Economic & Market Commentary

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The Contrarian Value Advisor

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2019 Outlook

CVA Highlights

Market likely bottomed Dec.24 & has begun a final parabolic up leg into a secular top

I expect a melt-up to take the S&P to 3500, Dow to 32,000 & Nasdaq to 9500 in 1st half of 2019. Historic bear could take market down 80% in 2nd half

FAANG stocks, along with semiconductors, gold miners & industrials will lead in the melt-up

Fed is committing a big policy error and that, combined with the massive leverage in the global system, will trigger a global deflationary bust in 2nd half of 2019

Inflation peaked for this cycle last summer. Fed still fighting the inflation bogeyman when deflation is the far greater risk

China is experiencing its weakest economic growth in many years & given all its debt, will play a key role in the coming global bust

USD poised for a sharp decline to 85-86 in coming months. EURUSD to 1.25-1.28 & USDJPY to 1.00. GBP, CAD & AUD should also see significant rallies

Weak dollar will spur gold & silver to their highest prices in 6 years. Gold to $1550 & silver to $26

Oil prices down 45% in 3 months. Oil will tumble to $10 in global bust later this year

Secular bond bull market that began in 1981 is likely in its final year. Sharp drop in yields with 10yr to 1/2% & 30yr to 1% in the bust. TLT to $160

After two strong years in 2016 and 2017, the U.S. equity markets spent much of 2018 in correction mode. The S&P experienced a 15% correction in the latter part of 2015 and early 2016, then embarked on a strong rally that took it up 62% in the next two and a half years. After reaching an all-time peak in September of 2018 at 2940, the S&P fell to a closing low of 2351 on Christmas Eve, about 20% off the highs. This sell-off has brought out the bears. Bearish sentiment is back to the levels of early 2016, just prior to that big rally, and by some measures is back to the levels we saw at the 2008/09 bottom. It remains to be seen whether or not this correction is over, but if not, we are darn close. That is certainly not the opinion of a majority on Wall Street these days. Strategists seem to be trying to outdo one another to see who can provide the most bearish projections. This is a far cry from the past few years when it was almost universally accepted that the bull market was healthy and nowhere near a top. As a contrarian, I am happy to see all of this negative sentiment. It suggests to me that the bull market is alive and well and has further to run. It remains my view that there is one final parabolic up leg left in this secular bull market, a bull market that began in August of 1982. I think we will see a melt-up in the first half of 2019, that will take the S&P to a minimum of 3500, the Dow to 32,000 and the Nasdaq to 9500. Right now, the Street consensus believes that the economy is rolling over and that the bull market has ended. The consensus is forecasting much lower lows just ahead. I think this negative sentiment will help fuel what I expect to be a very dynamic rally culminating in a secular and cyclical top in the first half of 2019. By the time we get to this top, I suspect sentiment will have shifted from deep despair to ebullience, with the consensus proclaiming the bull market healthy and far from an end. Market psychology is a powerful force, and at its extremes, it is best viewed from a contrarian perspective.

Both the U.S. economy and the global economy appear to be slowing quite significantly. The Fed has hiked rates nine times and has been shrinking its balance sheet for over a year now. Meanwhile, the ECB has recently announced that it is also ending its quantitative easing program. It is rather unprecedented and troublesome for these central banks to be tightening just when economic growth is heading south. It is particularly disconcerting, given the massive leverage that exists in the

