

## Investment Commentary—January 2019

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When we brought up the possibility of a bear market (a stock market decline of twenty percent or more) in our previous commentary—cognizant that the Federal Reserve’s interest rate hikes might eventually take a toll—we had in mind the next two years, not the next two months. Little did we suspect that by Christmas Eve the stock market would come within a whisker of bear market status<sup>1</sup>.

The biggest culprit in last quarter’s stock market tumble may have been unrealistic expectations. One year ago all regions of the global economy were on the upswing. Optimistic investors were bidding up shares on the basis of a “synchronized global recovery.” We cautioned at the time that “for the global economy, this may be as good as it gets.” Global GDP growth was running around 3.7%<sup>2</sup>. That would have been considered run of the mill in the two decades before the Great Recession, but that was during a time when baby boomers were in their most productive years and the Chinese economy was growing ten percent a year. With the growth of the global labor force decelerating sharply over the last ten years and for the foreseeable future, 3% is the new 4%.

Fueled by a strong global economy and lower tax rates, U.S. corporate profits have skyrocketed. 2018 earnings on the S&P 500 Index will likely be up by around 27%—extremely impressive considering that 2017 earnings were already at record levels<sup>3</sup>. Analysts—ever the optimists—had been penciling in another 10% rise in 2019. Pie in the sky expectations of double digit earnings growth in 2019 left the stock market vulnerable to a reality check. By early October, sentiment had begun to shift and stocks, which had recorded an all-time high of 2,931 on the S&P 500 Index in late September, pulled back, dropping nearly ten percent to 2,641 by the end of October. The index remained in a range of 2,630 to 2,830 for the next six weeks, but fell sixteen percent in the three weeks ending Christmas Eve.

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<sup>1</sup> From September 21<sup>st</sup> to the Christmas Eve close the S&P 500 Index declined by 19.8%.

<sup>2</sup> Warning for anyone comparing this statistic to global GDP growth cited elsewhere: there are two methodologies for calculating global GDP; one adjusts for currency differences using market exchange rates; the other (on which the number we cite is based) handles currency differences based on “purchasing power parity.”

<sup>3</sup> As always, we use trailing GAAP (generally accepted accounting principles) earnings. Trailing means earnings that have actually happened, not someone’s guess about what might happen. GAAP means you don’t get to exclude the bad stuff.

December's precipitous decline can probably be attributed to several factors. The first was the aftermath of President Trump and Chinese President Xi's December 1<sup>st</sup> meeting in Buenos Aires. Three days after announcing that a truce in the US-China trade war had been agreed, Trump tweeted, "I am a Tariff Man." Around the same time, Canadian authorities were arresting the CFO of Huawei—the huge Chinese telecom equipment company—for extradition to the U.S. to face charges related to Iran sanctions violations. Neither the tweet nor the arrest seemed to bode well for a successful resolution of U.S.-Chinese trade differences. As late as May of last year, the World Trade Outlook Indicator was signaling strong expansion in global trade. By November the indicator was well into negative territory, indicating a significant deceleration, much of it due to the tariffs that have been put in place and the threat of more to come.

Slowing global trade has a relatively muted impact in the U.S. (as opposed to China and Germany, for example, which are much more dependent on exports). However, just as the stock market was reckoning with "Tariff Man" and the arrest of the Huawei CFO, bond markets began signaling a softer U.S. economy in 2019. The first hints began when high-yield bond "spreads"—the difference between yields on lower quality corporate bonds and U.S. Treasuries of the same maturity—began to widen sharply. Wider spreads suggest the possibility of increasing corporate bankruptcies from a weakening economy<sup>4</sup>. Perhaps more significantly, the bond market's expectations of future Federal Reserve rate hikes began to change rather dramatically. In mid-November the Fed funds futures market was forecasting an 87% chance of at least one additional rate increase in 2019. By early December that number had begun to plunge and is now around 24%, with a 10% chance of a rate cut. The Fed itself had been forecasting three rate hikes in 2019 (now two). The fairly clear implication of all this is that the bond market expects the U.S. economy to weaken noticeably this year and worries that the Fed is insufficiently attuned to that possibility.

President Trump has his own views on whether the Federal Reserve should raise interest rates in 2019 (which actually happen to align pretty well with the bond market) and wasn't shy about expressing them. By mid-December speculation had begun that the President would attempt to fire Fed Chair Jay Powell. It's very likely that he doesn't have the authority to do that, but the prospect that he might try was disturbing enough and was a large factor in the nine percent decline in U.S. share prices in the week before Christmas. The threat to Powell's job security may have crystallized growing political and geopolitical concerns, fed by the Yellow Vest protests in France, the rise to power of anti-EU populists in Italy, the possibility that the U.K. will be forced into a "hard Brexit," and the abrupt resignation of Secretary of Defense Mattis.

As difficult as it was to watch, there may be some benefits from the fourth quarter's steep decline in global stock markets. Most notably the tumble in share prices seems to have gotten the Fed's

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<sup>4</sup> Admittedly there were other factors at work. For example, spreads had been unreasonably low, so some widening was overdue. Also, energy companies are overrepresented in the high-yield universe; some of the tightening was a direct response to a plunge in the price of oil.

attention, as evidenced by Powell's recent retreat from a hawkish (i.e., insistent on more rate increases) early December press conference. Inflation continues to defy expectations and remains quite low. Oil prices settling back in at around \$50 a barrel will help on that front. If the Fed takes the opportunity to hit the pause button on interest rate hikes<sup>5</sup>, it's quite plausible that the economy will settle into a moderate growth trajectory this year, achieving the elusive "soft landing" that is the holy grail of every Fed Chair.

Fed Chair Powell is probably not the only person in Washington to take note of the sharp drop in share prices. President Trump has made it very clear that he pays close attention to the stock market and considers it a report card of sorts. It must be clearer than ever that investors want a trade deal and want it soon. With the Chinese economy under significant pressure from ongoing structural changes, together with increased tariffs on U.S. exports, President Xi must also be highly motivated to find common ground. None of that guarantees that a deal will happen, but we wouldn't bet against it.

In the meantime, expectations for corporate earnings growth have become more realistic, nudged along by warnings from the likes of FedEx and Apple among others. If the U.S. and China can negotiate a trade deal in the first half of the year, there is a reasonable chance for some growth in corporate profits this year. Along with a trade deal and the Fed staying on the sidelines, that would be a pretty good formula for rising share prices. With U.S. Treasury yields significantly lower than they were three months ago, and dividend yields on stocks significantly higher (due to a combination of increasing dividends over the course of 2018 and recent share price declines), stocks would look reasonably attractive at current levels in an environment of steady, moderate growth. Anticipation of a relatively benign scenario along these lines probably accounts for the ten percent rally in share prices from the Christmas low.

It's tempting to worry about political and geopolitical headlines, of which there are and will continue to be, no shortage (Brexit and the government shutdown come to mind at the moment). As we've written many times, however, capital markets can tolerate a great deal of political and geopolitical turmoil as long as there is a limited impact on economic growth and corporate profits. On that score, the most relevant situation by far is the trade negotiation between the U.S. and China. If talks breakdown and the Trump administration imposes additional tariffs there will be a significant impact on global trade and the stock market is likely to react accordingly. Hopefully appreciation of that consequence by all parties concerned will help to ensure the opposite result.

*January 15, 2019*

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<sup>5</sup> "Quantitative tightening," selling bonds from the Fed's balance sheet, will almost certainly continue, so there will be some upward pressure on interest rates even in the event of a pause on rate hikes.