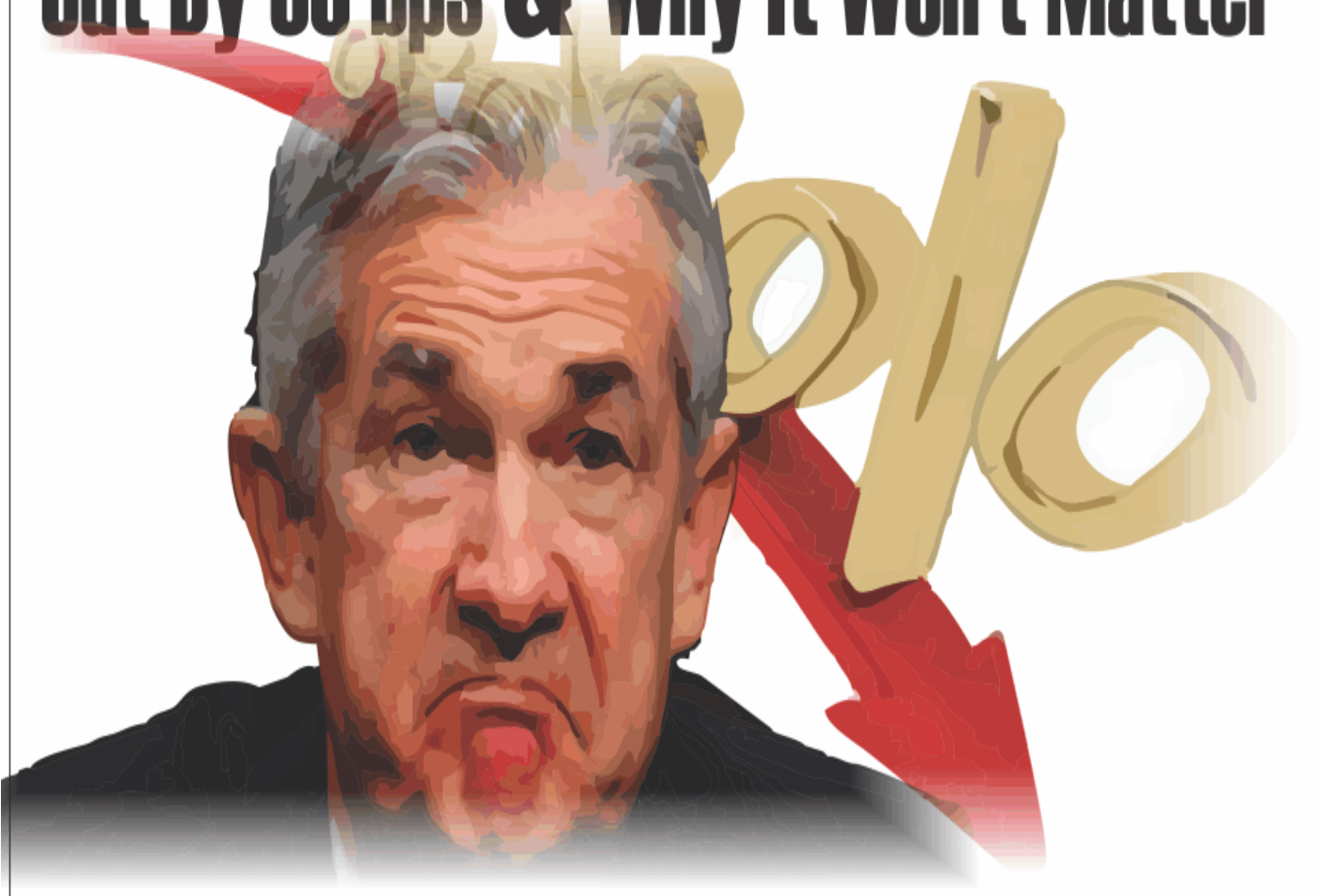




Why The Fed Could Cut By 50 bps & Why It Won't Matter



- *Review & Market Update*
- *Why The Fed Could Cut By 50bps*
- *Why It Won't Matter*
- *Sector & Market Analysis*
- *401k Plan Manager*

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Market Review & Update

[Last week](#), we laid out the bull and bear case for the market:

The Bull Case For 3300

- *Momentum*
- *Stock Buybacks*
- *Fed Rate Cuts*
- *Stoppage of QT*
- *Trade Deal*

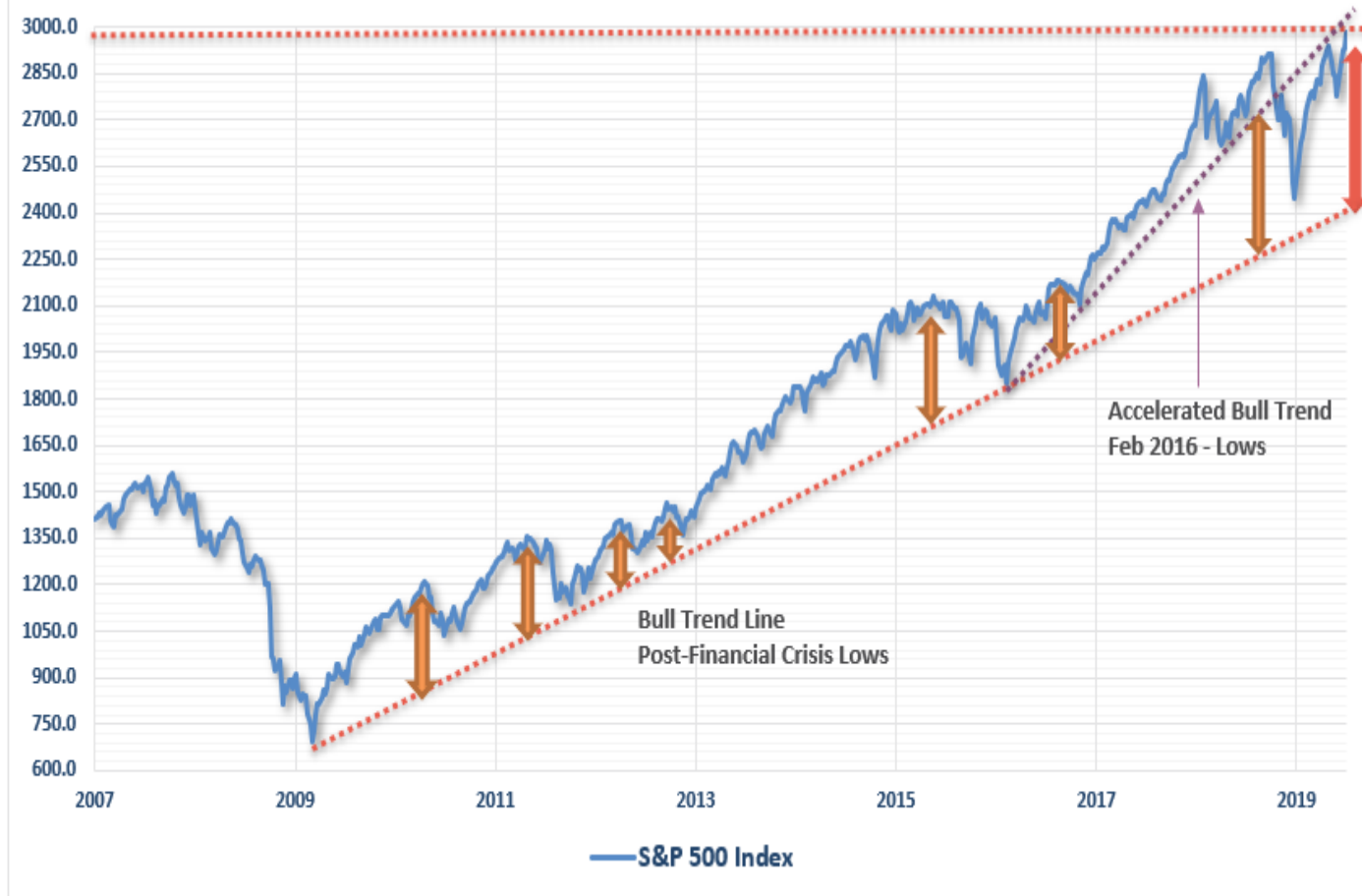
The Bear Case Against 3300

- *Earnings Deterioration*
- *Recession*
- *No Trade Deal/Higher Tariffs*
- *Credit-Related Event (Junk Bonds)*
- ***Mean Reversion***
- *Volatility / Loss Of Confidence*

We laid out the case for a near-term mean reversion because of the massive extension above the long-term mean. To wit:

"There is also just the simple issue that markets are very extended above their long-term trends, as shown in the chart below. A geopolitical event, a shift in expectations, or an acceleration in economic weakness in the U.S. could spark a mean-reverting event which would be quite the norm of what we have seen in recent years."

Trend Line Support



This analysis led us to take action for our [RIAPRO subscribers last week \(30-Day Free Trial\)](#), as we added a 2x-short S&P 500 index fund to **Equity Long-Short Account** to hedge our longs against a potential mean reversion. **(on Friday that portfolio was UP .03% while the market FELL by 0.62%)**

"This morning, we are adding a small 2x S&P 500 short position to the trading portfolio to hedge our core long positions against a retracement over the next few weeks. We will remove the short if the market can regain its footing and move higher, or the market sells off and reaches oversold conditions."

This is the purpose of hedging, as it reduces volatility over time, which inherently reduces the risk of emotionally based trading mistakes.

The correction this past week was not surprising as we [wrote previously](#):

"With a majority of short-term technical indicators extremely overbought, look for a correction next week. What will be important is that any correction does not fall below the early May highs."

While the market is still hanging above the May highs, further corrective actions are likely next week as the short-term oversold conditions have not been resolved as of yet. The deviation above the long-term mean is also only starting to reverse as well.

