MORNING BRIEFING
November 29, 2018

Powell Put

See the collection of the individual charts linked below.

(1) Fed getting the message. (2) Powell takes it back: Rates no longer a long way from neutral. (3) Buffett's big buffet of financials. (4) Financials are cheap, and should be overweighted. (5) The debanking of America. (6) Biggest mortgage lender isn't a bank. (7) Nonbank middle-market lenders are proliferating. (8) The Fed's financial stability report isn't raising a red flag about CLOs yet. (9) Deep pockets. (10) Car wreck, housing slump. (11) Faster 3D printing.

Fed: In Powell We Trust. We nailed it in the 11/19 *Morning Briefing*, titled "On Your Mark, Get Set, Pause." We wrote: "President Donald Trump and Larry Kudlow, his economic adviser, have been calling for Fed officials to pause their interest-rate hiking. So has CNBC's Jim Cramer. And so have I. Fed Chairman Jerome Powell and his colleagues may be starting to get the message and act accordingly."

Yesterday, in his speech at The Economics Club of New York, Powell confirmed our assessment when he said, "Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy—that is, neither speeding up nor slowing down growth."

Stock investors jumped for joy on Wednesday, as we predicted they would on Tuesday. What about last month's stock market rout? It was triggered on October 3, when Powell said the following in an interview: "Interest rates are still accommodative, but we're gradually moving to a place where they will be neutral. We may go past neutral, but we're a long way from neutral at this point, probably." Now they are "just below" neutral. In other words, the October 3 comment was a gaff, and Powell took it back yesterday. We applaud his flexibility.

The Fed's critics will say that now we have a fourth Fed chair in a row providing the stock market with a put, i.e., the Powell Put. Maybe so. However, if Janet Yellen was the "Fairy Godmother of the Bull Market," as we often fondly called her, then Powell for now is the bull market's Santa. The Santa Claus rally that started on Monday should drive the S&P 500 back to retest its 9/20 record high around 2900 by the end of this year.

Financials I: Following Buffett. Berkshire Hathaway recently revealed that during Q3 it purchased 35 million shares in JP Morgan and smaller stakes in PNC and Travelers. The holding company, led by Warren Buffett, has been steadily adding to its holdings of financials and now counts American Express, Bank of America, JP Morgan, Wells Fargo, US Bancorp, and Goldman Sachs among its top 10 positions, according to an 11/14 CNBC article.

Despite Buffett's blessing and much to our chagrin, financials have not fared well this year. Here's how the ytd performance (through Tuesday's close) of the S&P 500 Financials sector stacks up against its peers: Health Care (10.4%), Consumer Discretionary (5.0), Tech (3.9), Utilities (3.7), Real Estate (0.5), S&P 500 (0.3), Consumer Staples (-3.7), Financials (-5.2), Industrials (-7.9), Energy (-10.7), Materials (-12.2), and Communication Services (-12.3) (*Fig. 1*).

Financials sold off, as the Federal Reserve has raised the federal funds rate three times in 2018 and the yield curve unexpectedly flattened (*Fig. 2*). If the economy does roll over in the upcoming quarters, banks and brokers may have to boost their loan loss reserves, which would hurt earnings (*Fig. 3*). Though that has yet to occur, recent news out of the housing industry and the threat of more tariffs have everyone on the lookout. And then there's always issuer-specific news (like the 1MBD scandal that cost Goldman Sachs shares nearly a quarter of their value ytd).

Two S&P 500 Financials industries' stock price indexes have outperformed this year: Financial Exchanges & Data (13.7%) and Insurance Brokers (11.7). But that's not where Buffett is buying. The S&P 500 Diversified Banks stock price index has dropped -5.7% ytd, and the S&P 500 Investment Banking and Brokerage stock price index has tumbled 16.7% (*Fig. 4* and *Fig. 5*). Let's see what analysts expect for these industries:

(1) The S&P 500 Diversified Banks industry is expected to increase revenue 3.2% this year and 3.3% in 2019 (*Fig. 6*). Earnings are forecast to slow from this year's torrid 26.8% pace to a still-respectable 11.9% (*Fig. 7*). Analysts' net earnings estimate revisions have actually been positive for the Diversified Banks industry in recent months, with NERI (our Net Earnings Revision Index) readings of 3.1 in November, 6.1 in October, and 8.3 in September (*Fig. 8*). And the industry's forward P/E has retreated to a more reasonable 10.1 from 13.1 earlier this year (*Fig. 9*).

