

What have the markets been telling us? And what do we expect for 2019?

The storm clouds we saw gathering at the end of the 3rd quarter pelted us with rain, and we don't see beautiful clear skies ahead. Increased volatility is here to stay, with very few places to hide.

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On the political front:

December's equity market selloff sent a clear signal that trade wars and presidential interference with the Federal Reserve will not be tolerated. While the administration walked back comments about firing Fed Chairman Powell, ongoing trade issues with China will be more difficult to resolve. This uncertainty will leave the market unmoored, whipsawed by every tweet and news soundbite.

Oil prices fell dramatically partly due to President Trump's actions regarding oil policy, namely side deals with Iranian oil sales and jawboning Saudi Arabia to keep world oil supply up and prices down. Although Trump appears hellbent on lower oil prices, he fails to recognize that the US has gone from an oil importer to an oil exporter. Just like you can be too rich or too thin, oil prices can be too low (more on that later).

Large equity market swings from day to day, both in the U.S. and foreign markets, reflect political uncertainty about Brexit, the Italian budget, tariffs, U.S. government shutdown, a split Congress, and revolving door of White House personnel to name a few. Widespread computer (and momentum) driven trading increases these price swings. Both businesses and markets dislike uncertainty, so we expect continued higher volatility in 2019.

On Fed Policy:

In the past two months, the 10-year Treasury yield has fallen from 3.26% to 2.62%. Conversely, over the course of 2018, the 3-month treasury bill has risen from 1.37 to 2.37%, a direct result of Federal Reserve rate hikes intended to prevent an overheated economy. This recent drop in longer dated Treasury yields in the face of rising short-term rates (called a flattening yield curve) shows the market expects a Fed policy error to cause a recession. Historically, most U.S. recessions have been caused by the Fed raising short term rates either too quickly or too many times. No wonder Powell says policy making is like walking through a dark room without shoes!

While Chairman Powell stated any future rate hikes will be less dogmatic and more dependent on economic data, he plans to continue rolling securities off the Fed balance sheet on an automated schedule. Since 2015, the Fed has reduced its balance sheet by about \$375 billion and plans to continue that reduction by \$150 billion per quarter this year. This process, called quantitative tightening, decreases liquidity and can lead to a slowing economy, another reason behind the recent drop in Treasury yields and equity prices.

While Treasury bond yields are lower for now, these levels will be difficult to maintain given rising federal deficits, concomitant with larger Treasury auctions, and lower investment levels by foreign governments (namely China and Japan). At the same time, we have record level refinancings of U.S. corporate debt competing with this increased supply of government debt. In short, we have fewer buyers interested in buying our bonds at the same time as we will have a greater supply of bonds being offered, pressuring yields to rise. Since bond prices go down as yields go up, this should be negative for bond fund returns.

On inflation:

The flattening yield curve says the market thinks inflation is a non-issue. We're not convinced, and here are the reasons why...

The lack of qualified workers and an unwillingness to admit immigrants into the U.S. should lead to higher wages. Import tariffs cause the price of goods to rise. The increase in mortgage rates raises the cost of home ownership, all else being equal. And by the way, have you been to the grocery store lately? No wonder Trump is so interested in oil prices declining, a simple way to keep inflation in check.

On the economy:

There is no doubt the underlying US economy was strong during 2018, showing outsized earnings growth in response to corporate tax cuts. But, what will happen going forward? Current consensus expects the rate of US economic growth to slow, which is already evident in the latest housing and auto sales numbers but does not anticipate a US recession in 2019. Lower stock market P/Es reflect these consensus expectations.

Why does any of this matter?

The risk of recession is real. By remaining inflexible in their views, Trump, China, and/or the Fed may tip the balance from slower growth to recession, and there's always a chance of an unexpected exogenous event (think European bank issues and excessive corporate debt).

It feels like a bear market, but we don't know if it's recessionary or not. A recessionary bear market behaves differently than a bear market not accompanied by a recession: it lasts longer and drops further. The typical recessionary bear market sees an average decline in the S & P 500 of about 32% over fifteen months. It is not unusual to see 10% to 20% declines initially, followed by another 15% to 25% falloff as the downturn gets going. The average recovery time is 10 months.

So why don't we run for cover?

As we wrote in our piece, "The Art of the Deal", the economic outcome is up to Trump and the Fed. If Trump doesn't blink on trade policy, a stumbling economy will eventually cause the Fed to change course. Some pundits argue we are all ready at that inflection point. When the Fed reverses course, equity markets should lift. In the interim, market opportunities will present themselves as the babies get thrown out with the bath water.

Markets rise over 70% of the time. The graveyard is full of failed market timers. Getting out requires getting back in, so you need to be right twice. As long as you rebalance your asset allocation over time, remaining invested should pay off.

As we pointed out in an earlier blog, Doug Ramsey, chief investment officer of Leuthold Group, made an interesting observation in a Barron's article entitled Markets Take a Breather (November 20, 2017). He pointed out that the unluckiest investor, who bought the S&P 500 at the market's previous peak in October 2007—just before the worst financial crisis and severest economic downturn since the Great Depression—realized a total return of 7.3% per year, which includes dividends.

How do we stay dry?

- Maintain high cash levels which currently offer yields in excess of current inflation.
- Stay short term in fixed income investments with an emphasis on treasuries, due to low long-term yields, corporate credit concerns and looming supply issuance.
- Add specific names/funds on weakness and sell on rallies.
- Reallocate as things change.
- Increase exposure to late cycle industries (energy) and uncorrelated assets (gold).

What about Oil? ...If you aren't already exhausted!

Over the last decade, there has been consistent understatement of global oil demand coupled with concerns about overstatement of supply from Saudi Arabia and U.S. shale producers. If you combine those issues with oil prices in the US being below what it costs to produce oil, you get an interesting setup for energy.

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