Insights: December 2018

Market Overview and Performance

Last year at this time, we opened our December 2017 Insights with the following observations. "*Is this as good as it gets? Apparently not, because stocks rallied once again in November, pushing the consecutive positive streak out to 13 months. In fact, the S&P 500 has only experienced two down months out of the last 23. And with just a few trading days left in 2017, it looks like December will be an up month as well resulting in the first ever full calendar year with positive returns in every single monthly period*." In hindsight, that was as good as it was going to get. In short, the "sugar high" boost to corporate earnings in 2018 brought on by the corporate tax cuts has undoubtedly faded. To be clear, this does not mean that earnings and broader economic growth will not move higher in 2019, it simply means that the 20 percent growth levels were an aberration, not a leap upward into a new higher growth trajectory. None of this was unexpected by the market, but it was easy to sit back and enjoy the good times. Unfortunately now, investors are left to deal with the consequences of these policy actions, which leaves them bracing for an environment marked by escalating trade wars, exploding deficits, increasing interest rates and slower economic growth across the globe. While we have been writing about the developing warning signs for much of the year, we remained constructive and continue hold that posture despite the recent volatility. In fact, we would suggest that the near-term surprises (particularly on trade) may be to the upside.

Happy Holidays to all of our clients and friends. We wish you the every best in 2019. As always, thank you for reading our latest Insights.

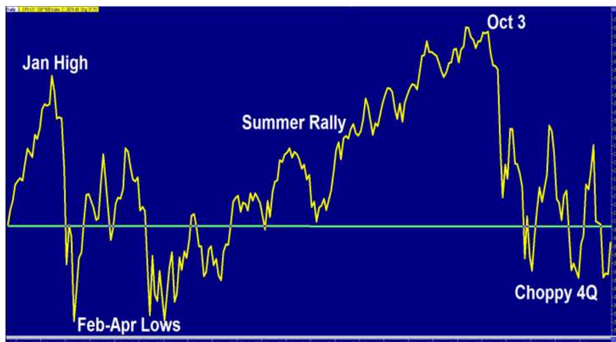
	Month to Date	*Year to Date*
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	2.04	5.11
Russell 2000 Index	1.59	0.98
MSCI EAFE Index	-0.13	**-9.39**
MSCI Emerging Markets Index	**4.12**	**-12.24**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.60	**-1.79**
Barclay's U.S. Aggregate Credit Index	**-0.40**	**-8.99**
Barclay's U.S. Aggregate Corporate High Yield Index	-0.86	0.06
Barclay's Municipal Bond Index	**1.11**	0.08
Macro Measures		
Gold	0.90	-6.79
Crude Oil	**-28.23**	**-18.63**
CBOE Volatility Index	**-17.49**	**38.90**
USD Dollar Index	0.14	5.29

Current Theme – Large Equity Declines Combined with Little Progress on Trade War Resolution Leave Investors Wary of the Path Forward in the New Year

Impact of Trade War Actions, Slowing Global Growth, Rising Interest Rates and Warning Signs from the Bond Market Lead the List of Worries for 2019

Although it never was the “greatest economy ever”, optimism ran high for much of 2018. After a 7.5 percent run-up in the first three weeks of January, a February pull-back was essentially viewed as a “healthy” consolidation that set the scenario for further gains going forward. That largely played out until Fed Chair Jerome Powell stated on October 3rd that the Fed was “a long way from neutral” implying several more interest rate hikes. This clearly upset the apple cart.

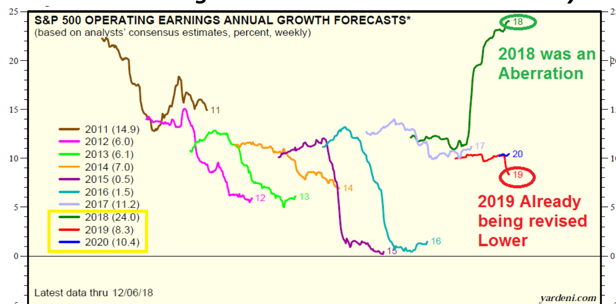
S&P Volatility in 2018 in Sharp Contrast to 2017 Calm



Source: Thomson Reuters

But in reality, the gains in 2018 (the S&P 500 was up 10.8% on October 3rd) were based off of false hopes. As one can see below, the 24 percent earnings growth was temporary, and not based on a sustainable trend.