(2) The S&P 500 Investment Banking & Brokerage industry's revenue growth is forecast to decelerate sharply, from 12.7% in 2018 to 3.6% in 2019 (*Fig. 10*). Analysts see a screeching slowdown for earnings growth too, from 35.3% this year to only 5.7% in 2019 (*Fig. 11*). This industry has enjoyed positive net earnings estimate revisions over the past three months, with NERI readings of 15.9 in November, 15.2 in October, and 11.2 in September (*Fig. 12*). And its forward P/E has slid to 9.5 from a high of 14.3 in January.

The S&P 500 Financials sector is a one of the few sectors where the share of its earnings contribution to the S&P 500 (18.6%) far exceeds its market-capitalization share (13.9) (*Fig. 13*). The gap has been both wider and narrower in the past. In our opinion, Financials stocks are cheap. In Buffett's opinion, they should be overweighted.

Financials II: Lurking in the Shadows. Massive disruption is occurring throughout the Financials sector, as new entrants capitalize on technology and the impact of changing regulations. In the past, we've noted that an online player, Quicken Loans, made more home mortgage loans last year than Wells Fargo or Bank of America. Likewise, Apple and PayPal are elbowing their way into the payments business, while robo advisors are offering retail investors inexpensive financial advice.

The "Debanking of America" is also occurring in middle-market lending. Nonbank private firms are now among the largest lenders to middle-market companies. The market was primed for change when in the 1990s banks began merging. The number of FDIC-insured institutions has shrunk more than 45% since the late 1990s, according to an April 2018 report by Ares Management. The industry also changed after capital regulations grew stricter in the wake of the recession, making holding onto certain loans and securities less profitable.

Opportunistic institutional investors filled the void, raising capital in numerous ways to lend to middle-market companies. Ares estimates that $354 billion of middle-market loans were made last year and that the size of the outstanding loan market is $909 billion. Nonbanks have grown their share of leveraged loan holdings from 29% in 1994 to 55% in 2000, 82% in 2006, and 91% in 2017, Ares' report states. Their market-share gains were helped by the low interest-rate environment and investors willing to look at unconventional investments in their search for yield.

The Federal Reserve's *Financial Stability Report* released yesterday noted that institutional leveraged loans have had 15.1% average annual growth from 1997 through Q2 2018, more than twice as fast as other loan areas. And while these loans have performed well so far, the Fed noted that more of the new loans hitting the market are issued by more highly leveraged companies.

I asked Jackie to continue our look into the world of middle-market shadow banking:

(1) *Naming names*. One of the largest of the nonbank lenders is Antares Capital, a private debt credit manager and leading provider of financing solutions for middle-market, private equity-backed transactions. Last year, the firm issued more than $21 billion of loan products and equity investments.

Antares was the most active Q3 lender to middle-market, private equity deals, ahead of Madison Capital Funding, Twin Brook Capital Partners, NXT Capital, and Golub Capital, according to a Q3 report on the US PE Middle Market by PitchBook. Note that not one traditional bank is among the top five lenders. Citizens Bank and ING Group both rank 16th, while Goldman Sachs, Credit Suisse, and Deutsche Bank all rank 20th, with four deals each.

Many of the lenders have relationships with insurance companies or other firms with deep pockets. Antares was acquired by GE Capital in 2005 and sold to the Canada Pension Plan Investment Board in 2015. Opened in 2001, Madison Capital is a subsidiary of New York Life Insurance. Twin Brook Capital Partners is a subsidiary of Angelo, Gordon & Co., a privately held alternative investment firm with $32 billion under management. NXT Capital is owned by a unit of ORIX Corp., a Japanese financial services company.

