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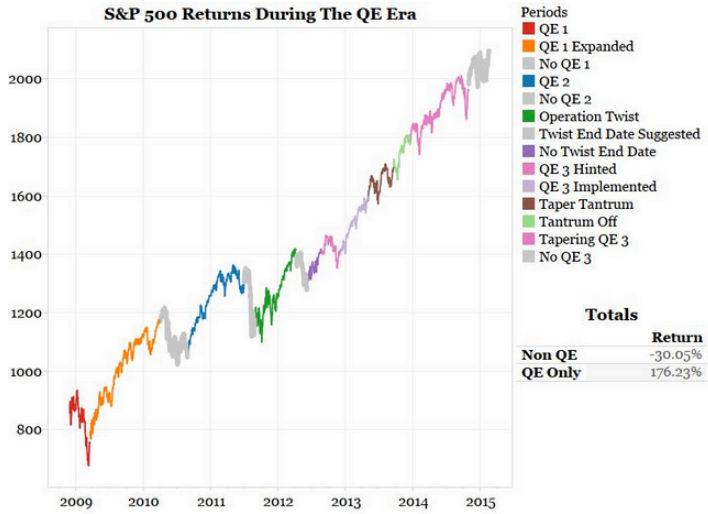
The just-released CNBC survey of economists, market strategists and money managers placed the blame for the stock market decline that started in late September on a variety of catalysts including, as prioritized in the survey: 1) tariffs and trade wars, 2) a weakening global economy, 3) the risk that the Fed raises rates too much, 4) a decline in corporate earnings and 5) a slowing domestic economy.

While we agree that each is an important consideration, and that each is likely playing an important role in what had previously been a bear market primarily affecting foreign stocks finally reaching U.S. shores, we find it remarkable the lack of consideration being given in the poll to what we consider to be the single most important catalyst.

We are referring to the shrinking level of global monetary liquidity, and to illustrate its level of importance, we will refer back to an *Outlook* that we wrote back in June of 2017, when we used the following analogy:

"Imagine a family relaxing in a swimming pool, with every family member using a flotation device to remain on the surface of the water. It doesn't matter who is stronger or who is a better swimmer because everyone is being kept afloat by an external force. If the amount of water in the pool is increased, they all elevate together, and if the water level is lowered, everyone moves closer to the bottom of the pool at the same pace.

In many ways, this analogy applies quite nicely to the domestic capital markets for much of the past eight years, ever since the Federal Reserve made the conscious decision, in coordination with the world's other major central banks, to balloon the global money supply, as a means of inflating the prices of both financial and real assets.



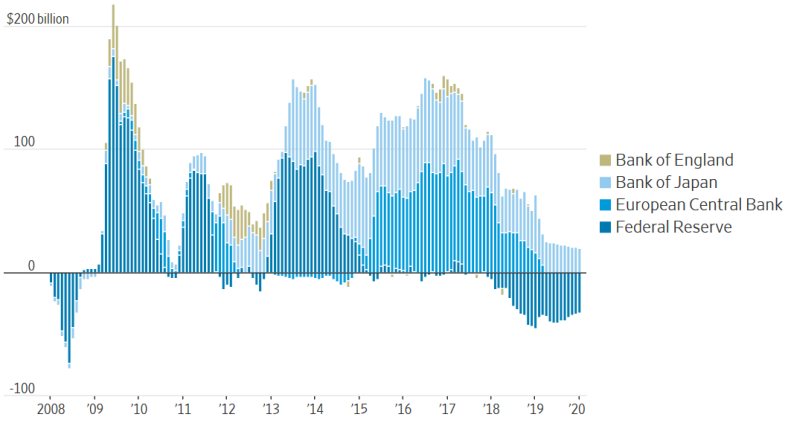
Essentially, the Fed created trillions of dollars of credit, which they used to buy both treasury debt and asset-backed securities, thus pushing down interest rates and replacing bonds, which can't be spent, with cash, which can. This, in turn, both stimulated U.S. consumer spending, which represents approximately 66% of the domestic economy and 20% of the global economy, and lifted inflation up from what had been dangerously low levels."

The above describes the policy known as 'quantitative easing" or "QE" and, as you can see in the chart, it was so effective that the S&P 500 Index rallied 176% during periods when QE programs were in effect and fell by 30% during periods (grey bars) when they were not.