system. The markets are very concerned about this, even if the central bankers are not. I have been among Jerome Powell's biggest critics. He was appointed Fed Chairman despite having a lack of formal economic training and little monetary policy experience. He is a lawyer who has spent his career in private equity. He has displayed a real lack of understanding of certain aspects of monetary policy in some of the statements he has made during Fed press conferences. Among other things, he has made it quite clear that he believes that the Fed's balance sheet needs to be reduced dramatically, regardless of the impact that reduction has on the markets. Removing much of the monetary excess from all of the quantitative ease of earlier in the cycle may seem like sound policy, but doing so at this point in the cycle will prove costly. Experienced macroeconomic analysts understand the value of the market as a leading economic indicator. The market itself, along with many of its components, can provide an early read on the economy. Right now the market is sending a clear signal that Fed monetary policy is too tight. The economy is headed for a recession and likely something far worse, unless the Fed reverses policy very soon. Unfortunately, Powell has chosen to ignore the market and instead has been intent on sending the message that unlike his predecessors, he has no interest in propping up the markets. In other words, there will be no Powell put. Instead he and his fellow governors are focused on backward-looking data that shows the economy in good shape. As a result, the Fed has been slow to recognize the emerging weakness that is now evident in several sectors of the economy. Further, this Fed continues to focus on fighting the nonexistent inflation bogeyman even though inflation for this cycle peaked at 2% last summer and is clearly heading lower. The Phillips curve is still prominently featured in Fed modeling, even though the assumed inverse correlation between unemployment and inflation has been nonexistent throughout this recovery cycle. Even with historically low unemployment, we are seeing no signs that it is triggering inflation. The Fed is so model-driven that it seems to be ignoring the deflationary implications of the oil price decline in the fourth quarter that took oil from $77 down to $42. Powell and the Fed are clearly behind the curve and underestimating the rising deflationary risks. This is what has the markets spooked. There is a real and growing concern that the Fed, under Powell's leadership, is committing a big policy error here. The good news, however, is that the Fed doesn't operate in a vacuum. No doubt, Powell is hearing the criticism and there are signs that he now realizes the need to put further rate hikes on hold. I expect the Fed to soon wake up to the emerging weakness and to also halt the quantitative tightening, at least temporarily. The markets would respond very positively, were he to do that.

The December jobs number was a surprisingly strong number, causing many to dismiss talk of an economy heading for recession. However, employment is a lagging indicator and there can be a lot of problems in trying to get the seasonal adjustment factor right at this time of year. It was a good number, but I wouldn't put much stock in it. Housing, autos, semiconductors and manufacturing are all displaying significant weakness. Combine this weakness with the weakness we are seeing in oil and the rest of the commodity sector, and there is good reason to suspect that the Fed policy is overly tight and in danger of pushing the economy into recession. It is not just the U.S. economy that is slowing either. Citigroup's Global Economic Surprise Index finished the year below zero for the first time since 2008. Europe is slowing, Canada and Australia are slowing, the emerging market economies are struggling, and probably most concerning of all, China is facing its biggest and most widespread slowdown in years. The purchasing manager indexes are universally weak across the globe. The global PMI index is at a 27 month low. The Eurozone PMI is at its lowest reading in nearly five years. The U.S. PMI is at a fifteen month low and China's manufacturing PMI was the weakest it has been in three years. CapEx is slowing all around the globe. Auto sales in China suffered their first annual decline in thirty years. Chinese retail sales growth was the lowest in fifteen years. Property sales in China were the weakest in three years. Chinese consumption tax receipts declined 71% year over year in December. China has been dealing with weakness in the industrial sector for a while, but of real concern is the fact that the consumer and service side of the economy is also displaying weakness for the first time in many years. Although the

Chinese government is still reporting GDP above 6%, many believe the true number is probably closer to 2% and perhaps even lower. There is real reason to be concerned, given the massive debt that has built up in China over the past two decades. China has been the economic engine of the world for several decades. They may now be the biggest reason why the next downturn will be the steepest and deepest of the post WWII era.

Powell is not just missing clues provided by the stock market. He is also ignoring some important messages being sent by the bond market. Ten year yields have fallen sixty-five basis points in just three months. High yield spreads have widened substantially, and even investment grade spreads are beginning to widen significantly. Both the bond market and the stock market seem quite concerned about the direction of the economy and the apparent lack of awareness and/or concern on the part of the Fed. As a Fed watcher of some forty-five years, I cannot remember a FOMC that was so lacking in monetary policy training and experience. Not since G. William Miller in the late 1970's, have we had a Fed chairman with so little understanding and training in the relationship between markets and the economy. The stock and bond markets are the best leading indicators of future economic activity Powell has and yet he has seemingly removed both from his toolbox. I expect Treasury rates to continue to head lower throughout 2019, while corporate spreads continue to trend higher. It won't happen in a linear fashion, but ultimately I expect high yield spreads to approach and maybe even surpass their peak in 2008. A global bust is coming and it won't be kind to the corporate bond market. There has been a doubling in the issuance of corporate bonds in the U.S. since 2007. Corporate balance sheets have been leveraged up, as corporate treasurers sought to take advantage of the historically low rates. A big percentage of the bond proceeds were used for stock buybacks. As we all learned in business school, leverage can enhance earnings on the way up, but it will turn into a real albatross when the economy and revenues head south. We are getting a bounce in the corporate bond market, but Treasury bonds should far outperform corporates through most of this year. I continue to have the most bullish Treasury bond forecast on Wall Street. I expect the 10yr yield to fall to ½% and the 30yr to 1% in the second half of 2019, as investors across the globe seek out safety during the bust. TLT, the ETF that tracks the 20yr T-bond, should rise to $160 from its current level in the low $120's.

