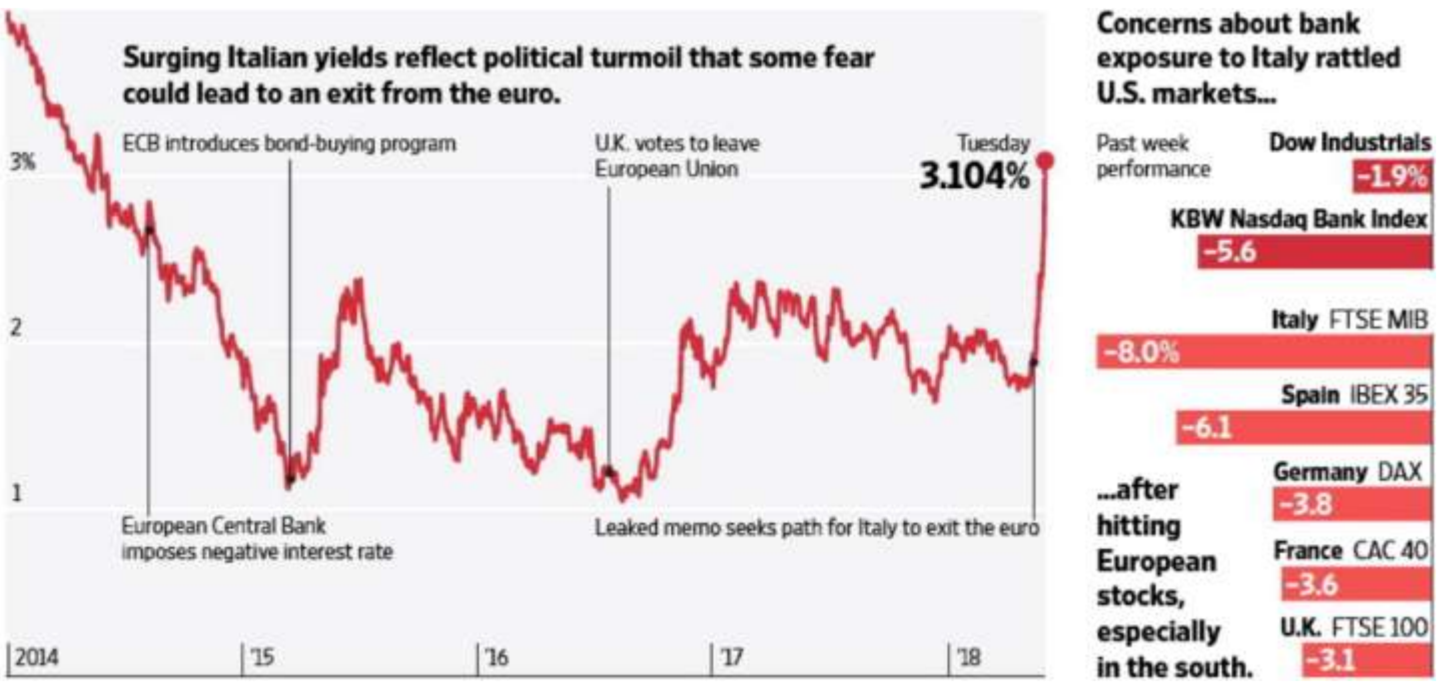
May 2018

While the Russell 2000 (Small Cap stocks) made an all time high last week, it's the S&P 500 index that is determinative, and so 2018's Correction continues. The latest down draft resulted in the WSJ's lead story on Wednesday:

Italian Tumult Spurs Global Selloff



Dow loses nearly 400 points and Treasury yields fall sharply as investors cut risk

By Jon Sindreu and Mike Bird

Political upheaval in Italy drove a global retreat from risky assets on Tuesday, sending U.S. stocks tumbling and Treasury yields to their largest daily decline in almost two years.

Six years after the eurozone stepped back from the brink of a breakdown, a violent selloff in Southern European debt bled into broader financial markets, pushing investors toward the safety of the dollar and the Japanese yen, which rallied sharply.

Bank stocks led the market's charge lower, reflecting fears that turmoil in Italian markets could spread throughout the eurozone, infecting the bloc's banks and causing systemic issues in global markets.

The turbulence follows Italian President Sergio Mattarella's decision Sunday to block the formation of a euroskeptic government, which revived longstanding worries about the broader stability of the eurozone. The move suggested a fresh round of elections that could strengthen the hand of antieuro forces, some of which seek to untangle Europe's increasingly vulnerable union. ...

The Dow industrials dropped 1.6%, falling back into the red for the year. The S&P 500 declined 1.2% and the Stoxx Europe 600 closed 1.4% lower.

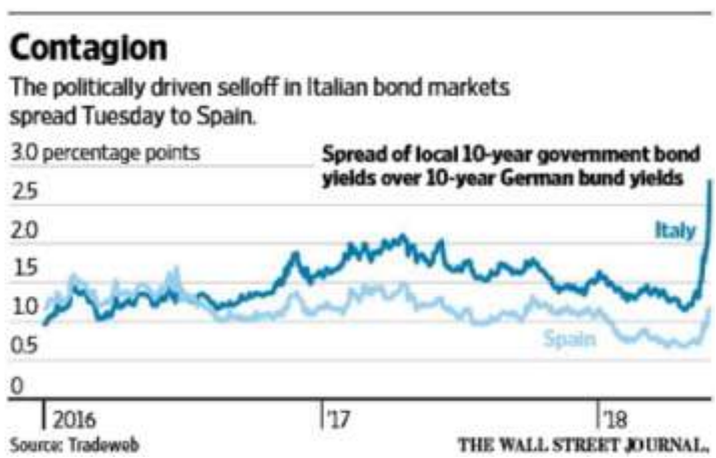
Financials were the hardest- hit sector in the S&P 500, sliding 3.4%, as bank shares tumbled. JPMorgan Chase & Co., the biggest American bank by assets, fell 4.3%, while Morgan Stanley , the smallest of the big banks, lost 5.8%.

The decline in longer-term U.S. bond yields also weighed on bank stocks, reflecting fears that a smaller difference between short- and long-term rates will dent profits. Yields on 10-year Treasurys fell to 2.772% Tuesday ... the largest one-day yield decline since June 2016.

The euro, meanwhile, dropped to its lowest level against the dollar since July 2017, falling 0.7% to $1.1541 .... The WSJ Dollar Index rose 0.3% to 87.56, its highest closing value since November 2017.

