

2018 Review and 2019 Outlook

Eat Sweets, Get Indigestion

January 8, 2019

Executive Summary

- Heightened market volatility has shaken investors, notwithstanding continued economic expansion and still-solid growth prospects ahead.
- Three inter-related issues of Trade Wars/Tariffs, the Fed, and the Real Economy are the key drivers for the future direction of markets.
- Oversold equity and overbought fixed income markets are pricing in a 2019 recession that's not likely to emerge until 2020 at the earliest.
- Our base case calls for positive equity returns, gradually rising long-end rates, and modest increases in 2-5 year yields.

Long time readers and followers will recall the following slide we've been using for years regarding our thoughts on Fed policy:



Initially, we were surprised by both the scale and duration of unprecedented post-crisis actions taken by the Fed (such as the Zero Interest Rate Policy, or “ZIRP,” and Quantitative Easing, or “QE”, which were large-scale direct bond purchases). We referred to this as ‘Central Banks on Steroids.’ After QE and ZIRP finally ended in 2015, we wondered how markets would react to the first steps in the process of draining the generous “liquidity punch bowl.” This was aptly characterized as ‘Return to Normalcy.’ More recently, we questioned whether the Fed would ‘Stick the Landing’ in the next phase of the tightening cycle, which called for a series of steady hikes to normalize the Fed Funds yield – i.e. bring it up to at least the rate of annual inflation.

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In the last two months of 2018, we experienced stock market mayhem and extreme volatility, seemingly a delayed response to the cumulative post-2015 tightening of liquidity. We’ve been watching the markets for over thirty years and can’t recall seeing anything like this. Despite:

- The US economy growing at 3%,
- Unemployment at historic lows of 3.7%,
- Core inflation at a very tame 2.2%,
- Low oil prices below \$50, and
- A host of other positive data,

The stock market is clearly discounting an extreme reversal of economic conditions in 2019. *But does that make sense?* Read on for our outlook.

2018 Review—Cash was King

For the first time since the Great Financial Crisis, “cash was king,” as Money Market Funds outperformed all major US dollar-denominated stock and bond indices.

We also witnessed the return of choppy markets, with US equities gradually peaking mid-year before declining sharply in October, mildly recovering in November, and imploding in December (down 9% on the month). Ultimately the S&P 500 ended the year down 4.2%, which was significantly better than non-US markets, as European and Emerging Markets stock indices significantly underperformed. While we maintained near zero direct exposure to emerging markets and were well underweight European (Non-US developed market) equities, our US stock exposure was largely caught up in the recent market turbulence.

In fixed income, Treasury rates across maturity ranges all moved higher, but unevenly – short-end yields rose faster than those on the long-end, leading to a flatter yield curve. The short-end increases were closely tied to the Federal Reserve’s rate hikes, while long-end rates peaked at 3.25% and recently declined to approximately 2.65% due to recession fears and a flight to safety during the year-end market sell off.

Asset	Total Return
MSCI Emerging Markets (USD)	-14.3%
MSCI Europe (USD)	-9.8%
S&P 500	-4.2%
Bloomberg Barclays US Bond Agg	0.0%
Bloomberg Barclays US Muni Agg	+1.3%
Money Market Fund (Govt)	+1.7%

Source: Bloomberg

Asset	Total Return
Russell 2000 (Small Caps)	-10.8%
S&P 500	-4.2%
Dow Jones	-3.3%
NASDAQ	-2.7%

Source: Bloomberg

Maturity	Treasury Yield As of 12/31/17	Treasury Yield As of 12/31/18	Change Through 2018
1 Year	1.75%	2.61%	+0.86%
2 Year	1.91%	2.50%	+0.59%
3 Year	2.00%	2.46%	+0.46%
5 Year	2.24%	2.51%	+0.27%
10 Year	2.43%	2.68%	+0.25%

Source: Bloomberg

Municipal bonds were remarkably calm all year. Short-end municipal yields rose less than those of Treasuries with equivalent maturities (leading to lower municipal/Treasury ratios that indicate richer municipal valuations). In contrast, long-end municipal rates generally moved in-line with equivalent Treasury yields, maintaining their municipal/Treasury ratios and relative valuations.

Maturity	AAA Municipal Yield (Ratio) As of 12/31/17	AAA Municipal Yield (Ratio) As of 12/31/2018	Change Through 2018
1 Year	1.42% (81%)	1.90% (70%)	+0.48% (-11%)
2 Year	1.54% (80%)	2.01% (72%)	+0.47% (-8%)
3 Year	1.57% (78%)	2.07% (73%)	+0.51% (-5%)
5 Year	1.68% (75%)	2.21% (77%)	+0.53% (+2%)
10 Year	1.99% (82%)	2.60% (85%)	+0.61% (+3%)

Source: Bloomberg

Corporate bonds faced an entirely different dynamic, as corporates of all maturity ranges experienced yield spikes exceeding those in Treasuries. This surge in corporate bond rates was caused by “spread widening” – i.e. rising yield premiums on corporate bonds over the risk-free rate of equivalent maturity Treasuries. The main driver was mounting market concern over the impact of a slowing US economy on corporate earnings and debt loads; accordingly, investors began demanding greater yield compensation over Treasuries.

