CIBC PRIVATE WEALTH MANAGEMENT

ASSET ALLOCATION

What's Bothering the Stock Market?

December 10, 2018

Volatility—and in a downward direction—returned to global equity markets in the early days of December. The S&P 500 Index (S&P 500) was down about 4.6% last week, and is off more than 10% from its all-time high in September. On a year-to-date basis, the total index return is essentially flat.[1]

We see three fundamental factors impacting sentiment, boosting volatility and prompting "risk off" behavior:

1. Perceived risk that economic growth (and earnings) next year will fall short
2. Monetary policy and the yield curve
3. U.S.-China tensions

THE ECONOMY

Sentiment has shifted from optimism to pessimism, with growing chatter about the rising risk of recession.

With Q2 and Q3 GDP growth rates of 4.2% and 3.5% respectively, the economy is showing signs of downshifting. This is consistent with our expectations given the progressively smaller impact of fiscal stimulus, the direction of monetary policy and weaker conditions abroad. The consensus forecast for Q4 GDP growth is 2.6%, slowing to 2.3% by the end of 2019.[2] In other words—not a recession.

The November employment report is a good snapshot of where the economy stands:

- Solid job growth, but slower than earlier in the year
- At or close to full employment (3.7% unemployment rate)
- Moderate wage growth of 3.1% which is steady vs. the prior month

The nearly 30% drop in the price of oil over the last two months has been cited as a symptom of something badly wrong with the global economy. The December 7 OPEC agreement to limit production, and the jump in oil prices that followed, confirms our view that the price weakness was a function of oversupply, rather than a material weakening in demand.

Bottom Line: While some sectors have softened, the U.S. economy is in relatively good shape, and we rate the probability of a recession in the near-term as low.

THE YIELD CURVE AND THE FED

A flatter yield curve is contributing to investor angst over recession risks. The 5-year Treasury yield fell below the 2-year yield last week, inverting that segment of the curve and heightening concerns. The 5/2 inversion holds little economic significance, and we see the more conventional 10-year/2-year curve flatness as a less useful indicator of recession risk than it has been in prior cycles.

At its September meeting, the Fed signaled three additional hikes in 2019 and could use the December meeting to signal a slightly more dovish rate projection in recognition of tighter financial conditions, such as weaker equity prices, wider corporate credit spreads and higher levels of volatility.

Just a few weeks ago, markets were pricing in a high likelihood of two additional increases to the target rate in 2019. Odds in the future markets of even a single move in 2019 have dropped below 50%. The Fed runs the risk of appearing overly aggressive if their 2019 projections fail to recognize the shift in market sentiment.

Bottom line: We expect the Federal Open Market Committee to raise rates on December 19, but also provide a slower pace of rate-hike expectations for 2019. In 2018, the Fed was calendar dependent—raising rates once each quarter. In 2019, we believe they will be data dependent—analyzing economic trends and reacting accordingly. Given a slower economic growth trajectory and well anchored inflation, this most likely means just one or two rate hikes next year.

THE TRADE WAR WITH CHINA

The glow of last weekend's Trump-Xi Jinping trade ceasefire faded fast. News that the CFO of Huawei—the "Apple" of corporate China—was arrested in Canada at the request of the U.S. government raises the specter that re-escalation could follow less than a week of de-escalation on the trade front.

We believe this trade dispute is the most vexing issue for stock market sentiment. Actions to date (tariff and non-tariff) have had some micro impacts, but not much macro impact. That could change if the conflict escalates from here.

Decisions among U.S. and Chinese policymakers on where to go next are fluid. There is an economic case to be made that both sides should "stand down," but there's a political narrative suggesting that each side should "double down."

The stock market is worried about the "double down" scenario, which would involve more tariffs back and forth. There is also concern that after U.S. government action against Huawei and ZTE, China might directly retaliate against U.S. companies. It is speculation at this point, but clearly unnerving for equity investors.

Bottom line: We believe that the "stand down" option will eventually prevail, because financial markets will demand it. China's economy has clearly slowed, and the Trump Administration needs a strong economy going into 2020 elections. However, it is quite possible that the situation heats up in the short term as strong arm tactics dominate.

WHERE WE GO FROM HERE

Reflected in the chart below, once the S&P 500 fell below its 200-day moving average in October, it has struggled to gain any traction.

Source: Bloomberg, as of 12.07.2018.

Our general view is that gathering pessimism on the economic outlook is overblown, that the Fed is on its way to adapting to a measured slowing in the economy and that corporate profits will post moderate growth in 2019.

We view market valuation as a neutral factor. As seen below, both forward and trailing price-to-earnings multiples are right at their long-term medians for the S&P 500.

Source: Evercore ISI, as of 12.07.2018.

Volatility may persist in the short term, and it will probably take more clarity on the China trade issue for calmer waters to prevail.

However, we see few precursor conditions for an equity bear market. ■

1,2 Bloomberg as of 12.10.2018.

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