Market & Economic Commentary: Too Much Ado About Somethings?

Winter 2018/2019

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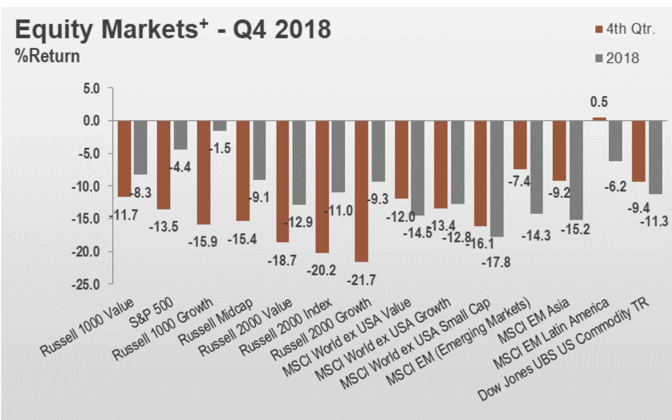
Market & Economic PIER*spective*

Too Much Ado About Somethings?

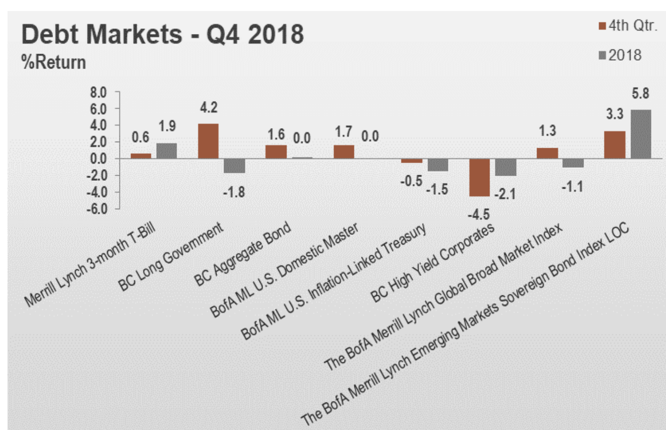
The last quarter of 2018 proved to be quite a shock to most investors, completely erasing the hard-fought gains for the year in U.S. equities. As renewed headlines and conjecture about a trade war with China caused pessimism to rise in the equity markets, ill-timed statements from Fed Chairman Powell added fuel to the fear. The Fed was thought in late November to have indicated that they were hell-bent on continuing to tighten monetary policy well into 2019, regardless of a potential slowing in the U.S. economy. Markets feared that the Fed was out of touch and would surely push the economy, which they thought was teetering, over the edge into recession. Add in light reductions in the outlook for Europe's economy and a swift decline in oil prices, and global equity and subsequently credit markets got hit with wave after wave of selling, the likes we haven't seen in since the financial crisis of 2008/2009.