(2) *Where's the funding?* Nonbank middle-market lenders can tap the deep pockets of their owners. But they also raise private funds from institutional investors, and many of them manage collateralized loan obligations (CLOs). Of the 10 recently priced CLOs listed on creditflux.com, the managers were largely these private lending firms. Among the deals sold last month was a $1 billion CLO that Antares Capital will manage, a $510 million CLO managed by Ares Management, and a $638 million CLO managed by Oak Hill Advisors.

A September 2018 report from Maples and Calder, a law firm specializing in CLOs, says that as of 9/4, $92.5 billion was raised in 169 new CLO deals, up from $73.3 billion in 132 deals during the same period last year. The Fed's *Financial Stability Report* notes that CLOs now purchase about 60% of leveraged loans at origination. The report concludes: "It is important to continue to monitor developments in this sector."

(3) *What does this mean for banks?* Hopefully, the dispersion of loan activity outside of the traditional banking channel should mean that traditional banks will be better positioned to withstand the inevitable economic downturn. Large banks have become more like agents, distributing large, liquid bank loans to the country's largest investors.

However, banks do still own an awful lot of loans, and some have large holdings of CLOs, perhaps because they structure and sell CLOs. Wells Fargo had $36.7 billion of collateralized loan and other debt obligations, according to its 2017 annual report. They equated to 8.8% of Wells Fargo's investment securities portfolio. JP Morgan had $20.9 billion of CLOs, representing 5.5% of its total trading assets, down from $27.4 billion in 2016, according to its annual report.

(4) *Back in the pond?* As regulations around CLOs and CDOs (collateralized debt obligations) loosen up, large banks and brokers likely will try to become managers of these securities pools once again. In February, the US Court of Appeals for the District of Columbia Circuit ruled that firms managing CLOs do not have to retain 5% of the deals' credit risk anymore. The ruling overturned a risk-retention rule dating back to the Dodd-Frank Act.

Regulators are also looking at the part of the Volcker Rule that prevents banks from owning CLOs that include anything other than loans. "The LSTA is urging regulators to ease that rule by allowing banks to own CLOs that mostly hold loans but can invest up to 10% in junk bonds—a move that could give an extra jolt to the already red-hot CLO market," an 11/7 *WSJ* article noted.

Meanwhile, the FDIC has proposed that "banks with less than $10 billion in assets could be subject to a single leverage ratio for their capital holdings, replacing a more complex set of requirements that applies to larger banks," an 11/20 *WSJ* article reported. To qualify for the looser regulation, the small bank must have 9% of equity to total assets. Looser rules and regulations may help banks and brokers return to the middle-market lending business, but it's awfully hard to put the chicken back in the coop once it has flown out.

Consumer Durables: Car Wreck, Housing Slump. It makes sense on paper: Sales of crossover vehicles and light trucks are rising, while sales of cars are declining, so GM decided to cut production in plants that produce cars. It's a trend that began in 2000 for the entire auto industry and has accelerated over the past four years. Sales of light trucks continued to climb from 7.4mu (saar) in August 2014 to 9.5mu in October, but sales of cars dropped from 6.1mu to 4.2mu over the same period (*Fig. 14*).

That pencil-and-paper analysis, however, fails to factor in politics. President Trump recently tweeted his displeasure with GM CEO Mary Barra, who once sat on his Strategic & Policy Forum. He reminded the world that the US government "saved" GM and warned that his administration is considering ending subsidies for electric cars. Lost in the Twitter storm was GM's plan to add a third vehicle—a Cadillac crossover—to production at its Spring Hill plant in Tennessee, per an 11/26 article in *The Tennessean*.

Importantly, the move from cars to light trucks hasn't hurt overall auto sales, which have been plateauing at a high level. The 12-month moving average for US motor vehicle sales was 17.2 million (saar) in October, little changed over past three years (*Fig. 15*).