As we noted in last month's report, this created an environment where there was an almost unlimited number of dollars chasing a limited number of securities, which created a scarcity factor that drove the prices for financial assets almost universally higher.

Receding Tides

Central bank net asset purchases are set to turn negative at year end.

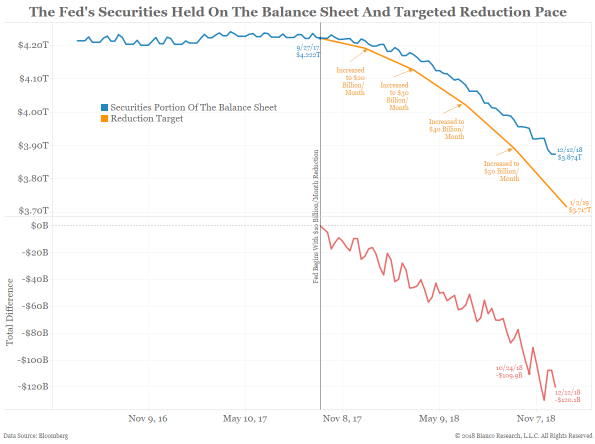


Note: Three-month moving average; figures after 2018 are forecasts
Source: Citi

This powerful tailwind became a headwind with the onset of the Fed's quantitative tightening policy, through which it is draining $50 billion of financial liquidity per month out of the domestic economy. Moreover, that headwind is continuing to grow, with Japan's curtailment of systematic QE and the recent announcement from the European Central Bank that they are going forward with their plans to stop expanding their QE programs effective the start of the new year.

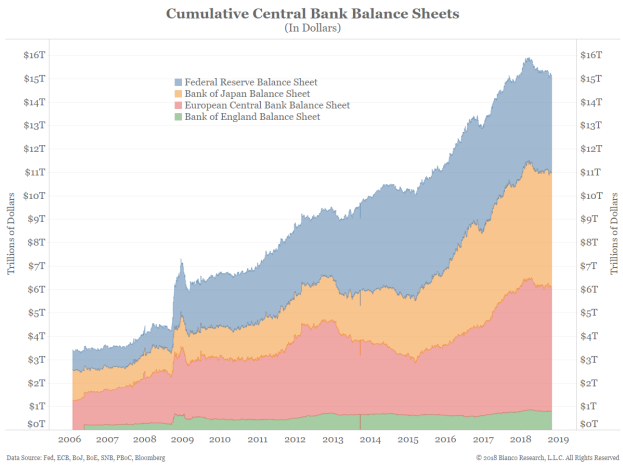
It is notable that this decision is being made despite the fact that the European economy is already slowing significantly, and that a potentially very disruptive "hard Brexit" of Britain from the European Union is a real possibility.

From an investor's perspective, it means that there should be over at least the immediate future a shrinking supply of money chasing an increasing supply of securities. Of note, the increasing supply is largely a function of the ballooning of government budget deficits and corporate indebtedness, which has raised the total value of global debt, both public and private, by 60% over the past decade, to a record high of $182 trillion, and this sum is likely to continue its climb, if higher rates raise the cost of servicing this massive debt. Indeed, for the first time in three decades, corporate debt levels exceed 45% of the size of the domestic economy.



Quantitative tightening is the exact opposite of quantitative easing and so are its impacts. Just as quantitative tightening caused virtually all financial assets to gain in value, the withdrawal of that liquidity is reversing those gains, and just as was the case with raising the water level of the pool, it doesn't matter who is the stronger swimmer when the water is withdrawn. Everything essentially declines in unison, which helps to explain why 2018 will go down in the record book as having had a higher percentage of asset classes lose value than in any year since 1901.

The Fed's balance sheet has contracted by 7.7% over the past year, the G-4 (U.S., Japan, England, & European Union) combined central bank balance sheet is shrinking at a 1% annual rate, and the global monetary base has contracted 6.2% in U.S. dollar terms from year-earlier levels.



On December 18th, Goldman Sachs released a report that tried to quantify the impact of this reduced liquidity. According to their calculations, over the past twelve months, single-stock liquidity for U.S.-listed stocks has declined by a remarkable 42% to the lowest levels since the end of the financial crisis.

