PRIVATE WEALTH MANAGEMENT

MARKET COMMENTARY

The Stock Market in 2019: Desperately Seeking Clarity

January 2, 2019

Superstition is not anybody's recommended guidepost for making investment decisions. But, years ending in "8" have produced unnerving volatility for investors.

In 1998, the Asian financial crisis crashed onto our shores, producing a 20% drop in the S&P 500 over six short weeks. In 2008, the worst of the Great Recession hit, and the S&P plummeted 38% for the year. And now, we bid good riddance to 2018, a year which featured two market corrections—one early, one late—and a 4.4% decline for the year.

A Rough Year All Around

	2018 Total Returns	Decline From Peak
U.S. Large Cap	-4.4%	-14.0%
U.S. Small Cap	-11.0%	-22.1%
Developed International	-13.3%	-18.7%
Emerging Markets	-14.5%	-22.2%

Source: FactSet SPAR, as of 12.31.2018. Returns are in U.S. dollars. Indices represented are S&P 500 (U.S. Large Cap), Russell 2000 (U.S. Small Cap), MSCI EAFE (Developed International) and MSCI EM (Emerging Markets).

As we consider where equities are headed this year, we are focused on four key variables:

1. The economic outlook
2. Monetary policy
3. Investor sentiment
4. Valuation

These factors are co-dependent. Without a clearer picture on the economy and Fed, investor sentiment will likely remain skittish, and valuation will provide little support in the short term.

1. THE ECONOMIC OUTLOOK

Our forecast of divergent growth trends was realized in 2018 with U.S. acceleration sparked by tax cuts alongside deceleration for most remaining global markets. The theme for the global economy in 2019 is likely to be a “synchronized global slowdown.” In other words, growth in the U.S. should revert to its average for this expansion—around 2% real GDP growth—down from about 3% last year. With that said, there has been a steady stream of market commentary stoking fears of a recession.

The trajectory of the U.S. economy is a huge issue for equity markets. If the economy is headed for recession this year, then the pummeling equities took in the fourth quarter of 2018 was in fact the start of a bear market. If, however, the economic expansion continues, then there is likely room for stock prices to move higher.

There is a case to be made for 2019 being a poor year—or even a recession—for the U.S. economy. It centers on some gathering warning signs: a very flat yield curve that could invert, widening yield spreads on corporate credit, the potential for weakness abroad and a strong dollar to reduce exports. Also, a number of surveys suggest that the industrial side of the economy hit a wall in December.

It is fair to say that the risk of recession has risen in recent weeks, in part because a persistent loss of confidence in markets can infect attitudes about the strength of the economy. But it is still not the most likely outcome. Rather, a fairly benign slowdown in the economy’s growth rate is our base case. The U.S. consumer is in good shape, supported by a very strong job market, growing wages, moderate debt levels and record tax refunds coming in the next few months. While fiscal stimulus from the tax cut package had its maximum impact last year, it will likely still be additive to growth in 2019. While the risk factors described in the prior paragraph should be monitored, the current shape of the yield curve and credit spreads are consistent with slowing growth—not a recession.

Another popular narrative is that the double-digit stock market decline late last year signals a recession. This may be the case; however, there have been five other market corrections in this long bull market that did not foreshadow a recession. As Nobel Prize-winning economist Paul Samuelson once said, “The stock market has predicted nine of the last five recessions.”[1]

2. MONETARY POLICY

At its December 19 meeting, the Federal Open Market Committee’s actions were consistent with market expectations by lifting short-term interest rates another 0.25%. Their forward guidance—projecting another 0.50% increase over the course of 2019—disappointed investors hoping for a long-term pause.

Further, the stock market had a negative reaction as the Fed's words spoke louder than their actions. Fed Chairman Powell used the word "autopilot" to describe the Fed's approach to the pace of bond sales as it aims to shrink its balance sheet.

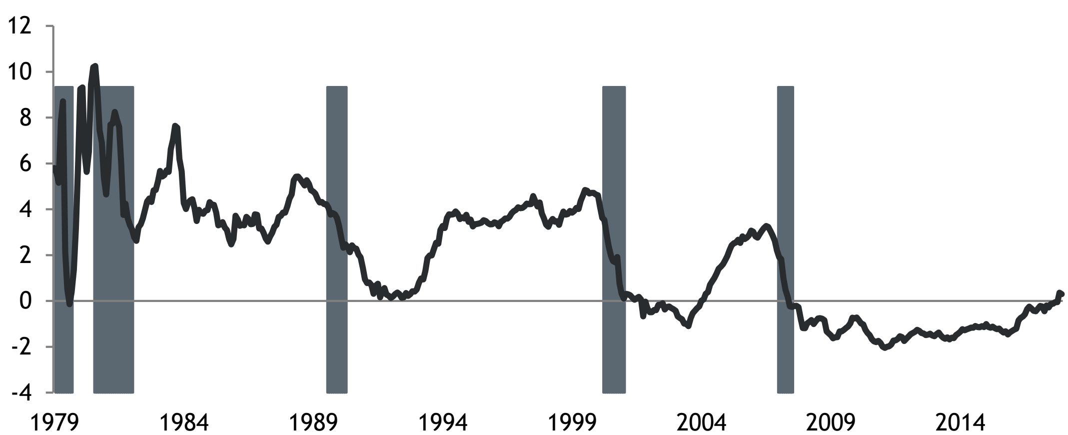
For a nervous market dealing with a sense of growing uncertainty, this was interpreted to mean that the Fed would not alter the pace at which it is reducing liquidity—regardless of how the economy behaves.

