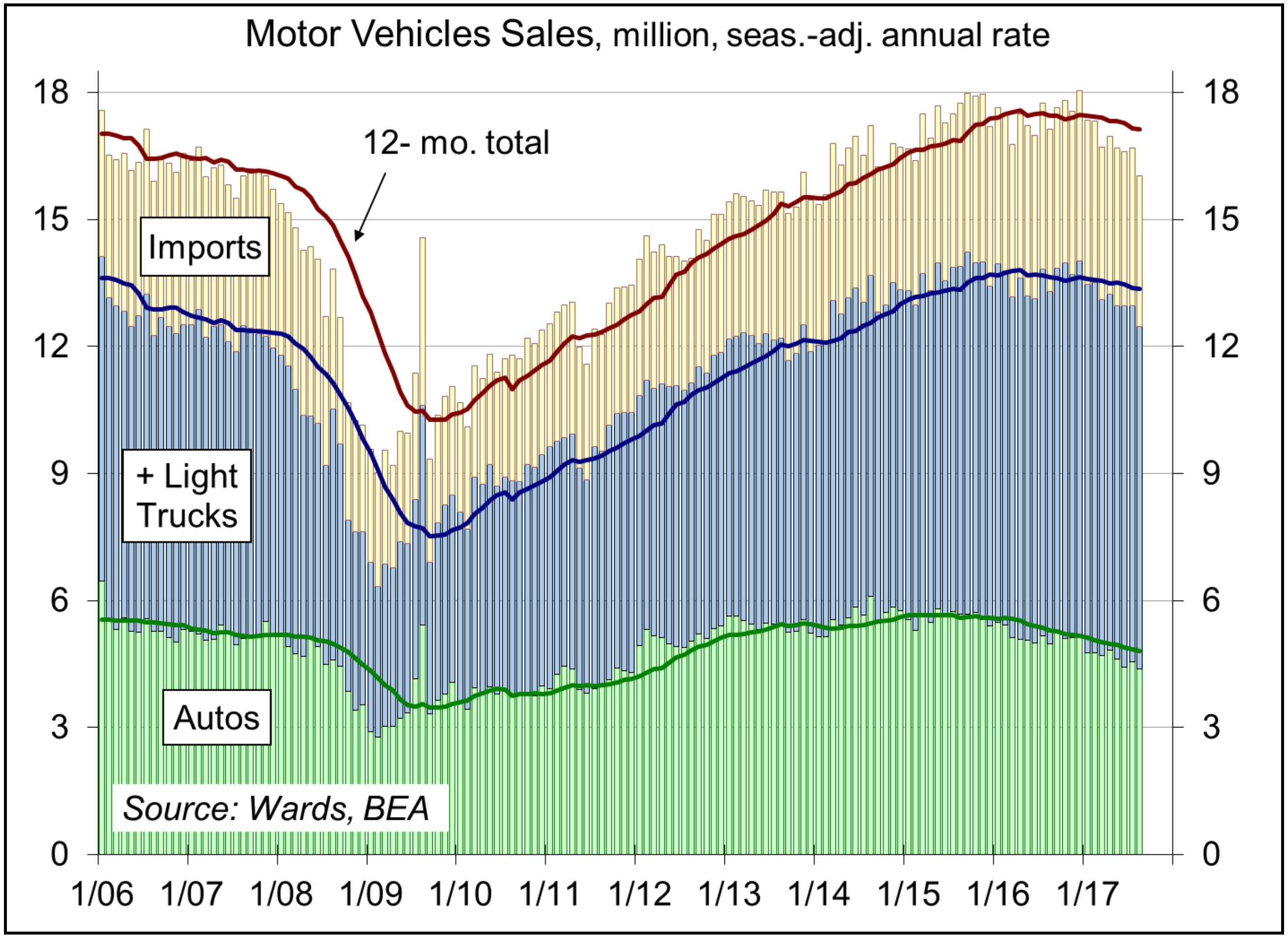
Vehicle Sales Have Been Trending Down in 2017



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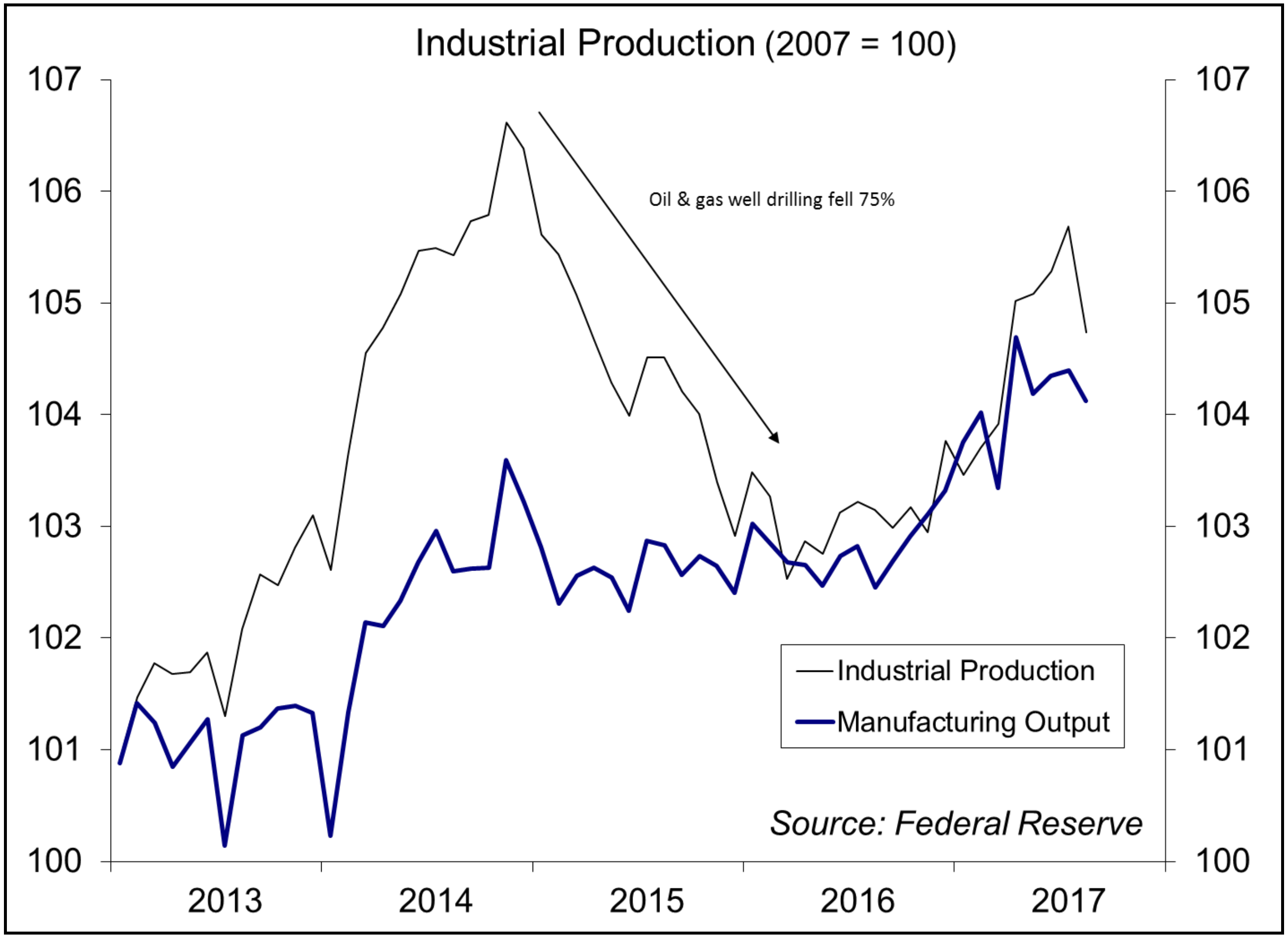
Industrial Production Fell in August (Partly Weather)



