EQUITY MARKET UPDATE

As of 12/31/18 | Volume 7, Issue 4 | FFTAM.com

Throughout 2018, investors were concerned with Fed tightening and the escalation of trade skirmishes with China. As the year ended, those fears went into overdrive causing the worst monthly sell-off in stocks since the financial crisis of 2008. Volatility spiked after the Fed raised interest rates another 25 basis points, and Chairman Powell gave investors the impression additional tightening was around the corner in 2019. A government shutdown on the eve of Democrats taking control of the House also provided anxiety. Economic data showed the US economy remains on firm footing due to further job gains and strong consumer spending, although manufacturing data signaled a significant drop in future orders. Outside the US, economic indicators showed the global economy continued to slow, especially in Europe and China.

Heavy Selling as the Year Ends

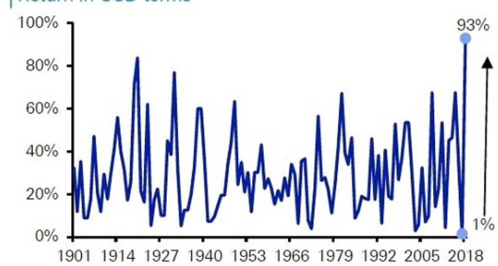
Stocks finished the month deep into negative territory as investors got a one-two punch from slowing economic data outside the US, coupled with another rate hike from the Fed. The decline was so fierce that the yearly gains were quickly erased, and the market finished with its first negative year since 2008. The S&P 500 fell 9.03%, while the Dow Jones Industrial Average declined 8.59%. The NASDAQ lost 9.38% as investors continued to rotate out of tech stocks with high valuations. For the year, the S&P 500 and the Dow Jones Industrials were down 4.39% and 3.48%, respectively. Even though tech stocks experienced a tough fourth quarter, the NASDAQ outperformed both the S&P 500 and the Dow in 2018 with a total return of -2.81%.

Smaller sized companies did even worse in December. The S&P 400 Mid-Cap Index dropped 11.32%, while the S&P 600 Small Cap Index lost 12.08%. Small and mid-sized companies trailed their large cap peers in 2018 with total returns of -11.10% and -8.52%, respectively.

The selling in international markets was less intense in December. The MSCI EAFE Index declined 4.83% on further political uncertainty around Brexit. The MSCI Emerging Market Index fell 2.81% as consumer and manufacturing data out of China indicated a steep slowdown in economic activity. For the year, both indexes performed poorly. The MSCI EAFE Index was down 13.32%, and the MSCI Emerging Markets Index lost 14.49%. A sizable amount of the decline in emerging markets was attributable to the 22.7% drop in Chinese stocks.

Stocks were not the only asset class to experience negative returns. Investors had virtually nowhere to hide as bonds, commodities, cryptocurrencies, and other asset classes also fell in value. The chart to the right from Deutsche Bank shows 93% of all assets had a negative total return in US Dollar terms in 2018, a record high.

Figure 2: Percentage of Assets with a Negative Total Return in USD terms



Source: Deutsche Bank, Bloomberg Finance LP, GFD. Note, returns YTD are until December 20

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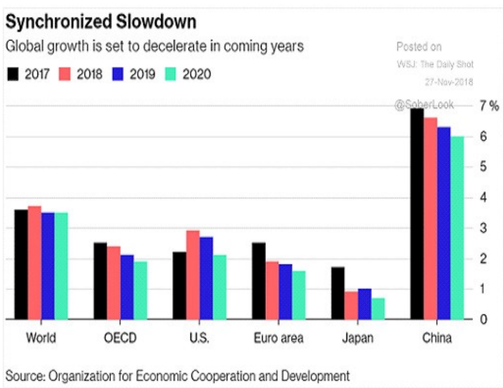
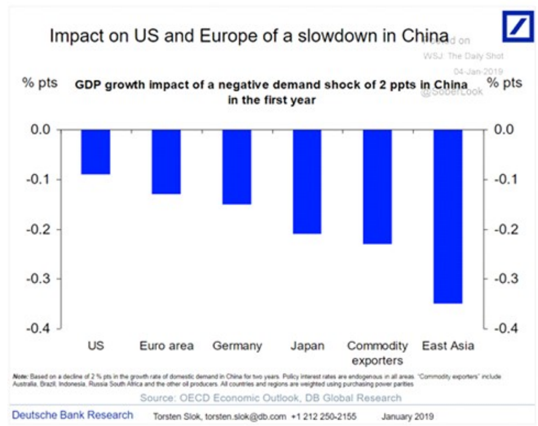
Odds of an Economic Slowdown in 2019 Increases