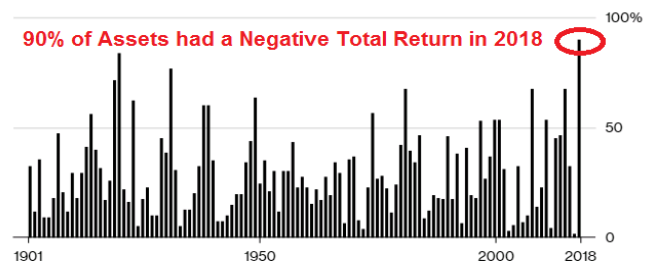
24 Percent Earnings Growth in 2018 Was an Anomaly



Source: Yardeni Research as of 12/6/18

As the previous chart illustrates, in any given year, estimates for earnings growth start around 10 percent and trail downward. The opposite occurred in 2018, with earnings exploding 24 percent higher on the back of the corporate tax cuts. Going forward however, 2019 estimates are already trending lower and are now close to 8 percent. One would think that a huge boost in profits like that would subsequently vault prices higher as well. But in fact, as the reality that there would be consequences to these policies set in, prices fell. In fact, ALL prices fell for the most part.

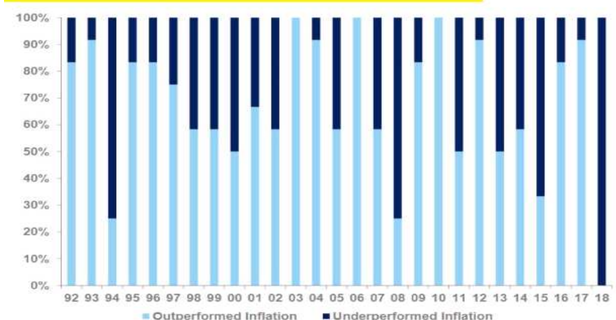
A Record 90% of Assets Posted a Negative Return in 2018



Source: Deutsche Bank AG; Bloomberg

As one can see above, an incredible *90 percent* of asset prices declined in dollar terms in 2018. A number not matched in over 100 years according to Deutsche Bank. One might suggest that, “well, perhaps that other 10 percent did very well and may have compensated somewhat.” Again, this was not the case. According to Morgan Stanley, out of the 17 major asset classes they track, *none* were able to beat US inflation in 2018. That means that even a well diversified portfolio not only lost value (a typical 60/40 equity/bond portfolio was down -3.5 percent on 11/28), it also lost purchasing power.

For the First Time, No Major Asset Class Beat US Inflation



Source: S&P; BLS; Global Financial Data; Robert Shiller; Morgan Stanley

In typical fashion, that disappointing performance has not stopped Wall Street strategists from publishing their most bullish forecast since the Financial Crisis. As of 12/2, the consensus 2019 price target for the S&P 500 is 3,056, some 15 percent higher than present trading levels. Thankfully, we do see some evidence that the current dour mood regarding the outlook in the US is somewhat overdone.

US Manufacturing and S&P Returns Tightly Correlated

Exhibit 1: Trailing 12-month S&P 500 return well below level implied by ISM
as of December 7, 2018

Source: Goldman Sachs Global Investment Research

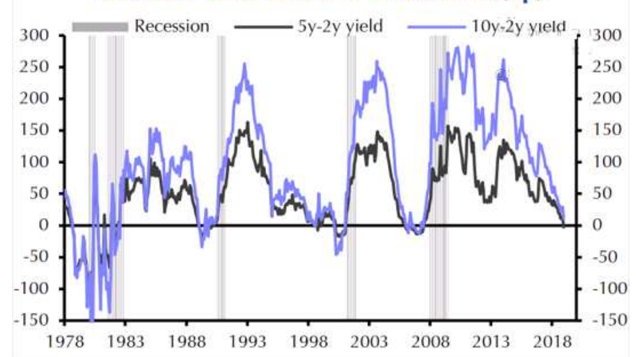
In the above, the light blue line shows that ISM US Manufacturing Index remains robust at 59+ (below 50 signals contraction). This data correlates very well with S&P yearly returns. The recent gap is obvious and as Goldman stated, it is highly unusual for S&P returns to go to zero when this measure of activity is above 50.