Total returns in corporate bonds greatly lagged those of Treasuries and municipals, which were both able to buck the effects of Fed hikes and produce a (nominal) positive total return. The spread widening in corporate bonds negatively impacted our client portfolios, as we typically seek total return opportunities in this sector.

2018 Total Returns: Municipals vs Treasuries vs Corporates



Source: Bloomberg

Looking Under the Hood – What’s Driving Markets?

Three inter-related issues are impacting the markets – and by extension our forward outlook. Developments in these 3 factors, and how well they fit with market expectations, are likely to be dominant drivers of US markets for at least the first half of 2019.

The Fed

We’re now 3 years into a gradual Fed tightening cycle, with an admittedly-low Fed Funds rate of 2.25-2.50% that’s nonetheless a significant increase from the ZIRP years (2009-2015). However, we’ve reached the point where the previously steady pace of hikes will slow, so long as inflation remains moderate.

To be clear, there are certainly good reasons to continue tightening – the still-growing US economy, a strong labor market, and the Fed’s own deep-seated institutional desire to “normalize” monetary policy ahead of the inevitable next recession. But for the first time since December 2015’s “liftoff”, there are now also good reasons to pause – a slowing global economy, the apparent lack of inflationary pressures, and the prospect of directly triggering an inverted curve.

Ultimately, we think the Fed will pause in 2019 to “assess the impact of prior rate hikes,” but they will likely fit in another two hikes (of 25bps each) *if* economic data doesn’t deteriorate and signal a dramatic slowdown. Although the Fed doesn’t want to push short-term rates up enough to invert the yield curve, we don’t think they view it as a dealbreaker; inverted curves are technical market situations which are curious to observe but don’t translate into the real economy.

As evidenced by market reaction to their December meeting, the Fed’s communication during this nuanced phase will be a challenge to navigate. Small changes in forward guidance can have an outsized impact, particularly since investors are carefully seeking clues as to the potential timing and duration of an upcoming pause. There’s little room for either communication or policy errors. Fundamentally, though, this is to be expected; it’s an unavoidable problem in transitioning from an extremely accommodative post-crisis monetary policy to a more normalized policy. Basically, the markets have been gorging on sweets for years and must now face the consequent indigestion of normalizing monetary policy.

Tariffs/Trade Wars

While simmering trade disputes often dominate headlines and spur market moves, it’s essentially impossible to anticipate next steps with confidence. The nature of the multi-sided conflicts, fraught with diverse political objectives and ill-defined goals on each opposing side, makes forecasting developments and their impacts an inherently speculative exercise.

Nevertheless, our base case for 2019 is for a stable to slowly-deteriorating *status quo*: current China tariffs maintained and/or slowly ratcheted higher, the US-Mexico-Canada trade agreement being ratified, and further action against the EU/Japan threatened but not taken. Simply put, we’d be surprised if the US-China trade conflict is resolved in 2019, but absent major deterioration in relations we don’t expect the situation to continue serving as an overhang to equities. However, the growing influence of the upcoming 2020 Presidential election cycle may spur outcomes in unexpected directions.

One thing we are confident forecasting is that current heightened market volatility is here to stay. Free trade ultimately opens more opportunities for businesses, while uncertainty in trade policies helps derail corporate planning for growth/expansions, optimizing supply chains, etc. Policy murkiness extracts a price in the form of volatility, and will continue to do so until the uncertainty fades.

Real Economy

A remarkable aspect of the recent choppy markets is that underlying economic data haven't shown any unexpected deterioration to confirm the gloomy investor sentiment. In fact, the data continues to suggest *the opposite* -- that US economic fundamentals remain strong, suggesting recession shouldn't be in the cards for 2019.

To be fair, the use of the phrase "unexpected deterioration" in the preceding paragraph was intentional. Both we and the market already expected the pace of growth in 2019 will be noticeably slower than in 2018. This is a widely-held and uncontroversial view, as 2018's large (20+% YoY) corporate earnings growth was boosted by 2017's tax cuts. Moreover, it's important to remember that if 2018 represented this expansion cycle's "peak growth" year, that doesn't mean it was also the peak earnings year; that is, the *rate of growth* may have crested but outright recession (i.e. a negative YoY earnings comparison) is unlikely to occur in 2019. Our base case is that we won't see a meaningful slowdown before 2020 at the earliest.