Economic data in December continued to paint the picture of a decelerating global economy. Overseas economies appear shaky. Italy is near recession and has been fighting with the European Union over its 2019 budget that calls for deeper deficit spending. Anti-government protests about climate change taxes broke out in France. Brexit appears to be heading towards a messy conclusion as Parliament refused to vote on the terms Prime Minister Theresa May negotiated with the EU. Finally, many data points indicated China's economy is worsening as the trade fight with the US takes its toll. Chinese Manufacturing PMI fell into contractionary territory for the first time since early 2016, and retail sales growth in China was its slowest in 15 years. Profit warnings from Apple and FedEx confirmed that Chinese businesses and consumers are nervous. The Chinese government has responded by pumping extra liquidity into the banking system by cutting the required reserve ratio, a similar move to what they did in 2016. These reports have led many economists to question whether the global economy will experience a synchronized slowdown in 2019 as indicated in the following graphs from the OECD and Deutsche Bank.



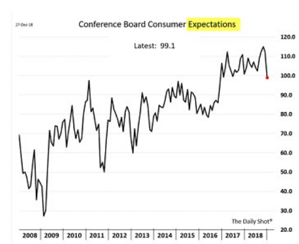


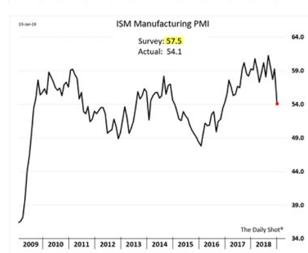
Fears about decelerating growth hit the oil market especially hard. After falling 22% in November, crude dropped another 10.84% in December. More importantly, WTI dropped below the critical $50 a barrel level deemed by many to be the breakeven point for shale operators.

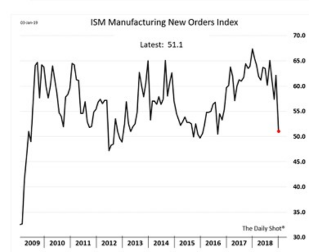
Resilient US Economy Provides Mixed Signals

Compared to its international peers, the US economy appears to be on much stronger footing; however, some indicators are pointing to softness. US GDP in 2018 is on pace for its fastest growth since 2004 due to tax cuts, deficit spending, and easy financial conditions. The strong US Dollar, coupled with the four rate hikes making their way through the system, makes it difficult for 2019 to repeat 2018's success. As a result, the Fed lowered their 2019 GDP forecast to 2.3% after the December meeting.

For the first time this year, US economic data is beginning to provide mixed signals about the future. Early indicators of trouble (sentiment measures and stock performance) are rolling over from previous highs as worries about trade and slower global growth take hold. On the other hand, hard data on economic conditions remains strong, especially job creation, wages, and consumer spending. However, the forward-looking indicators inside the hard data point to slower growth in 2019.







