ECONOMIC OUTLOOK

bounty management

unique investment insight

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Markets Return to Volatility As Global Central Bank Liquidity Reverses

Measured on an annual basis, 2018 proved to be the worst year for U.S. stocks since 2008. A 19.8% correction from the peak in September through December 24th was also the deepest drop during the bull market dating to March 2009. Both stocks and bonds struggled, with over 90% of asset classes posting negative total returns for the year. This was a record and higher than the 29% average going back to 1901 according to Deutsche Bank data. Adding to the stock market's worry has been a rare simultaneous drop in bond prices. U.S. shares nonetheless fared better in 2018 than many global peers with a drop of 15.2% in the Eurozone, 16.9% for emerging markets, and 16.8% in Japan. The fall in the U.S. markets was severe enough for Treasury Secretary Mnuchin to call together the "Plunge Protection Team" – a working group including the heads of the Fed, SEC, and CEOs of the six largest banks – on the Sunday before Christmas. Although the stated purpose of the group was to "assure normal market operations," the meeting raised anxiety as investor's wondered if the Treasury could see a deeper financial crisis was brewing that the rest of the market was missing.

Renewed equity market volatility comes in the wake of the advance in the S&P 500 that followed the 2016 election, and was boosted by the late-2017 tax cuts. Strong domestic growth and expansionary fiscal policy prompted a quicker pace of rate hikes and tighter policy from the Federal Reserve in the early part of 2018. Valuations supported by seven-plus years of zero-rate policy and a $4 trillion expansion in the Fed's balance sheet lost support more quickly than expected, all poorly timed against renewed global and government uncertainty fueled by the trade war, a government shutdown, and fresh signs of a slowdown in Europe and Asia during the quarter. The good news is that a number of global uncertainties that led to reduced risk sentiment in the fourth quarter may be resolved soon. The U.S.-China trade war faces a decision point ahead with a scheduled boost in tariff rates in the first quarter. The long-running Brexit showdown between the UK and EU faces a deadline of March 29, 2019 with the ball currently in the UK parliament's court. Italian budget drama has been resolved for the moment, but the May EU parliamentary elections will still be a key event.

Financial market turmoil does not always lead to recessions and extended bear markets, as in the market crash of 1987, or rolling crises in the mid-to-late 1990s. We will need to watch for any impact of Wall Street pain on Main Street and corporate sentiment. At the moment, strong job growth, moderate inflation, and continued wage acceleration continues to support domestic household fundamentals, and corporations just finished one of the best years on record for profit growth aided by the corporate tax cuts. The response of firms and households to recent market developments will determine whether we look back at poor equity market performance in 2018 as a return to normal volatility, or the precursor to something worse.

U.S. Economy

Incoming data suggest a strong year-end finish for the U.S. economy, possibly exceeding the 2.9% y/y posted in 2015 as the best year during this expansion. Consumer spending growth may reach 4% annualized in the fourth quarter after Q3 3.5%. Top-line GDP growth near 3% remains above "potential" growth, conventionally estimated at just below 2%. "Potential" is an uncertain and estimated economic concept, and a lack of sustained price inflation pressures hint that the speed limit could be a bit higher. A fade to 2% on average would still be good in this context, even if historically subpar. A risk is waning fiscal stimulus by the end of 2019, along with current global trade slowdown. The best two-month stretch for the ISM Non-Manufacturing survey has transitioned to the best three-month stretch on record, with the index rising 0.4 points to 60.7 in November before plunging to 54.1 in December – although still in expansion territory above 50, this is the largest monthly drop since October 2008. The latest Federal Reserve forecast for 2019 revised growth down from 2.5% to 2.3%.