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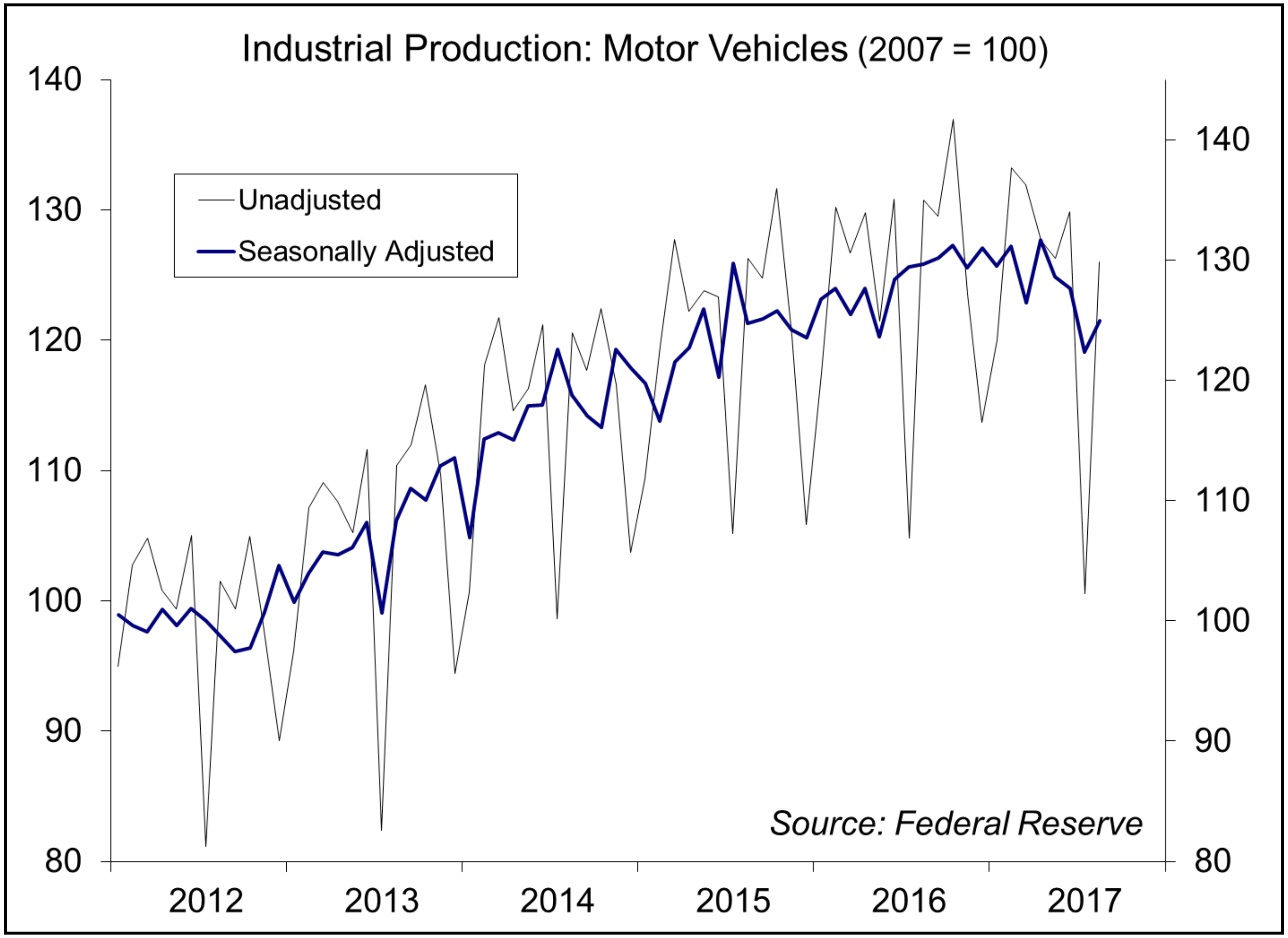
Motor Vehicle Production Has Been Trending Lower



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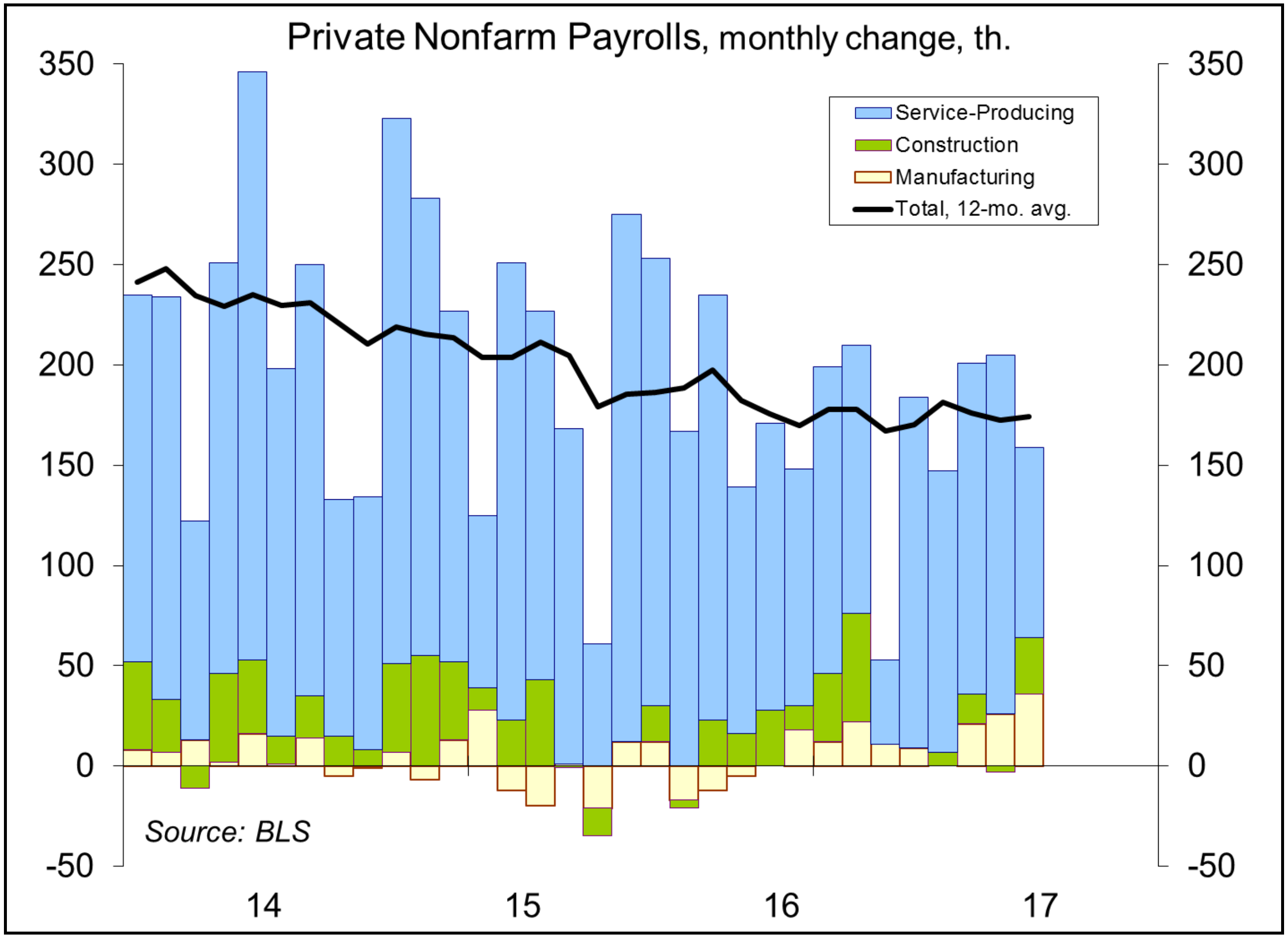
Job Growth Is Trending at a Moderately Strong Pace



