BALDINI
INVESTMENT STRATEGIES

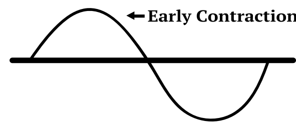
December 2019

Month in Review

The buying stampede that began in October intensified in November with the S&P 500 Index gaining 3.6% by month end. Central banks were largely on the sidelines so attention shifted to tentative signs of improvement in the economy. The US Purchasing Managers' Index (PMI) showed a pickup in activity in both manufacturing and services, and the latest estimate of third-quarter US GDP rose unexpectedly. Add to that the $300 billion increase in the Fed's balance sheet over the last two months, and the "melt- up" we presaged last month became a reality. It's time to check our indicators to see how the resurgence in investor optimism has affected them. I have also updated your asset allocation and provided a brief summary of our thoughts on the market going forward.

I. CREDIT CYCLE

PHASE III: EARLY CONTRACTION



Credit markets have rallied as financial conditions ease, credit spreads stabilize, and recession risks recede. Some cracks are beginning to show in the weakest credits, however, as spreads on CCC-rated bonds and double-B CLOs (securitized corporate loans) are widening even as spreads for higher-rated bonds are close to their lows. The divergence is a warning that investors are backing away from the weakest links in the credit market and may signify higher default rates ahead.

II. RISK LEVEL INDICATORS

US STOCKS: LOW

The Risk Level for **U.S. Stocks** remains **LOW** as negative positioning and FOMO ("fear of missing out") drive prices relentlessly higher. The equity markets are overbought but as long as the Swing Indicators are positive any pullbacks will likely be short and shallow and can be taken as opportunities to "buy the dip"

INTERNATIONAL STOCKS: LOW

The Risk Level for **International Stocks** is also **LOW** for the first time in over three years, and equity flows have been rotating away from the US and into the rest of the world. Risk assets of all types benefit from the Fed's easing, especially emerging markets. While the risk level for emerging markets is lagging the developed world, it is on the verge of giving a buy signal. The reversal in flows and newfound strength in emerging markets seem to support the belief that a trade deal will get done before the December 15 deadline.

US HIGH QUALITY FIXED INCOME: GUARDED

The Risk Level for **US Fixed Income Quality** is **GUARDED** and the relative strength ranking continues to decline. Investors have rotated from bonds to stocks on signs that a recession is not imminent—a fear that has been lurking since the yield curve inverted earlier this year. A rotation can turn into a rout and if the economy continues to improve bonds could see further downside before stabilizing.

III. LOOKING AHEAD

It all depends on how we look at things, and not how they are in themselves.
Carl Jung

Last year at this time, investors fretted that the Fed's overly restrictive monetary policy would trigger a recession and that the trade war with China was escalating. The S&P 500 proceeded to plunge by 19.8% through Christmas Eve. The Fed soon reversed course and the US and China agreed on high-level talks to try to resolve the trade dispute. The S&P began a melt-up of sorts that has resulted in a year-to-date gain through November of 25.3%. However, the rise looks less like a melt-up when we consider that the S&P has gained just 7% since last year's September peak. What has melted up is the S&P 500's valuation multiple, or P/E. According to economist Ed Yardeni, the forward P/E of the S&P 500 peaked at 18.6 on January 23, 2018, crashed to 13.5 on December 24, 2018 and soared back up to 17.5 last week. All the while real earnings per share have barely budged. With valuations near all-time highs, any further market upside will need to come from earnings gains, not multiple expansion. Next year's estimated earnings growth rate of 10% could help with that!

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