Indicating the worry about Italy's future, the government's borrowing costs skyrocketed Tuesday. An auction of six-month Italian debt, which sold for a negative yield as recently as April, drew a yield of 1.213%, with lackluster demand from investors. The country's two-year bond, which offered a negative yield as recently as two weeks ago, exploded Tuesday to as high as 2.69%.

Italy's woes rippled across the eurozone, driven by investor worries that an exit by the bloc's third-largest economy could force others out—as gauged by the spread between the 10-year government bond yields of each country and Germany's. For Spain, these spreads widened to their biggest levels in a year, and for Portugal to the widest since September. ...



The spread between different eurozone government bonds is seen by some as a key gauge of how likely the bloc is to survive, rather than of economic performance. Even after two Italian antiestablishment parties reached an agreement for a new government earlier this month, Italian debt was mostly unruffled.

It was the news that the proposed government might seek to break eurozone rules—and had even drafted plans to exit from the euro—that brought back echoes of the 2011-2012 sovereign-debt crisis, which European Central Bank President Mario Draghi is credited with ending with the promise to do "whatever it takes to preserve the euro." ...

The banking sector is seen as especially vulnerable to write-offs in its large holdings of government debt, as well as people taking their money out of Europe.

Shares in Italy's UniCredit SpA and BPER Banca SpA ended the day down by over 5%.

From Bloomberg:

The Bad Days Have Been Really Bad in 2018's Stock Market

By *Lu Wang* and *Elena Popina*

May 29, 2018

- Volatility jumps the most since February as S&P sinks on Italy
- Average down day is 24% bigger than the average up day in 2018

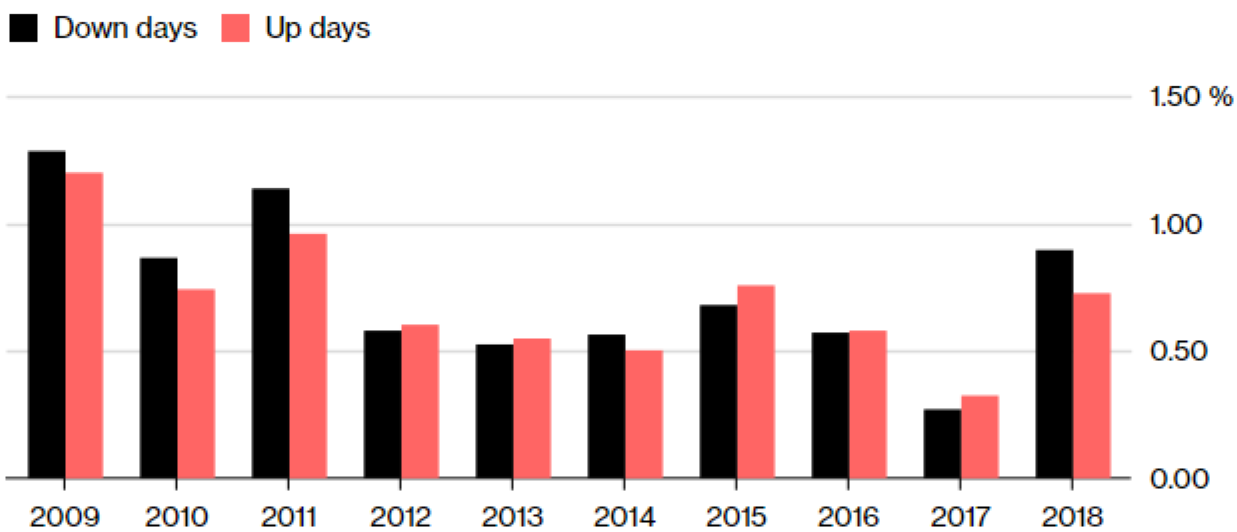
None of the narratives floating around the market make any sense. Bond yields are too high, and too low. Politics don't matter, then they do. There's excessive inflation, or not enough.

But one message the market keeps sending: don't get comfortable, because around the corner is pain. Stock traders have been chained to their screens in a year when the average down day is 24 percent bigger than the average up one, the biggest gap since 1948.

It played out again Tuesday as investors were treated to a session of price swings that would have ranked with the worst of the preceding two years -- but in 2018 doesn't crack the top 20. Phrased differently: the biggest decline in the S&P 500 last year, a 1.8 percent drop on May 17, would rank as the eighth largest since January. And it's only May.

Bigger Losses

The S&P 500's daily move on down days outpacing that on up days by most since 1948