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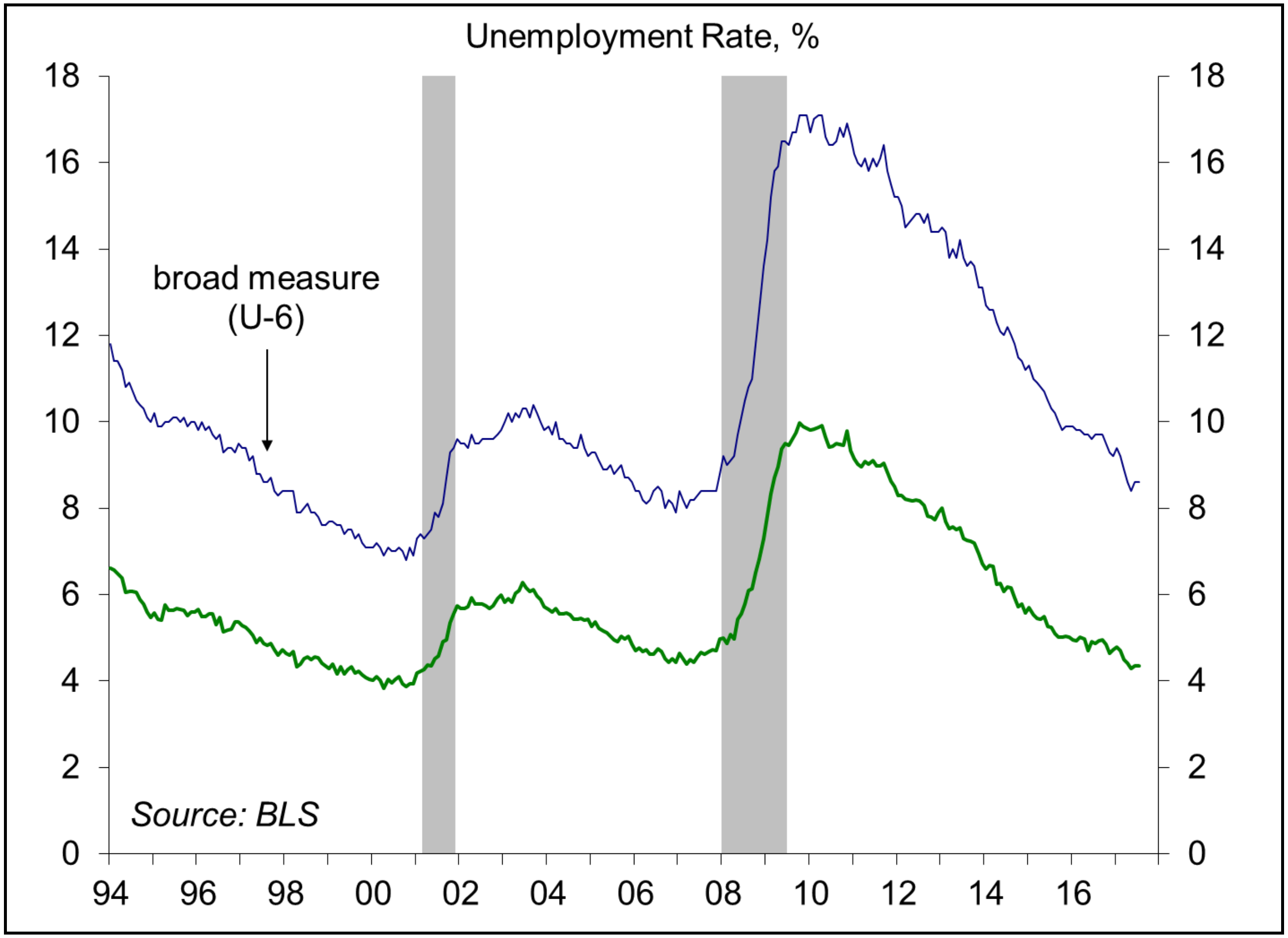
The Unemployment Rate is Low



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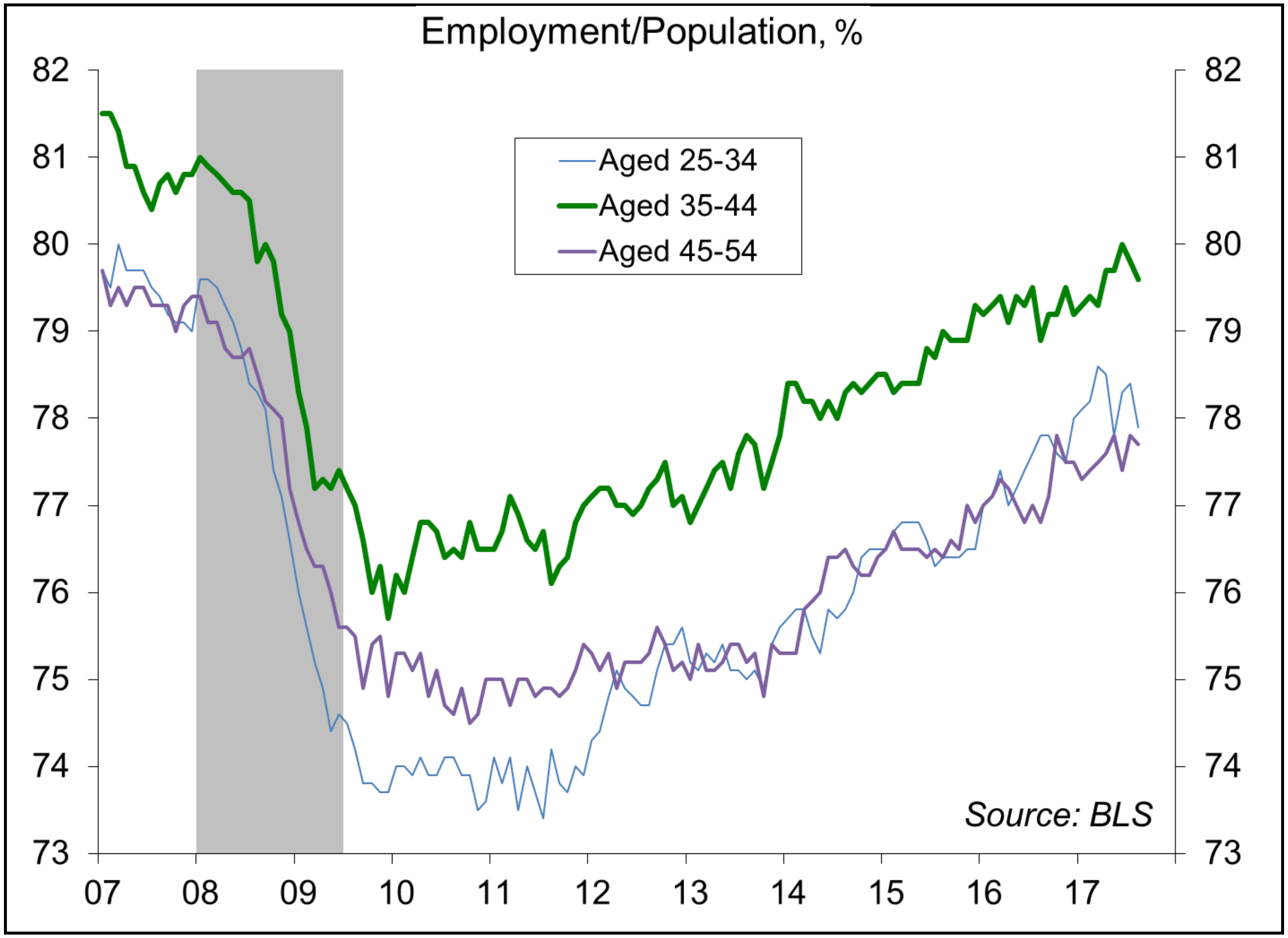
Labor Market Slack Has Been Reduced