\$SPX S&P 500 Large Cap Index INDX

19-Jul-2019

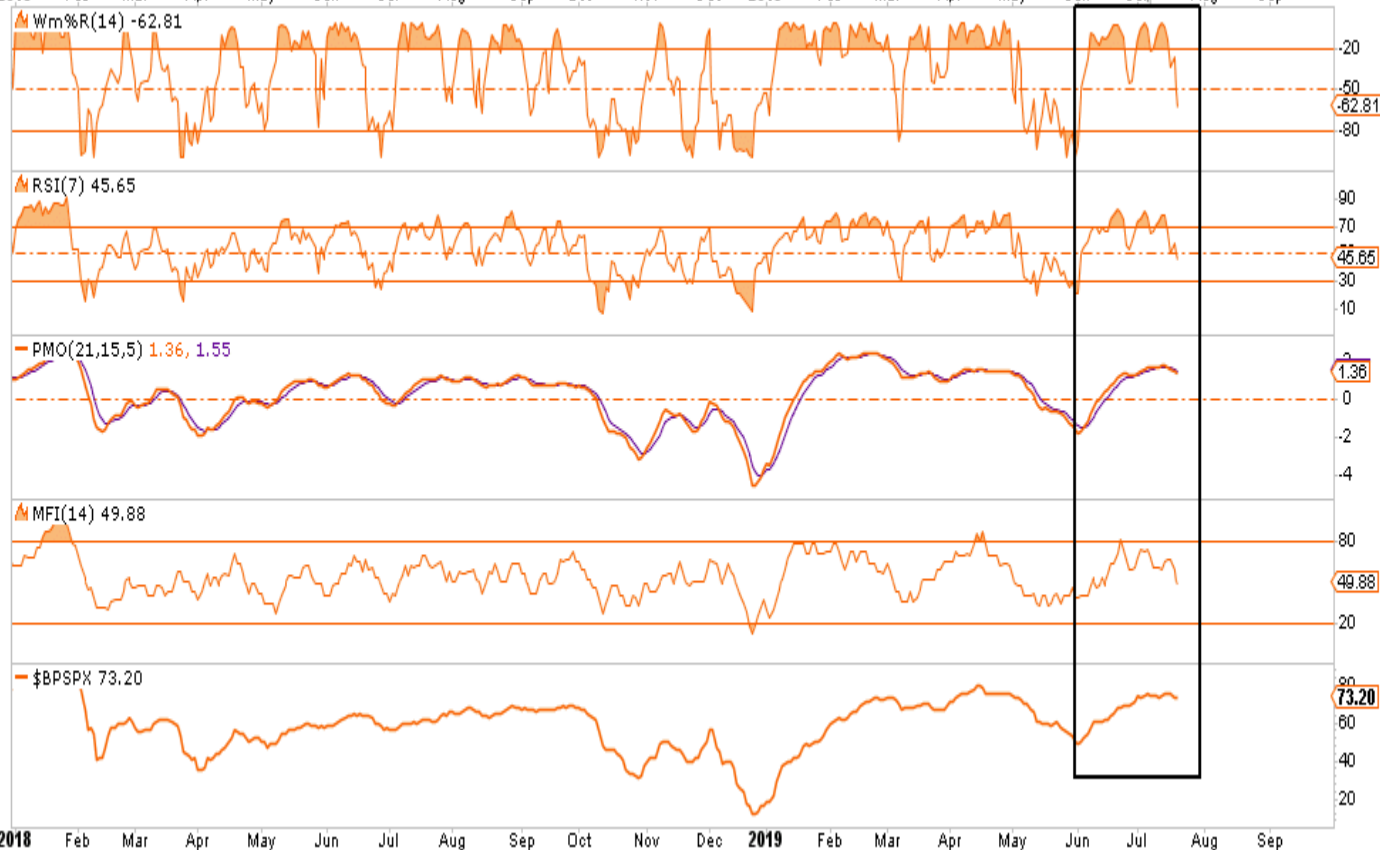
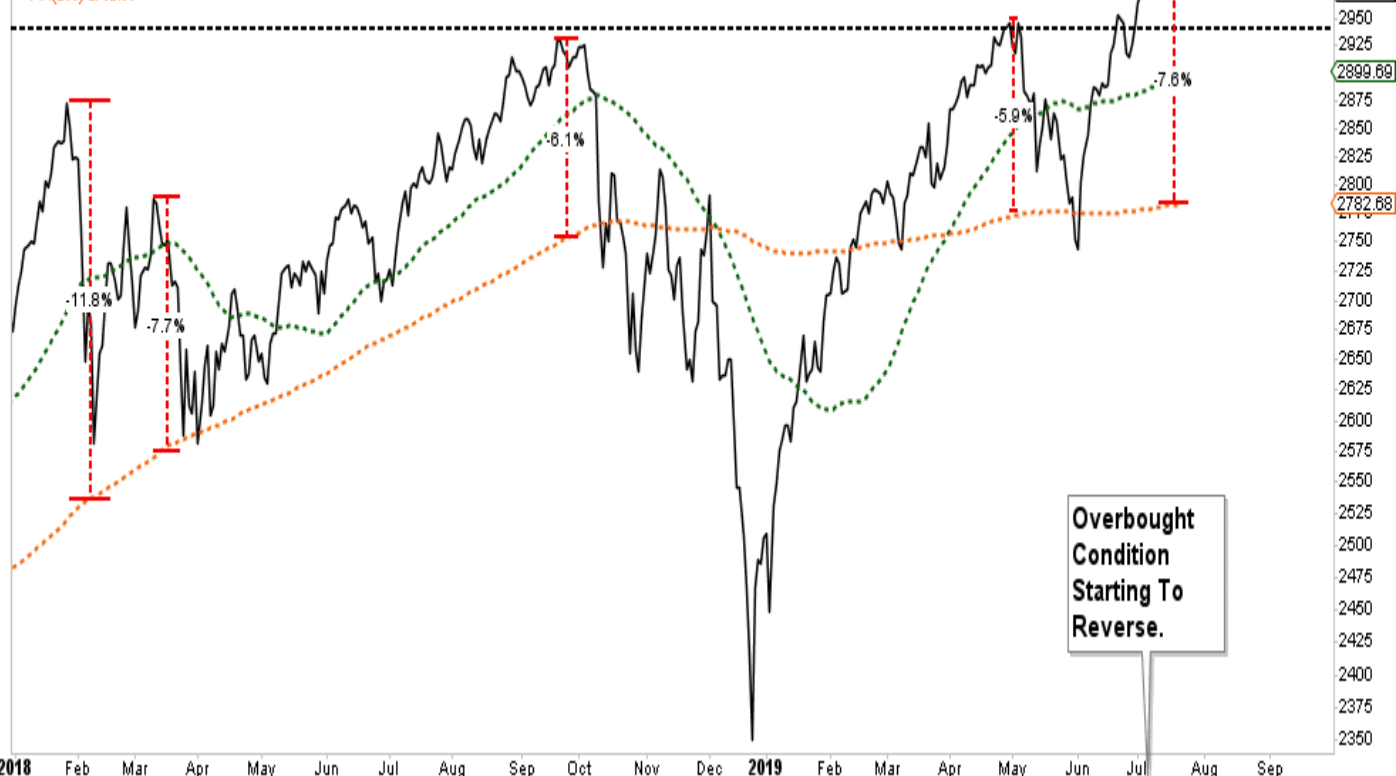
© StockCharts.com

Open 3004.26 High 3006.02 Low 2975.86 Close 2976.61 Volume 1.8B Chg -18.50 (-0.62%)

— \$SPX (Daily) 2976.61

--- MA(50) 2899.69

--- MA(200) 2782.68



Importantly, once we get past the end of the month, and assuming the Fed does indeed cut rates and no "trade deal" with China, the markets will return their focus to economics and earnings. As we stated previously:

"Such continues to suggest the August/September time frame for a larger corrective cycle is still in play."

More importantly, as [Chris Kimble noted on Friday](#), the market is continuing to ignore the economic warnings being sent by bonds and commodities.

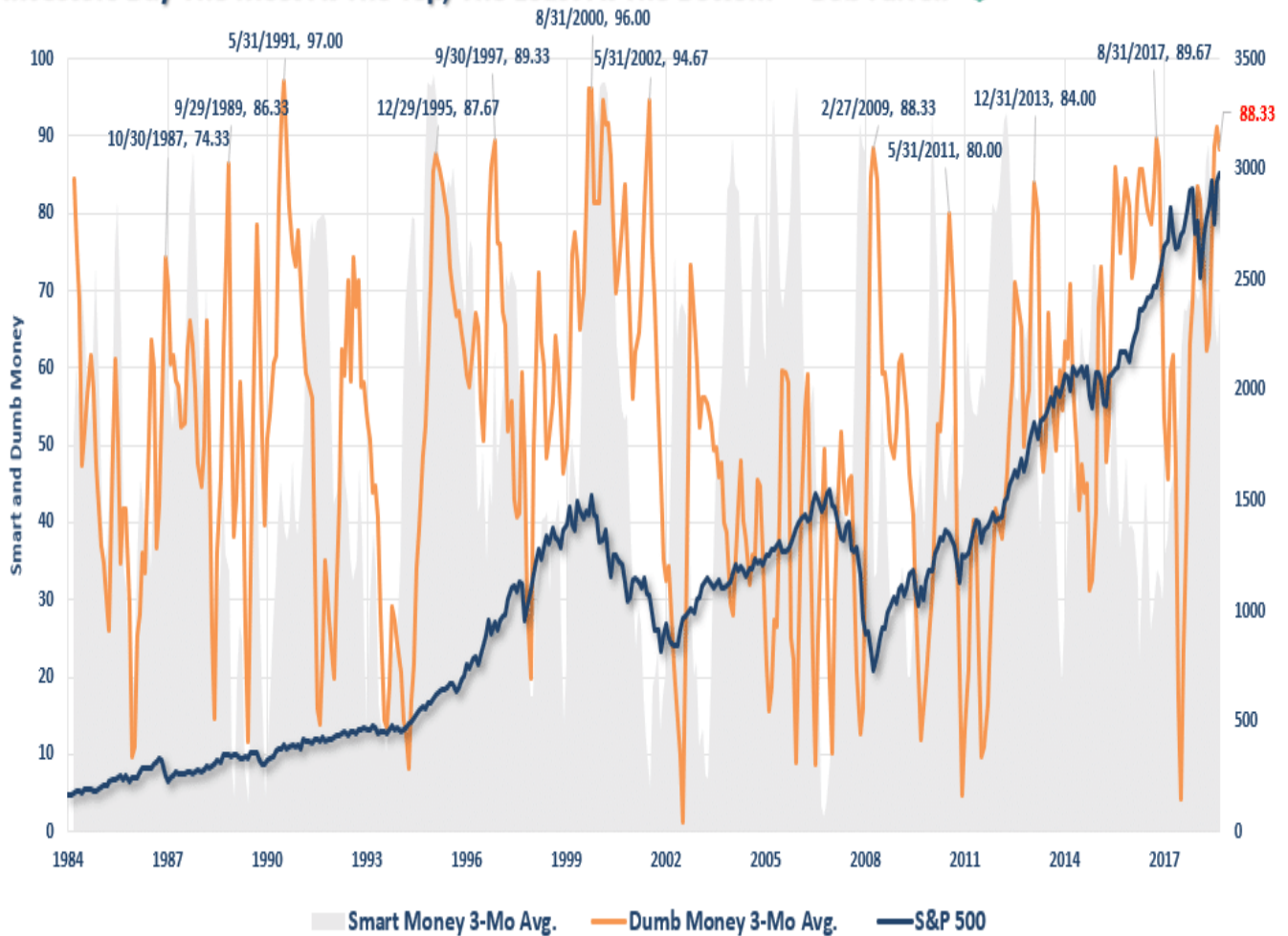


Moreover, the *"Dumb Money"* is now all the way back in.