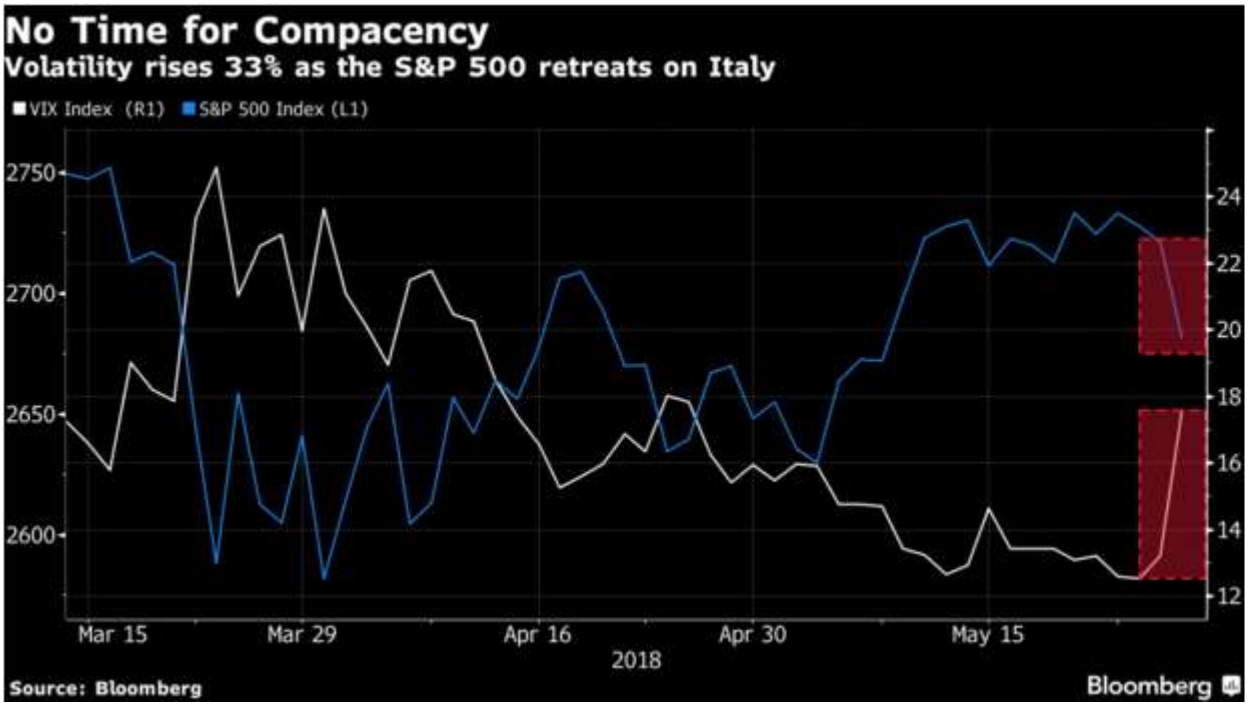
Source: Bloomberg

Only one thing has been constant in 2018, that every few weeks equities get hammered. U.S. companies are in the midst of one of the biggest earnings expansions ever, everything from buybacks to capital spending is surging and forward valuations are cheap. But it's proving little barrier to intermittent wipe-outs.

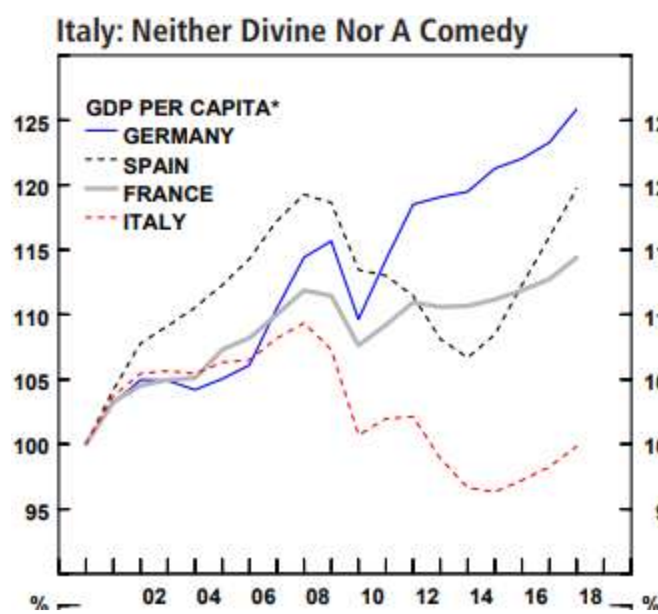
It often seems as if good news is right on the verge of drowning out the bad. Like last week. Moods in the market brightened. The VIX eased. Data from Investors Intelligence showed newsletter writers classified as bulls reached the highest in almost two months. Statistics from Ned Davis Research Inc. reflected a similar trend. Everyone's favorite stocks, the Faang block, vaulted to records just last week.

Then political uncertainty in Italy flared up, sending ripples across Europe. And the S&P 500, which had swung an average of 0.3 percent the previous 10 sessions, fell four times that on Tuesday. The Cboe Volatility Index spiked 29 percent, the most since March, to 17.02.

Ten-year yields dropped by the most since at least November 2016 to 2.78 percent. Half a month ago, when yields were at 3.1 percent, such a decline would probably have sparked an equity rally. Not Tuesday.



Italy is a political, and, as a result, economic basket case, as can be seen in BCA's chart to the right. Despite having experienced their own Trump (9 years & 54 days of Berlusconi), Populism is again ascendant. From Friday's Signal: "The populist Five Star Movement and Lega will now form a government after all. ... Polls indicate that 57 percent of Italians favor both a universal basic income and big tax cuts, promises offered by these two parties. More government spending and less government revenue is a questionable idea for a country with the highest debt-to-GDP ratio of any EU country not named Greece."



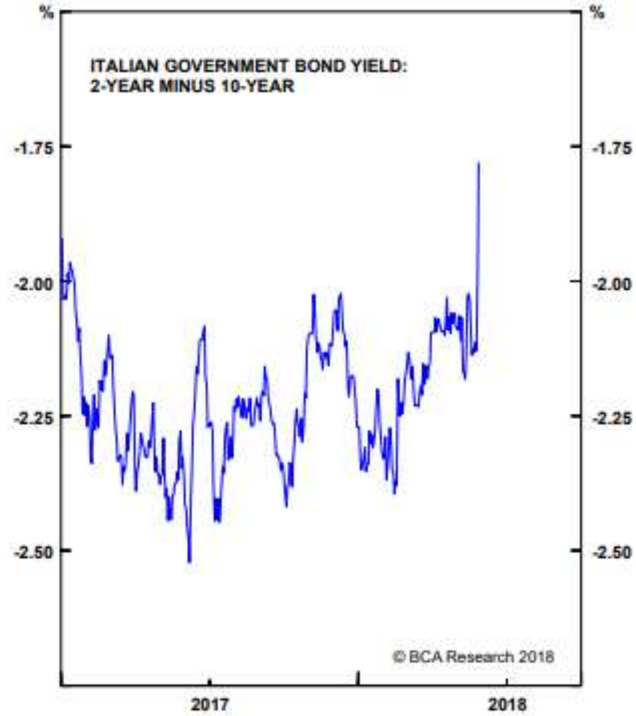
So is Italy about to reprise Greece's starring role in the last Eurozone crises? From BCA Research's Geopolitical Strategy's May 30th Client Note:

Is Italy Going To Leave The Euro Area?

The Italian bond market is beginning to price severe geopolitical stress. The 10-year BTP spread versus German bunds has grown 98 basis points since the election (Chart 1), while the 2/10 BTP yield curve has nearly inverted (Chart 2). The latter suggests that investors are beginning to price in default risk, or rather Euro Area exit risk, over the next two years.