The U.S. dollar has been in rally mode for much of the last year, but is now showing signs of rolling over. I expect it to fall to 85-86 in coming months. As the economy continues to weaken and the Fed finally recognizes the need to ease, we will see the dollar fall and fall quite sharply. Investors are positioned bullishly and will no doubt be unwinding those positions in the coming weeks and months. Dollar strength has really put pressure on the emerging market countries that leveraged up with dollar denominated bonds and are now finding it very costly to service that debt. They need the relief that a weaker dollar would provide. And, of course, dollar weakness means other currencies will be rallying. The Japanese yen has recently started trading up aggressively against the dollar, and I expect the euro and the Chinese yuan to follow suit. My target for JPYUSD is 1.00 and for EURUSD is 1.25. I also expect the British

pound to rally once we see a successful resolution to the Brexit negotiations, and yes, I still do expect Brexit, despite all of the current pessimism. The Canadian and Australian dollars should also experience significant rallies against the U.S. dollar in the first half of 2019. I suspect that as the dollar falls below the lows of a year ago, near 88, we will hear all kinds of bearish predictions about the dollar losing its reserve status, with projections of 80 and lower. That will be the signal that it is time to begin reestablishing positions in the dollar.

Commodities, led by oil, are weak and likely to get weaker, as the global economy continues to slow. In three months' time, oil fell from $77 down to $42, a 45% decline in price. Much of this weakness was due to excess supply, but demand is beginning to soften as well. Most of the metals have been weak and are getting weaker, including copper, aluminum, nickel, tin and lead. Global demand is slipping and I expect further weakness immediately ahead as the global economy continues to weaken. We could get a commodity bounce that coincides with some announcement of central bank ease, but ultimately, I expect much lower prices when the bust hits later this year. I expect oil to fall to $10 in the bust and copper could go as low as $1. By the time 2019 draws to a close, I expect deflation to be a dominant theme. We haven't experienced a global deflationary downturn since the Great Depression, so I don't think most investors really understand what a game changer it could be. It won't be the mild sort of deflation that Japan experienced in recent years. This version will likely be steep and rather broad-based and impact assets, as well as goods and services. It will also be accompanied by a substantial amount of involuntary debt liquidation and some significant bank failures. This is why I have been so critical of Jerome Powell. He clearly has no idea of the magnitude of the risks we are facing, nor the imminent nature of these risks. Global liquidity was down sharply in 2018, and yet his plan is to continue to drain liquidity to the tune of $50 billion per month. History will not be kind to Chairman Powell.

Gold and silver are finally showing signs of coming to life. Both have been under a good deal of selling pressure since their peaks in 2011. I expect both metals to perform very well in the first half of 2019, along with the miners. I think the weak dollar will be the primary impetus to this move, but they will also benefit from the uncertainty in the markets, as well as, a move in the direction of easier monetary

policy by the Fed. I continue to expect gold to rally to $1550-$1600 in coming months, before rolling over and heading to sharply lower lows in the deflationary bust. Silver has underperformed gold for the past 2 ½ years, but that may soon change. I am calling for silver to trade as high as $26 in this rally, which would be nearly triple the return I am expecting in gold. Silver typically outperforms gold on the way up and underperforms it on the way down, and this time should be no different. The miners are poised for nice moves as well. GDX, the large cap gold mining ETF, is currently trading at $21 and I think can trade up to $40. GDXJ, the junior miner ETF, is trading at $31 and can trade up to $70. The set-up here looks very much like what we saw in 2016, when a weak dollar propelled the metals and the miners sharply higher over the course of six months. Rallies have been short-lived these past couple of years, so investors have been conditioned to trade the miners and to be quick to take any profits or risk losing them. I would suggest that investors not be so quick to trade these stocks here, and to let their profits ride for the next several months. I expect such a strategy to prove quite rewarding.