Similar to much of what has occurred in recent weeks, we would rate market reaction to these comments as overwrought. In its official statement and the Chairman's press conference, the Fed expressed confidence in the outlook, but acknowledged that "cross-currents" had developed, and that financial conditions had tightened due to widening credit spreads, weaker stock prices and a stronger dollar. In other words, there was a tacit implication that there are downside risks to the forecast, and that the Fed stood ready to adapt as necessary.

We expect the Fed to up its communications game in 2019. Meanwhile, a combination of slower economic data and low inflation readings is likely to keep interest rate hikes in hibernation for the foreseeable future. While the Fed projects two rate hikes in 2019, we believe that they will not raise interest rates in the first half of the year as they assess incoming readings on the economy. In other words, we believe the Fed's sensitivity to inherent risks to the outlook is underestimated in today's equity prices.

Meanwhile, it is important to remember that despite three years of rate increases, the Fed's pace has been slow, and they started from zero. The result is that short-term interest rates, after adjustment for inflation, are barely positive and well below the tight policy reflected prior to past recessions.

"Real" Fed Funds Rate (Funds Rate – Inflation)

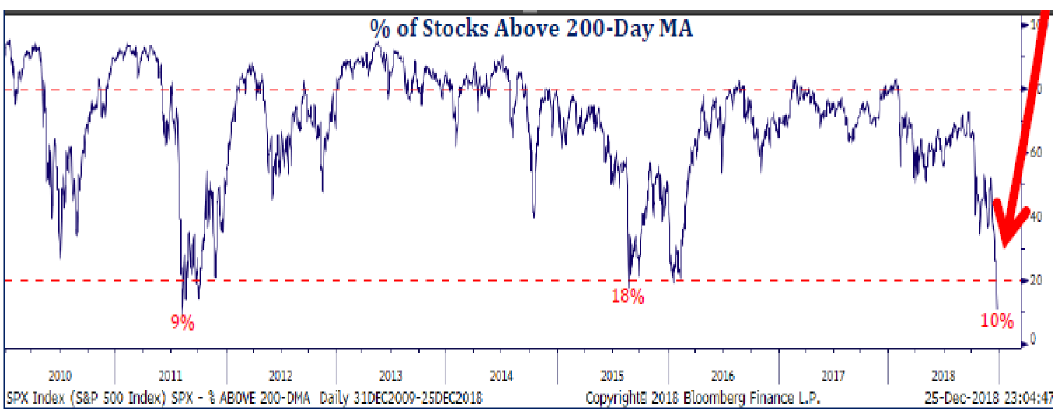


Note: Shading represents recessions. Inflation adjustment uses the Core Personal Consumption Expenditures annual change. Source: FactSet, as of 11.30.2018.

3. INVESTOR SENTIMENT

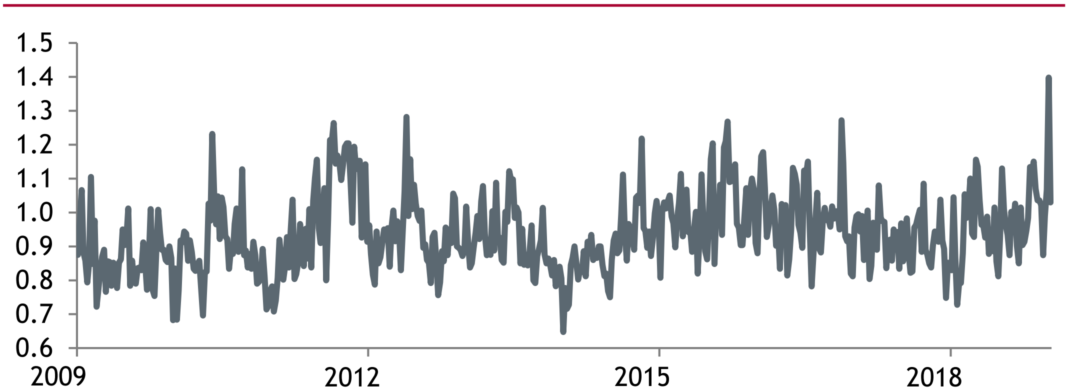
During periods of extended selling pressure, stock market technicians look for signs of capitulation—panicked, irrational selling that often signals a market bottom. Our approach is to focus more on fundamentals than technical factors, but also believe that intensely negative market sentiment is eventually a bullish, contrarian indicator. And, intense negativity is easy to find. Substantial outflows from mutual funds and exchange traded funds occurred in December amidst a plunge in investor sentiment surveys.