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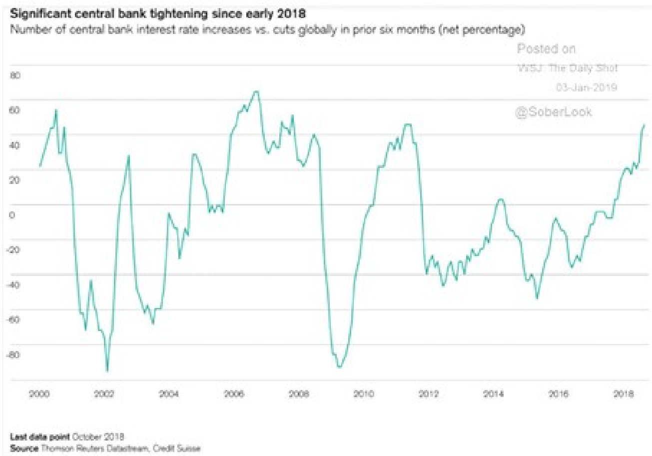
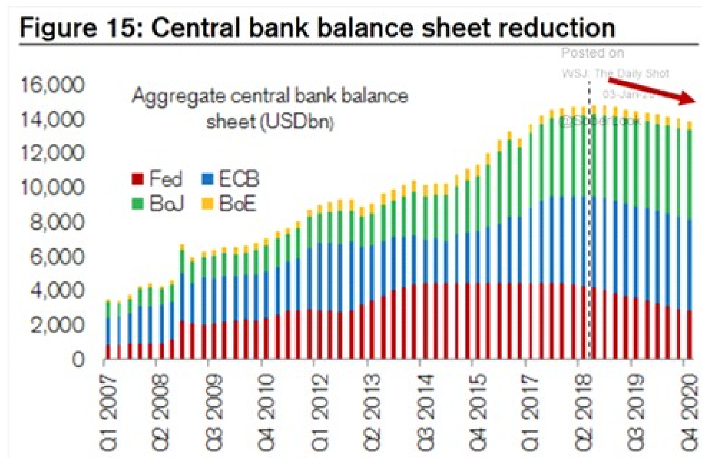
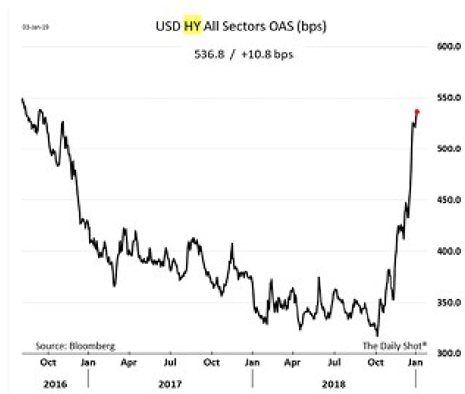
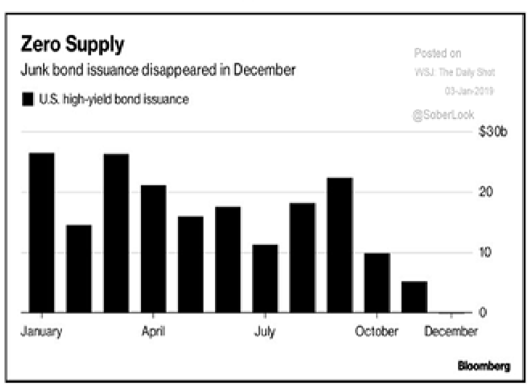
Tight Financial Conditions Hit the Credit Markets & Stocks

On December 19th, the Fed raised interest rates another 25 basis points to a range of 2.25%-2.50%. This was the fourth rate hike for the year. The FOMC Dot Plots indicated the committee forecasts another two rate hikes in 2019. During the post-meeting press conference Chairman Powell used the phrase "autopilot" to describe the Fed's balance sheet reduction program. Markets reacted negatively to these comments as concerns grew that the Fed will go too far. Corporate credit spreads widened in both investment grade and high yield bonds. The move was more pronounced in high yield because energy credits comprise 20% of the high yield index. Liquidity in high yield completely dried up as no junk bond issue came to market in December.