"Investors Buy The Most At The Top, The Least At The Bottom" - Bob Farrell



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These last two charts confirm the old Wall Street axiom:

"Individuals buy the most at the top, and the least at the bottom."

This is why we are hedging our risk, carrying a higher level of cash, and holding onto our bonds as if they were the last lifeboat on the Titanic.



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ADVICE

Are your investments prepared
for the next bear market?

**SCHEDULE YOUR
CONSULTATION
TODAY**

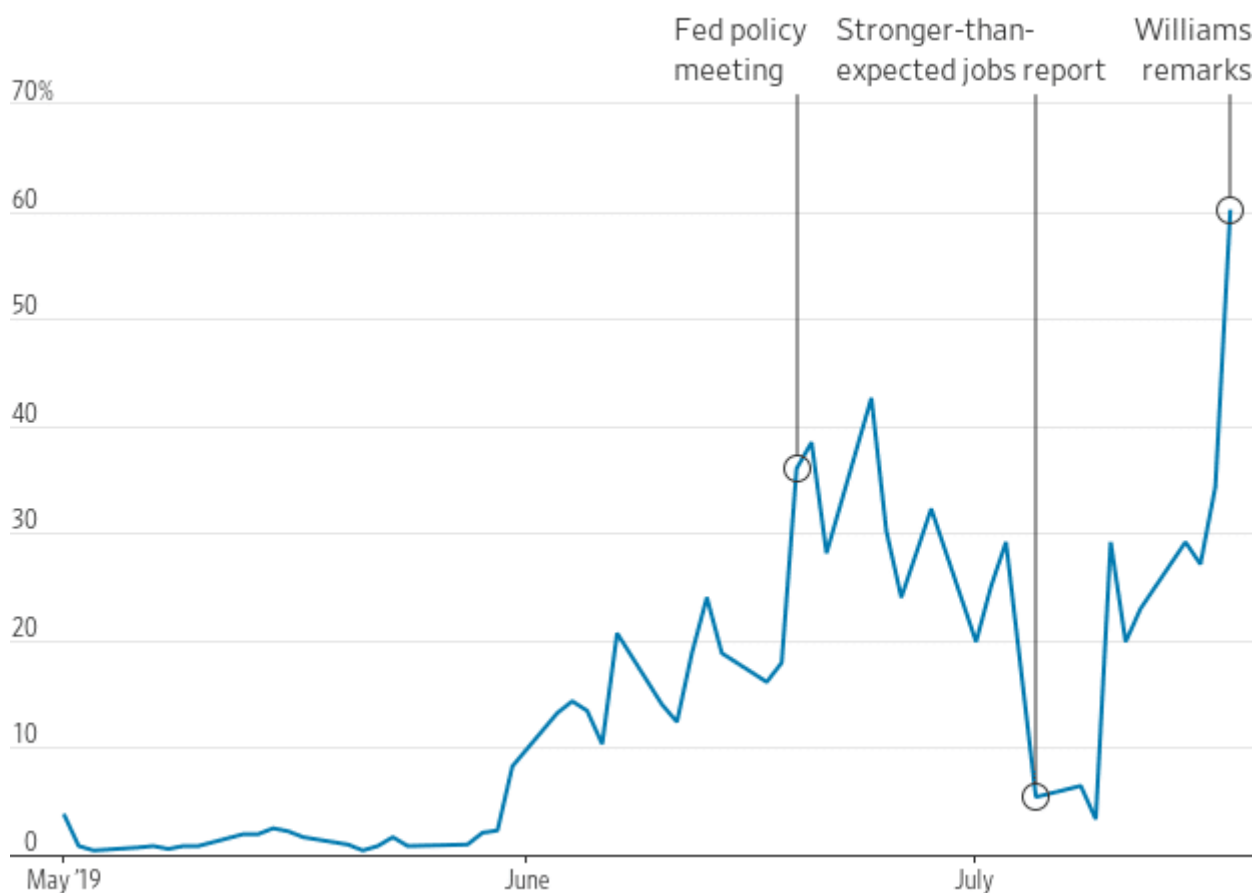
Why The Fed Will Cut By 50bps

It is now widely expected the Fed will cut rates at the end of the month following comments by Fed officials last week. Per the WSJ:

"New York Fed President John Williams on Thursday stoked expectations for a hefty cut. Already-low interest rates are a big reason to cut aggressively at the first sign of

economic distress, he said. **'Don't keep your powder dry?that is, move more quickly to add monetary stimulus than you otherwise might.'** But a bank spokesman later walked that back, saying Mr. Williams didn't intend to suggest the central bank might make a large cut this month."

Market-implied probability of the Fed lowering rates by 0.5 percentage point in July



Source: CME FedWatch Tool

Interestingly, that statement was quickly walked [back by the NY Fed](#):

"However, in an unprecedented move, the NY Fed subsequently released a statement stating that President Williams's speech on Thursday afternoon was not intended to send a signal that the Fed might make a large interest rate cut this month but rather it was "an academic speech on 20 years of research."

Why did the NY Fed do this?

Simple: as BofA explains, 'the FOMC was uncomfortable with the market moving toward a 50bp cut and wanted to push the market back to a 25bp baseline.' In other words, as Meyer puts it, 'Williams unintentionally misguided the markets.'

With the markets pushing record highs, recent employment and regional manufacturing surveys showing improvement, and retail sales rebounding, it certainly suggests the Fed should remain patient on cutting rates for now at least until more data becomes available. **Patience would also seem logical given very limited room to lower rates before returning to the "zero bound."**

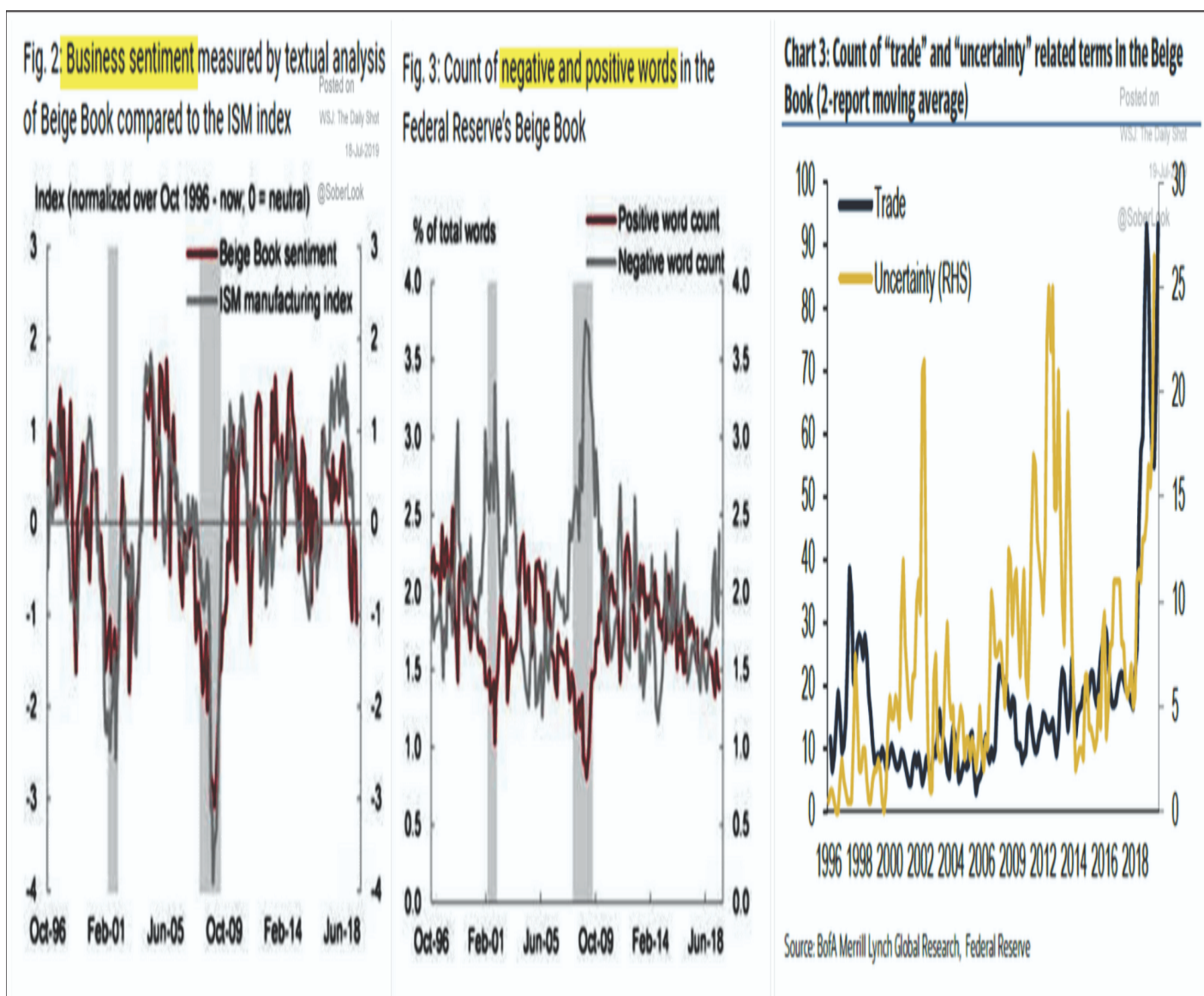
However, there is also support for rate cuts. This is the point we will discuss today.

It's Beige

Let's begin with the Fed's [Beige Book report](#).