How the Markets Fared

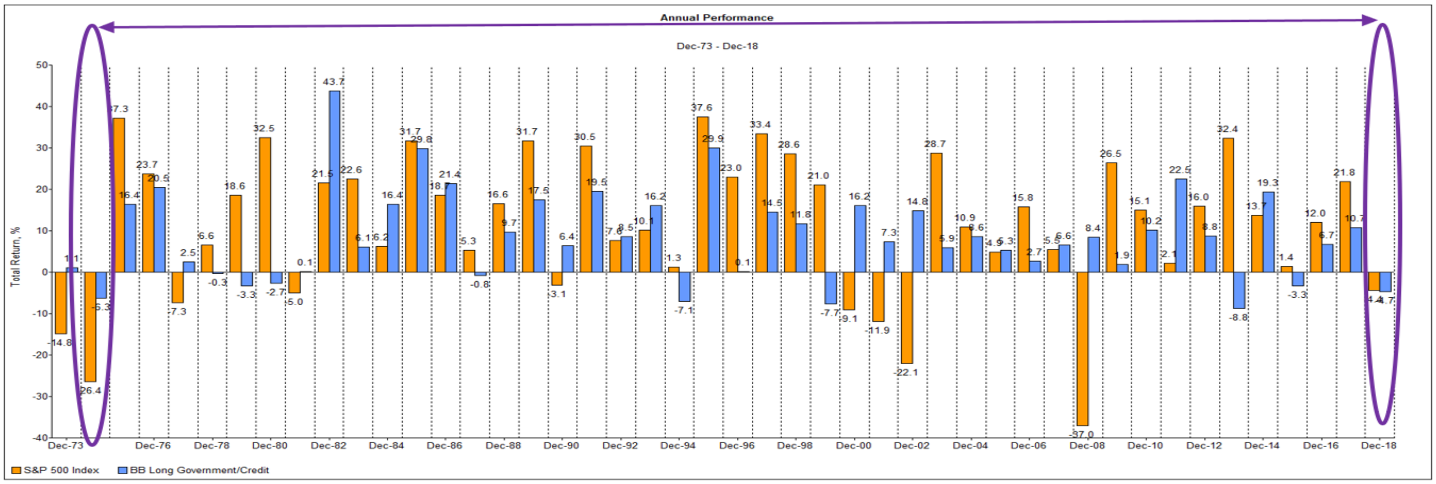


After a rough Q2, which was weighed down by many of the same fears that raised their heads in the most recent quarter, markets began to claw their way back as confidence was restored. But when investors were again faced with the possibility for slower global and U.S. growth in 2019, markets became distraught, quickly reversing their appetite for risk in the third quarter. Equity investors were hit particularly hard, catching many off-guard. The S&P 500 was down 13.5% for the quarter, briefly flirted with bear market territory before beginning a recovery rally in the last few days of 2018. International and emerging market equities also declined. Value oriented-stocks outperformed growth sectors as investors fled from high-valuation names in the tech and telecom space. In the United States the Russell 1000 Value index preserved capital better than its growth counterpart by over 4%, for what felt like the first time in ages.

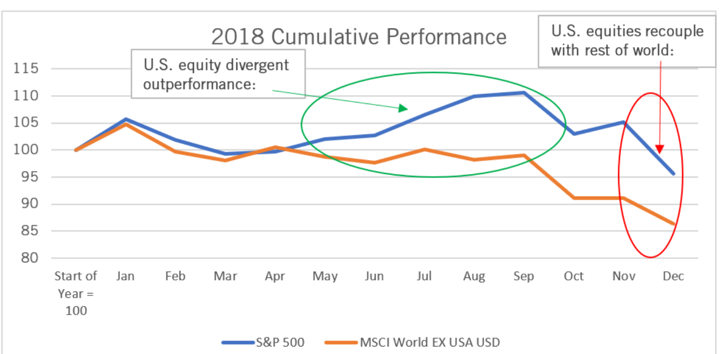
Quality was king in fixed income as well. Fearing an economic slowdown in the coming year, investors fled bonds that had any risk exposure, driving prices down and widening credit spreads. Government bonds outperformed both corporates and high yield meaningfully. Commodities prices were not spared either. Oil, one of 2018's best performing assets through the first three quarters, was quickly trounced as concerns about slowing demand and oversupply dominated trading. Prices fell from a high of $75 a barrel in early October to $42.5 in December, a peak-to-trough decline of 44% at a pace that rivaled the 2015/2016 plunge. No doubt, PTSD from oil's plunge from $100 to $26 just three years ago likely fueled the panic that hit stock, commodities and credit markets alike.



2018 was a peculiar year, short-term government T-bills (cash equivalents) were the only major taxable asset class to generate positive returns. For the last 10 years, holding any cash was a drag on performance. Its paltry 10-year annualized return of 0.37% would have seen inflation quietly erode investor's purchasing power. No longer; cash is now a viable investment. By tightening monetary policy in 2017 and 2018, the Federal Reserve has elevated short-term interest rates above the level of inflation for the first time since the financial crisis. These rising interest rates pressured both stocks AND bonds in 2018, resulting in the rare phenomenon of simultaneous negative returns in both asset classes. One would need to venture back to 1974 to find a calendar year in which both the S&P 500 and an index of U.S. government bonds posted negative nominal returns. And these markets weren't alone. Practically every major asset class lost money in 2018, making this one of the worst environments for diversification in history.



2018 was bookended by extremes. Coming into the year investors were undeniably exuberant. Tax cuts and Bitcoin were all the rage. Continuing on a meteoric 2017, January saw the S&P rise 5.6% before volatility made a comeback, accelerating into February as the stock market sharply, yet briefly corrected. After bouncing around for a few months between trade headlines and stellar corporate earnings, the domestic markets took off again in Q3. However, while markets in the United States had recovered to new all-time highs, surpassing the levels reached in late January, international markets were struggling. Foreign markets were dealing with higher U.S. interest rates and continued dollar strength, putting pressure on returns (when measured in dollar-terms). This led to a divergence in equity performance that climaxed late in the third quarter:



The pessimism that was weighing on international markets caught up with domestic counterparts in the fourth quarter as concerns about global growth dominated the final three months of the year. The gloom was not entirely unfounded, as data out of China and the core of Europe began to signal a slowdown in those regions. China has been caught in a catch-22; deleveraging their economy while maintaining economic growth has thus proved to be quite a challenge. Whether directly or indirectly, China has become an increasingly important source of global economic growth as developed Western nations recovered from the financial crisis. Unfortunately, China is undoubtedly slowing as its economy continues to mature. Auto sales fell on a year-over-year basis for the first time in over two decades. Anecdotal data from companies like Apple and FedEx led many to project that a weaker Chinese economy is likely to persist into 2019. Europe also ran into road blocks in the second half of 2018. Using German manufacturing PMI as a barometer for European activity, we can see this measure was consistently declining in 2018 after peaking in late 2017. A reading above 50 is still expansion territory but the negative momentum is noticeable.

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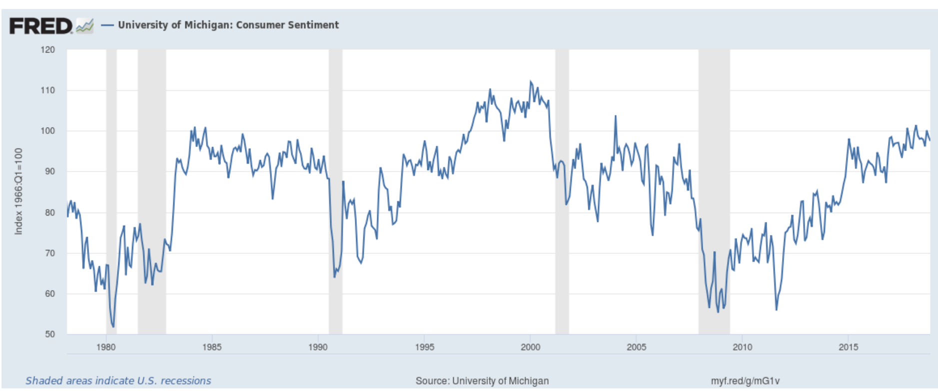
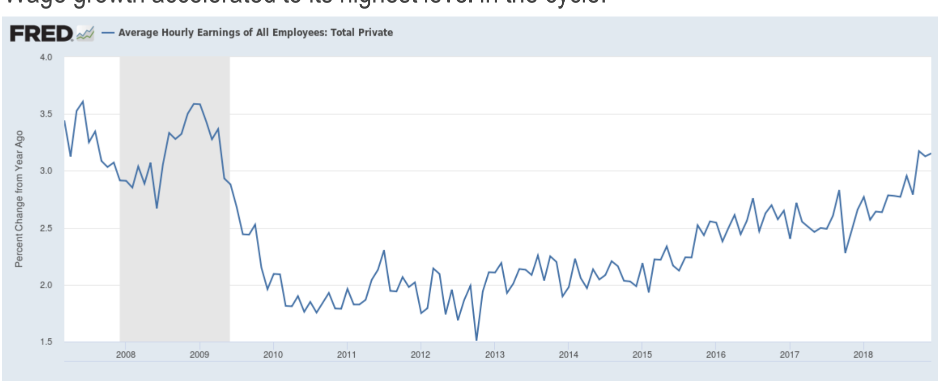
PIERing Ahead

The United States economy will likely log its strongest annual performance since the recession a decade ago. Annual GDP growth should exceed the stubborn 3% threshold for calendar year 2018 and the unemployment rate remains at multi-generational lows. Despite the recent market turmoil, confidence among businesses and consumers remained robust throughout the year, and continues in that direction in 2019. Though the rate of growth for 2019 is expected to recede from last year's elevated levels, many forecasters are still projecting 2.2%-2.5% growth, which would be considered good economic performance in most environments. Moderation is bound to happen eventually; but talk of a recession is premature at this point, and is based mostly on conjecture and not hard economic data. Yes, sentiment based confidence reports ebbed after the market shocks of December, but most have since firmed. Less elastic data, like labor statistics, still show a strong and resilient environment that is showing little signs of reversal. Global equity markets are now trading at discounts to long-term norm, seemingly factoring in further deceleration ahead. Though there are many paths that could lead to that conclusion, at North Pier, we see it far more likely that markets have overcorrected and that the next surprise could be to the upside. If the globe moderates and firms, instead of slipping into malaise or worse, present valuations will prove to be bargains and the coming year will be a good one for value-oriented investors.