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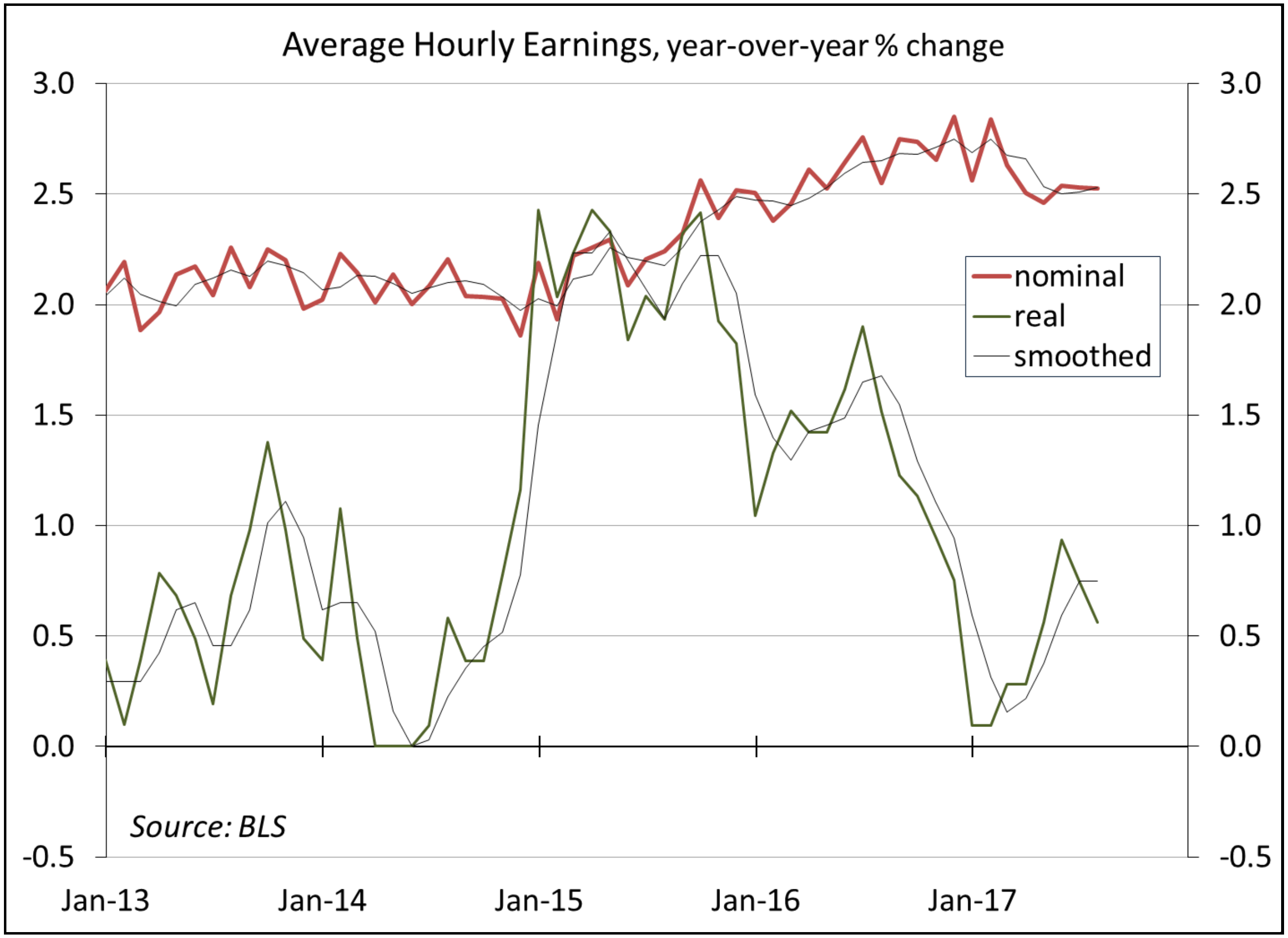
Real Wage Growth Fell in August



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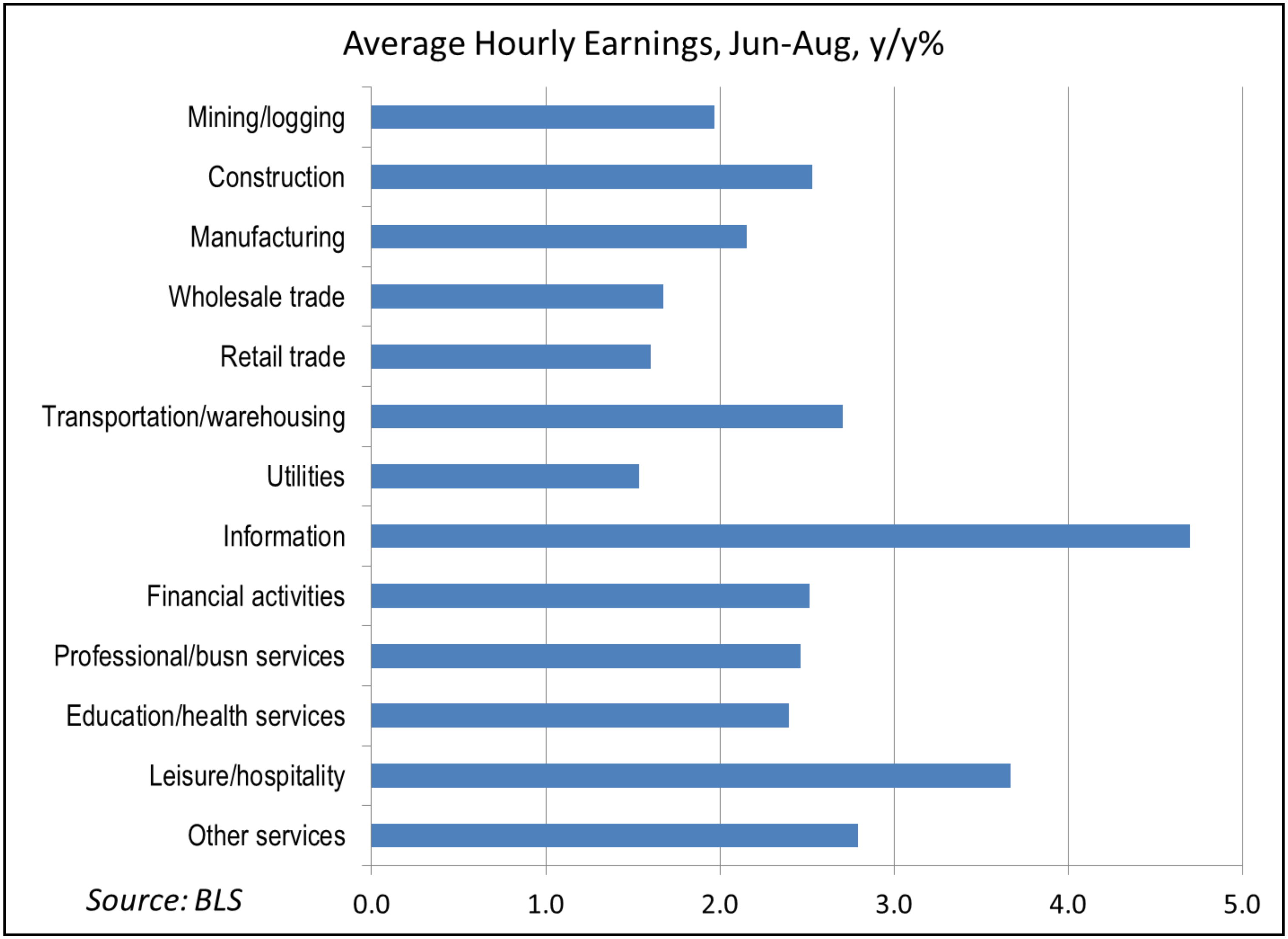
Wage Growth Had Been Moderate Across Most Industries