Those decrying economic drag should point fingers not at the auto industry but at housing. Auto sales have recovered to their pre-recession sales volume levels, but housing completions have never fully recovered from their sharp downturn (*Fig. 16*). New home sales fell 8.9% m/m to 544,000 (saar) in October, and unsold homes has jumped to a 7.4 months' supply. Hopefully, the recent decline in the 10-year Treasury yield will help lift housing out of its slump (*Fig. 17*).

Tech: 3D Printing but Faster. Carbon—the company, not the material—is turning 3D printing on its head, literally. 3D printing usually involves adding layer after layer of a material until a product is produced from the bottom up. The ability to produce something on site, on demand is game-changing, but its mass adoption is limited by the length of time it takes to make an object.

Inspired by the "Terminator 2" movie scene where a terminator emerges from a puddle of liquid metal, Carbon turned 3D printing upside down. Its machine uses light and oxygen and pulls a product out of a pool of resin. CEO Joseph DeSimone said in his 2015 TedTalk that the process is 25-100 times faster than traditional 3D printing. For those looking to take a deep dive into the subject, try this 5/16/16 video.

The company has helped Adidas produce sneaker soles, a dental lab produce models and castings, and a manufacturer make cell phone cases. Who says life doesn't imitate art?

CALENDARS

US. Thurs: Personal Income & Consumption 0.4%/0.4%, Headline & Core PCED 2.1%/1.9% y/y, Jobless Claims 220k, Pending Home Sales 0.0%, EIA Natural Gas Report, FOMC Minutes, Mester, Evans. **Fri:** Chicago PMI 58.0, Baker-Hughes Rig Count, Williams. (Econoday estimates)

Global. Thurs: Germany Unemployment Change & Unemployment Rate -10k/5.1%, Germany CPI 0.2%m/m/2.4%y/y, France GDP 0.4%q/q/1.5%y/y, Japan Industrial Production 1.2%m/m/2.5%y/y, Japan Jobless Rate 2.3%, Japan CPI Headline, Core, and Core-Core 1.1%/1.0%/0.6% y/y. **Fri:** Eurozone Headline & Core CPI Flash Estimates 2.0%/1.1% y/y, Eurozone Unemployment Rate 8.0%, Germany Retail Sales 0.4%m/m/1.4%y/y, Italy GDP 0.0%q/q/0.8%y/y, UK Gfk Consumer Confidence -11, Canada GDP 2.0%q/q(saar)/2.3%y/y, Japan Consumer Confidence 43.2, Japan Housing Starts 941k, China M-PMI & NM-PMI 50.2/53.8. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus-per-share forecasts for forward revenues and earnings dropped w/w. Forward revenues is down less than 0.1% from its record high a week earlier, and forward earnings is down 0.6% from its record in early November. As more weight is placed on the lower 2019 y/y growth expectations for revenues and earnings, their forward growth rates will continue to fall. Analysts expect forward revenues growth of 5.7% and forward earnings growth of 9.5%, compared to 5.8% and 9.8% a week ago. Forward revenues growth is down from an 80-month high of 6.3% at the end of February. Forward earnings growth is down to the lowest level since August 2016 from 16.9% in February. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenue growth was 5.5% and forward earnings growth was 11.1%. Turning to the annual revenue growth expectations, the 2018 forecast was steady w/w at 8.8%, and 2019 dropped to 5.5% from 5.6%. Looking at annual earnings growth, the 2018 forecast rose 0.1ppt w/w to 24.0% and dropped 0.3ppt to 8.5% for 2019. The forward profit margin remained steady at 12.3%, but that's down 0.1ppt w/w from a record high of 12.4% in mid-September. Still, that's up from 11.1% prior to the passage of the TCJA in December and compares to a 24-month low of 10.4% in March 2016. The S&P 500 ex-Financials forward revenue growth forecast rose 0.1ppt w/w to 6.0%, but forward earnings growth fell 0.5ppt to 9.7%. The S&P 500 ex-Financials forward profit margin dropped 0.1ppt w/w to 11.3% and is down from a record high of 11.5% in mid-September, but that's still up from 10.4% before the TCJA. Valuations fell for a second week to multi-year lows. The S&P 500's forward P/E was down to 15.3 from 15.6, which compares to a 16-year high of 18.6 at the market's prior peak in late January and is the lowest since February 2016. The S&P 500 price-to-sales ratio fell to 1.88 from 1.92, which compares to late January's record high of 2.16 and is the lowest since February 2017.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenues and earnings forecasts rose w/w for four of the 11 of the S&P 500 sectors: Communication Services, Materials, Tech, and Utilities. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward margins are at record highs for 8/11 sectors, all but Energy, Health Care, and Real Estate. Energy's forward revenues and earnings are back on uptrends after stalling during 2016-2017, and its earnings has about tripled from the 18-year low in April 2016. Forward P/S and P/E ratios are now well below their 2018 highs for all sectors. Energy's valuations remain elevated relative to historical levels, but are slowly returning to normal now after soaring in 2016 when revenues and earnings collapsed. Energy's P/S ratio of 1.04 compares to a record high of 1.56 in May 2016, and its P/E of 13.6 is down from a record high of 57.5 then. Due to the