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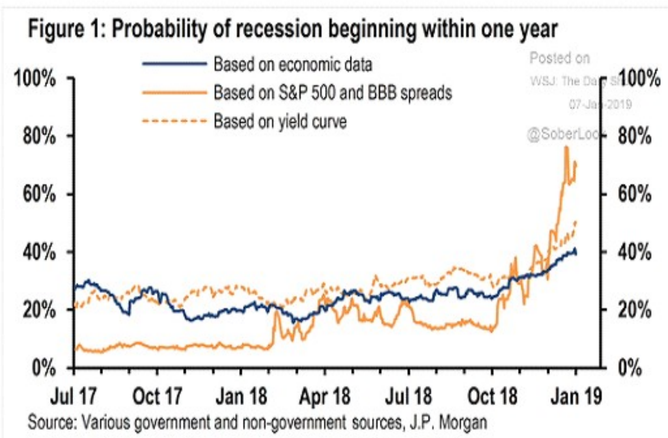
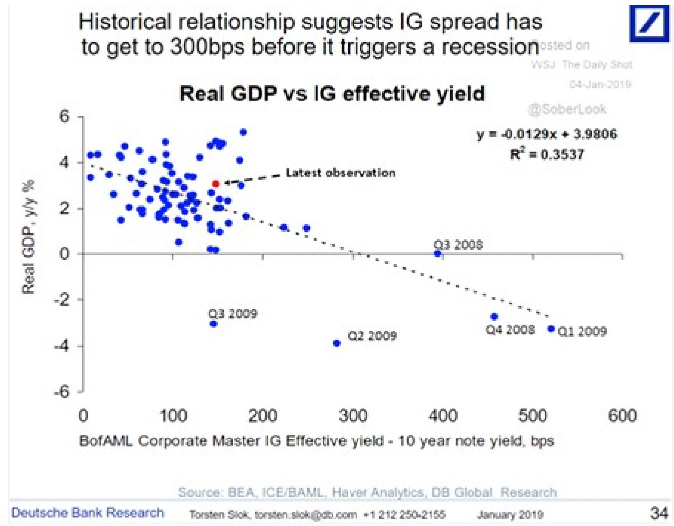
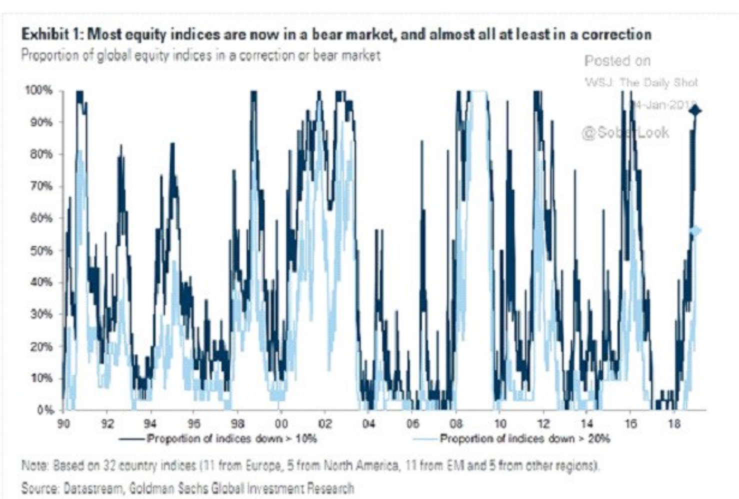
Ballooning credit spreads naturally had a negative effect on stocks. Fearing the Fed had miscalculated the risks associated with trade and market volatility, several firms on Wall Street increased their odds of a recession in 2019. This added to the year-end panic. The following charts from JP Morgan and Deutsche Bank show the probability of recession in 2019 varies widely depending on which metric is observed. In either case, it does confirm the economy will grow less in 2019 than 2018, and we are firmly into the later stages of the economic cycle.

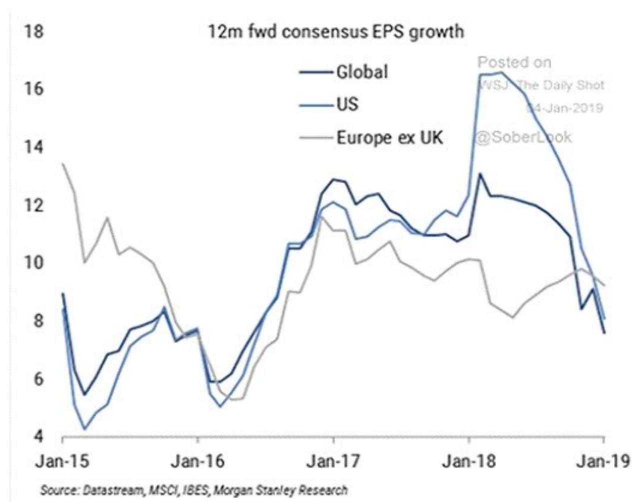




<u>Attractive Stock Valuations after Deep Sell-Off, if Earnings Estimates are Right</u>

The widespread sell-off in stocks has over half of global stock markets trading in bear territory (declines more than 20% from the highs). Nearly all the world's markets are in correction territory (declines more than 10% from the highs). This has historically been an attractive time to buy stocks. What makes things tricky is earnings estimates have been revised downward. At the current time, the S&P 500 trades at 14.9x earnings estimates for the next twelve months. This is below both the index's long-term average of 15.2x and the 18.5x seen at the beginning of 2018. If these earnings forecasts are correct, the market is trading at its lowest forward PE in over 5 years.