Cash Levels Highest in a Decade as T-Bills Yield 2.3%

Source: Bloomberg

In spite of this evidence which suggests that the US economy is not as weak as currently perceived, investors are reflecting their negative sentiment in a variety of ways. One of the more telling is the move to cash. Money market assets of ~$3 trillion are near decade highs and have risen sharply this year in a reflection of defensive positioning. Rising interest rates clearly are playing a role here as well. Again for the first time in a decade, the yield on a 1-month treasury bill is higher than the yield on stocks making cash a compelling asset for the first time since the Financial Crisis. The more ominous sign of investor worry is the yield curve which inverted during the first week of December. This pre-recession signal is a clear warning that investors believe that growth is slowing.

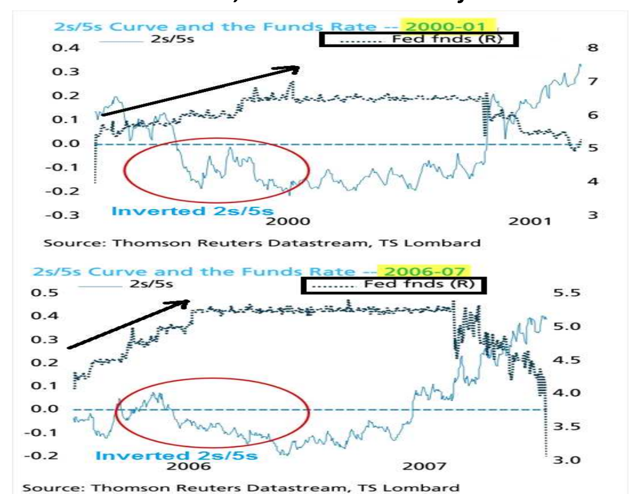
Curve Inverted: 5s2s at -04bpt and 10s2s at Just .09bpt



Source: Capital Economics

Since an inverted yield curve has preceded the last 9 recessions, investors are perhaps pinning their hopes on the notion that the Fed will take notice of this concern and slow or even end their policy of raising interest rates. However, as the chart below highlights, during the past two recessions, the Fed kept raising rates well after the yield curve (2s/5s) had inverted.

Last Two Recessions, Fed Cont. to Raise after Inversion



Source: The Daily Shot; Thomson Reuters DataStream; TS Lombard

If repeated, this course of action would be in sharp contrast to what the market is pricing in. As the chart below illustrates, the market clearly does not believe the Fed's stated intention to raise interest rates 3 times in 2019. Prior to October, 3 hikes were in fact priced in, however, expectations are now for less than one hike (essentially no hikes) and for rate *cuts* by 2020. This means that the market not only sees no need to slow the economy in 2019, it believes that the Fed will need to spur the economy to speed up activity. That would be a dramatic slowdown from current growth of about 2.5 percent.

Market Sees Less than 1 Hike in 2019 and Cuts in 2020

Source: Bloomberg

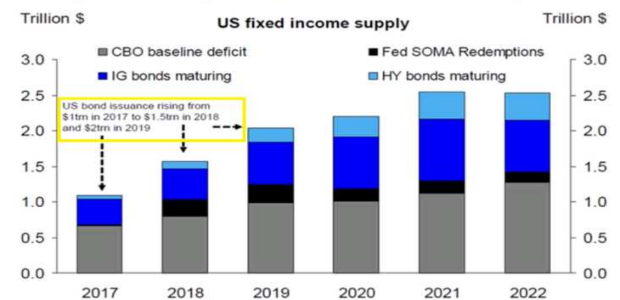
On an encouraging note, an inverted yield curve, while very accurate in signaling direction, is a poor indicator of timing. As the chart below shows, going back to 1950, an inverted yield curve provided no certainty, or even a trend, as to where equity prices head in the following six months. The range has been down -10 percent and up 18 percent. And while an inverted yield curve is almost certainly associated with a recession, historically, it has taken anywhere from six months to two years for the economic contraction to occur.

Curve Inversion Not Conclusive for Equity Returns

Source: Nordea and MacroBond

While the curve continues to flatten, one thing that looks to be unavoidable is the increasing level of the rates themselves. As we have discussed in the past, with the US deficit moving up to extraordinarily high levels as a result of the current fiscal policies, the US government needs to issue a tremendous amount of debt to fund itself.

