Economic Commentary

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"It will fluctuate my boy, it will fluctuate."

- J.P. Morgan in response to being asked what the stock market will do

The fourth quarter of 2018 was one of the more volatile periods in recent history. After hitting record highs in early October, stock prices swung sharply in the following weeks before plunging in December. The 660-point drop on December 24th was the largest loss in history for Christmas Eve, a traditionally positive trading day. The losses last month were the worst results for a December since 1932 and the quarterly numbers were the worst since the first quarter of 2009. From peak to trough, U.S. equity indices fell over 20% in the quarter.

Domestic stocks fell 13.52% during the quarter and ended the year down 4.38%. This was the first losing year for stocks since 2008. International stocks were hit even worse, with the EAFE Index posting a -13.79% return for the year. Bonds were the beneficiaries of the turmoil and ended the year with a gain of 0.92%, after gaining 1.80% in the quarter. Cash was the best performer for the year.

There were multiple causes to blame for this volatility. The Federal Reserve under Jay Powell has been aggressive in its efforts to normalize monetary policy. The scope of these efforts became painfully clear following the September FOMC meeting and fears were heightened by some of the comments made following the December 19th rate hike. Trade tensions reached a boiling point following the G-20 meeting in Buenos Aires at the end of November. With the U.S. and China issuing contradictory statements about the summit, it appeared no progress would be possible in the year ahead. Some high profile earnings warnings and year-end tax selling added to the turmoil.

While the last quarter was volatile, the economic picture has not yet changed dramatically, as illustrated by the strong December jobs data. However, many measures, such as the recent PMI data, do point toward a noticeable slowing, even as the numbers remain positive. We see the sell-off in the fourth quarter as a sign of valuation multiples compressing to reflect this lower rate of economic growth rather than a symptom of a crashing economy.

Sustaining growth is the biggest concern for the markets. The American economy is driven by consumer spending. The strong employment numbers suggest consumption should remain healthy. However, the stimulative effects of the tax cut program enacted last year are now priced into the market, making year-over-year comparisons harder to achieve. Economic growth slowing from 3.5% to 2-2.5% is not terrible, but it does suggest corporate earnings growth will also slow. With corporate earnings already high and wage pressures rising, there is an increasing fear that growth will be hard to achieve in the years ahead. We do not see an economic recession occurring in 2019, but decelerating earnings growth may be possible.

If there is an unknown on the economic front, it is how the recent market volatility will affect individual activity. The "wealth effect" does play a role in consumer psychology. There is a risk that the recent volatility has rattled consumers and businesses alike. When consumers feel their wealth has shrunk, they typically cut spending and consumption. Businesses put growth plans on hold and delay hiring new employees. Stock markets have rallied nearly 10% since the Christmas Eve bottom, but the risk of market actions predicting a recession may become a self-fulfilling prophesy.

Interest rates and Federal Reserve policy also remain a concern. Continued risks (trade tensions, stock market volatility, etc.) in the marketplace have allowed Chairman Jay Powell to suggest monetary policy is now at a neutral position, a significant change from comments in September. It is now widely accepted that we are likely to see one additional rate hike in 2019. Indeed, some investment strategists are now speculating that rate cuts might be forthcoming this year. However, the Fed's balance sheet unwinding effort is expected to continue, even if further hikes to the Fed funds rate are tempered.

The Fed is scheduled to allow approximately $600 billion in security maturities to roll off its balance sheet in 2019. These liquidations will put the refunding obligations for the maturing bonds back on open market sources. This refunding pressure will be added to the funding needs for the estimated $1 trillion Federal budget deficit expected this year. Adding to these pressures, foreign capital may be returning home as several foreign central banks – namely the ECB and the BOJ – are expected to begin policy normalization efforts of their own in 2019.

Treasury yield concerns may be exacerbated by the structure of the corporate bond market. Over the past five years, companies have issued a mountain of debt to repurchase stock, pay dividends and make acquisitions. This debt is beginning to come due and we will see a wave of maturities coming due over the next three years. This corporate debt will be competing with Treasury debt for investor dollars, causing yields and credit spreads to rise. Rising borrowing costs are another reason we believe corporate profit margins may have peaked.

Trade issues, of course, remain a problem. As with most crises, politicians on both sides of the issue will eventually react. We believe some solution is inevitable, even if it is not what either side wants. As the economic pressures mount, even a token agreement will be enough for both sides to declare victory.

The economic expansion will soon be in its tenth year, but many expansions have been sustained longer. The 1982-2000 period is a good example. Barring a policy error, the economy still has room to expand, even if markets are beginning to look tired. We expect more volatility in the year ahead. It is important to remember the economy and the financial markets usually move in the same direction, but rarely in lockstep.

Strategy and Market Outlook

Current market conditions make insights into 2019 outcomes very hard to outline. We are facing several issues that may break both ways in the terms of market movement. Economic growth, for example, should lead to higher equity prices. However, it will also lead to higher interest rates, which in turn might push stock prices lower. In aggregate, though, we see 2019 shaping up to be a positive, but modest year for equity returns.

There has been no shortage of equity market volatility in recent weeks. We believe that our focus on a long-term oriented, quality-focused approach will reward investors over time. We seek to use volatility to position our portfolios in companies where we see compelling competitive advantages and business models that generate strong and growing cash flows over the full business cycle. Quality is independent of the business cycle in our opinion, and the strongest management teams are often able to take advantage of business cycle swings to strengthen their positioning and create greater value for shareholders over the long run. We believe greater value and risk management benefits can be gained for our clients through high quality security selection rather than attempting to correctly time the market.

On the fixed income side, long-term bond prices have been adjusting to the economic and trade issues roiling the market. Yields have fallen accordingly. However, short-term yields, which are driven by the Fed funds rate, have barely budged. We now have the flattest Treasury yield curve since 2007. Several segments of the Treasury market are now inverted and the yield differential between the 1-year T-bill and the 10-year Treasury note recently narrowed to just 5 basis points. An inversion between these two segments of the curve has often preceded a recession.

One worrisome trend within the rally is the widening of yield spreads over the comparable risk free rate. Spreads across all segments of the bond market are widening, reflecting the potential increased risk profile of non-government bonds if business conditions begin to slow. Corporate bond spreads are likely to be increasingly sensitive to yield changes, given the wave of corporate bond maturities coming due in the next three years. A rising Federal budget deficit and efforts to unwind the Fed balance sheet will only exacerbate this sensitivity. We expect bonds with weaker balance sheets to have a magnified reaction to these changing conditions.

We look for Treasury bonds to outperform many sectors of the bond market this year. High-grade municipal bonds are preferable as budget pressures increase the threat of higher tax rates. However, issuer specific risks are rising. Corporate bonds still offer higher yields and steeper yield curves, especially in the BBB-rated sector of the market, but security selection is increasingly important given the stress on credit profiles. We do not believe current rates warrant aggressive buying in the sector. We continue to prefer the higher-rated sectors of the bond market and higher-rated issuers within the sectors owned.

The interaction between stocks and bonds continues to be a dynamic to watch. We believe the two asset classes will have little correlation in the year ahead. For now, we maintain our positive outlook for the year ahead. We see equity prices producing low but positive returns, and bonds facing pressure as rising yield pressures offset the coupons paid. Staying with lower duration and higher quality will reduce the risk for bond portfolios while preserving the income and stability characteristics of the asset class.

As always, please contact us should you have any questions or concerns.

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