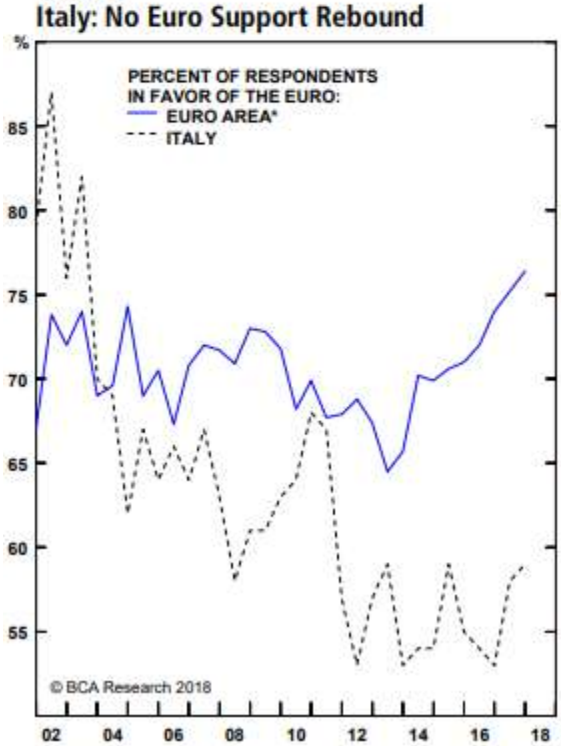
CHART 1
Probability Of *Itexit* Has Risen…

CHART 2
…But Two-Year Horizon Is Overstated



We have long contended that Italy is the premier developed market political risk. Its level of Euroskepticism is empirically higher than that of the rest of Euro Area (Chart 3) and we have expected that Italy would eventually produce a global risk off. It is just not clear to us that this is the moment.

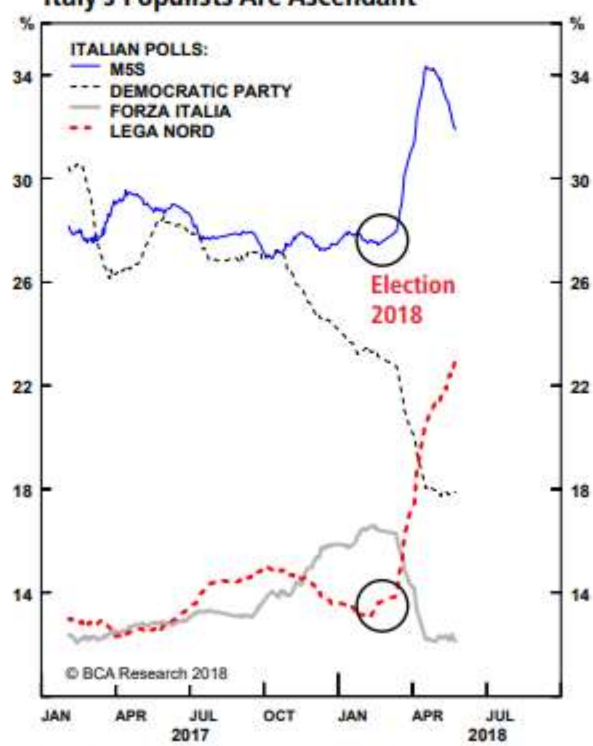
CHART 3
Italy: No Euro Support Rebound



* EQUALLY-WEIGHTED AVERAGE OF GREECE, GERMANY, SPAIN, FRANCE, PORTUGAL, BELGIUM, THE NETHERLANDS, AUSTRIA, FINLAND, AND IRELAND.
SOURCE: EUROBAROMETER.

First,

CHART 4
Italy's Populists Are Ascendant

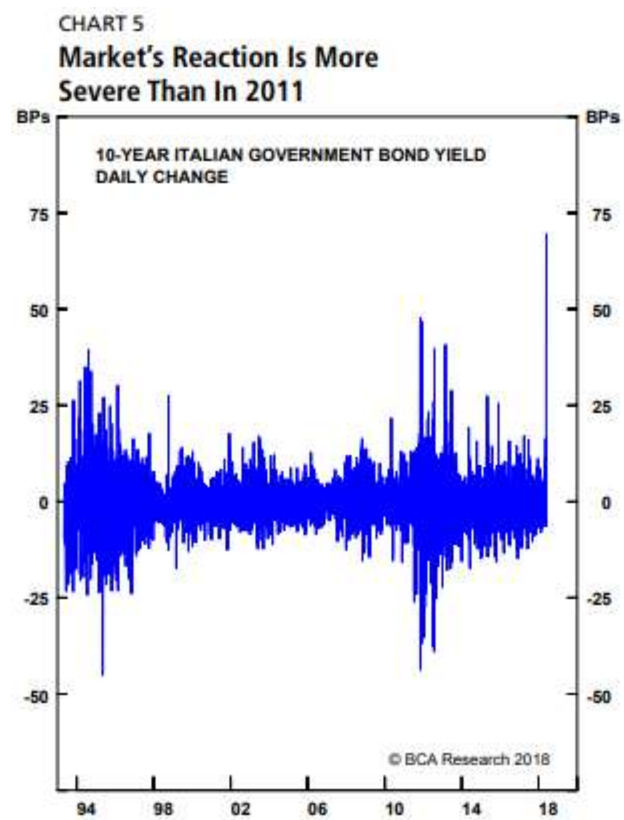


SOURCE: VARIOUS POLLING AGENCIES.

support for the Euro Area remains in the high 50% range and has largely bounced between 55-60% for several years. This is low relative to its Euro Area peers, prompting us to raise the alarm on Italy. But it is also still a majority, showing that Italians are not sold on leaving the Euro Area.

Second, the anti-establishment Five Star Movement (M5S) has adjusted its policy towards the euro membership question in view of this polling. In other words, M5S is aware that the median Italian voter is not convinced that exiting the Euro Area is the right thing to do. We would argue that the anti-establishment parties performed well in this year's election precisely because of this strategic decision to abandon their Euroskeptic rhetoric on the currency union.
Nonetheless, the deal that M5S signed to form a coalition with the far more Euroskeptic Lega was an aggressive deal that signals that Rome is preparing for a fight against Brussels, the ECB, and core Europe. The proposed tax cuts, unwinding of retirement reforms, and increases in social welfare spending would raise Italy's budget deficit from current 2.3% of GDP to above 7%. Given rules against such profligacy, and given Italy's high debt levels, the coalition might as well be proposing a Euro Area exit. **...**

The two populist parties, M5S and the Lega, are gaining in the polls, particularly the latter, which is the more Euroskeptic (Chart 4). This suggests to investors that the more Euroskeptic approach is gaining support.



... it is understandable that investors will fret about Lega's rise in the polls. However, the closer Lega approaches M5S in the polls, the less likely the two parties will be to maintain their current coalition. At some point, it will not be in the interest of M5S to form a coalition with its chief opponent, especially if Lega gains support and therefore demands a greater share of power in the revised coalition deal. A much preferable coalition partner for M5S would be the center-left PD, which will be weaker, and hence more manageable, and would be a better ideological match.