TCJA, higher margins are expected y/y in 2018 for all sectors but Real Estate, but that sector's forward earnings includes gains from property sales and typically improves as the year progresses. Higher y/y margins are expected in 2019 for nine of the 11 sectors, all but Communication Services and Real Estate. During the latest week, the forward profit margin edged lower for Tech and rose for Real Estate. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.8%), Financials (19.1), Real Estate (15.5), Communication Services (14.8), Utilities (12.7), S&P 500 (12.3), Materials (10.9), Health Care (10.6), Industrials (10.2), Energy (7.7), Consumer Staples (7.5), and Consumer Discretionary (7.5).

US ECONOMIC INDICATORS

GDP (*link*): Real GDP expanded at an unrevised 3.5% (saar) last quarter, slowing from Q2's 4.2%—which was the fastest growth since Q3-2014. While there was no change to the top line, there was movement within the components. Real consumer spending (to 3.6% from 4.0%, saar) was still the biggest positive contributor to Q3 real GDP growth, though was a couple of ticks below Q2's 3.8%—rather than the fastest growth in nearly four years, as the initial estimate depicted. Durable goods consumption (3.9 from 6.9) accounted for virtually all of the revision to real consumer spending; nondurable goods (5.3 from 5.2) and services (3.1 from 3.2) consumption basically matched their initial growth rates. Meanwhile, real nonresidential fixed investment (2.5 from 0.8) was stronger than first reported, driven by upward revisions to structures (-1.7 from -7.9), which was less negative than first reported, and equipment (3.5 from 0.4), which was more positive. Spending on intellectual property products (4.3 from 7.9) grew at roughly half the pace of the initial estimate. Real inventory investment rebounded to $86.6 billion (saar) rather than $76.3 billion as first reported—a big swing from Q2's contraction of -$36.8 billion. The real net exports deficit widened (-$945.8 billion from -$939.0 billion) more than first reported—recording its biggest gap in the history of the data going back to 1947—as the decline in real exports (-4.4 from -3.5) was steeper than the initial estimate, while real imports (9.2 from 9.1) growth was little changed. Real residential (-2.6 from -4.0) investment declined at a slower pace than first reported, though was still double the -1.3% decline posted during Q2. Growth in real government spending (2.6 from 3.3) was still the fastest since Q1-2016—though was slower than first reported. Within government spending, state & local government (2.0 from 3.2) spending was weaker than first reported, while growth in federal government (3.5 from 3.3) was just slightly faster than the initial estimate.