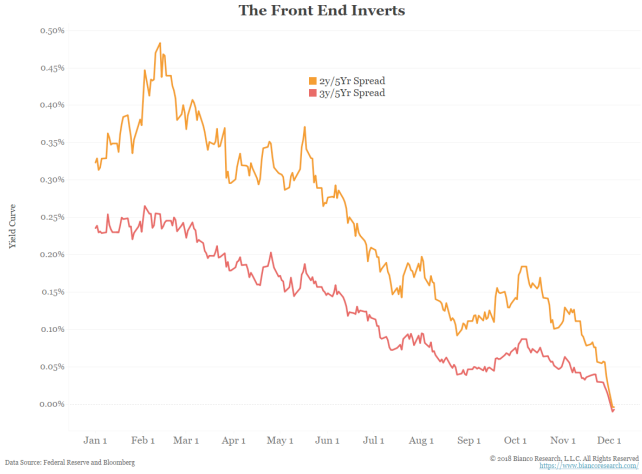
This condition of illiquidity has been exacerbated by a bearish shift in investor sentiment that started early in the fourth quarter, and what has essentially been a "buyers' strike" over recent weeks that has facilitated a vicious decline on low volume. At minimum, it has created a condition where there is much less competitive bidding for securities, and it is manifesting itself in lower asset prices, as is illustrated by the fact that the Standard & Poor's 500 Index is essentially flat since quantitative tightening started eighteen months ago.

It is similarly telling that the risk premium (the additional yield) that investors are demanding to hold lower-rated CCC corporate debt over AAA debt hit its highest level in more than two years. Moreover, the impact of quantitative tightening is not limited to securities prices. It also has a very real impact on the economy, as the current pace of quantitative tightening has an estimated economic impact similar to the Fed raising short-term interest rates by as much as 1% annually. This helps to explain why the Fed's relatively modest pace of interest rate increases produced such a rapid and material slowdown in the economy.

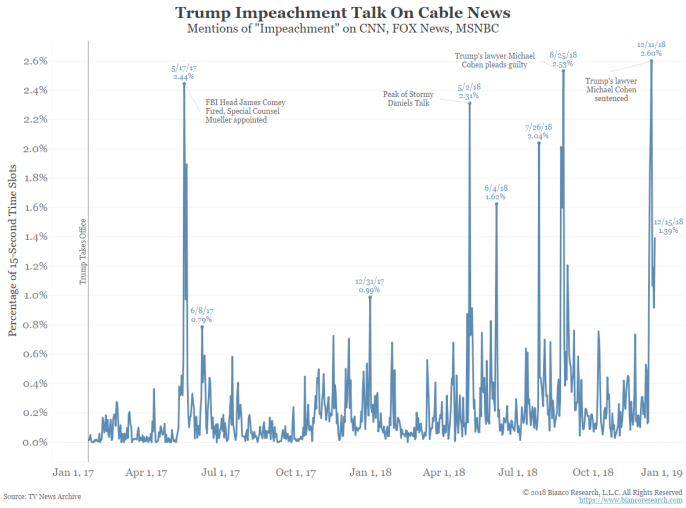
Given the significant importance that we place on these liquidity-related conditions, it is with great interest that we are reading the growing speculation that the Federal Reserve may be content holding a larger than anticipated balance sheet ($3.8 trillion rather than $2.5 trillion), and thus end its quantitative tightening program sooner than the markets currently expect. Thus far, the Fed has reduced its balance sheet by roughly $365 billion to $4.14 trillion. Morgan Stanley now estimates that the Fed will cease quantitative tightening next September, and TD Securities has just targeted next October, while Barclays and Deutsche Bank are targeting "mid-to-late 2019" and late 2019 respectively. Others disagree, including UBS, who believes that the program will continue into June of 2020. Fed Chairman Powell stated last July his expectation that QT would continue until 2020 or 2021, and reaffirmed that stance this week.

Of course, as was pointed out in the CNBC survey, there are certainly factors beyond monetary liquidity that are impacting the financial markets. Indeed, there are three (and we believe soon to be four) major factors driving markets today that are so dominant that they seem capable of overwhelming virtually everything else except for monetary liquidity.

They include interest rates and the credit markets, the coordinated slowing of the global economy, and the ongoing trade-related conflicts. We believe that a fourth major influence that will come to the fore early next year will be a formidable array of political and legal threats to President Trump, which are likely to, at minimum, further exacerbate both uncertainty and equity market volatility.