Therefore we believe that the market is getting ahead of itself. Italian policymakers are looking for a fight with Brussels, Berlin, and the ECB over fiscal room and profligacy. This is a fight that will take considerable time to resolve and should add a fiscal premium to the long-dated Italian bonds. In fact, May 29 had the biggest day-to-day selloff since 1993 (Chart 5). However, policymakers are not (yet) looking for exit from the Euro Area. As such, risk premium on the 10-year BTPs does make sense, but the sharp move on the 2-year notes is premature.

Bottom Line: Italian policymakers are not looking to exit the Euro Area. Their fight with Brussels, Berlin, and the ECB will last throughout 2018 and makes it dangerous to try to "catch the falling knife" of the BTPs. However, expecting the yield curve to invert is premature as an Italian Euro Area exit over the next two years is unlikely.

Over the next ten years, however, we would expect Italy to test the markets with a Euro Area exit attempt. We are sticking to our view that such an event is far more likely to occur following a recession than it is today.

On the same day this week that the markets were tanking we received the latest Dividend.com from one of our DIYers. Before examining this latest attempt at crystal ball gazing, we should note how their last two prognostications have fared. On 4/22 we shared our analysis of his "Momo Is a No-Go", in which he conflated the Momentum Factor with Growth Stocks. Since then MTUM has added another 4% to its gains. On 4/7 we shared our analysis of his "Large is Still Beating Small". To quote, with our comments in red: "Given that the trends are still in place for large-caps to keep on beating smaller firms (Not only have large-caps not beaten small-caps "since about 2013" when properly measured, but both history and current "trends" support the Size Factor, especially when combined with the Value or Quality Factors.), the time to keep betting big is now (not if Capital Appreciation matters)." As we noted above, while the S&P 500 (Large Caps) remains mired in a Correction, the Russell 2000 (Small Caps) broke out to an all time high last week. So, here we go again:

The Recession May Be Here Before You Know It

It's hard to see the negatives about something when things are going so well.

That's kind of what is going on these days in the market. We've had years of strong equity returns and one of the longest economic expansions in history. And, by all accounts, everything is still going fine. There's really no need to worry. Or should we?

According to asset manager State Street, an economic downturn may be closer than you think and overweigh the current wave of optimism. (Sentiment was most recently at extreme levels of pessimism.)

For investors, State Street's prediction certainly throws plenty of cold water on the market's rally and the economy as a whole. It also could serve as a big-time warning sign.

Finally, We Have Growth

After several years of sideways economic output, the economy is finally moving in a positive direction. (The economy has been "moving in a positive direction" since June of 2009.) Driven by President Trump's pro-business policies, a variety of economic measures have continued to rise. Consumers are spending money, producers are producing and unemployment is at near-full levels. All in all, GDP growth managed to hit 2.3% in the first quarter of 2018.

And, with that, equity prices have continued to surge. The **iShares Core S&P 500 ETF** (IVV) managed to produce a 23% return last year and is up more than 270% since the recession lows. This rally has been one of the longest on record and recently surpassed nine years' worth of gains. With the economy still hitting its marks, many analysts and investors believe we could still see more gains down the road.

To say that investors are optimistic (they aren't, hence the current correction) would be an understatement. The problem is, maybe we're getting too optimistic in our expectations. And that's just what a new missive by asset manager State Street is saying. With GDP growth still going strong, many of us are overlooking several other warning signs that could end the long equity rally and push the economy into a long overdue recession. (**"Expansions don't die of old age, they are murdered by the Fed". -** Rudy Dornbusch)

State Street Sees Three Big Issues

Talking into context the scenario of a kid in a candy store on a sugar high, State Street recently had a blog post about three dangers to the economy and equity markets that investors aren't paying attention to. These hefty amounts of “sugar” will ultimately lead to a big sugar crash and a resulting headache for the economy and investors. What’s more, like eating candy, the effects are usually pretty quick.

For starters, State Street argues that the tax cuts could be the ultimate dose of sugar for investors. In the short run, the dearth of repatriated cash and lower corporate tax rate have been great. Dividends have surged and earnings have instantly increased. The issue is, that without these boosts, estimates for 2018 EPS growth on the S&P 500 were actually lower than last year. What happens after the initial rush caused by the tax cuts is that things go back to a more normalized pace – which could happen as early as the second-quarter EPS announcement.

Secondly, State Street shows that most fiscal policies like this occur during troubled times: FDR’s New Deal, LBJ’s War on Poverty (LBJ's and Nixon's attempt to have both "guns and butter" during the Vietnam War led to inflation which the Fed eventually killed by driving the economy into recession with interest rates that hit over 20%.), the Bush tax cuts, etc. Often, Congress will do these sort of wide-sweeping programs with the goal of jumpstarting growth in mind. Taking on such a massive policy when times are good leaves little wiggle room when times go bad. (As our dysfunctional politics has repeatedly shown, Congress will "wiggle" away when it's in their presumed interest, regardless of the deficit.) The irony is that when investors realize that the tax cut effects are temporary, we could see a major equity sell-off and trigger a recession. ("Major equity sell-offs" don't "trigger" recessions. October of 1987 is a prime example.)

The next point State Street makes is that the tax cuts have only made another problem much worse – the growing budget deficit. Before the tax cuts and reduction in government revenue, Washington finished 2017 around $666 billion in the red. That was $80 billion higher than 2016 and the biggest short fall since 2013. It was also the sixth biggest deficit on record. The tax cuts remove even more money from the government’s piggy bank. (While we agree with this concern, there hasn't been any money in the "government’s piggy bank" since Clinton.)

