# When Doves Fly the Bull Cycle Remains

## With Chris Hyzy

### Chief Investment Officer

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Chris Hyzy: Hello. This is Chris Hyzy, Chief Investment Officer. Today's audio recording will detail our market view as we stand here with the first two months, almost the first two months of the year going by, and about three-quarters of the first quarter over with.

The title of the audio cast is When Doves Fly the Bull Cycle Remains. We've had significant move off the lows over the course of the last couple of months. While economic data has come down, and a lot of the questions that we're getting now is how can one pay up for slower growth and lower earnings?

The simple answer to the question has a lot to do with the change at the Federal Reserve. So why the recent Fed switch from being more on the hawkish or tightening side to very much on the dovish side? That switch happened at the beginning of January and it continues the pace today in most Fed communications.

There's a few reasons for the Fed switch. Housing starts were one of the lowest levels in the last 2-1/2 years. Inflation, importantly, is closer to 1-1/2 versus their target of two. Non-US growth became a major headwind, particularly out of Europe. Consumer confidence had dropped, particularly in December. And liquidity, perhaps the most important reason, was significantly declining.

The Fed finally realized that balance sheet normalization plus the hikes that were already in the system and their forecast of four more hikes for 2019 were simply too tight. Therefore we believe that the appropriate market theme and market view over the course of the next few months and throughout 2019 is more about when doves fly. And that's precisely why we believe the bull cycle remains.

So overall we had written a report not too long ago, that was discussing a theme called Watch the Movie, it had five parts to it. And it spelled out the word movie.

The first part was all about monetary policy or M. And monetary policy, at that point, was too tight in our view. And we felt as though there needed to be a major adjustment by the Federal Reserve, which ultimately would induce adjustments to the more dover side by the European Central bank, perhaps by the Bank of Japan and importantly by the Chinese Central Bank.

Whereas we sit here today, we've already addressed the fact that the Fed did a 180 degree switch from being hawkish to very dovish, and that has a lot to do with two primary adjustments. The first one is obviously rates. It appears that the Fed is completely in pause mode. And they have switched from trying to control growth to controlling inflation, or trying to re-induce inflation. And they have switched from being watching growth closely to trying create reflation. And that has a lot to do with their pause. But more importantly, they have also removed the so-called auto-pilot from their balance sheet normalization.

Those two things together has induced a greater transparency on what the actual cost of capital, what short term rates are likely to be, what risk capital and the cost thereof is likely to be, versus the concern that the Federal Reserve was on its way to being very, very tight for 2019 into 2020.

The second thing in the movie that needed to happen was two O's. The first 'o' was opportunities for a trade agreement, and the March 1st deadline is fast approaching, but as we have received recently there is a delay to that deadline. And in fact there's very good progress as far as we can tell on a trade agreement with China. And we should be getting more news over the next two to three weeks. But it seems there is a more transparent conclusion to this on the positive end, versus what we knew to close the year in 2018.

The other O within that category is oil prices. Oil prices have stabilized. Going back a few months back, oil prices were fast dropping towards the $40 a barrel, if not further through that level. $40 a barrel or so is a key level psychologically, but also fundamentally. Going below that level would likely produce less capital expenditure growth, particularly in energy and then other parts of the energy infrastructure equation. Now that we're back up into the fifties, and we have stabilized, that helps consumers, that helps countries that produce, and that also helps cap backs. So stabilizing oil prices is also another positive.

The V was all about valuation. We were hitting 18 times on a perspective basis as it relates to the highs that we saw in September. There was a major reset in the fourth quarter to equity prices induced by the Fed being too tight, as well as concerns over trade and concerns over geopolitical risks like Brexit. But as valuation was reset we felt as though it went too far. It overcorrected, it corrected all the way down to 14-1/2 on the S&P 500, and everybody asked the question; how could we reset valuations higher in a market environment in which we still don't have the full answers to trade or Brexit or other things, and the fact that growth is slowing?

And the simple answer to that is the Fed is very important. The Fed controls liquidity. As we said before, it controls the actual cost of capital. And if you have greater transparency that that cost of capital is going to remain stagnant or go lower and not increase like previously, then the multiple tends to expand before earnings expanse. You first get liquidity, you then get multiple expansion, and as investor sentiment improves, earnings follow later and the earnings catch up to valuations. And that's what we expect between now and the end of the year. Right now we're at about $170 in earnings forecast for the S&P for 2019. And going from a market multiple of 14-1/2 to 17 on $170 in earnings is the forecast of target for the S&P of 2900, if we get to 17-1/2 that puts us at a new high. We can get to 17-1/2 if the Fed remains on pause and continues to produce dovish comments around balance sheet normalization, as well as the fact that an earnings recession remains at bay.

And that brings me to the last two points which is I, investor sentiment. Investor sentiment, given the over correction, became very poor, at the lows of December 24. It remains low, according to previous highs. Investor sentiment has improved the first two months of this year, but it's still in neutral territory. And we still are experiencing negative equity flows. So from the standpoint of whether or not we've already exhausted the returns in our view for 2019, we're simply not there yet. Can we consolidate over the next few months? Yes. In fact, we've seen previous times in history where after having such a large rise off the bottom, a 20% move that we've had recently, tends to have a three month return that's flat in the overall market because of the sharp gains that have happened in very little time.