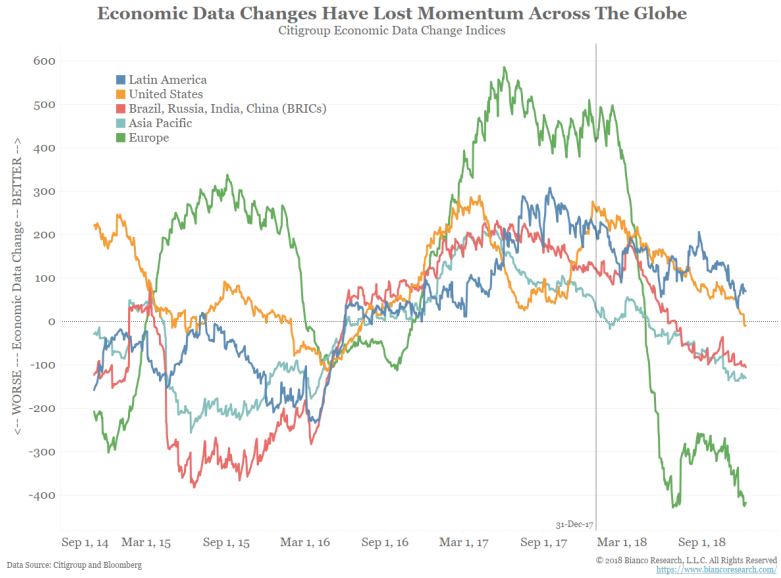
However, we believe that investors are presently so captivated by the more immediate issues that Trump's impending challenges are not yet a significant influence on investor psychology. As such, we will limit our commentary for the time being, and just make the point that, while there is some modest possibility of President Trump being forced from office, the greatest likelihood is that these issues will prove to be nothing more than a major distraction for the Trump administration and a source of considerable uncertainty for investors. Moreover, it is now likely that the delay of the Mike Flynn sentencing may push the conclusion of the Mueller probe well into 2019, thus prolonging its potential influence over the markets.



It is notable that the three other issues, on which we will concentrate in the remainder of this writing, are inextricably linked with one another like a Gordian Knot. This interconnectedness has evidenced itself quite dramatically over recent weeks with the partial "inversion of the yield curve", which describes a condition where certain longer-term rates drop below certain shorter-term rates. In this instance, the two and three-year Treasury yields rose above 5-year Treasury yields.

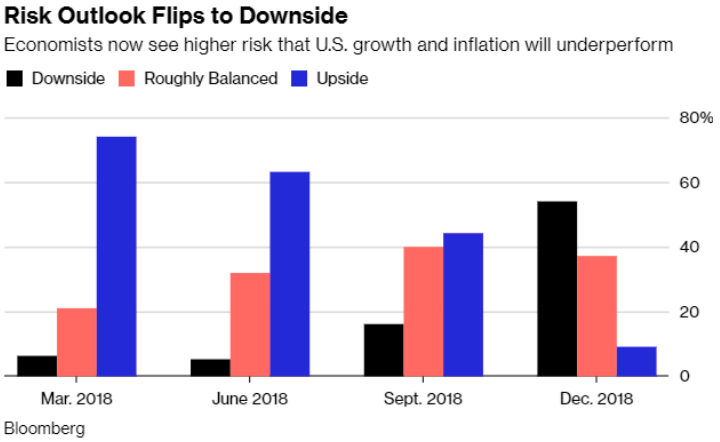
This is potentially very important, as a yield curve inversion is viewed as an indication that monetary policy has become too restrictive, and that higher rates and reduced money supply are on the verge of causing a recession. Indeed, the yield curve has inverted prior to every U.S. recession in the last fifty years. It is also an important consideration as the inversion was clearly a catalyst for the recent downwards acceleration in equity prices.

Importantly, the only inversion to-date has occurred in the so-called "belly of the yield curve" (intermediate-term rates), and that it is a full inversion (where three-month yields exceed ten-year yields) that has had a virtually perfect record of predicting recessions. At the same time, every past inversion in the belly of the curve has ultimately led to a full inversion before the end of the cycle.