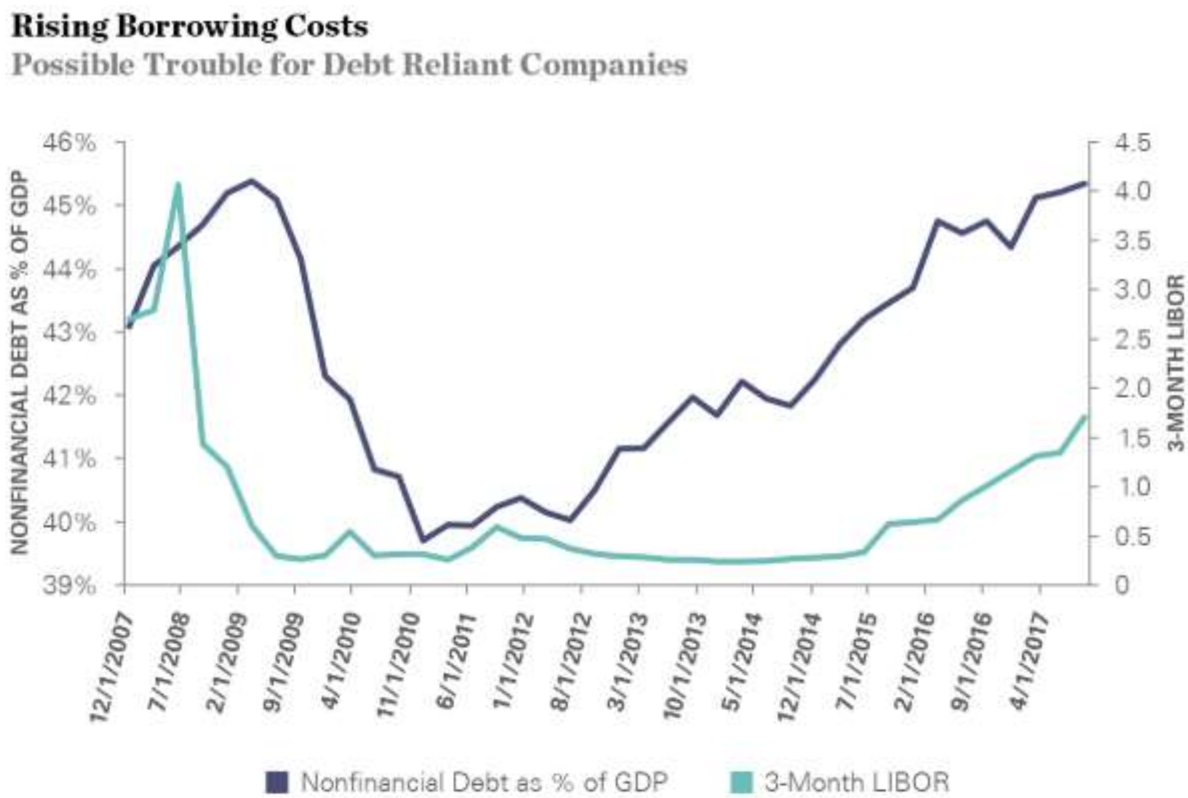
This poses a huge problem in future government spending and makes dollar investments less attractive to the rest of the world. As a result, we’ve already started to see a lessening demand for U.S. assets. Continued budget issues and lower government spending could help bring a recession closer to home. (Government spending is headed higher, not lower.)

Finally, credit is quickly becoming a two-edged sword. The low rates of the last few years have allowed consumers and corporations to binge on cheap debt. Household and corporate debt remains at all-time highs. (Not true for Households relative to their Income, as detailed by BCA Research below.)

However, with the Fed finally ratcheting up interest rates, those high debts are now getting more expensive to hold.

Just take a look at the following chart from State Street’s report. You can clearly see the jump in borrowing costs.

These higher costs will be the biggest determinant to the approaching recession and will clamp down on spending activity. Thereby sending the economy into a recession faster than expected, especially when you add in the other two points of missed expectations and lower government spending (Again, what "lower government spending"? Economist John Cochrane from May 26th: "One thing we know for sure — recessions are unpredictable. If we knew for sure a recession would happen in the near future, then it would already have happened today. If we knew stocks would go down tomorrow, they would have already gone down today. If



companies knew business would be bad next year, they would stop investing and business would be bad today. So take all predictions with that grain of salt — but examine hard the logic behind them.)

Closer Than You Think

So, while there is still reason to be optimistic about the growth of the economy and equity returns, there are some big red flags waving in the not so distant future. According to State Street, these are real concerns that need to be addressed when it comes to portfolio construction as the impending recession could be here before anyone realizes it. (They usually are, as the official NBER designation occurs months later, and is then subject to revision.)

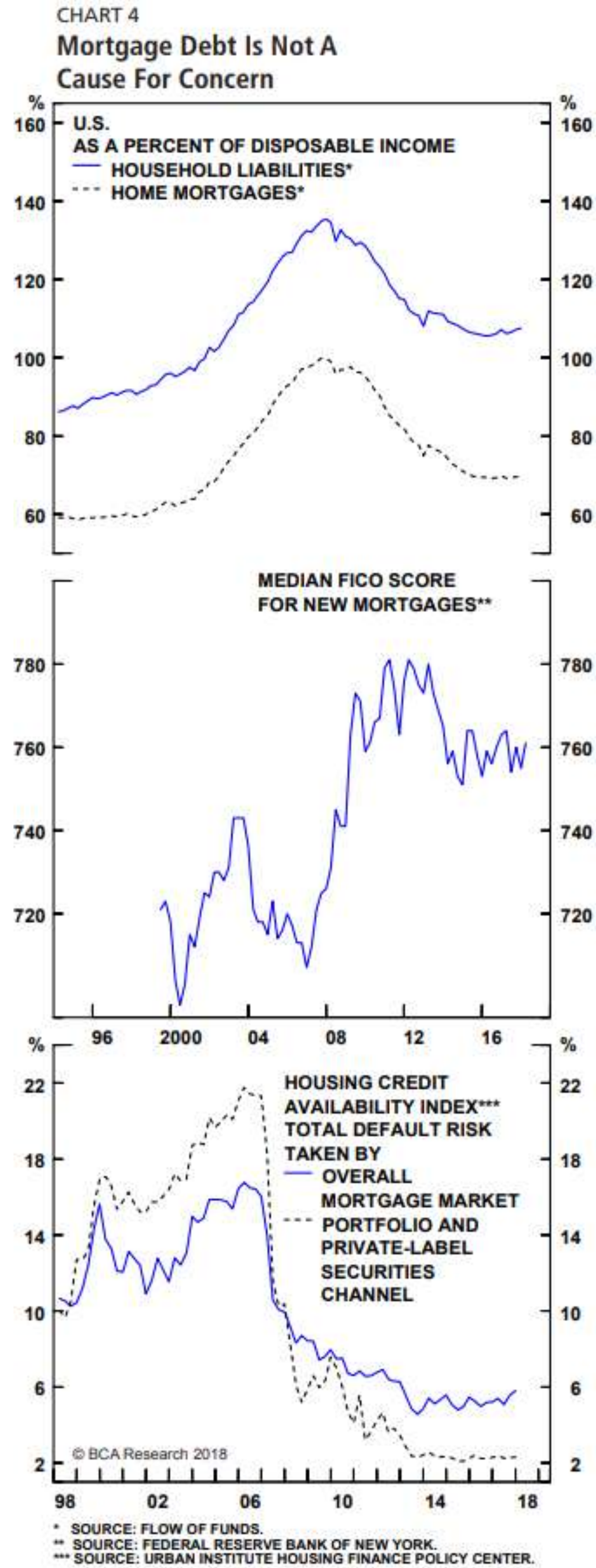
While the asset manager didn't give specific recommendations on what to do, the standard playbook of being diversified, holding short-term bonds and betting on defense stocks like dividend-paying equities makes a ton of sense. The time to back off risk is now. (No, the time to "back off risk" is when we create your Risk Profile. Attempting to time the Market is a fool's errand.)