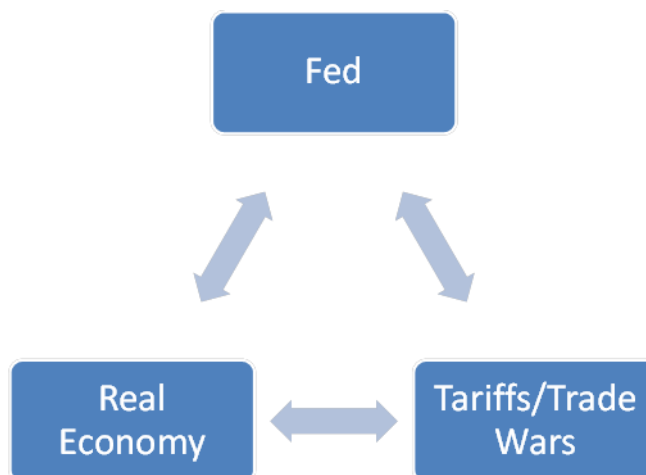
Over the years we've repeatedly emphasized that economic expansions don't die from "old age," but rather because a distinct catalyst derails the fundamental growth story. At this point, we still don't see such a catalyst on the immediate horizon, and the data point to a growth story that still appears intact:

- The unemployment rate is very low;
- Inflation and inflation expectations remain low and well-anchored, and are trending downward along with declining oil prices;
- Consumer and small-business confidence are still elevated;
- Measures of business growth (ISM surveys) remain at healthy levels; and
- The 2017 tax reform's heavy incentives for business capital expenditures/reinvestment are still in place, encouraging American companies to invest in greater productivity.

Altogether, we expect these factors will be enough to support real US GDP growth of approximately 2.5% in 2019. While it's certainly a step down from 2018's 3%+ real GDP growth, it's still above the post-crisis average and, more importantly, a long way from negative.

Obviously each of these issues both effects, and is affected by, the other 2. For example:

- New tariffs or trade war threats → affect the real economy → which shows up in data the Fed studies → which affects their rate hike projections → which move Treasury yields → which then affect the real economy...



Moreover, as always there are also other important factors to consider:

- The labor market remains tight and wage growth is likely to pick up steam. An inflationary spike would influence Fed behavior and, by extension, market rate projections and Treasury yields.
- With higher rates comes an increasing cost of borrowing for corporate bond issuers. This could eventually pressure the most overextended companies, leading to some high-profile downgrades and market repricings. However, while elevated corporate debt levels are certainly a concern for highly-leveraged outlier businesses, overall corporate cash flows are still strong and likely to remain so as long as the economic expansion doesn't roll over.
- The federal budget deficit continues to expand and reach unusually high levels compared to the benign economic environment. This automatically leads to an increased supply of newly-issued Treasuries to finance the spending gap. Thus far, market demand has stepped up to handily absorb the increased supply in Treasuries, constraining the rise in yields. But with the surge in issuance continuing unabated, will this always be the case?

Putting it All Together - 2019 Outlook and Strategy

As long-term investors tasked with preserving our clients' wealth, our outlook revolves around developments in economic fundamentals. If we detect deteriorating fundamentals pointing towards rising odds of a near-term recession, we dial down risk in asset allocations and tighten credit standards. And for now, we see a still-positive but slowing fundamental environment in 2019.

While 2018 represented "peak earnings growth", corporate earnings are nonetheless set to keep rising through at least the first half of 2019. While it's likely to be a more modest 5-8% Year-over-Year bump vs. 2018's blistering 20%+, this would still be a solid improvement. We expect the positive tailwinds from plummeting oil prices and the continuing effects of tax reform to support EPS growth, barring the realization of a worst-case scenario in the trade wars.

As a result, we're maintaining average equity allotments when rebalancing client Asset Allocations. The silver lining of recent stock market declines is that with the positive underlying earnings backdrop, Price/Earnings ratios have compressed several "turns" compared to the beginning of the year, going from 18.5x down to 15.5x.