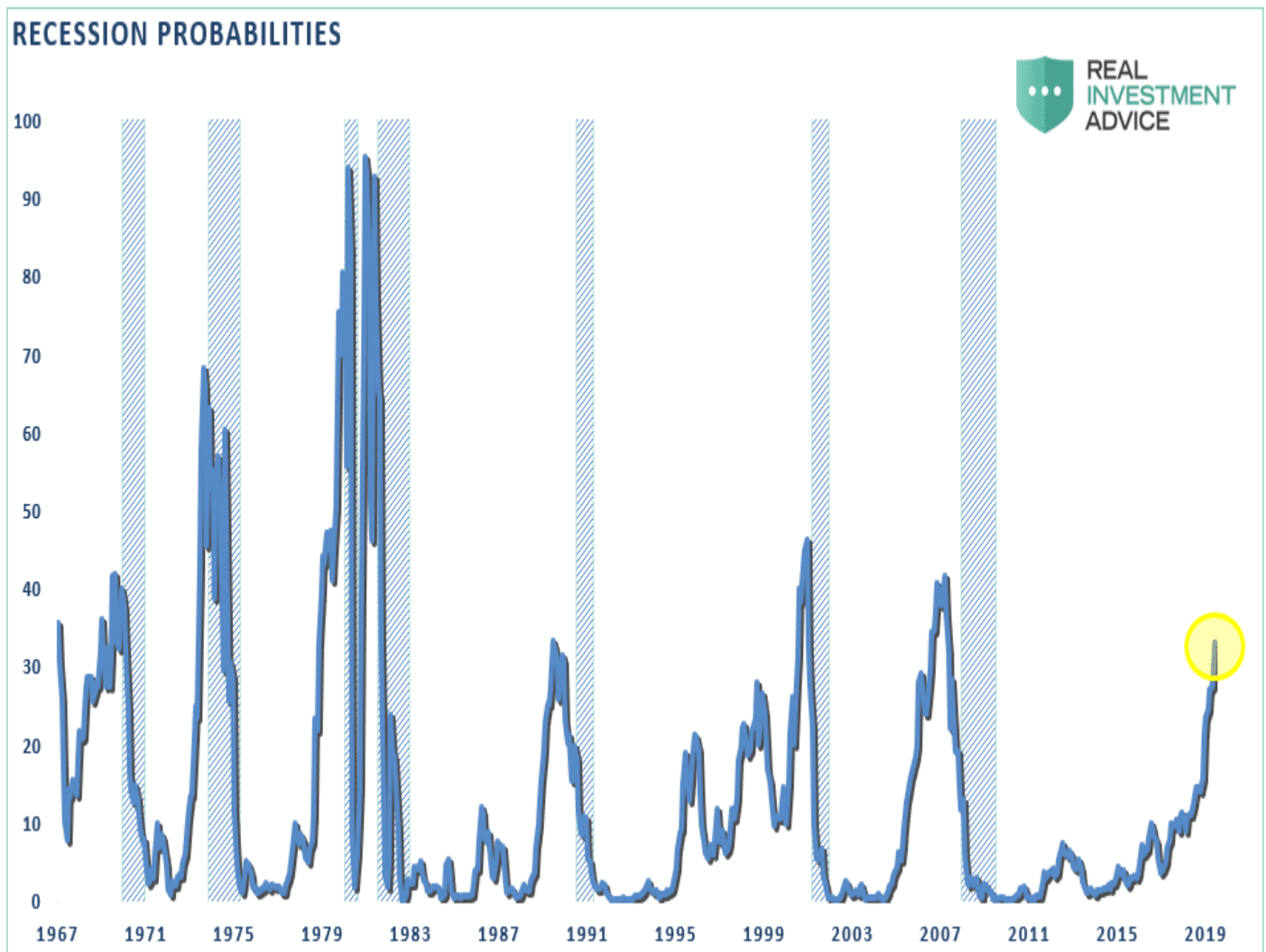
- Labor markets remained tight, with contacts across the country experiencing difficulties filling open positions. **The reports noted continued worker shortages across most sectors, especially in construction, information technology, and health care.** (Tighter job market leads to higher costs, which impacts profitability.)
- **Compensation grew at a modest-to-moderate pace, although some contacts emphasized significant increases in entry-level wages.** Most District reports also noted that **employers expanded benefits packages** in response to the tight labor market conditions. (Note: cost of labor is rising, which will impede corporate profit margins. Increases in labor costs ALWAYS precede the onset of a recession.)
- Tariffs were mentioned 49 times in the report.
- Districts generally saw some increases in input costs, stemming from higher tariffs and rising labor costs. However, **firms' ability to pass on cost increases to final prices was restrained by brisk competition.** (Note: higher input costs without the ability to pass it on impacts profitability.)

[Click to Enlarge](#)



Recession Probabilities•

The Fed's own recession probabilities index has spiked to levels historically coincident with the onset of a recession. (Yes, *this time could be different, but probably not a bet the Fed is willing to take.*)



Yield Curve Inversions

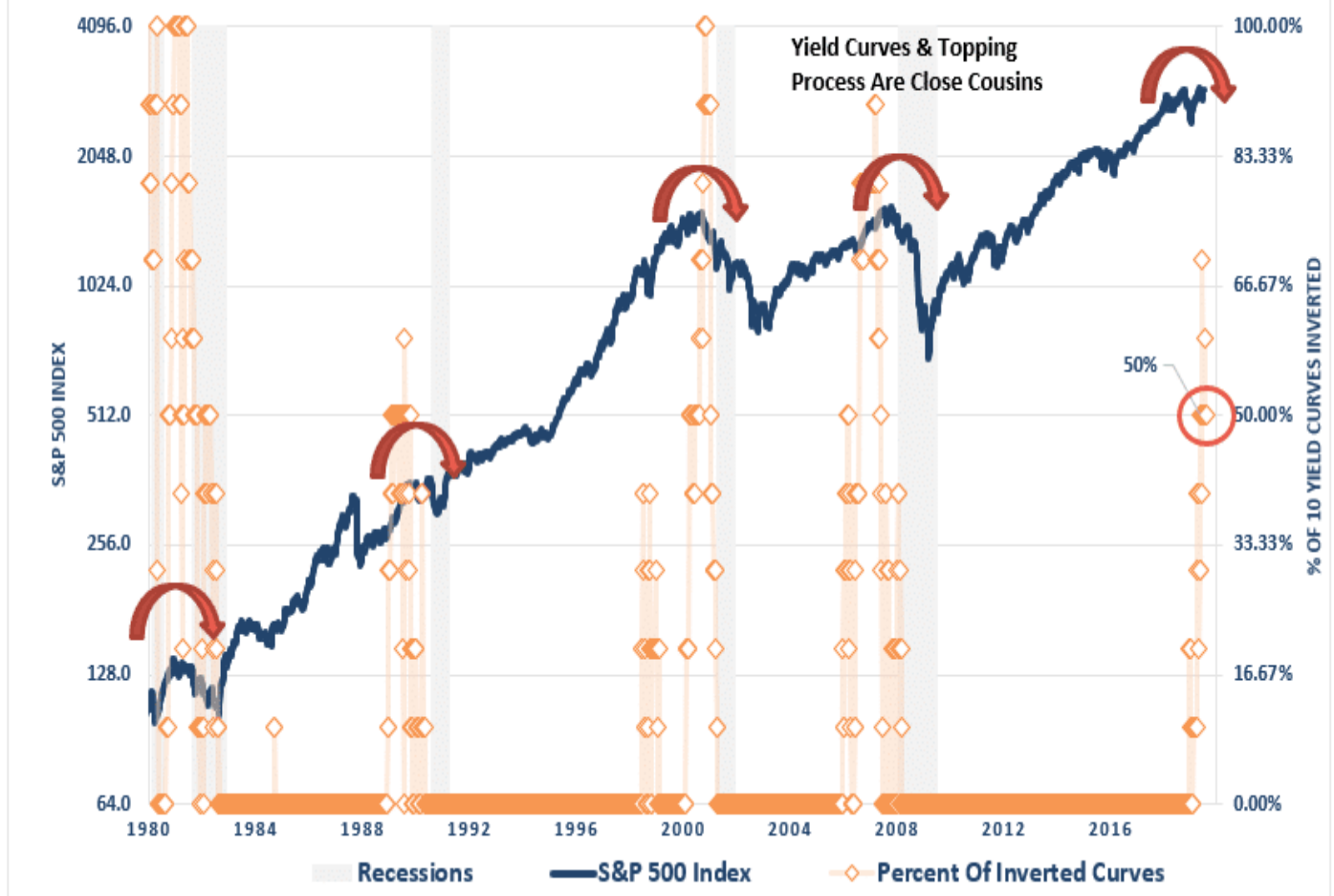
Interest rates are a direct reflection of economic growth. As I wrote in December 2018• in "[Why Gundlach Is Still Wrong About Higher Rates:](#)"

"Given the structural backdrops to the economy, there is an inability to increase rates of productivity substantially, output, wage growth, savings, or consumption, which would lead to stronger rates of economic growth. In fact, we are currently running some of the weakest rates of economic growth, productivity, and wages on record."

Currently, 50% of the 10-yield curves we track are inverted and have remained so for more than 3-months. Historically, when inversions last for one-quarter or more in duration, recessions have not been too far behind.