Most of the recovery saw Wall Street doing better than Main Street but their fortunes seemingly reversed in 2018.
Consumer confidence remained high:

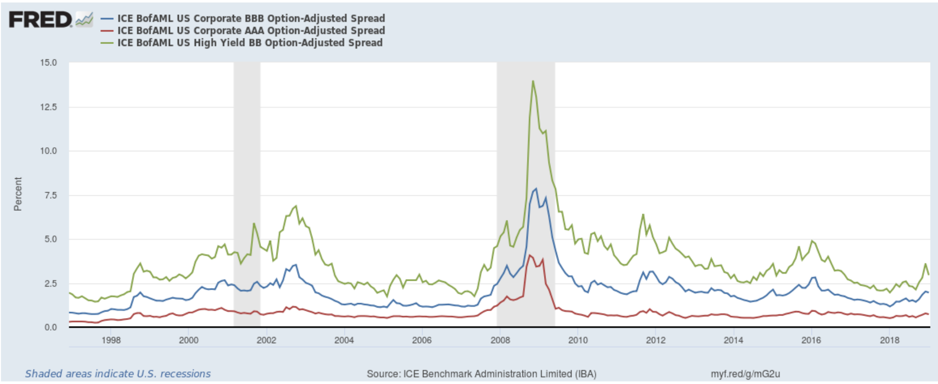


Wage growth accelerated to its highest level in the cycle:



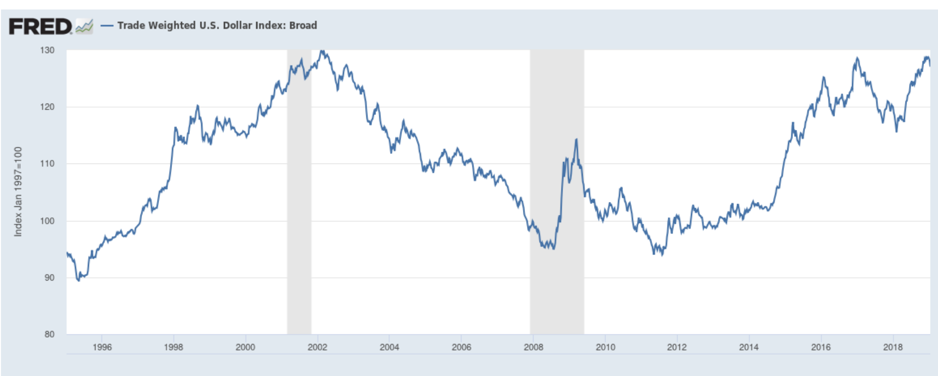
And yet financial assets performed poorly. The shift from expansionary monetary policy & restrictive fiscal policy to normalizing monetary policy & fiscal stimulus (tax cuts, large federal spending increases) may be part of the reason.

Credit spreads widened in 2018 but are hardly problematic:



Political volatility on both sides of the Atlantic continued. France has been roiled by weekly protests, Italy's fiscal position remains a point of contention and Brexit uncertainty persists. Europe will need to find firmer footing in 2019 as the European Central Bank removes monetary accommodation and prepares to raise interest rates for the first time in years. Not to be outdone, stateside politics remained turbulent. The political parties now with split control of government are likely to remain combative as ever. We are getting a taste of what the next two years will bring as we muddle through what has become the longest government shutdown in American history. The trade war continues to be a drag. All these factors fed into negative fourth quarter sentiment.

The 2019 outlook remains unclear. While the United States economy remains well situated at present the rest of the world must contend with headwinds. In my opinion a rotation to more value-oriented equity and quality fixed income should continue as investors grapple with volatility and contemplate an aging economic cycle that will eventually hit its expiration date. The strong dollar will continue to be the largest detractor from global growth and I see no signs that the currency is destined to weaken in the near term.



The Federal Reserve remains committed to reducing their bond and mortgage backed security portfolios and are still projecting a couple more interest rate hikes, though they will probably be postponed until the second half of the year. Other major powers are still easing (Japan / China) tentative on policy tightening (Europe), or just confused (Britain). There doesn't seem to be the necessary pressure on the dollar to drive it lower as the other currencies all have issues of their own. A decisive and productive conclusion to the trade war could provide the necessary catalyst to reprice the dollar lower. While investors may yearn for a return to 2017 it is likely that 2019 will share more in common with 2018 as many issues that dominated headlines remain unresolved. 2019 is off to a great start with markets bouncing hard off the Christmas Eve lows and sustaining that momentum into January's first half. It may be prudent for investors use the recent strength to consider their risk exposure and contemplate a more defensive position to protect some of the gains that have accrued during what truly has been an incredible decade of market returns.