Trading data also indicates a degree of carnage in the markets usually associated with oversold conditions. The percentage of stocks holding above their 200-day trading average is in single digits:



The extreme reading on the put/call ratio indicates that investors are almost exclusively seeking protection from the market rather than looking for opportunities. From a contrarian perspective, this conjures one of Warren Buffett's favorite sayings: "Be fearful when others are greedy and greedy when others are fearful."[2]

CBOE Composite Put/Call Ratio – 5-Day Average



Source for this chart and previous chart: Bloomberg, as of 12.28.2018.

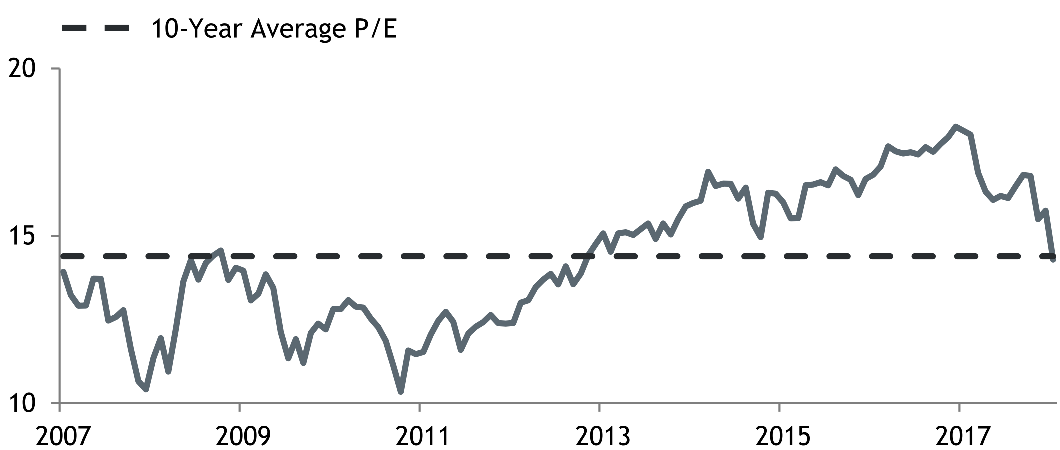
These indicators suggest that stocks are poised for a rebound. However, that rebound will not be sustainable unless the path we expect for the economy and the Fed comes to pass. We believe it will, but it may take some time for investors to be convinced.

4. VALUATION

Over the course of 2018, most stock prices went down while corporate profits skyrocketed. Fourth quarter reports have not yet been released, but the consensus estimate for earnings growth in 2018 is over 20%.[3] Given the expected economic slowdown this year, and the one-time boost to 2018 profits from corporate tax reform, earnings this year should advance more slowly—with the consensus expectations forecasting about 7.5% growth.

The end result is a stock market with relatively attractive valuations, as seen below.

S&P 500 Forward 12-Month P/E Ratio: 10 Years



Source: FactSet, S&P, data as of 12.31.2018.

In isolation, valuation rarely causes an inflection point in stock prices. A catalyst is usually required to focus investors on under- or over-valuation metrics. In this case, we expect the catalysts to be a somewhat more-comforting assessment of the economy and monetary policy. However, that could take some time to materialize. Below we list the key factors and events we are focused on in the weeks ahead.

WHAT TO WATCH

There are a number of events in January that will help clarify whether our cautiously-optimistic view for 2019 is realized.

- **Earnings reports.** Companies across a variety of industries will announce fourth quarter earnings, and more importantly, provide guidance for 2019. We will be looking to see if corporate behavior is shifting toward a more defensive posture, which could have a self-reinforcing negative effect on the economy.

- **The consumer.** Readings on household income, spending and confidence will be important to determine if stock market volatility has an adverse effect on consumer spending, which represents 70% of the economy.

- **The trade war with China.** This remains the biggest wild card, and in our opinion, the most damaging to the economy if it gets worse. There have been some positive developments, with a 90-day delay in more tariffs being implemented and announced negotiations later this month. We believe an agreement—or at least a longer-term truce—is likely to be announced sometime in the first half of the year. However, given the wide variety of issues and a volatile political environment, it is hard to have a high degree of confidence.

- **The Fed.** After its bungled messaging in December, much attention will be paid to the next Federal Open Market Committee meeting that concludes on January 30. Markets will be looking for assurances that the Fed's forecast is realistic and that they stand ready to change policy if market conditions and the data warrant it. ■

1 *Newsweek,* 09.19.1966.
2 Berkshire Hathaway 2004 Annual Shareholder Letter.
3 *Bloomberg,* as of 12.31.2018.