PERCENT OF 10-YIELD CURVES INVERTED

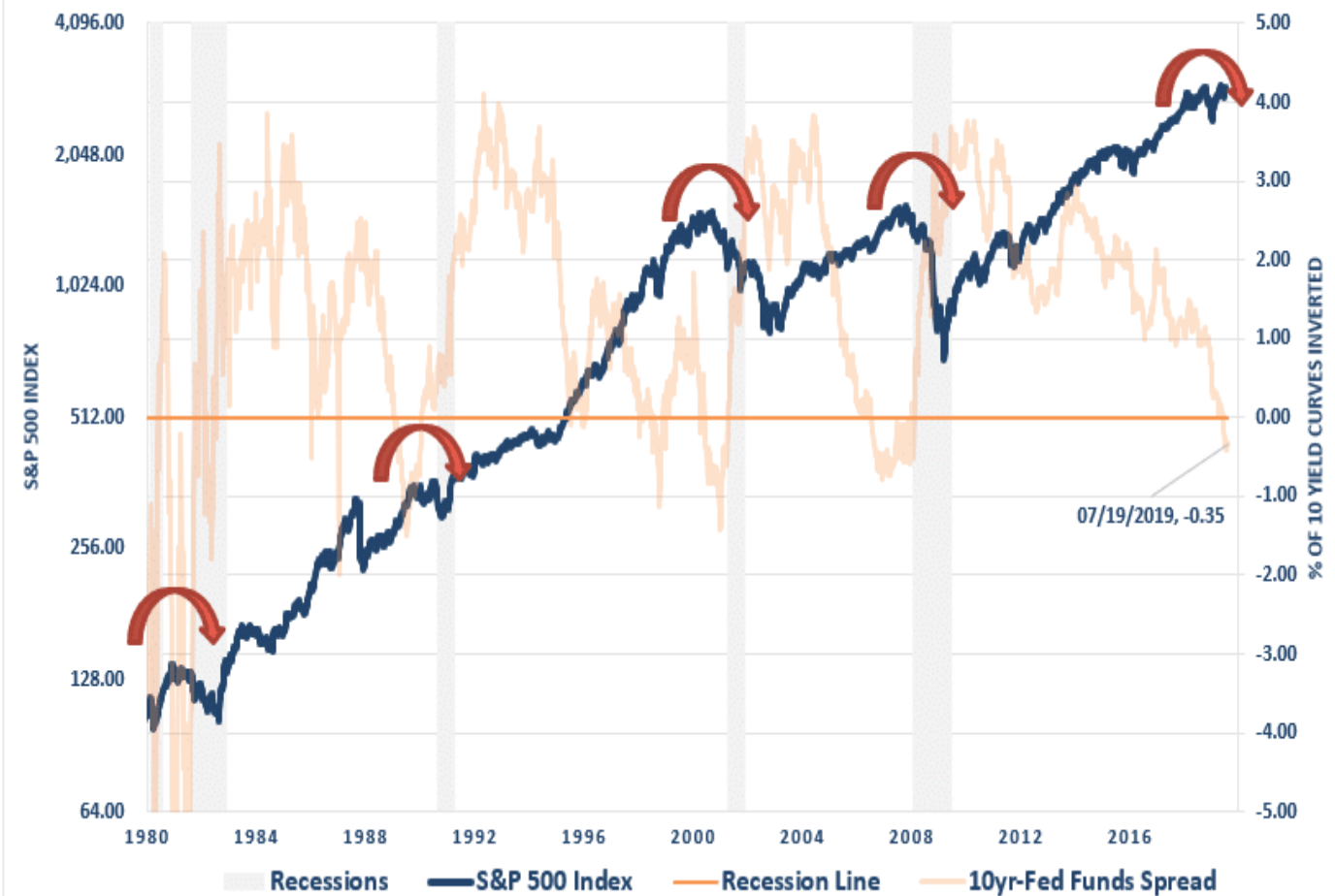
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However, one of the biggest reasons the Fed is about to cut rates by up to one-half point is to un-invert the Fed Funds to the 10-year Treasury rate. The inversion between the ultra-short and long-end of the curve is impairing loan activity. The Fed clearly understands that if they don't resolve this inversion, the probability of a recession grows rapidly.

INVERSION OF 10-YEAR TO FED FUNDS RATE

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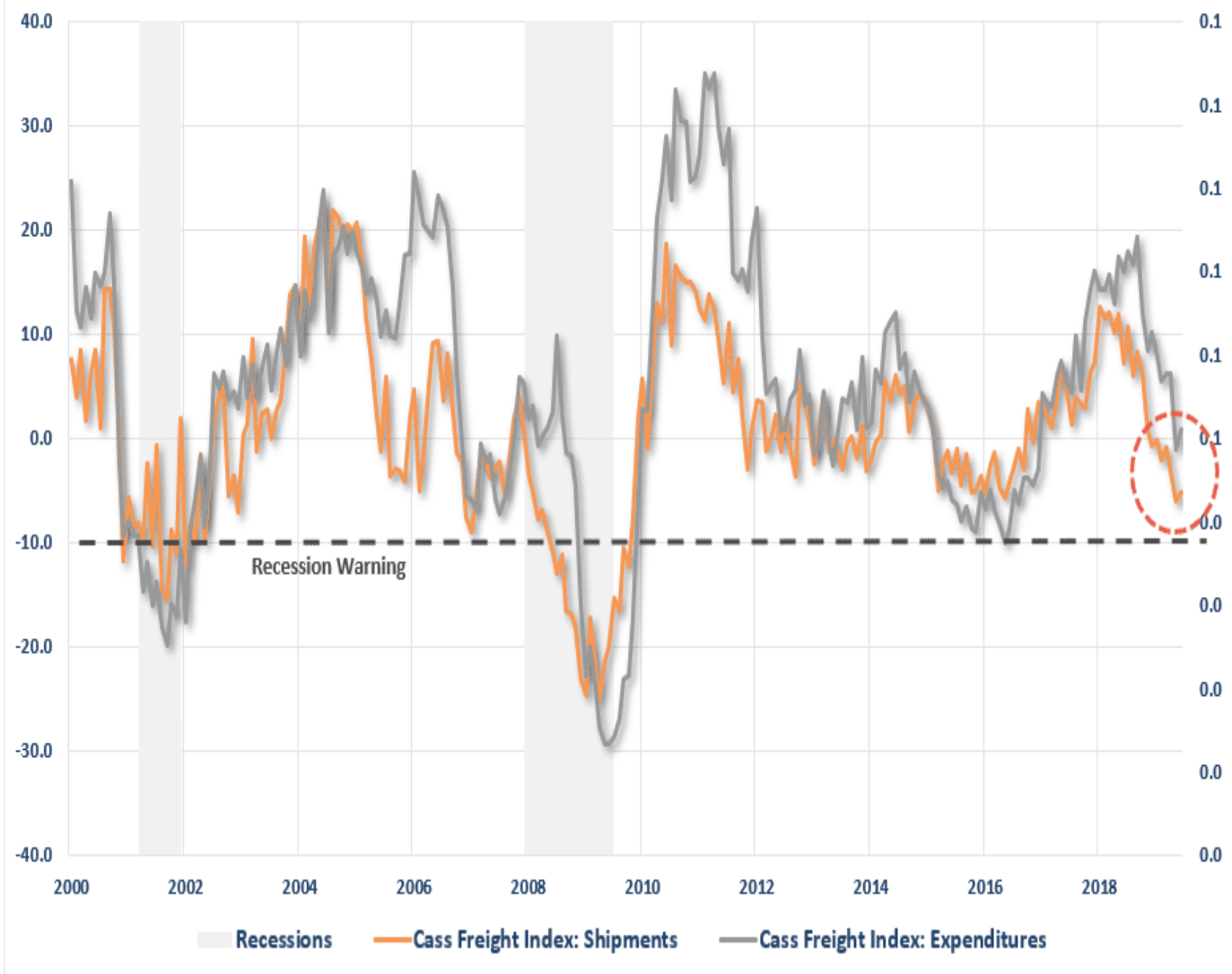


Cass Freight Index

There is also substantial *"hard data"* evidence the economy is under severe pressure. While *"sentiment-based"* surveys, or *"soft data,"* has rebounded recently, data like the *"Cass Freight Index"* is ringing alarm bells.

Cass Freight Index Suggests Weaker Economy

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Leading Economic Indicators Drop

However, it is the Leading Economic Indicator (LEI) index, which has our attention currently.

As [Mish Shedlock](#) noted on Thursday:

"The Conference Board's LEI index turned negative in June. The yield curve finally made a negative contribution. The conference board provides this press release on Leading Economic Indicators for June.

'The US LEI fell in June, the first decline since last December, primarily driven by weaknesses in new orders for manufacturing, housing permits, and unemployment insurance claims. For the first time since late 2007, the yield spread made a small negative contribution.' - Ataman Ozyildirim, Senior Director of Economic Research at The Conference Board

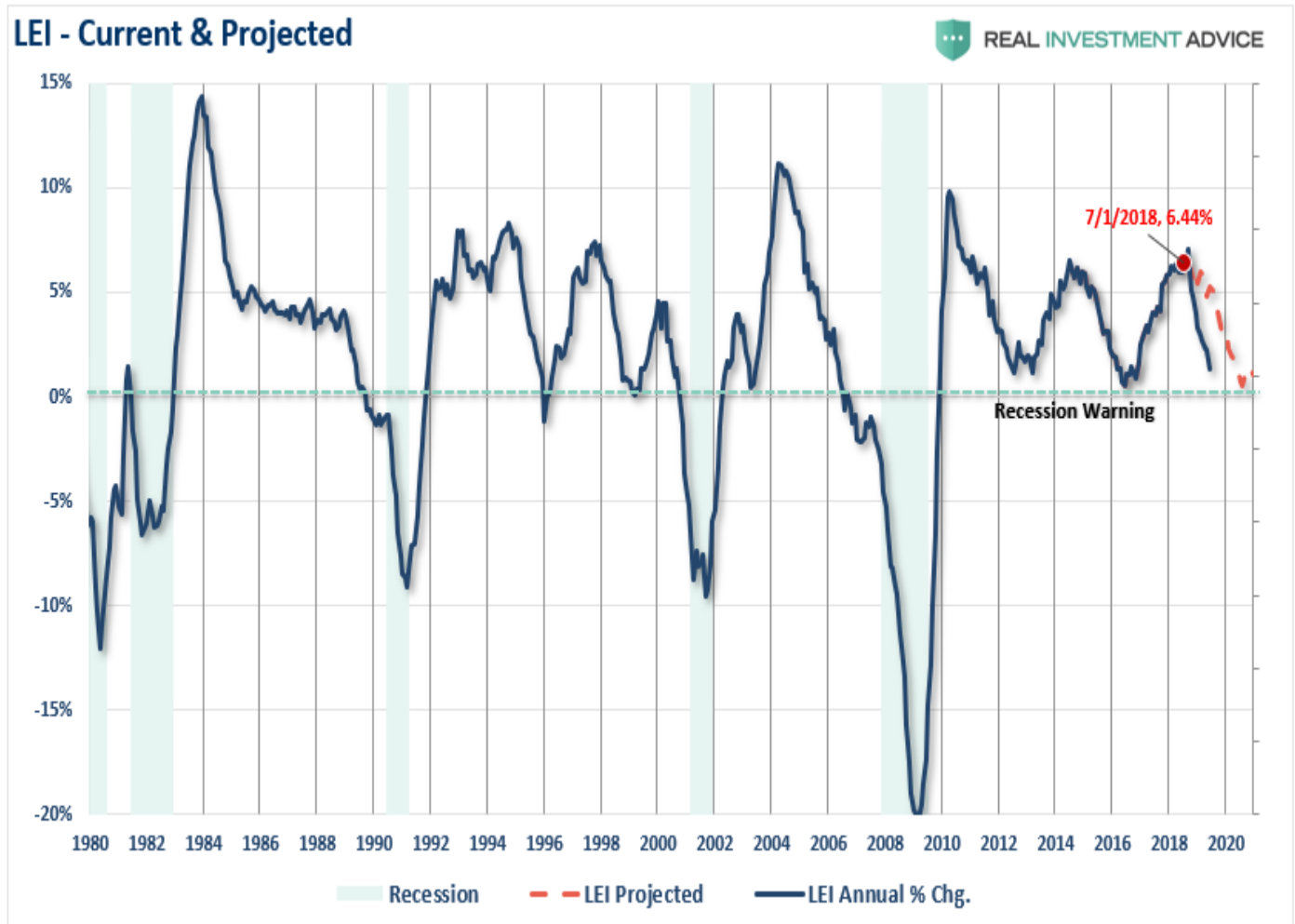
The consensus estimate was for LEI of +0.1, the read was a **-0.3**