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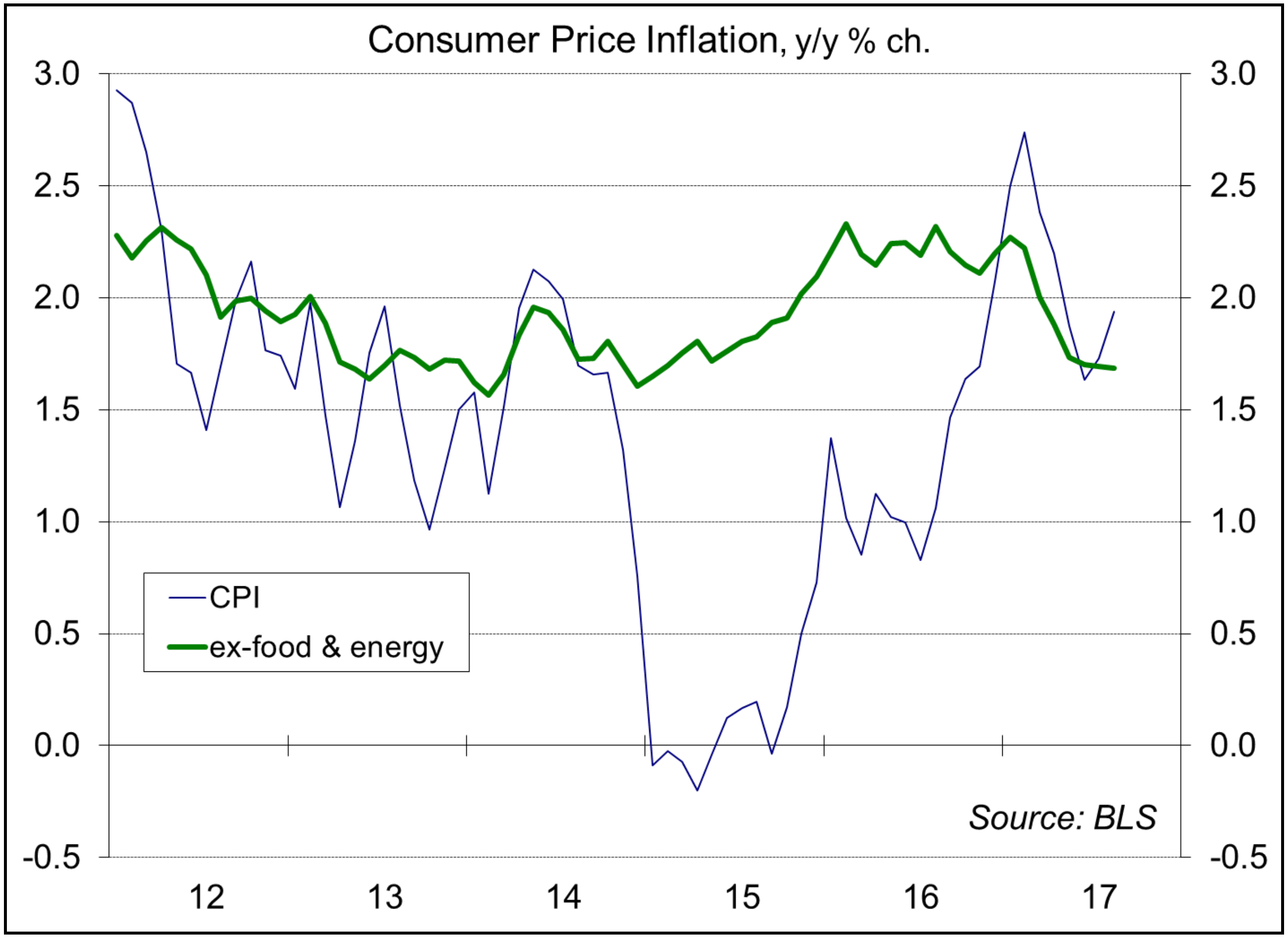
Core Inflation Has Remained Low



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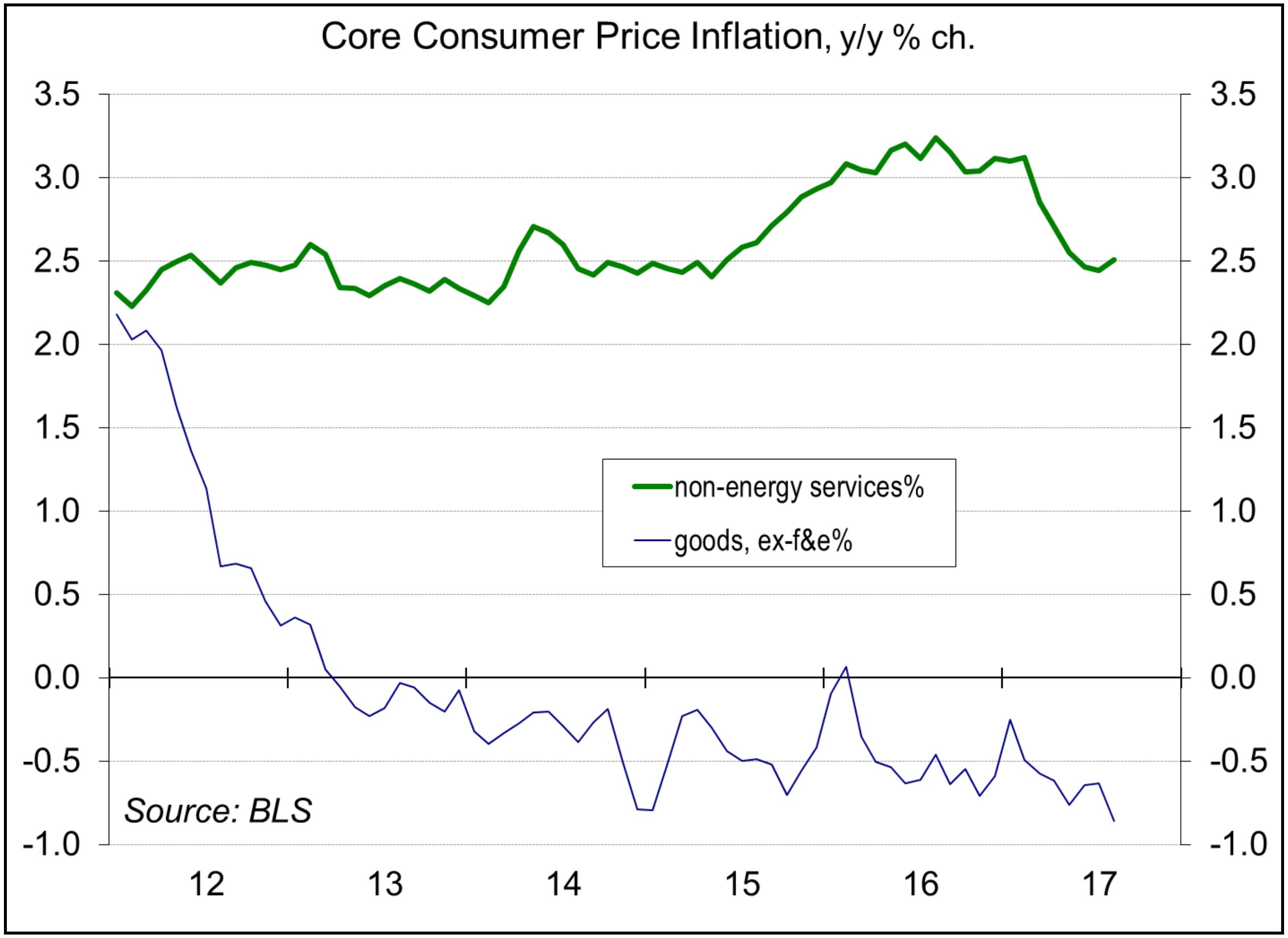
Deflation in Goods; Moderate Inflation in Services