Consumer and Employment

Key consumer fundamentals to gauge the economy include employment, wages, sentiment, the household balance sheet, and access to credit. On the first, employment growth remains strong, rising 196,000 per month on average in October/November (third quarter 190,000). Wage growth accelerated to 3.1% y/y over the first two months of the fourth quarter, up from 2.8% in the third quarter, the highest during the current economic upturn. The Atlanta Fed's Wage Growth Tracker, which monitors constantly-employed individuals, pointed to even stronger gains nearer 4% in November. Sentiment remains strong in the long-running University of Michigan survey, though it did dip below 6- 12- and 24-month averages in December. The Conference Board's December survey saw a hit from the equity market decline, but it still remains above historically strong levels seen as recently as mid-year 2018. Wealth effects from the equity market's drop are unlikely large enough to disrupt confidence and spending, but this will be an important dimension to monitor in 2019.

Real Estate

The residential real estate market is flashing slowdown as price gains moderate and sales rates moved lower in the fourth quarter. Supply remains historically low, but has risen in y/y comparisons. The National Association of Realtors pending home sales index fell 7.7% y/y through November, the eleventh consecutive y/y decline and the steepest drop since April 2014. That period also followed a spike in mortgage rates amid continued expansion. The labor market remains a key tailwind for sales, but affordability has deteriorated for the median buyer, particularly in the West.

Manufacturing

In the fourth quarter, U.S. manufacturers still struggled to keep pace with demand, though supplier delivery delays and transportation bottlenecks began to ease. Anecdotal evidence from Fed surveys and the national-level ISM survey did point to some softening in demand later in the quarter. Firms with global supply chains still aren't sure whether early 2019 will bring another ratchet higher in the China-U.S. tariff rate to 25%, from 10%. The new orders and production components of the ISM Manufacturing survey held at strong levels above 60 in the November reading before tanking to readings in low 50's showing continued business strength, but at much lower levels due to softer demand. With new export orders plunging to two-year lows by quarter-end, imports sluggish, and y/y growth in actual manufacturing production slowing to 2% y/y in November from 3%-plus in the third quarter, headwinds are brewing.

World Economy

Europe

A growth downshift in the Eurozone continued through the fourth quarter, with a sequence of downbeat economic data across the region. Two of the three largest Eurozone economies are contracting (Italy, France), with bear or near-bear equity markets across the region. The sharp drop to sub-50 PMI levels in France was driven by weeks of “yellow vest” protests, unrest due to fuel taxes and the middle class squeeze prevalent across developed markets. Even if unrest proves temporary, economic strains will persist.

UK Brexit Update

After two and a half years, the UK cabinet approved a 500-plus-page Brexit deal in mid-November, one that maintains very close ties with the EU, along the lines of Norway. The deal, which held few surprises, includes a $50B divorce settlement, a standstill transition period to the end of 2020, and a backstop for Northern Ireland which could keep the UK in an EU customs union for years to come. This “soft” Brexit means the country would never really leave the EU, while subject to rules about which it has no say. The compromise does not have enough support to get through the UK parliament by the March 29, 2019 deadline, and the prospect of a better deal from the EU is limited. A second Brexit referendum is still a possibility. If reversed, all of the drama of the previous two-plus years will have been a massive waste of time.

Japan

The economy is set to rebound after natural disasters in the third quarter led to contraction (-2.5% annualized), but weakness in China and European economies and U.S. trade uncertainties remain major risks in the short to medium term. Wage growth is rising moderately, averaging over 1% y/y in 2018, but has failed to keep up with inflation. Price pressures are fading, with no signs of approaching the 2 percent target. While monetary policy remains accommodative, fiscal policy is scheduled to turn restrictive in the fourth quarter of 2019 when a consumption tax hike hits. A past iteration caused a significant slowdown in growth back in 2014.