Leading Indicators Turn Negative Lagging Indicators Negative Third Month

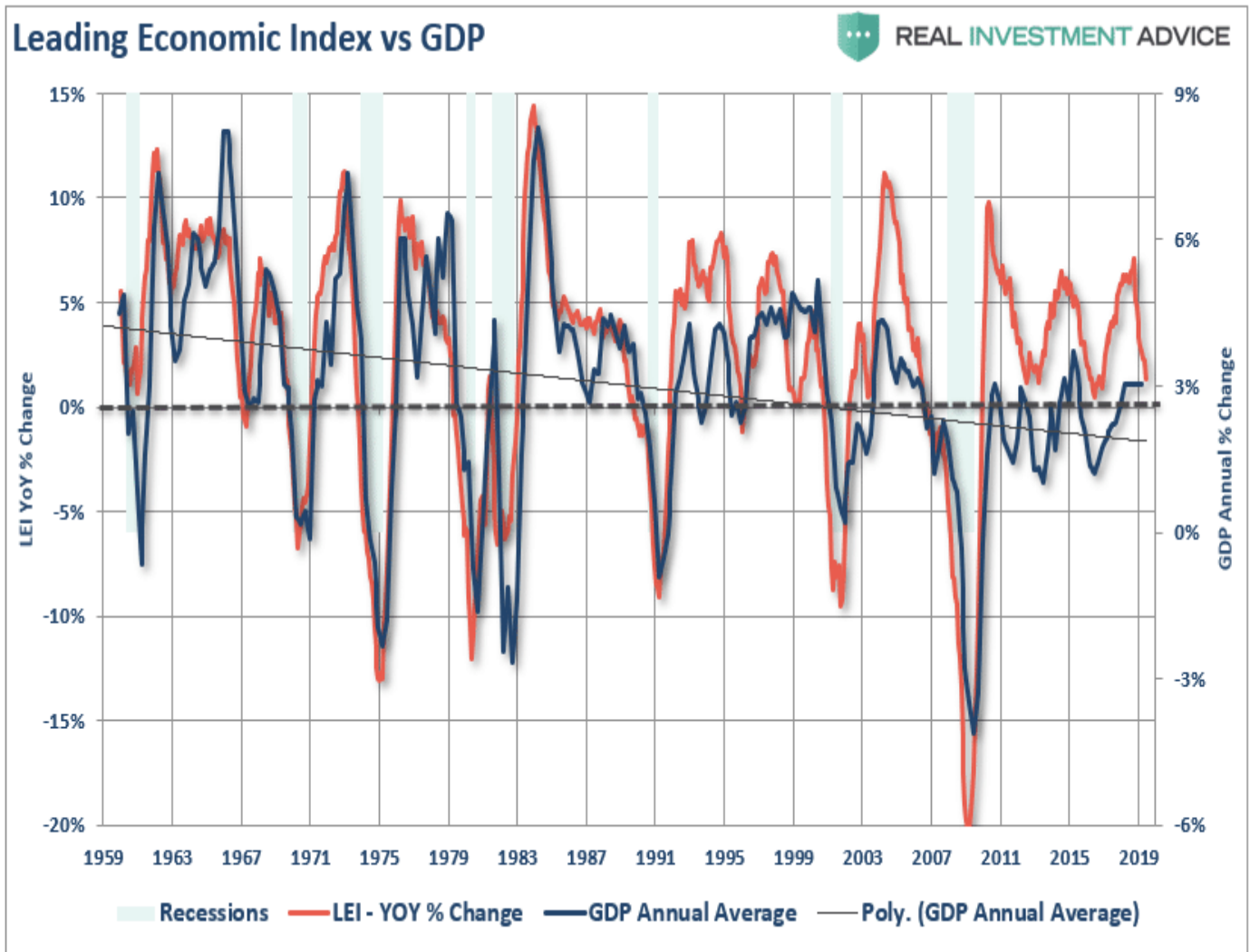
	Jan	Feb	Mar	Apr	May	Jun
Leading Economic Indicators	0.0	0.2	0.1	0.1	0.0	-0.3
Coincident Economic Indicators	0.0	-0.1	0.1	0.1	0.2	0.2
Lagging Economic Indicators	0.5	0.3	0.2	-0.1	-0.2	-0.2
coincident-lagging ratio	98.9	98.5	98.4	98.6	99.0	99.0

MishTalk

This decline is not surprising to us. In July of 2018, as noted in the chart below, we laid out a predicted path of reversion in the LEI index. As you can see, the reversion has been even sharper than we originally estimated.



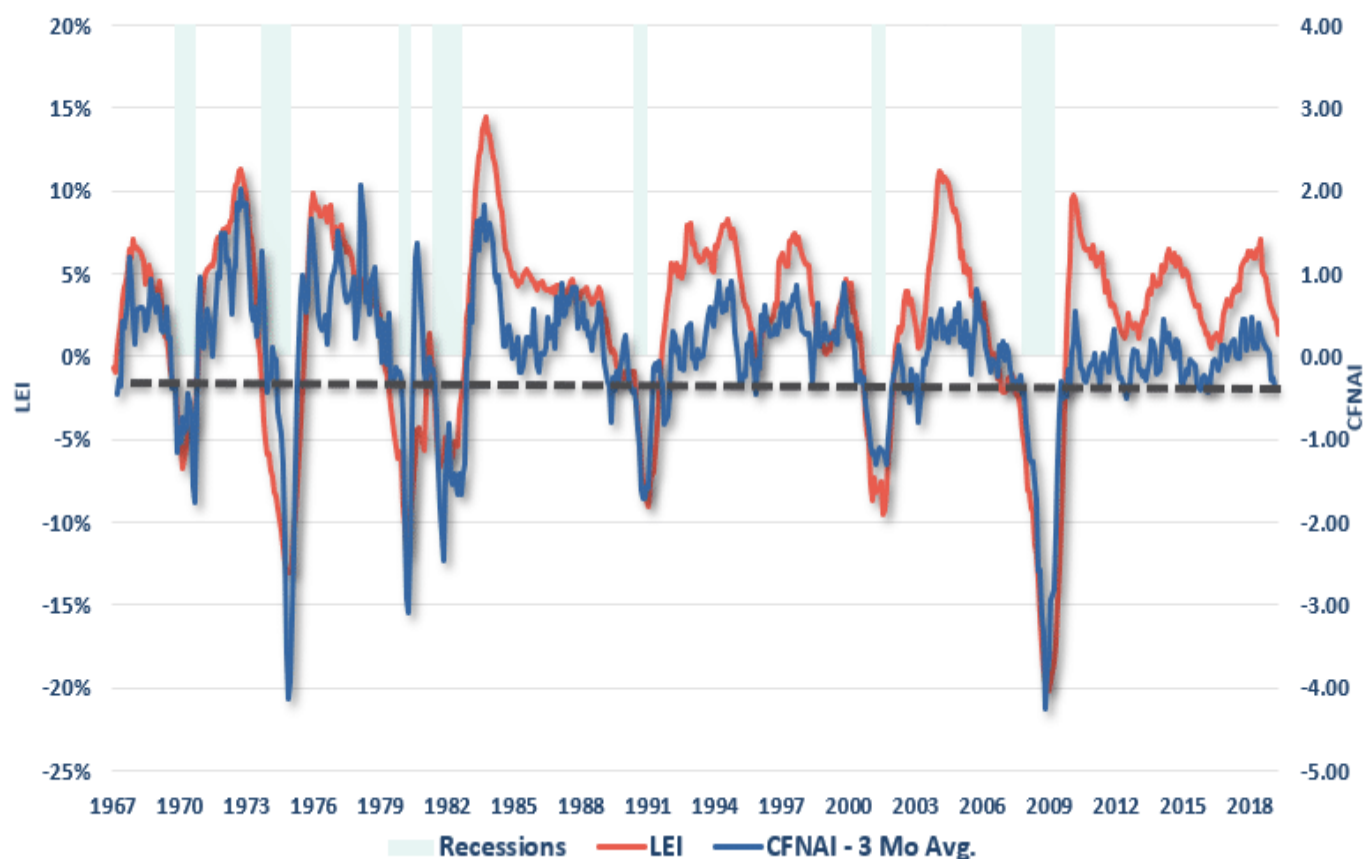
What is more concerning, and a reason the Fed is likely acting now, is there is a high correlation between the LEI and GDP, economic activity, and corporate profits. When compared to nominal GDP, the LEI index is suggesting a sharp slowdown is just ahead.



The **Chicago Fed National Activity Index (CFNAI)** is one of the broadest measures (*80-sub components*) of economic activity. The LEI and CFNAI, not surprisingly, also have a high correlation, which suggests further weakness is ahead.