Contributions to GDP Growth (*link*): Real consumer spending once again was the number-one contributor to real GDP growth last quarter, while trade was the major drag after being a major positive contributor during Q2. (1) Real consumer spending accounted for 2.45ppts of real GDP growth last quarter, with services (1.45ppt) consumption the biggest contributor; goods consumption added 1.00ppt—led by nondurable (0.73) goods; durable (0.28) goods' contribution was less impressive. (2) Inventory investment (2.27) was another big contributor to growth last quarter, after subtracting -1.17ppt during Q2, entirely nonfarm (2.29) related. (3) Real government spending added 0.44ppt to growth last quarter, with both federal (0.23) and state & local (0.22) government spending contributing. (4) Nonresidential fixed (0.35) investment's contribution was triple the initial estimate, with equipment's (0.21) contribution bigger than first reported and intellectual property product's (0.19) smaller; structures' (-0.05) contribution was much less negative. (5) Residential investment (-0.10) was a slight negative contributor during Q3; it has contributed positively only once in the past six quarters. (6) Trade (-1.91) was a major drag on economic growth, as both real imports (-1.36) and real exports (-0.55) subtracted from growth.

Regional M-PMIs (*link*): Five Fed districts have now reported on manufacturing activity for November—Philadelphia, New York, Kansas City, Dallas, and Richmond—and they indicate factories continued to grow at a solid, though slower rate. We average the composite, orders, and employment measures as data become available. The composite index slipped to 16.6 this month, down from June's record high of 26.1. Composite indexes for the New York (to 23.3 from 21.1) and Kansas City (15.0 from 8.0) regions accelerated this month, while Dallas' (17.6 from 29.4) and Philadelphia's (12.9 from 22.2) decelerated; Richmond's (14.0 from 15.0) was little changed from October's pace. The new orders gauge slowed to 15.2, though remained at an elevated level; it was at a record high of 27.7 in May. Orders growth in the Kansas City (20.0 from 7.0) region nearly tripled, while indexes for both Philly (9.1 from 19.3) and Dallas (9.7 from 18.9) were virtually halved. Meanwhile, New York's (20.4 from 22.5) wasn't far from October's robust pace. Richmond's (17.0 from 20.0) gauge eased for the second month from September's peak of 34.0. The employment measure (12.7 from 15.9) reveals job gains slowed again this month, and were roughly half June's pace of 24.1. Manufacturers in the both the Philly (16.3 from 19.5) and Dallas (15.9 from 23.9) regions hired at a slower pace than last month, though still faster than those in the New York (14.1 from 9.0) region, which actually showed a pickup in job growth this month. Richmond's (11.0 from 19.0) factories hired at their slowest pace since the start of the year, while Kansas City's (6.0 from 8.0) manufacturers hired at a much slower pace than those in the other four regions. Meanwhile, inflationary pressures have eased, according to the prices-paid and -received indexes, in all five of the regions. Four of the regions measure their indexes as the difference between those reporting higher prices and those reporting lower prices—here's a look at the prices-paid indexes for November versus their respective peaks this year: Philadelphia (to 39.3% from 62.9%), Kansas City (41.0 from 55.0), New York (44.5 from 54.0), and Dallas (33.7 from 54.4). Here's the same drill for the prices-received indexes: Philadelphia (21.9 from 36.4), New York (13.1 from 23.3), Dallas (7.5 from 17.5), and Kansas City (23 from 29)—with the latter holding near its high. Richmond's region expresses its price indexes as annualized percent changes: Both the prices-paid (4.7% from 5.7%) and prices-received (2.1 from 2.8) measures eased from their October peaks.

New Home Sales (*link*): New home sales—tabulated when contracts are signed—fell in October for the fourth time in five months, to its lowest level since March 2016. Sales tumbled -8.9% in October, and -16.7% over the five-month period, to 544,000 units (saar), as unsold homes on the market (336,000 units) climbed to the highest level since January 2009. The months' supply jumped to 7.4 months, the most since February 2011. Regionally, sales over the five-month period dropped in the Northeast, Midwest, and South by -33.3%, -27.7%, and -19.3%, respectively, while sales in the West were unchanged—though still down -31.0% from last November's peak rate. Meanwhile, the National Association of Home Builders/Wells Fargo Housing Market Index (HMI) for November tumbled 8 points to 60—the lowest reading since August 2016. All three index components fell sharply this month: current sales conditions (to 67 from 74), expected sales (65 from 75), and buyer traffic (45 from 53).

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