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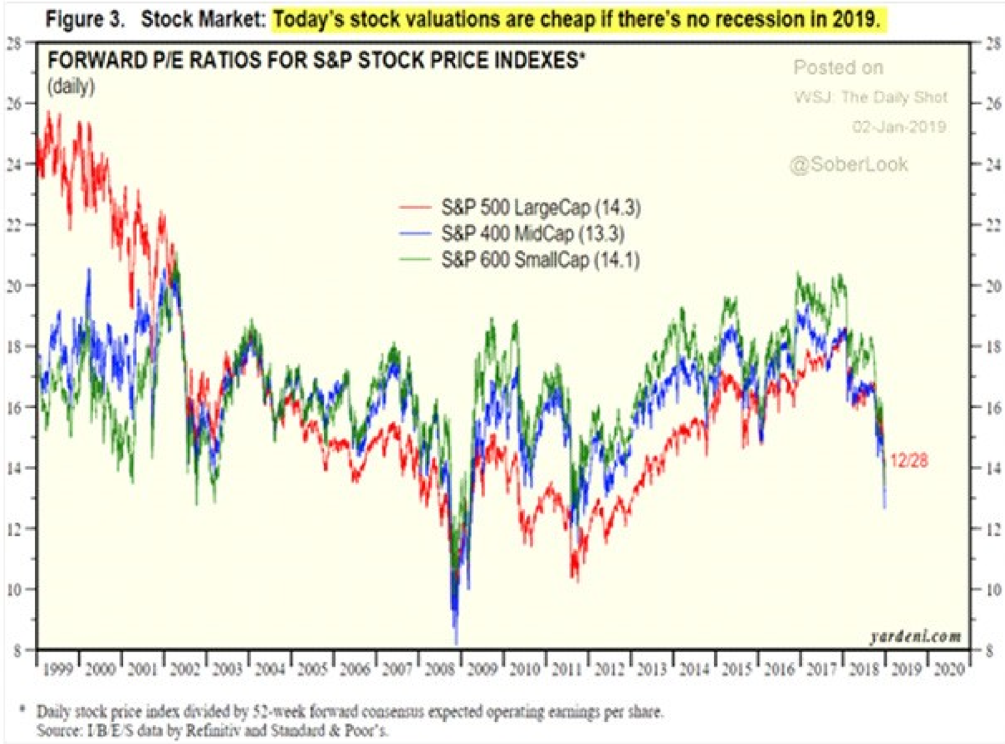

Source: Yardeni Research

What are We Doing—Our Strategy

A decline in stock values, along with widening corporate bond spreads and tumbling commodity prices, are clear signs that stress is in the capital markets. Most data points in our proprietary economic checklist indicate the US economy is in the late stages of the economic cycle. Despite the insistence from central bankers that they will move at a slow and measured pace, it is fair to say that further tightening will serve as a headwind for stock PE multiples. This puts additional gains from here on the shoulders of continued earnings growth and improving economic conditions, which leads us to believe that total returns in stocks will be much lower than what has been seen over the past 10 years with higher levels of volatility.

Given the Fed's dot plots, there is the possibility that the Fed will tighten too much in 2019, which could result in a self-created economic slowdown or recession. Signs of this are already appearing in the fixed income market with the 2-year and 5-year part of the US Treasury curve inverted, along with tight spreads between 2-year and 10-year US Treasuries. Tightening economic conditions will serve as a major headwind for growth stocks as their high PE multiples come under pressure.

All year, we have written about the need to slowly remove earnings variability from the portfolio as the economic cycle matures. In 2018, we focused primarily on lightening technology and industrial stocks given their high valuations and exposure to the trade skirmish between the US and China. As we enter 2019, we plan to continue to de-risk the portfolio as equities recover from their oversold position. Future trades will primarily come from financials, energy, and biotech.