Each time that's happened, some components remain the same. In many cases you've seen the Fed actually cut rates. Now the way we view this time around is with balance sheet normalization there's an extra tightening in the actual process induced by the Federal Reserve. With that now being removed from auto pilot, at the same time we have dot plots that we're suggesting for rate hikes, now down to two and potentially zero in terms of a Fed pause through the cycle. That is a major reduction in the forecast, which one could actually suggest that is equivalent to actually cutting the forecast. And not only cutting the forecast, but it actually creates greater liquidity.

So today's cut in the forecast of the dot plots, mixed with less tightening of the balance sheet is equivalent, in our view, to actually what yesteryear's cuts would have been. And that increases the likelihood of multiple expansion and better investment sentiment in the preceding months after potential consolidation in the next few months.

And the last, but not least, the fifth component that we talked about is earnings. The big worry in the marketplace today is an earnings recession. Quite frankly, analysts have now cut earnings expectations down to a negative growth number, around negative 1% for the first quarter. Negative 1% is on a market cap weighted basis. When we run the numbers on a medium basis, we still see positive earnings growth and we still see positive revenue growth.

And there's a number of different components that would suggest our headwinds to earnings growth that simply weren't in the cards last year in the third or fourth quarter. Some of those have to do with the energy comps and the sector of energy given where oil prices were versus where they were 12 months hence. Some of it has to do with big cap technology names that had had lower earnings growth. And some of it has to do with a tax change. Obviously that's not continuing in magnitude like we saw from 17 over into 18. You roll that all up, we still feel very constructive overall in the full year for 2019 of around 5% earnings growth. So we expect earnings revisions to bottom in the first half of 2019, and ultimately earnings to catch up with multiples as we work through.

And again if we get to 17-1/2 and we get the conditions on the first four components, M-O-V-I, come through like we expect, new highs should be in the cards in our view for 2019.

Let's take a look quickly at market internals before we close the call. The bounce off the low is very important. Obviously about 20%. We've seen some of this in years past. We experienced that in 1998, and we experienced it about ten to 12 times since 1957. As we mentioned before, a common component through most of those ten to 12 times was the fact that the Fed actually cut interest rates. So everybody keeps asking right now well if they're not cutting this time, can we have a similar move up and a resumption of the bull cycle? And our view is yes, given the fact that there's a major cut to the forecast of what the Fed was going to do.

The second thing to think about is we're heading into the third year of a presidential cycle right now, and typical presidential cycles have positive developments in the equity markets to them given the need to go for growth. We think there's a very similar theme in the marketplace this time.

And then last but not least when you go back to 1998, we mentioned this before, the Fed cut rates 75 basis points between September and November, and the move off of the loads was also 20% after falling 20%. And when you think about what the Fed did after those cuts, they were on hold for seven months. And then earnings started to accumulate again and profits started to rise, but that was after multiple drives from about 22 times to about 29 times.

This time around, in our view, that's equivalent to something like 14-1/2 to 17-1/2. Lower multiples, similar move up, similar dynamic of the Fed and similar story as it relates to multiples going up and then earnings following.

So last but not least I wanted to just talk about portfolio strategy. We remain overweight equities versus fixed income. We remain overweight to US large cap space and emerging markets. We still view the emerging markets as benefiting finally from lower rates, a stable dollar, stable oil prices and a low cost of capital overall. That is a barbell in our equity portfolio. We want to have a higher quality exposure through US large caps and a growth option through the emerging markets.

We also still emphasis tech on the sector basis, technology, industrials, healthcare and financial.

In the fixed income space we still view the shorter term yields as attractive given the term premium and most importantly we still feel that long term muni's are attractive, short term credit. And we view treasuries as a hedge on equity exposure.

Similarly in the commodity space, we still view gold as a hedge overall on so called equity risk. And we also view commodities overall right now as more neutral, even though they've recovered sharply and they're exhibiting late cycle behavior, we expect some of that to continue, particularly as the Fed continues with their reflationary tendencies, the dollar remains stable and overall it's just counting a better emerging market pricing power picture.

Some portfolio themes to keep in mind: diversification, high level of diversification is paramount in the late cycle, as we are right now, a solid mix between value and growth. And again at the security level, dividend growth and yield themes at the late cycle basis still remain on our emphasis list.

We believe rebalancing during high negative volatility times is very much important. And as earnings announcements start to get closer to our view, which is that earnings bottoming in the first half we view weakness in the equity market as rebalancing opportunities for the long term investor in between earnings announcements. It's very important because as the multiple goes up prior to earnings confirming the investor sentiment, your negative volatility backdrops during those times, in our view, should be opportune times to rebalance.

The bottom line here is the Fed's sharp 180 degree change in policy is more powerful than what many are suggesting. We expect to reach new highs in equities by the end of the year.

We want everyone to be ready to act when the markets get volatile. But in our view, market timing is not a consistently driven successful strategy. Rather we want to stick to a disciplined process that includes rebalancing within a well-defined risk budget. And this helps particularly when markets overcorrect like we saw in the fourth quarter of last year, and in particular like we experienced in December.

We're going to see news headlines, in our view, create more noise, but the fundamentals are still in place and have not deteriorated to a point where we believe the business cycle is over.

When you think about everything that we've talked about throughout the fourth quarter of last year, what was most important was the Fed needed to make an about face and that has happened. In our view the Fed informs liquidity and the cost of capital. The cost of capital and liquidity informs the level of credit conditions. The level of credit conditions informs risk taking, which informs the residual value or net worth, otherwise known as equity.

We are still in the bull cycle when doves fly. Thanks for listening.

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