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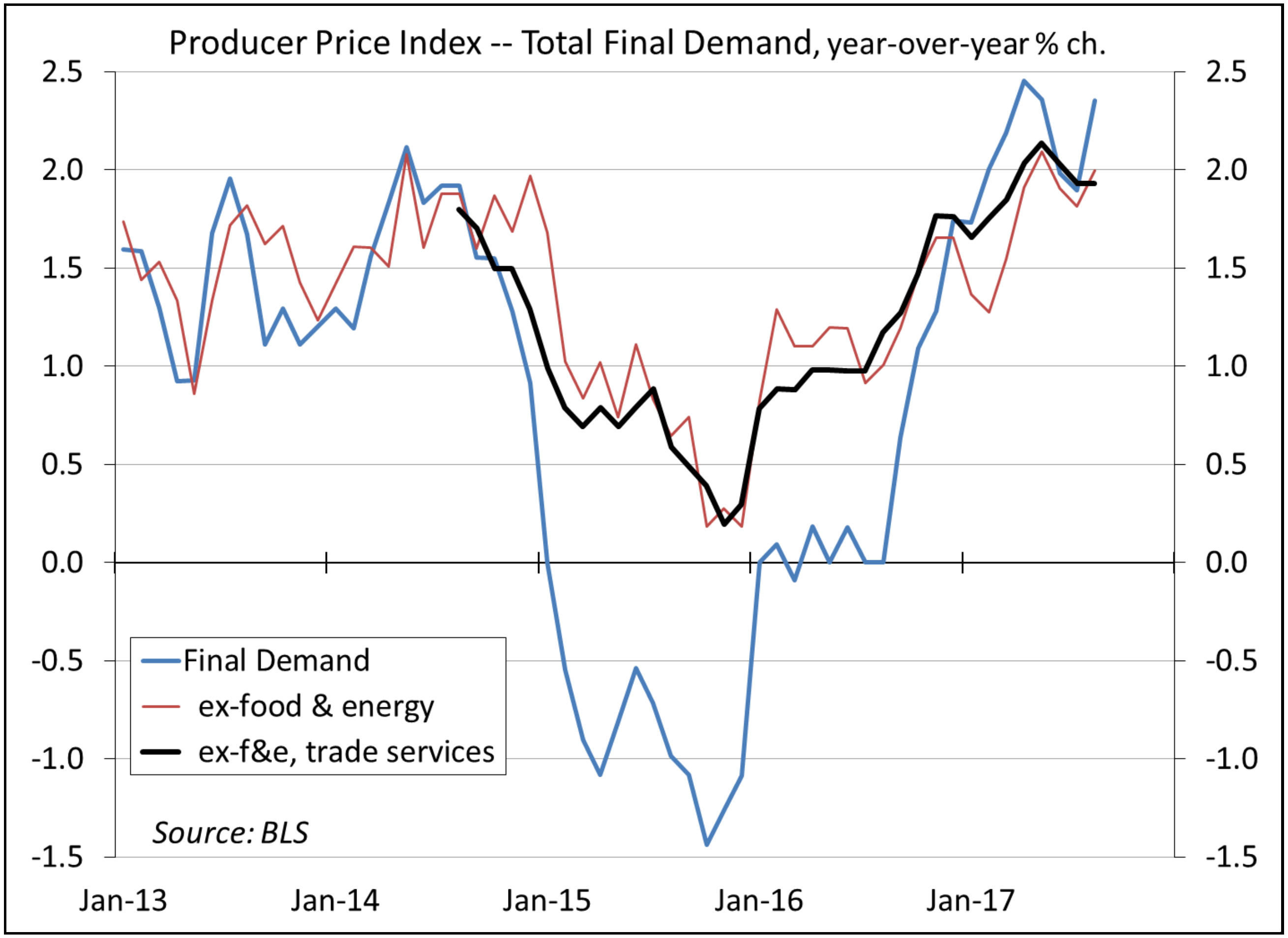
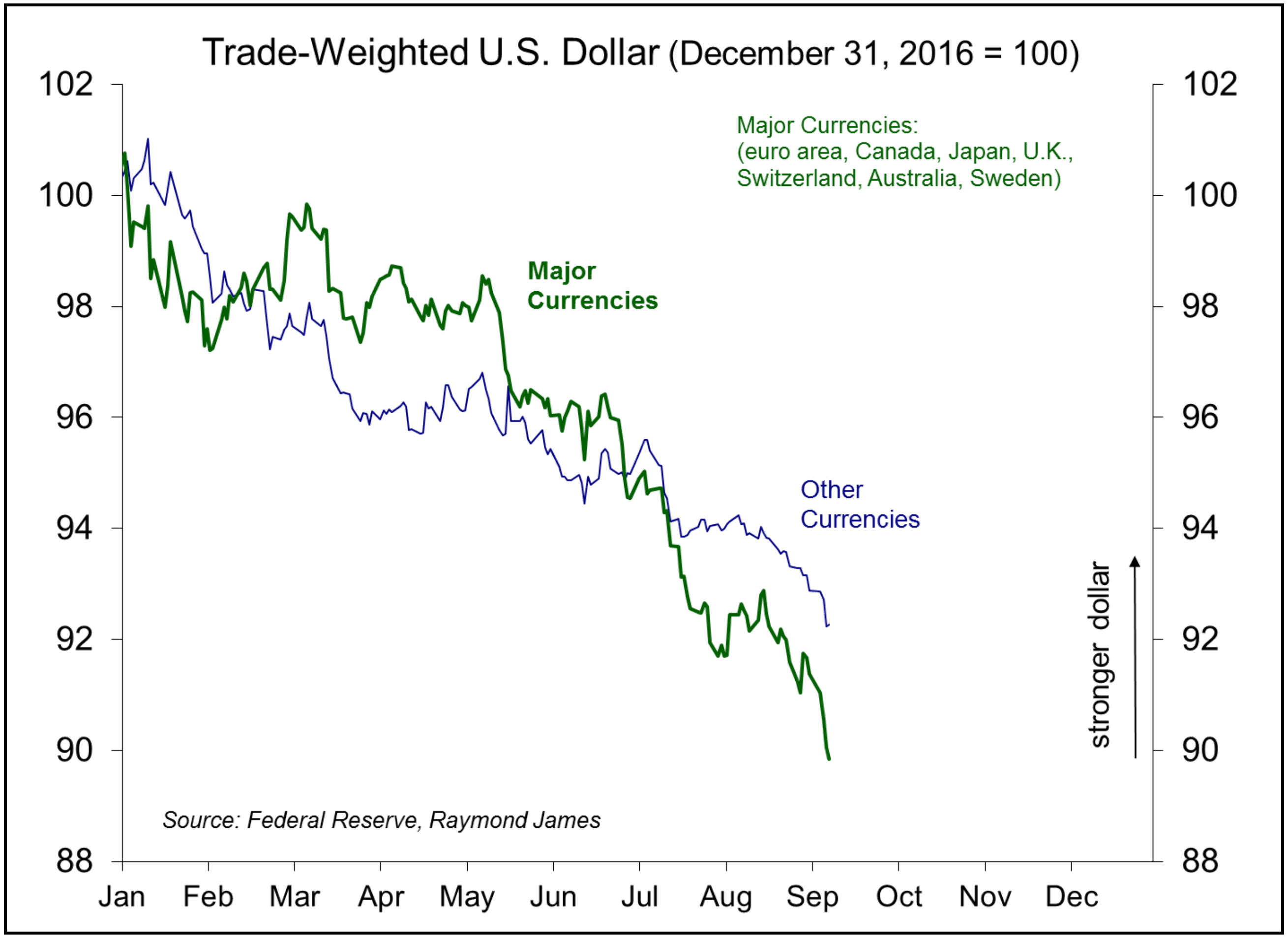
There Is Some Pressure in the Inflation Pipeline