All in all, the good times will end. (They always do. As economist Herb Stein has noted, **"If something cannot go on forever, it will stop."** However, as we have previously shared, returns tend to be highest toward the end of a Bull Market. John Templeton, **"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."** We haven't been noticing much "euphoria" lately. Perhaps too many Investment Managers are too busy holding their breaths while waiting for the next tweet from on high to hit.) And if State Street is right, they could end sooner than we think. (Peter Lynch, *one of history's all-time top mutual-fund managers:* **"If you spend 12 minutes a year worrying about economics, you've wasted 10 minutes."**)

From BCA Research's Global Investment Strategy's June 1st issue:

Household Debt Is Not Yet At Worrying Levels

Lenders also remain circumspect (**Chart 4**). Mortgage debt has barely grown as a share of disposable income throughout the recovery, and is still 31 percentage points below 2007 levels. The average FICO score for new mortgages stands at a healthy 761, well above pre-recession standards. The Urban Institute Housing Credit Availability Index, which measures the percentage of home purchase loans that are likely to default over the next 90 days, is nowhere close to dangerous levels. This is particularly the case for private-label mortgages, whose default risk has hovered at just over 2% during the past few years, down from a peak of 22% in 2006.



A dwindling share of loan originations since the financial crisis has involved adjustable rate mortgages. This has made the housing market more resilient to Fed rate hikes. Other parts of the household credit arena look more menacing, but not so much that they threaten to short-circuit the economy. Banks have been tightening lending standards on auto loans since Q2 of 2016 and credit card loans since the second quarter of last year. This should help moderate the increase in default rates that has been observed in those categories.

Student debt has continued to trend higher, but the vast majority of these loans is backstopped by the government. While the Treasury's own finances are on an unsustainable trajectory, this is more of a long-term concern than a short-term problem. If anything, fiscal stimulus over the next two years will allow the Fed to raise rates more than it could otherwise without endangering the economy.

Corporate Borrowing: High But Not Extreme

Like a river, market liquidity tends to flow along the path of least resistance, rather than towards those who happen to be the most thirsty. While the household sector was piling on debt during the 2001-2007 boom, the U.S. corporate sector was still recovering from the hangover produced by the capex boom in the late 1990s. A decade later, corporate balance sheets were in good shape.

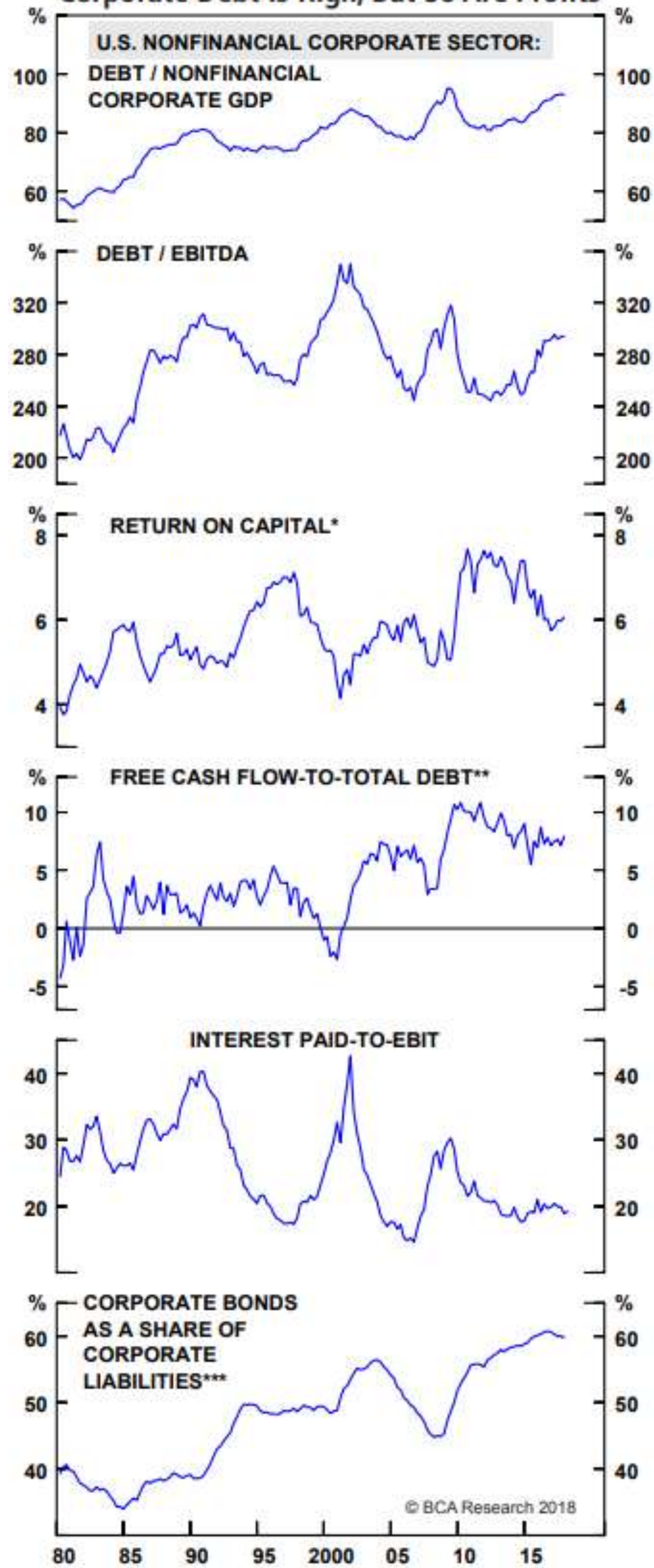
Spurred on by ultra-low interest rates, corporate debt levels began to rise. Today, the ratio of corporate debt-to-GDP is near a record high.