As a long-time contrarian, I have devoted a significant amount of my time to looking at the role that psychology plays in the market. The tape's action can really impact how investors perceive the market's prospects going forward. When you get a 20% sell-off in three months, after two years of almost no volatility, it is bound to have a significant negative impact on investors' psyche and it certainly has. I can easily make a bearish case here, both fundamentally & technically. In fact, I have provided plenty of reasons in this letter to support a bearish view of the stock market. Risks are high and the Fed is seemingly still unaware of the big policy error it is making. Fed tightening will cause a severe recession or worse, if it is not reversed soon. Yet despite all of these negatives, my call here is that we have completed a sharp correction and have begun a final leg of the secular bull market. I expect a rally that will take the market to substantial new highs in the first half of this year. Late in bull markets, the slope typically steepens and volatility increases. As a result, you can get quick, sharp moves in both directions. That is particularly true in today's market structure where trading is dominated by hedge funds, exchange traded funds, high frequency trading and an extensive use of derivatives. The December sell-off, and especially the Christmas Eve swoon, were exacerbated by the fact that several large hedge funds that were closing their doors, needed to liquidate positions before year-end and were running out of time. Some of these funds may have hoped for a year-end rally that had not yet materialized, and then were forced to unload positions in a more panicked fashion. I have heard many pundits suggest that we haven't yet seen the kind of capitulation selling that marks a bottom, but I think that the Christmas Eve sell-off indeed may have been that capitulation bottom. A retest of the bottom is certainly possible, but I would not count on it. There are many pundits advising investors to wait for the retest before going back in. Investors following this advice could find themselves sitting on the sidelines during a steep rally.

Among the outperformers in this final leg will be the gold miners, the semiconductor stocks, industrial stocks and the FAANG stocks. I know many analysts think the FAANG stocks are over-owned and expect them to underperform in coming months. I strongly disagree. I would take advantage of the recent weakness in this group and buy these stocks here. They should be among the leaders in this final move to the top. Another group that is very oversold and under-owned here are the emerging market stocks, as represented by the ETF, EEM. Selling in the high 30's, I think we could see EEM move up to 56. A weak dollar should help this group. Among the groups I expect to underperform during this final rally are consumer staples, utilities, financials and energy stocks.

Conclusion

This year is likely to be a tale of two cities. To paraphrase Charles Dickens, we may well see both the best of times and the worst of times in 2019. I think we are going to experience one of the biggest and steepest rallies in market history in the first half of the year, followed later in the year by what I think could be the biggest market decline in the post WWII era. Long time readers of this letter know that I have been saying for some time that whenever this cycle ends, it would likely end in a global deflationary bust. The reasoning has always been that with $250 trillion in global debt and over $1 quadrillion in notional value of derivatives, we have a far more leveraged system than ever before. This leverage will turn the next recession into something much worse. Normally, the central banks are the culprits who trigger a recession by draining liquidity from the system. More often than not, recessions were an unintended consequence of overtightening. The Fed is on the verge of a similar policy error here. The difference this time is the massive leverage. If the Fed doesn't soon recognize the need to reverse policy, a bust could occur sooner rather than later. Either way, I think we will likely see a bust before the end of this year. The good news is that Powell & his fellow governors are beginning to show signs that they need to ease up on their interest rate and balance sheet normalization plans. They have already indicated that further rate hikes are on hold, but they have yet to halt the monthly balance sheet roll-off. I suspect we will see that next. If we get that, along with a trade deal with China, we would likely see the market push back toward the highs. Push through those highs on good volume and I think we have the makings for a melt-up. The downward momentum of the tape triggered fear and sell programs. Strong upward momentum would cause a rush of buyers and potentially a melt-up. Hedge funds tend to be trading oriented and often trade in herd fashion. In general, they are also very momentum-driven. The hedge fund crowd sold a lot of stock and raised a lot of cash in the fourth quarter. A momentum reversal will have them jumping back into the equity markets once again. Now we just need the Fed to wake up.

The U.S. dollar is rolling over, and as a result, gold, silver and the miners look poised for a big run. In many ways, the set-up looks similar to early 2016. The economically sensitive commodities will not do nearly as well, however. They can bounce with the dollar weakness, but ultimately slowing global demand and a downturn in the economy will send these commodities to sharply lower lows later in the year. Oil could fall to $10 in the coming global bust. It won't stay down there very long, but even a short stay there will send many energy companies into bankruptcy. Treasury bonds will be the beneficiary of that economic weakness and financial turmoil. Investors both here and abroad will seek out the safety of the U.S. government guarantee and send the Treasury bond market to higher highs. We will see new lows in rates, with the 10yr falling to ½% and the 30yr to 1%. That should mark the bottom of an interest rate cycle that began back in 1981. Investors should be prepared for some historic moves this year and lots of volatility.

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