China and Emerging Markets

A common thread behind equity market turmoil is a greater slowdown in China than official statistics suggest. The Chinese economy posted 6.5% y/y GDP growth in the third quarter (Q2 6.7%). In December, policymakers promised significant tax cuts in 2019 and signaled more accommodating monetary policy. Government leaders continue to aim for debt deleveraging and a healthier real estate market. The November G-20 meeting in Argentina brought general promise from China to use that extra time to attempt to address key points of U.S. contention, including non-tariff barriers, intellectual property and cyber theft issues, and reducing the U.S.-China trade deficit directly through purchases of U.S. goods.

Oil/Commodities

The supply side of the oil market started the fourth quarter in a position of tightness due to Iran sanctions, pushing oil prices up above $75 per barrel in the U.S., or $86 on the world Brent crude benchmark. By the end of the fourth quarter, those prices were roughly 40% lower, or $45 and $52, respectively, as Saudi Arabia announced sufficient supply would be at the ready. Precious metals held their value last year with gold down about 2% for 2018. Sovereign debt has gone up relative to GDP around the world and the supply of gold has been less than any other form of printed fiat currency. The drop in energy and other commodity prices means inflation pressures will subside significantly across the globe. Headline CPI inflation could fall in the U.S., severely diminishing the need for further interest rate hikes over the next six-to-nine months.

Investment Perspective

The year ended with a few rally sessions, but the damage had been done as the U.S. markets logged their worst performance since 2008. Markets were derailed by a host of issues including higher interest rates, trade conflicts, the UK's messy exit from the EU, a slowdown in global markets, softer housing numbers, political chaos, and ever increasing debt. Investors may have hoped that October's drubbing was the worst the markets would face, but the 7% decline for the S&P 500 in October was followed by a 9% decline in December. It could have been worse – the intraday low on Christmas Eve was down 15.9% for the month of December and close to 20% from the high in September. 60% of the stocks in the S&P 500 reached the bear market (over 20% loss) or much worse.

The Federal Reserve's drive to raise interest rates or "quantitative tightening" contributed to the market's fall. The Fed raised interest rates four times in 2018, putting the brakes on extraordinary easy monetary policy. Non-traditional monetary policy - seven years of zero interest rates and $4 trillion in bond and mortgage securities purchases - has been the macro policy most responsible for the growth and the rise in asset values in the past decade and tighter monetary policy has the opposite effect. The connection between raising rates, the Fed balance sheet, and the stock market was made clear by the Fed itself – during January this year, the Fed reversed course and is now flexible about raising rates further and suggested rate hikes will be on hold.

We have also experienced periods of spiking volatility this year as the investment landscape shifted quickly in the fourth quarter. Much of the volatility has been based on trade friction. The euphoria surrounding the tax cuts and increased government spending has been replaced by a sense of caution amid the administration's trade and tariff policies. Trade policy news has triggered major daily jumps in U.S. stock prices - swings of at least 2.5% - four times since March. For context, that happened only seven times before, total, over the previous 118 years, according to University of Chicago professor Steven J. Davis.

The market sell-off that began in October occurred despite solid economic data, low unemployment, high consumer confidence, positive leading indicators, GDP above 3%, strong corporate profits, and moderate inflation. Even though growth is unlikely to be as robust in 2019, economic fundamentals point to growth. Share buybacks continue to support the market with over $800 billion in share purchases this year, but buybacks are not sustainable and corporations tend to buy their stock at market highs. We expect earnings to grow at 6-7% in 2019, slightly below consensus expectations of 7.6%, driven by solid U.S. economic growth and further stimulus. The U.S. economy has never experienced a recession while earnings were growing as corporate profits typically lead to growth in business investment, productivity, employment and consumption. We still favor equities with the caveat that valuations are lower, but still historically high. Short-term fixed income gives investors income and ballast for the equity volatility. Health care remains a favored sector, along with technology, energy, and communication services. We will focus on investing for the long-term in companies with above average growth prospects, good management, financial discipline, and selling at reasonable valuations. We will continue to navigate through the turbulence and as always, remain vigilant.

December 31, 2018
DJIA: 23,327.46
S&P 500: 2,506.85

About Bounty Management

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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