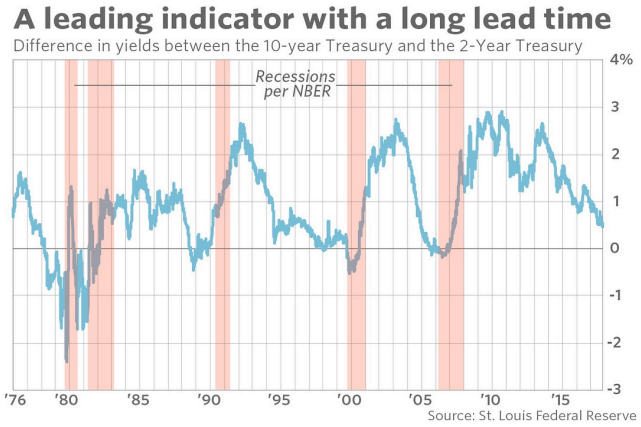
Legendary investor Sir John Templeton famously noted that "The most dangerous words in investing are 'it's different this time'". With these very sage words in mind, we will note that there is at least some potential for this recent partial inversion to not lead to a full inversion, as it could also be explained by hedge funds being forced to buy five-year Treasuries, as yields have fallen over recent weeks. This would make some sense, as it is known that hedge funds have been very heavily shorting five-year notes, and have recently sliced those short positions in half. In other words, they were forced to buy back the shorted securities in order to limit their losses in an environment of falling rates, and this technical anomaly could have caused the inversion.

Even so, investors ignore this inversion at their own risk, as Sir John Templeton makes a valid point about the persistence of market tendencies. However, what many investors fail to appreciate is that, because equities are based upon future rather than current expectations, there exists a very indirect relationship between the timing of recessions and the timing of equity bear markets. In other words, equity investors will often recognize a recession as a starting point for lower interest rates and fiscal stimulus and start to rally in anticipation of the eventual recovery.



In fact, out of the seven yield curve inversions experienced in the U.S. since the early 1950s, there has been only one instance when it has been profitable to sell equities immediately after the inversion. While the past is not necessarily prelude, the stock markets have, on average, continued to advance for 19 months after the initial inversion, and to average a gain of 21% over the period. Over the seven periods, post-inversion returns have ranged from -11% to +30%.

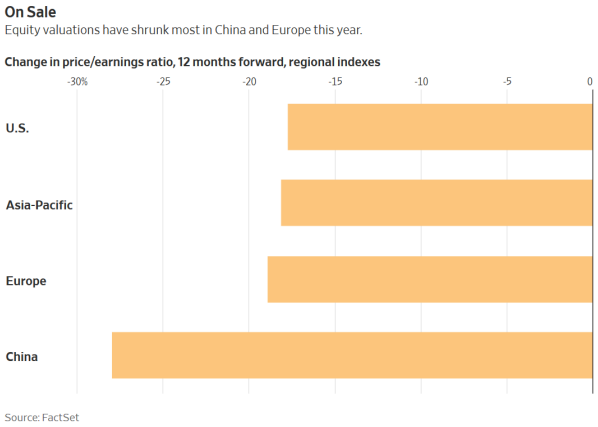
Recessions, on the other hand, have historically followed inversions by periods ranging from as short as a few months to as long as two-plus years, and equity market returns from the beginning of a recession to the peak of the market have ranged from -21% to + 37%.



The bottom line is that yield curve inversions have accurately predicted the eventual onset of both recessions and equity bear markets, but have proven to be almost useless as a timing tool because of the incredibly variant lag times. The phenomenon does seem to be much more immediately impactful on the economy than it is on equity markets, which suggests to us that much of the equity market selling that took place in response to the inversion may ultimately prove to have been unwarranted.

Date of Inversion	Date of Next Recession	Days to Next Recession
1/10/1969	Dec-69	325
6/14/1973	Nov-73	140
12/8/1978	Jan-80	389
11/7/1980	Jul-81	236
6/6/1989	Jul-90	390
7/31/2000	Mar-01	213
8/1/2006	Dec-07	487
Average		**311**

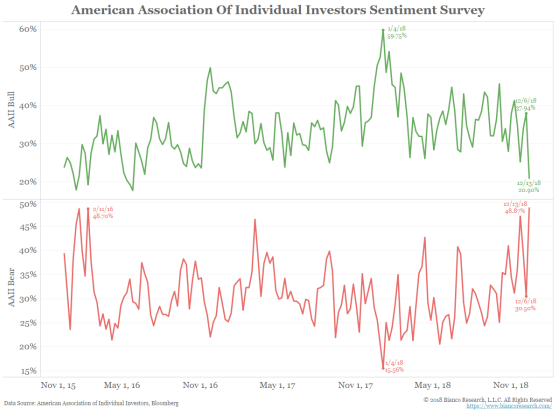
Indeed, with some indications of progress on the trade front and the Federal Reserve's recent adoption of a modestly less aggressive monetary policy, we believe that it is time to ask whether or not investors have now priced into stock and bond prices more bad news than is actually likely to be realized, at least over the immediate term, which is one of the reasons why we have been expecting the markets to find support around this year's February-March lows (a thesis that the markets are calling into serious question as we write this report).