Source: Bloomberg

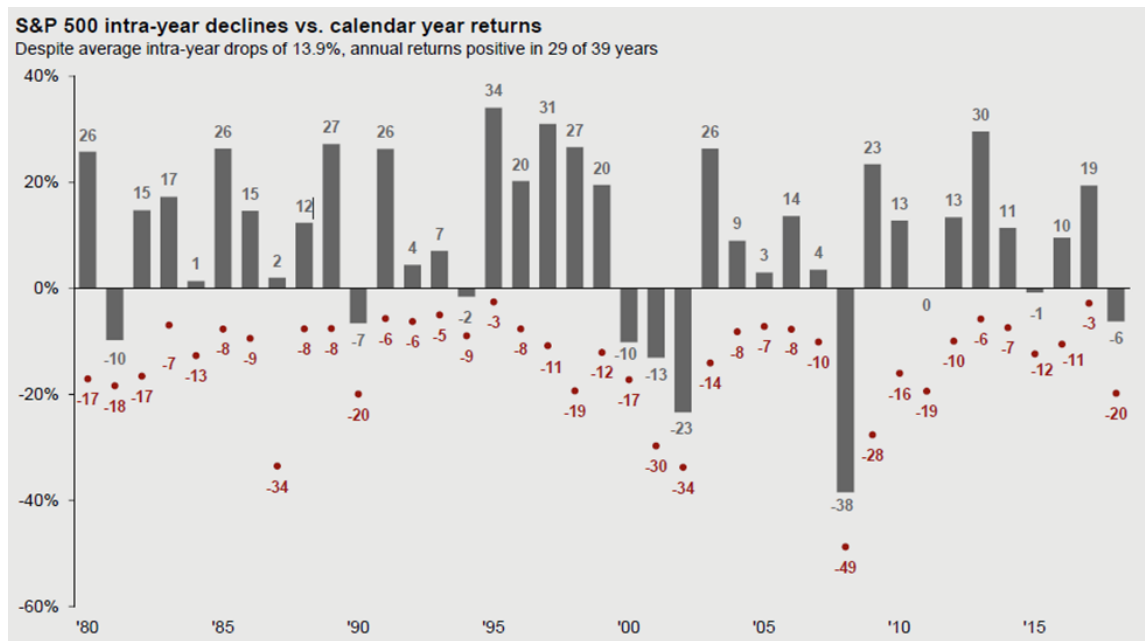
While stocks aren't at exceptionally cheap levels, current P/Es are below their long-term average:



Source: Bloomberg

At current P/Es, we believe the market is over-discounting the risk of recession in 2019 and expect positive equity returns as jittery investors' worst fears gradually fail to materialize.

It's important to note this doesn't mean investors won't have to accept increased volatility. History shows that since 1980, the S&P 500 has provided positive annual returns in 29 of 39 years despite an *average* intra-year decline of 14%. Remember; notwithstanding the recent declines, the relative calm of the past several years has been a historical aberration. As long-term investors, it pays to act with equanimity in the face of volatility.



Source: JP Morgan Guide to the Markets

Within fixed income, many of the factors mentioned previously will impact the direction of rates. Our base case takes into account the still-strong economic backdrop and calls for gradually rising rates on the 10 Year Treasury and modest increases in the shorter term 2-5 year sector of the curve. We expect additional spread widening in the corporate bond market and will continue to seek opportunities in selected issuers. The municipal market should continue to present opportunities, such as with the recent purchases of long final maturity-short call date municipal bonds in many client accounts.

Risks to Our Outlook

Until economic fundamentals start flashing warning signs, we remain positive. But what could make us change our view? In no particular order, here are the key risks to our outlook and positioning:

- We're underestimating the impact of Fed tightening (either via rate hikes or Quantitative Tightening) on a fragile global economy. As the only major world economy with rising rates and healthy GDP growth, global slowing can drag down the US economy.
- Sentiment among corporate executives deteriorates and CEOs/CFOs begin factoring an imminent recession into earnings forecasts. This would cause cautious businesses to scale back on planned capex and growth plans, converting "soft" sentiment fears into "hard" actions that spur a self-fulfilling prophecy.
- Inflation makes its long-awaited comeback, forcing the Fed to hike rates faster than anticipated.
- The previously-mentioned "worst case" scenario for tariffs/trade wars begins to manifest as presidential election year politics get uglier and the impact of tariffs begins to crimp corporate margins, disrupt supply chains, and weigh on consumer spending.
- The Fed commits a communication and/or policy error, overtightening or creating the impression they're going to raise rates faster than the market finds comfortable.
- Increased market volatility due to the blunt-force impact of "illogical" passive investment flows that take up an ever-increasing share of the market.

What are we doing to monitor for these and other risks? Naturally we're diligently following leading economic indicators and our traditional "channel checks." We're also carefully following company-specific earnings, keeping an eye out for deteriorating sentiment and signs that sales growth and profit margins are coming under pressure.

Above all, remember we've always been long-term investors with 3-5 year investment horizons. The current market selloff appears overdone, pricing in irrationally-high odds of a recession in 2019. For long term investors with multi-year horizons, current valuations at 15.5x forward earnings projections remain attractive.

Our best wishes to all our clients and friends for a happy, healthy, and peaceful new year.

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