Valuations for corporate assets have reached lofty levels. In inflation-adjusted terms, commercial real estate prices are 4% above their pre-recession peak. U.S. equities also trade at a historically elevated multiple to earnings, sales, and book value.

There are bright spots, however (**Chart 9**). Thanks to lofty corporate profits, the ratio of corporate debt-to-EBITDA is in the middle of its post-1990 range based on national accounts data. Interest payments-to-EBIT are near historic lows. Corporate bonds now represent 60% of total corporate liabilities. Bonds tend to have much longer maturities than bank loans, which provides a buffer against default risk. Although the picture is not as benign if one performs a bottom-up analysis of publicly-listed companies, the overall message is that the U.S. corporate sector can handle higher rates. Corporate stresses will eventually rise, but it will likely take a recession for this to happen, which we don't expect until 2020.

CHART 9

Corporate Debt Is High, But So Are Profits



* AFTER TAX EARNINGS PLUS INTEREST AS A PERCENT OF CAPITAL STOCK.
** AFTER-TAX CASH FLOW LESS CAPEX AS A PERCENT OF TOTAL DEBT.
*** CORPORATE LIABILITIES DEFINED AS THE SUM OF DEBT SECURITIES AND LOANS.
SOURCE: U.S. FLOW OF FUNDS AND BUREAU OF ECONOMIC ANALYSIS.

When we see an interesting study that doesn't justify its own Worth Sharing, it gets included in our Monthly Newsletter:

Why Stocks Can't Wait for the Midterms to Be Over

A stock-market pattern that not too many investors talk about could explain why gains are a struggle now—but will be easier after the election

By Mark Hulbert

May 6, 2018

The stock market is likely to struggle between now and the Nov. 6 midterm elections.

And it isn't because stocks favor one party or the other.

It's because investors hate uncertainty, and these elections create a healthy dose of just that. If anything, this year's election season appears to be creating an above-average amount of uncertainty, given the particularly large number of Republicans who have already announced that they won't run for re-election—most prominently House Speaker Paul Ryan. There currently is a 67% probability that the Democrats will win back control of the House in this fall's elections, for example, according to PredictIt, an online betting website.

There is a silver lining, however, for investors: The stock market should perform especially well in the six months *following* the elections, regardless of the outcome. That's because, no matter the results, this pre-election uncertainty will at least be resolved.

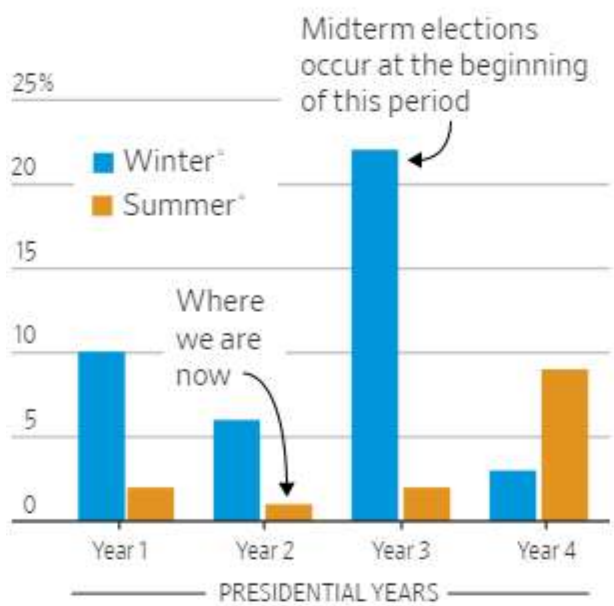
These are the findings of a [recent study] conducted by Terry Marsh, an emeritus finance professor at the University of California, Berkeley, and chief executive officer of Quantal International, a risk-management firm for institutional investors, and Kam Fong Chan, a senior lecturer in finance at the University of Queensland in Australia.

They found that ever since the Dow Jones Industrial Average was created in the late 1890s, it has produced an annualized gain of just 1.4% in the six months before midterm elections, in contrast to a 21.8% annualized return in the six months thereafter.

Their research holds other potentially significant findings. For one thing, this six-months-down and six-months-up pattern isn't as pronounced before and after presidential elections. And the midterm pattern can't be explained by the conventional wisdom about how the November-through-April period is generally better for investors than the May-through-October period. In fact, the researchers found, the six-month down-and-up cycle holds true *only* in midterm-election years. ...

Post-Midterm Magic

Dow Jones Industrial Average return, annualized



*Summer for this data is the six months from May 1 through Oct. 31; winter is the other six months
Data: 1898 to 2015

Source: Terry Marsh, Kam Fong Chan

Dead 'presidential pattern'

If the ups and downs are driven by political uncertainty, you might expect the pattern to be even more pronounced before and after presidential elections. However, the professors found that isn't the case: Those increases and dips aren't as sharp as they are for midterms.

That contradicts what many experts have contended over the years. According to their old theory, the stock market should perform better as a presidential election day approaches, because an incumbent of either party will do anything to win re-election. And that means striving to make the economy be strongest as voters go to the polls.

However, the data just don't show that, and Profs. Marsh and Chan invite political scientists to explore why that is. Regardless, they found that the only statistically significant pattern related to a presidential cycle is the one before and after the midterm election. The fourth year of the presidential term, which should be the strongest of the four if that old theory was correct, is actually no better than the average of all years.

But what about another piece of traditional wisdom: “Sell in May and go away,” also known as the “Halloween indicator”? These old saws say that the stock market is far stronger over the six months between Halloween and May Day than it is over the other half of the year.

But Profs. Marsh and Chan found that this six-months-off, six-months-on pattern exists only before and after midterms. In the other three years of the presidential term, there on average is no significant performance difference between these two six-month periods. Other than in midterm years, uncertainty doesn’t rise and fall in predictable ways.

In other words, the Halloween indicator wouldn’t exist but for midterm-election years.

Fortunately for investors who were looking forward to selling in May and going away, history says the next six months are likely to be a rough period for stocks, and that the stock market over the subsequent six months, from Halloween to May Day of 2019, is likely rise significantly. But if the future is like the past, you won’t get another chance to exploit this seasonal pattern until 2022.

Mr. Hulbert is the founder of the Hulbert Financial Digest and a senior columnist for MarketWatch.

Positions

STB - was acquired on 5/3 for 7.5/sh.