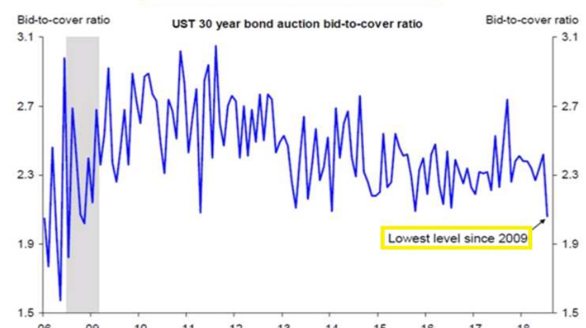
US Bond Issuance Moves from $1T to Above $2T by 2019



Source: Deutsche Bank; Standard & Poor's

As the chart above shows, the US issuance of bonds will go from $1 trillion (a huge number itself) up to over $2 trillion by next year. This is simply a huge amount of bonds for investors to absorb. With such a large amount of bonds being forced into the market, prices will likely move down which pushes yields higher. Investors will require higher yields to entice them to buy. That's fine in and of itself – that is how markets work – but unfortunately, recent data is suggesting that investors are already showing signs of fatigue. As the chart below shows us, the bid-to-cover ratio, a measure of how much demand there is during bond auctions, has trended lower for years, but it has moved sharply lower in 2018.

Demand for Newly Issued US Bonds is Falling Sharply



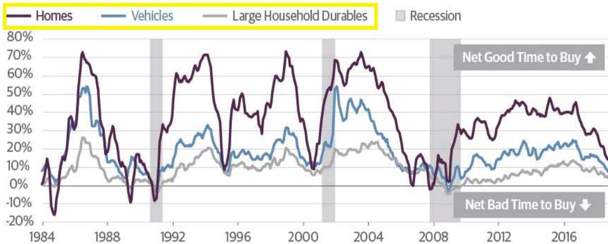
Source: Deutsche Bank

While higher yields on government bonds makes it more expensive for the Government to fund itself, consumers are largely more concerned with the level of interest rates. As we mentioned, the stated intention of the Federal Reserve is to raise rates once again this month and then three more times in 2019. This is not a welcome message to American consumers who are the true driver behind GDP growth. As the chart below points out, consumers opinions on whether or not it's a good time to spend money on big ticket items like a home or a car, have decreased rapidly this year.

Rising Rates Impact: Home Sales -12%; Autos -11% YoY

Rising Rates Have Bruised Home, Vehicle, and Durable Goods Perceptions

Opinions on Buying Conditions: Net Good Time to Buy Due to Interest Rates (3m Mov. Avg.)



Source: Guggenheim; Bloomberg; U of Michigan

And it's not just perception, we are seeing it in the real data. On a year over year basis, auto sales are -11 percent lower and home sales are down -12 percent. Similar to the yield curve inversion, these declines have historically coincided with coming recessions. Investors have taken notice of these trends and are worried that they are appearing just when economic growth looks be to slowing. As the chart below demonstrates, fiscal policy (tax cuts) and financial conditions (the Dollar, interest rates, etc.) are turning from a tailwind in 2018 into a headwind for 2019.

Financial Conditions Move From Tailwind to Headwind

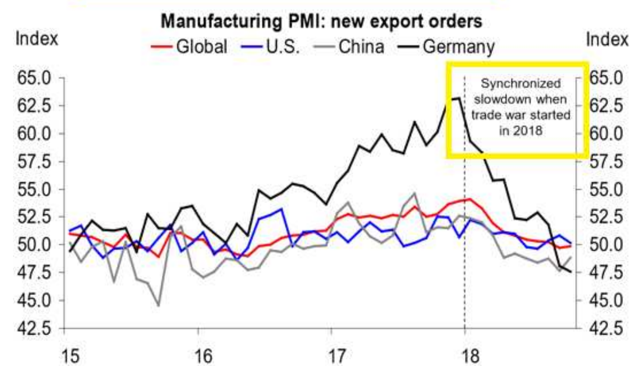
Exhibit 2: Tighter Financial Conditions and a Fading Fiscal Boost Should Drive Growth Lower in 2019

Source: Goldman Sachs Global Investment Research

To boil down all the factors into one idea, this is the reason behind the recent volatility across asset classes. Growth has slowed across the globe since the trade tensions began at the start of 2018. If growth slowed during the "as good as it gets" environment, than what will happen when the trends become more challenging? It is a good question without an easy answer. Again, we would stress that slowing growth does not mean no growth, but the deceleration clearly has the bulk of investors quite worried.