Scott Brown

The U.S. Dollar Has Weakened Since the End of 2016



Scott Brown

Federal Reserve Policy

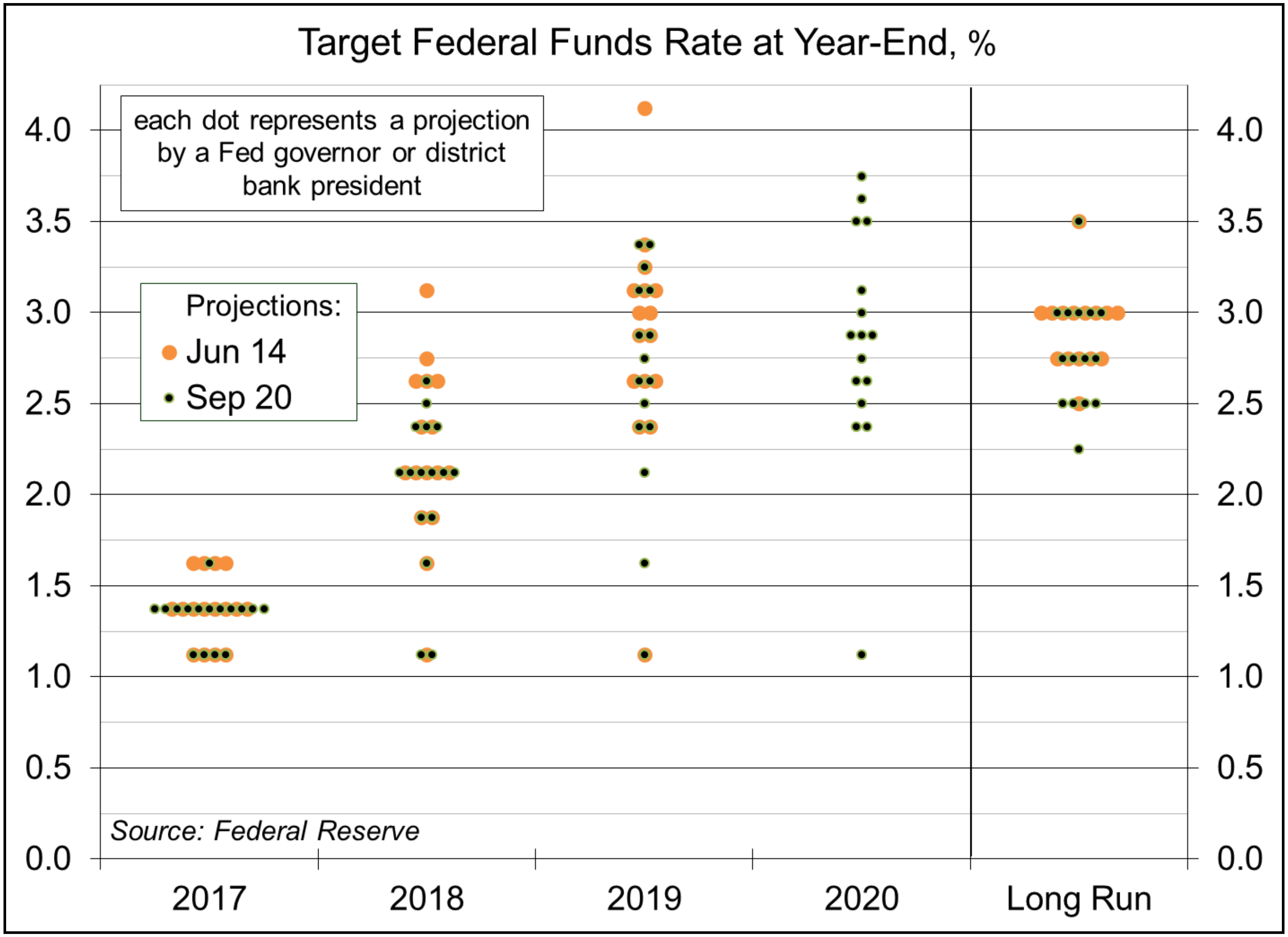
"We continue to expect that the ongoing strength of the economy will warrant gradual increases in that rate to sustain a healthy labor market and stabilize inflation around our 2 percent longer-run objective. That expectation is based on our view that the federal funds rate remains somewhat below its neutral level--that is, the level that is neither expansionary nor contractionary and keeps the economy operating on an even keel. Because the neutral rate currently appears to be quite low by historical standards, the federal funds rate would not have to rise much further to get to a neutral policy stance. But because we also expect the neutral level of the federal funds rate to rise somewhat over time, ***additional gradual rate hikes are likely to be appropriate over the next few years to sustain the economic expansion****. Even so, the Committee continues to anticipate that the longer-run neutral level of the federal funds rate is likely to remain below levels that prevailed in previous decades."*

-- Yellen Monetary Policy Conference (September 20)

Note that there are currently three vacancies on the Fed's Board of Governors. Randal Quarles has been nominated to the BOG (and as the Vice Chair on Supervision). Yellen's term as chair runs to February 3, 2018. Personnel changes add another layer of uncertainty to the Fed policy outlook.