We are not suggesting for even a moment that there doesn't still exist a wide array of bearish factors that the markets are going to need to navigate. However, the level of selling has been both so extraordinary and so pervasive that markets may be approaching the point of pricing in the "worst case scenario", which is a good thing. After all, as the old saying goes, "it is hard to break your arm falling from a basement window".

There are only four stock markets (Israel, India, Qatar, and Russia) that are positive on the year, with the average global stock down by 8% year-to-date and by over 15% since the highs of the year. If you take the domestic markets out of the picture, you can appreciate the fiscal carnage overseas, with the average foreign stock down by over 16% for the year and over 22% from their most recent highs.

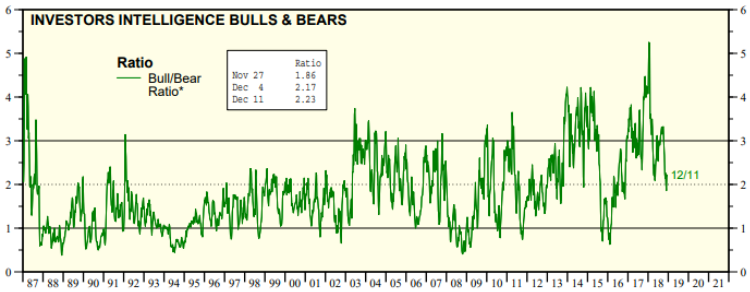
Barring an imminent recession, the valuations of domestic stocks are quite modest at 15.5 times expected earnings, which compares to an average over the past fifty years of 16.2 times earnings. Moreover, if you take out Facebook, Amazon, Netflix, Alphabet and Microsoft, the other 495 stocks in the S&P 500 Index trade at less than 13 times expected earnings, which is historically very inexpensive, particularly with rates anywhere near this low.



Moreover, according to Value Line, more than 100 S&P 500 companies trade at forward price-to-earnings multiples below 8, which is a number that we have not seen since the financial crisis. Notably, at a price-to-earnings ratio of 13.1 times forward earnings, foreign stocks offer even more value, although we question somewhat that value on a risk-adjusted return basis.

Sentiment has also reached bearish extremes, as illustrated by the American Association of Individual Investors (AAII) Survey, which shows bulls at only 20.9% (the lowest since May 2016) and Bears at 48.9% (the highest since April of 2013). The last time that the survey showed such bearish sentiment, the stock market rallied by 16%. The Investors Intelligence Survey of investment newsletter writers shows similar measures of bearishness. While no guarantee of the future, such extreme readings have, in the past, often indicated that most potential sellers have already sold.

The one thing missing that would help to confirm a market bottom is a classic "capitulation day", as identified by huge volume, at least ten declining stocks for every advancing one, and a spike in the VIX ("fear index") to above 40. It is true that significant declines normally do not end until investors experience such an emotional, gut-wrenching day. At the same time, with an estimated 80% of all trading now being done by emotionless computers (and approximately three-quarters of that based upon algorithms), it is certainly possible that capitulation looks different than it used to.



We think it significant that investors pulled $27.6 billion from domestic equity mutual funds and ETFs in the second week of December, which is the second largest weekly outflow in history. Further, the just-released Bank of America/Merrill Lynch global fund manager survey showed "extreme bearishness" on the market and economic outlook, and the largest ever one-month rotation by money managers out of equities and into bonds.

We believe that equity valuations are attractive, that bearish sentiment is reaching extreme levels, and that there are some signs of capitulation, each of which suggests that the equity markets "should" be approaching a sustainable bottom. At the same time, we remain mindful of the quote attributed to renowned economist John Maynard Keynes, who noted that "Markets can remain irrational a lot longer than you and I can remain solvent".

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