Global Growth Has Slowed Notably Since Trade War Began

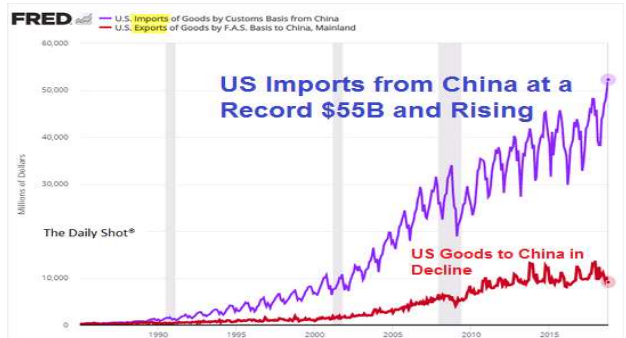
Trade war having a bigger negative impact?



Source: Deutsche Bank

The most obvious way to prevent a rapid slowdown from occurring is to resolve the trade disputes which insert a good deal of friction into global trade. As the chart below highlights, tariffs do little to change the demand factors and only hurt consumers, who as we said, drive growth in the US. As economist Paul Krugman pointed out recently, believing tariffs are a tax on China is like believing that sales taxes are a tax on Walmart. If we could wish for one thing this holiday season, it would be for end to these trade disruptions.

Despite Tariffs, US Continues to Buy Goods From China



Source: The Daily Shot

Going Forward

As we have discussed over the past two months since the October 3rd peak in equity prices, despite the market sell-off, little has fundamentally changed. Rather, most of the decline has been sentiment driven, or merely the perception or "feeling" that things are getting worse. As such, we are constructive on the near-term outlook for risk assets. However, there is strong evidence that 2019 may prove more challenging as both the US and global growth rates are in decline at a time when we still face a relentlessly flattening yield curve, rising interest rates, a strong US dollar, and a trade war with no obvious resolution in sight. Therefore, we remain focused on our base case scenario which calls for further gains in the US equities (although at a much more muted rate) while the downside risk increases as growth slows throughout 2019. A resolution of trade disputes combined with confirmation of a more dovish interest rate policy for 2019, could however lead to a more bullish shift at any given period.

With that outlook in mind, we would emphasize the technology, financial and healthcare sectors as we look to the last month of this year and beyond. The technology sector continues to display very strong sales growth and profitability and valuation is much more compelling after the 4th quarter declines. Financial names are very reasonably priced after substantially underperforming the S&P 500 Index for much of the year. We feel that this is overdone, and many valuation metrics reaching multiyear lows make several quality large cap names attractive. We also see an opportunity in select healthcare companies. These names are less impacted by trade issues, display high levels of cash flow and display reasonable valuations.

Small and mid-cap stocks were hit particularly hard during the recent sell-off and are attractive in our view. Importantly, smaller non-global companies are generally less impacted by trade tariffs, making them a good counterbalance to internationally exposed companies. In a very short time period, the Russell 2000 Index of small cap companies has surrendered its significant advantage over the S&P 500 for the year. Small cap stocks are particularly sensitive to investors' perception of economic growth which has been in decline. As a result, the Russell 2000 now trails the S&P 500 by -425 basis points this year. We believe that this move is overdone and may likely reverse in the near-term.

With the recent weakness in the US, equity markets outside of the US are even more compelling in our view. Regardless of uncertain political issues, non-US markets remain much more accommodative in their monetary policy endeavors. Valuations are lower than the US, and due to coming headwinds, growth outside of the US is expected to outpace US gains in 2019. We have favored emerging markets equites for much of this year. The asset class has suffered this year from both a strong US dollar and trade tensions. Despite this, we continue to view their valuation and growth as attractive and would be adding exposure as we approach 2019 with a long-term allocation view.

The flattening yield curve is far and away the fundamental concern to many investors. With the yield curve inverting in early December, concerns over a dramatic slowdown in growth and even a recession sometime in 2019 have come to the forefront. Bloomberg's recent survey had shown an expectation of the spread between the 2 year and 10 year treasury bonds to narrow to just 11 basis points by June 2019 – the spread went to just 9 basis points *this month*, a significant acceleration in compression. With that in mind, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to focus our exposure on municipal bonds and short-term corporate bonds and believe that the opportunity in these segments provides a better relative value.

Although gold has trailed other assets for much of the year, we continue to hold exposure as a diversifier. The metal proved its merit in a portfolio this quarter in particular with gold outpacing the S&P 500 by +13 percent from the October 3 stock peak to Dec 12th.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.

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