Scott Brown

Fed Officials Expect Gradual Interest Rate Increases: One More in 2017, Uncertain for 2018-2020



Scott Brown

Federal Reserve Policy – Balance Sheet Reduction

The Federal Open Market Committee directed the Open Market Trading Desk at the New York Fed "to reinvest each month's principal payments from Treasury securities, agency debt, and agency mortgage-backed securities (MBS) only to the extent that such payments exceed gradually rising caps":

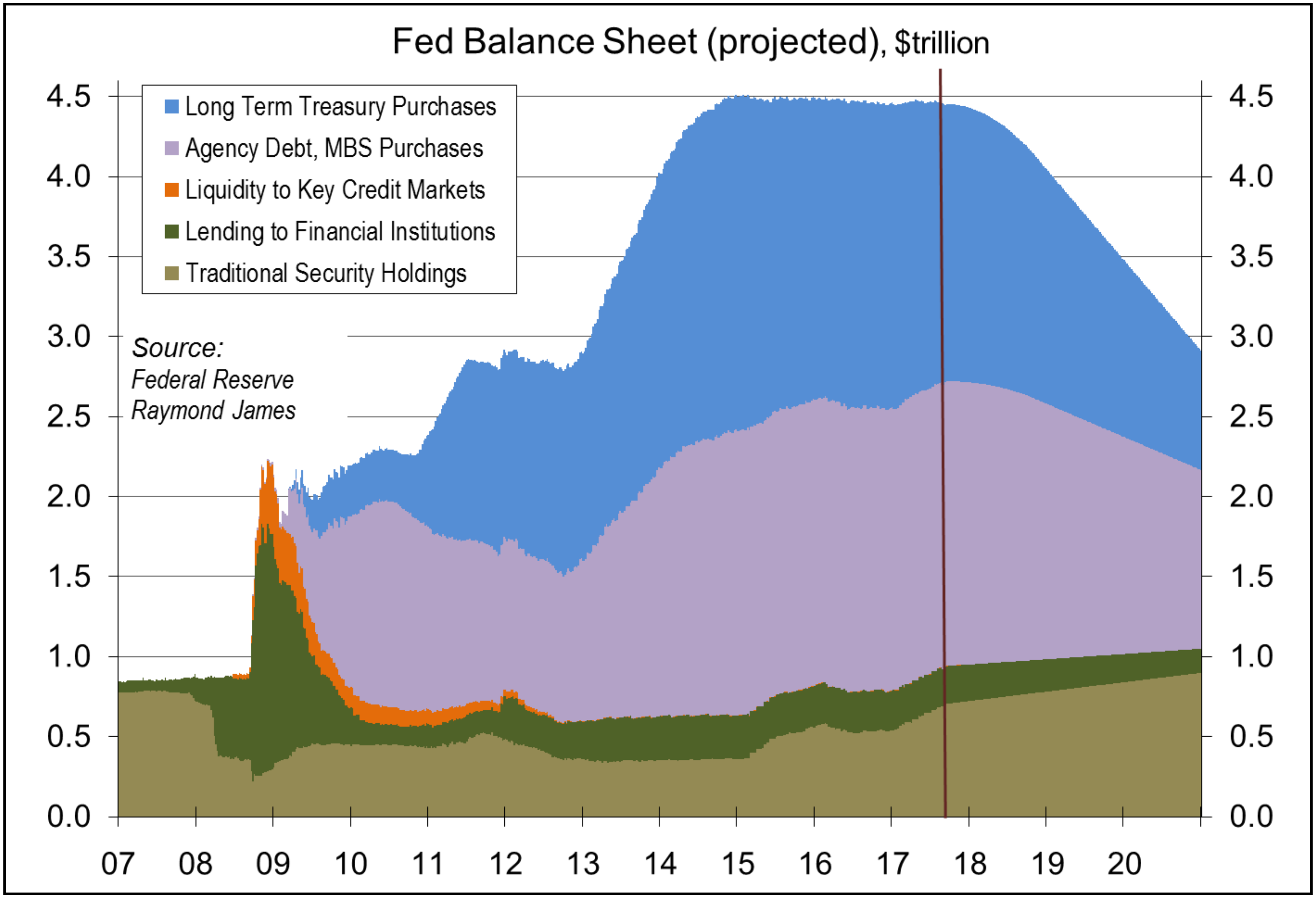
Monthly Caps on SOMA Securities Reinvestment

	Treasury Securities	Agency Securities
Oct – Dec 2017	$6 billion	$4 billion
Jan – Mar 2018	$12 billion	$8 billion
Apr – Jun 2018	$18 billion	$12 billion
Jul – Sep 2018	$24 billion	$16 billion
From Oct 2018**	$30 billion	$20 billion

**Applies to combined principal payments of agency debt and agency MBS.*
***Once caps reach their maximum amounts, they will remain in effect until the Committee judges that the Federal Reserve is holding no more securities than necessary to implement monetary policy efficiently and effectively.*

Scott Brown

Balance Sheet Reduction Will Take Years



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Economic Indicator	Status	Comments
Growth	Green	Hurricanes are likely to have a negative, but temporary, impact on 3Q17 GDP growth. The trend pace into 2018 is expected to remain moderate.
Employment	Green	Growth in nonfarm payrolls has remained moderately strong, but is expected to slow as labor market conditions tighten further.
Consumer Spending	Yellow	Wage and job growth have remained supportive, but figures suggest a lackluster trend into the second half of the year. Autos sales are trending down in 2017.
Business Investment	Green	Businesses remain generally optimistic. Capital spending should continue to improve. Exports and the rebound in energy exploration have been positive factors.
Manufacturing	Yellow	Uneven in recent months, the trend in factory output has been about flat since February. The energy rebound and an improving global economy are helping, but auto output has softened.
Housing and Construction	Green	Monthly figures have been uneven, but the year-over-year trends in homebuilding and sales has remained strong. Limited inventories and higher home prices have been restraints.
Inflation	Yellow	Core inflation has fallen back after a higher start to the year. Some of that is due to temporary factors (wireless telecom services, for example). Wage pressures have been moderate, but should pick up as the job market tightens further.
Monetary Policy	Green	The Fed expects to raise short-term interest rates gradually and has announced the start of the balance sheet run-off. Personnel changes (three vacancies on the Fed's Board of Governors, Yellen's term as chair runs to February 3) add uncertainty.
Long-Term Interest Rates	Yellow	The Fed's balance sheet unwind ought to put some upward pressure on bond yields, but gradually. Low-to-moderate inflation and low interest rates abroad are expected to prevent U.S. bond yields from rising too rapidly.
Fiscal Policy	Green	State and local government budgets are in better shape and spending should add a bit to overall GDP growth. At the federal level, the timing, character, and scale of infrastructure spending and tax cuts is very much in doubt, but (while hope remains) expectations have been pared back.
The Dollar	Green	Doubts about U.S. fiscal stimulus and expectations of tighter monetary policy abroad have put significant downward pressure on the dollar since the start of the year.
Rest of the World	Yellow	Brexit negotiations should be difficult for the U.K. and Chinese debt levels are a concern. However, the global economic outlook has been improving. The possibility of trade conflicts remains an important risk for the U.S. economic outlook.

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Key Calendar Dates

September 27	Durable Goods Orders (August)
September 28	Real GDP (3Q17 3rd estimate)
October 2	SM Manufacturing Index (September)
October 3	Motor Vehicle Sales (September)
October 4	ADP Payroll Estimate (September)
	ISM Non-Manufacturing Index (September)
October 6	Employment Report (August)
October 9	Columbus Day (bond market closed)
October 13	Consumer Price Index (September)
	Retail Sales (September)
October 17	Industrial Production (September)
October 27	Real GDP 3Q17, advance estimate)
November 1	FOMC Policy Decision (no press conference)
December 13	FOMC Policy Decision (Yellen press conference)

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