LEI & CFNAI - All Suggest Weaker Economy

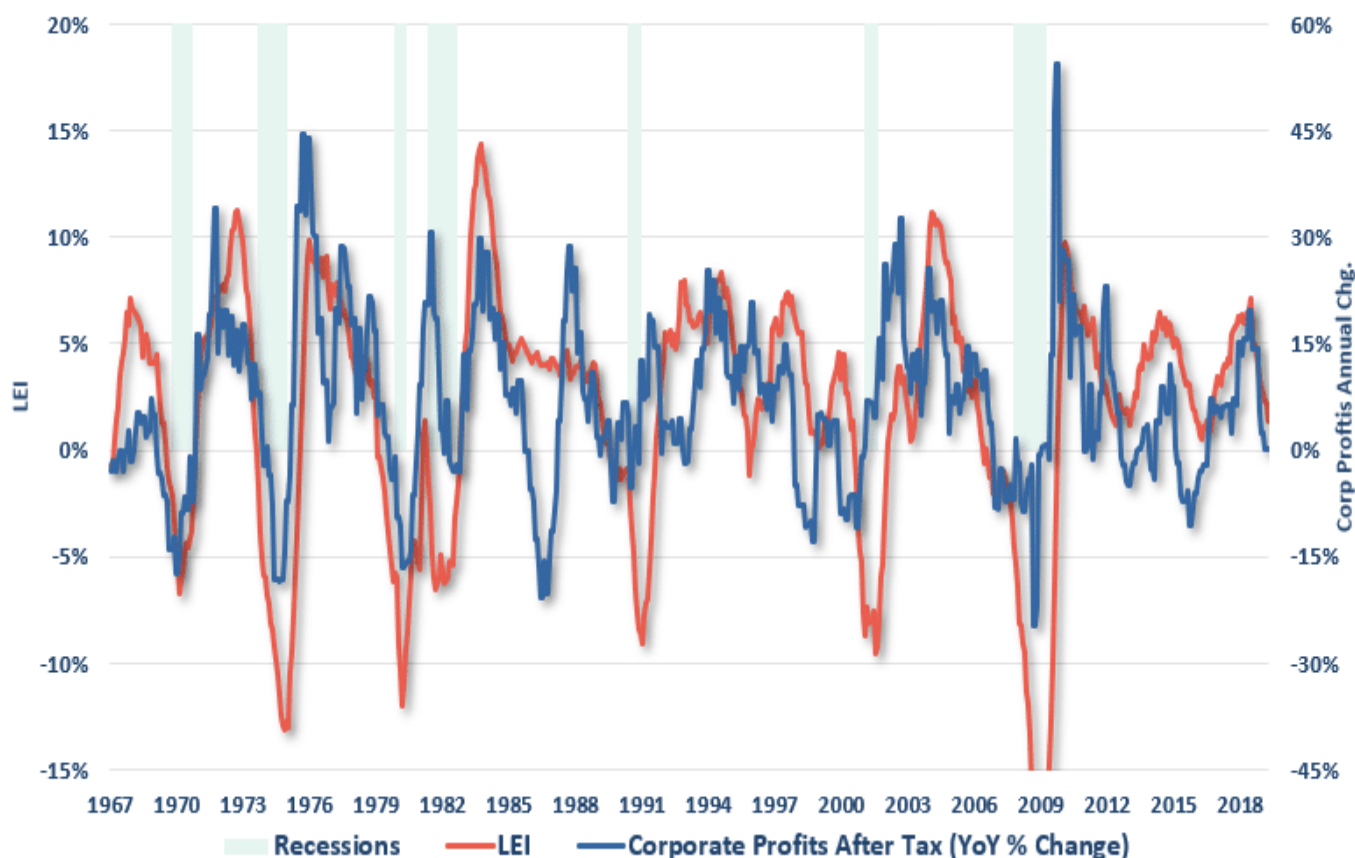
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Of course, if GDP, and underlying economic activity, is slowing down, it should not be surprising that corporate profits also decline.

LEI Suggests Weaker Corporate Profits

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The LEI is certainly not a perfect indicator for recessionary activity and has provided many false signals since the 2009 lows. **However, the recessionary correlation is the highest when the LEI is signaling a recessionary warning at the same time the Fed Funds/10-Year yield inversion is in place.**

I think the Fed is beginning to panic as they were never able to get yields up to high enough levels to be effective in the next recession. Of course, this is exactly what we said would happen numerous times previously:

*"The Fed surely understands that economic cycles do not last forever, and after eight years of a 'pull forward expansion,' it is highly likely we are closer to the next recession than not. **While raising rates would likely accelerate a potential recession, and a significant market correction, from the Fed's perspective, it might be the 'lesser of two evils.'** Being caught at the 'zero bound' at the onset of a recession leaves few options for the Federal Reserve to stabilize an economic decline."*

Janet Yellen was smart enough to "exit" and stick Jerome Powell with the "tab."

While the market rallied back from its 20% decline last year on "hopes" of an end to the "trade war" and "rate cuts," the market is missing an important part of the picture.

Rate cuts may not work.

Why It Won't Matter

My friend [Patrick Watson recently penned](#) the problem for the Fed:

"This used to be pretty simple. [When the economy slowed, the Fed would cut rates.](#)•This encouraged borrowing and investment. People bought houses. Businesses expanded and hired people. The economy would recover.

Now, it doesn't seem to work that way. Peter Boockvar succinctly explained why in one of his recent letters. The problem is that 'easy money' stops working when it becomes normal, as it now is.

Lower rates don't encourage borrowing unless potential borrowers think it's a limited-time opportunity. Which they don't anymore, and shouldn't, since the Fed shows no sign of ever going back to what was once normal."

Exactly correct.

Also, "stimulus" works best when the "patient" is in the worse possible condition, not when the patient is healthy. As I [wrote in "QE - Then, Now, & Why It May Not Work:](#)

*If the market fell into a recession tomorrow, the Fed would be starting with roughly a**\$4 Trillion** balance sheet with interest rates 2% lower than they were in 2009. In other words, the ability of the Fed to ?bailout? the markets today, is much more limited than it was in 2008.*

However, there is more to the story than just the Fed's balance sheet and funds rate. The entire backdrop is completely reversed. The table below compares a variety of financial and economic factors from 2009 to the present."

	Then 1/1/2009	Now 1/1/2019	Change
Fed Funds	0.15%	2.40%	2.25%
10-Year Treasury	2.52%	2.68%	0.16%
Nominal GDP	-1.75%	5.34%	7.09%
Inflation Rate	-0.12%	1.52%	1.64%
Unemployment Rate	7.80%	4.00%	-3.80%
Jobless Claims (4-wk Avg.)	543500	229000	-314500
Shiller CAPE-10	19	28	9
Government Debt (Trillion)	\$11.10	\$22.00	\$10.90
Private Non-Residential Fixed Inv.	-1.25%	8.61%	9.86%
Existing Home Sales	3820000	4370000	550,000
New Home Sales	336000	657000	321,000
Consumer Sentiment	61.2	91.2	30
NFIB Survey	83.9	101.2	17.3
PCE	-1.47%	3.98%	5.45%
Retail Sales	-11.48%	4.01%	15.49%
Leading Economic Indicators	76	111.3	35.3
Total Vehicle Sales (Million)	9.79	17.13	7.34
RIA Economic Composite	4.23	37.75	33.52

Feb Balance Sheet	\$915 Billion	\$4 Trillion	\$3.85 Trillion
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"The critical point here is that QE and rate reductions have the MOST effect when the economy, markets, and investors have been 'blown out,' deviations from the 'norm' are negatively extended, confidence is hugely negative.

In other words, there is nowhere to go but up."

Let me be clear; it is certainly possible that asset prices could rise in the short-term given the "training" investors have received over the last decade to "Buy The F***ing Dip." **However, given the economic and fundamental backdrop, rate cuts will not change the onset, duration, or intensity of the coming recession.**

Yes, participate with the "rate cut rally."•

We will be.

Just make sure you have a strategy to "leave the party before the cops arrive."

If you need help or have questions, we are always glad to help. [Just email me.](#)

See you next week.

Market & Sector Analysis

Data Analysis Of The Market & Sectors For Traders



If you are NOT an [RIA PRO subscriber](#), you are missing the most important part of each weeks? newsletter.

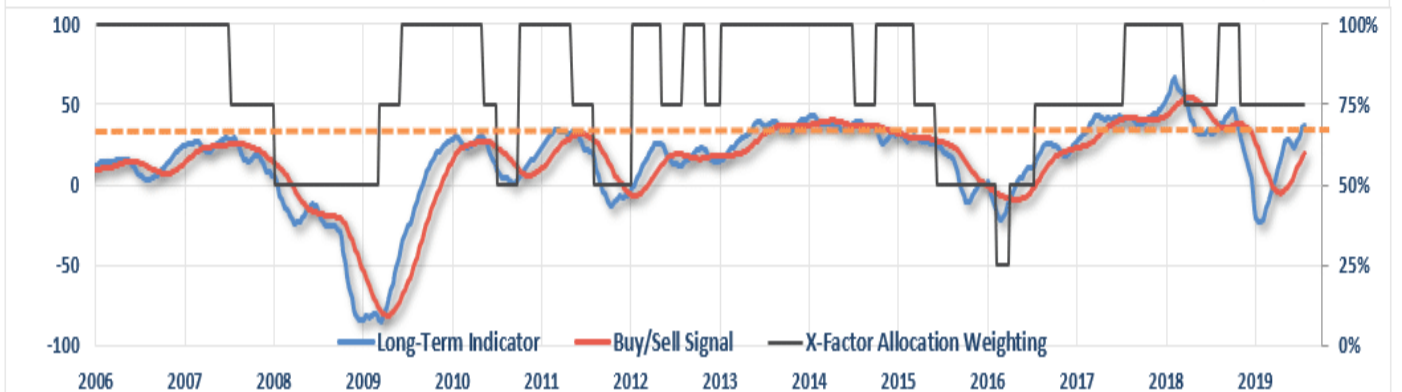
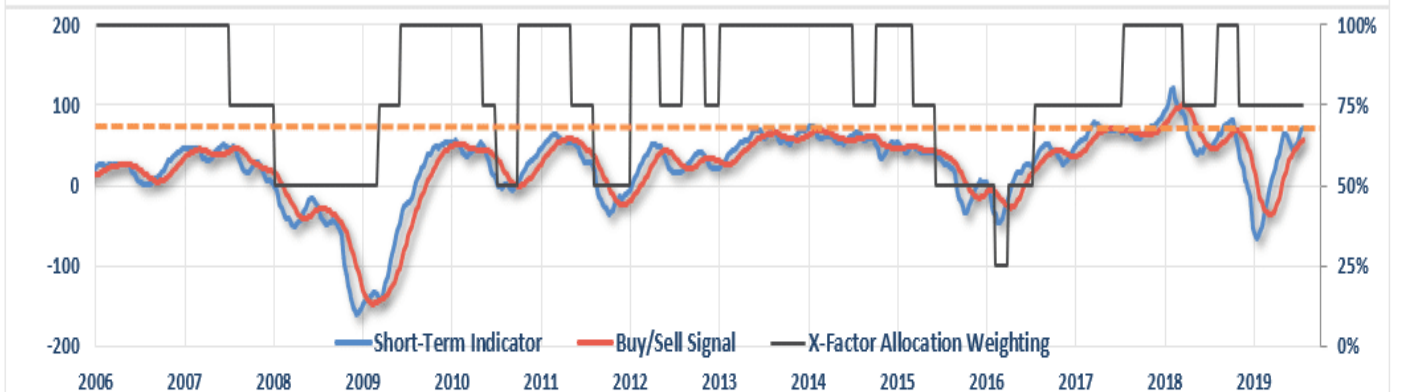
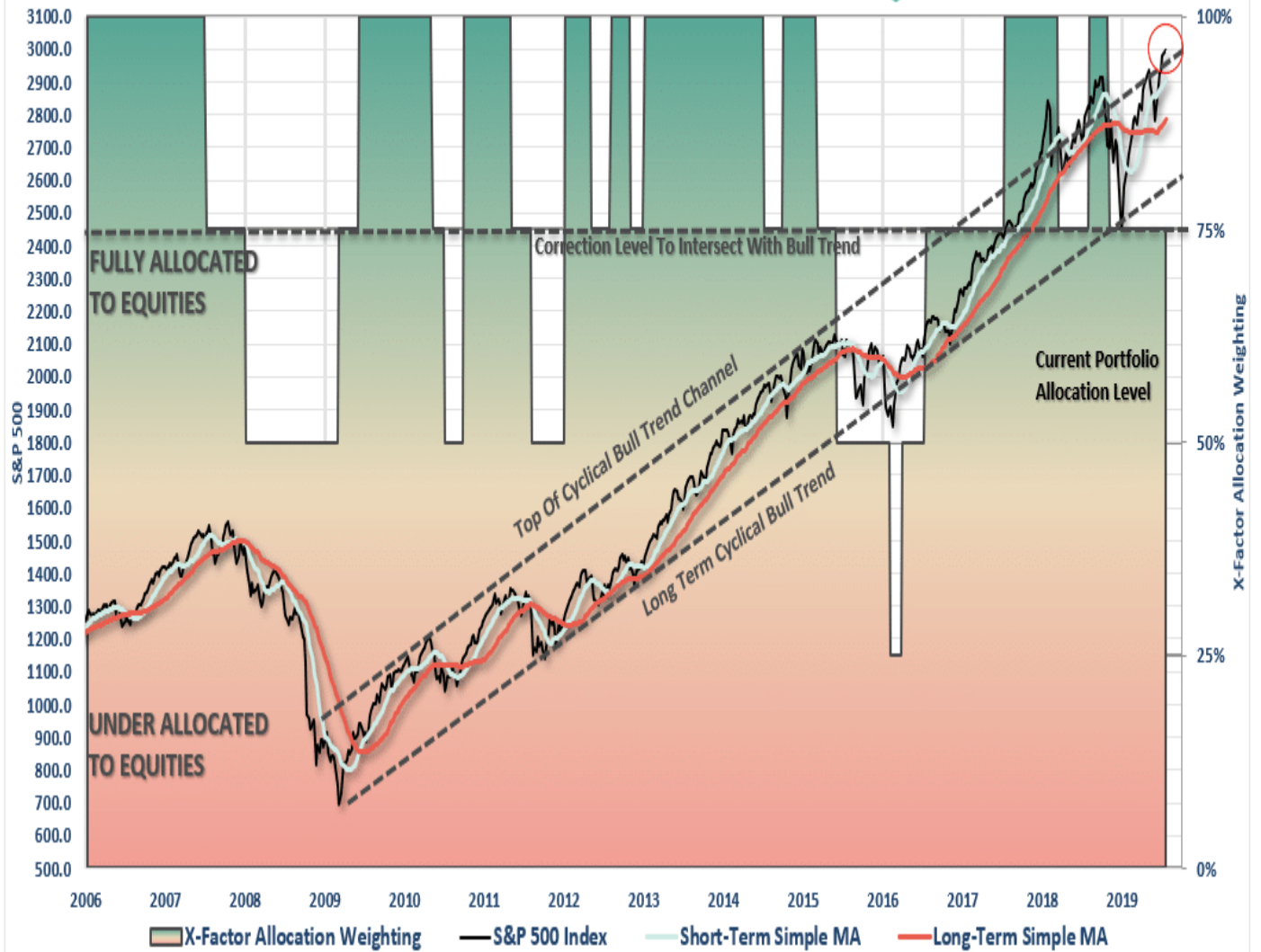
- ***Sector & Market Performance Analysis***
- ***Portfolio Recommendations***
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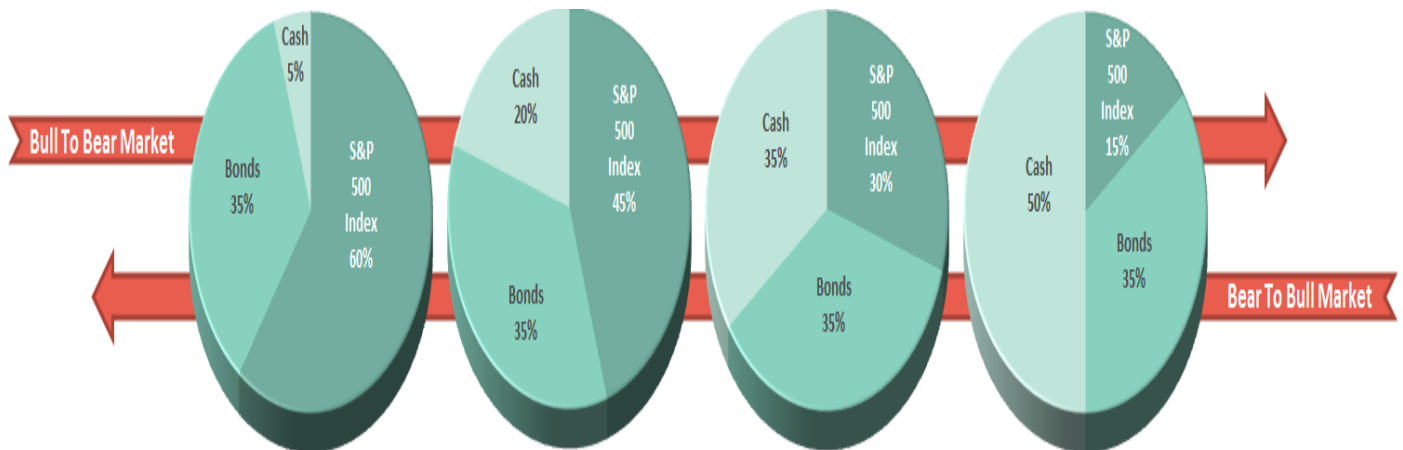
THE REAL 401k PLAN MANAGER

A Conservative Strategy For Long-Term Investors

Risk Management Analysis



There are 4-steps to allocation changes based on 25% reduction increments. As noted in the chart above a 100% allocation level is equal to 60% stocks. **I never advocate being 100% out of the market as it is far too difficult to reverse course when the market changes from a negative to a positive trend.** Emotions keep us from taking the correct action.



Market Stumbles As Overbought Condition Bites

As noted last week, the market breakout was straining the deviation from the long-term moving average. Such a situation rarely last for very long.

That corrective process started at the end of last week despite Fed officials trying to assure the markets a rate cut is coming.

As noted last week:

"With Q2 reporting season going into full swing next week, as noted above, there is a potential short-term risk to share prices which could provide a better entry point to add to equity exposure. Be patient for that confirmation.

As stated previously, July and August tend to be challenging months for the market, so we want to be careful, particularly with the economic backdrop weakening.

That remained the case this week. • If you have not taken any actions in your plan, do the following on Monday.

- If you are **overweight equities**- Hold current positions but remain aware of the risk. Take some profits and rebalance risk to some degree if you have not already. •
- If you are **underweight equities or at target** -rebalance risks, look to increase holdings in domestic equities opportunistically if the markets can hold support at the May highs next week. •

With the markets back to extremely overbought conditions, patience will likely be rewarded.

If you need help after reading the alert; do not hesitate to [contact me](#).

401k Plan Manager Beta Is Live

We have rolled out a very early beta launch to our [RIA PRO subscribers](#)

Be part of our "**Break It Early Testing Associate**" group by using **CODE: 401**

The code will give you access to the entire site during the BETA testing process, so not only will you get to help us work out the bugs on the 401k plan manager, you can submit your comments about the rest of the site as well.

We have several things currently in development we will be adding to the manager, but we need to start finding the "*bugs*" in the plan so far.

We are currently covering more than 10,000 mutual funds and have now added all of our Equity and ETF coverage as well.•You will be able to compare your portfolio to our live model, see changes live, receive live alerts to model changes, and much more.

We are building models specific to company plans. So, if you would like to see your company plan included specifically, [send me the following](#):

- *Name of the company*
- *Plan Sponsor*
- *A print out of your plan choices. (Fund Symbol and Fund Name)*

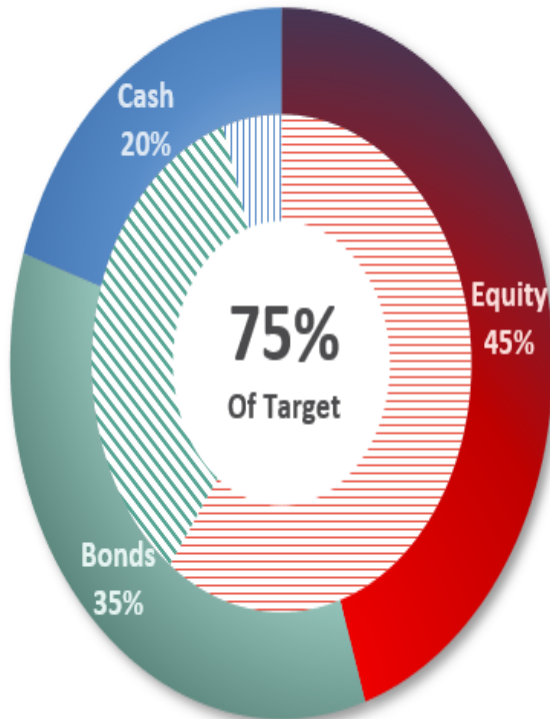
I have gotten quite a few plans, so keep sending them and I will include as many as we can.

If you would like to offer our service to your employees at a deeply discounted corporate rate, [please contact me](#).

Current 401-k Allocation Model

The 401k plan allocation plan below follows the K.I.S.S. principle. By keeping the allocation extremely simplified it allows for better control of the allocation and a closer tracking to the benchmark objective over time.***(If you want to make it more complicated you can, however, statistics show that simply adding more funds does not increase performance to any great degree.)***

Current Portfolio Weighting



Current 401k Allocation Model

20.00% Cash + All Future Contributions

Primary concern is the protection of investment capital

Examples: Stable Value, Money Market, Retirement Reserves

35.00% Fixed Income (Bonds)

Bond Funds reflect the direction of interest rates

Examples: Short Duration, Total Return and Real Return Funds

45.00% Equity (Stocks)

The vast majority of funds track an index.

Therefore, select on ONE fund from each category.

Keep it Simple.

10% Equity Income, Balanced or Conservative Allocation

35% Large Cap Growth (S&P 500 Index)

0% International Large Cap Dividend

0% Mid Cap Growth

Model performance is based on a two-asset model of stocks and bonds relative to the weighting changes made each week in the newsletter. This is strictly for informational and educational purposes only and should not be relied upon for any reason. Past performance is not a guarantee of future results. Use at your own risk and peril. •

