Monthly Commentary

December 2018

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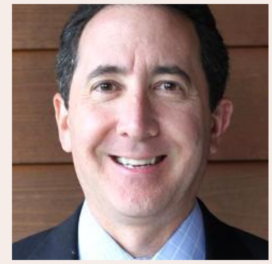

The month of December was pretty much the exact inverse of what was seen during the first few weeks of January, as 2018 started with a sharp upward market move right out of the gate. I'm going to list here the factors that I believe most influenced the markets in December, and then further expand upon these points:

1) After seeing softer data out of Europe and Asia, particularly in China, there are heightened concerns about a global economic slowdown. Also, a moderation in the US housing market and a plateau in auto sales have many analysts keeping a close eye on the US economy. The US consumer though, with a strong labor market and rising wages, has helped to buoy the domestic economy.

2) The Fed raised interest rates again in December, the 4th one of the year, and does plan on further hikes in 2019 if economic data comes in as expected. They also will remain on autopilot with the shrinking of their balance sheet which, as you may recall, is another form of tightening. Many are worried that the Fed is being too aggressive.

3) Hopes of a deal remain, but there is still uncertainty over what will come of the US and Chinese trade talks, as the timeline to reach an agreement is short.

4) Concerns that US corporate earnings are about to dramatically slow, as 40% of S&P 500 company revenues are sourced overseas.[1] At the same time, corporate profit margins might have peaked, and year over year comparisons may get more difficult.

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Global Economy

The mantra at the beginning of 2018 was that the world was experiencing 'global synchronized growth.' By year-end, that transitioned into a consensus of 'moderating global growth.' This was mostly due to slowing seen outside of the US, particularly in China and Europe. China's economy is dealing with the challenges of debt deleveraging, after a massive binge since the beginning of the decade, at the same time they're dealing with a trade spat with the US, which has resulted in corporate uncertainty.

Europe's economy has been much more mixed in 2018, after a strong 2017, and finished the quarter with particular softness in Germany, the economic power of the region. Germany's economy is very dependent on global trade with exports making up about 40% of its GDP[2].

1 - 2 Bloomberg

Global Economy *(continued)*

Thus, the slowdown in global trade has had an outsized impact on Germany. The Italian economy has been stuck with the budget battle between the new government and the European Union. The French economy has improved over the last few years, but in late November a government fuel gas tax hike brought protests and a disruption in economic activity. The UK's economy is besieged with Brexit uncertainty where we enter 2019 still unclear about how this will all turn out.

As for the US economy, the consumer is the main pillar of economic support in the midst of a strong labor market and rising wages. Although, a slowdown in housing and a plateau in auto sales limited faster growth, while the uncertainty over the direction of US trade policy has inhibited faster capital spending. Expectations for GDP growth in Q4 is 2.7% according to the Atlanta Fed's GDPNow forecast[3]. The NY Fed's Nowcast is at 2.5%[4].

"Uncertainty with the direction of US trade policy has inhibited faster capital spending."

Interest Rates and Monetary Policy

The Federal Reserve increased interest rates by 25 basis points in December to a new range of 2.25-2.5%[5]. While it was widely expected, the markets were disappointed by the indication in the Federal Open Market Committee's statement that they were still looking to raise rates two more times in 2019, depending on the incoming economic data.

At the same time, Chairman Jay Powell said the reduction in the size of the Fed's balance sheet will continue on its current path, which also upset markets. As a reminder, the Fed's balance sheet is shrinking by $50b per month, or an annualized pace of $600b.

This monetary tightening is coinciding with the end of the European Central Bank's QE initiative and a sharp reduction in the pace of the Bank of Japan's purchases. As a sea of liquidity helped to lift asset markets globally, the reversal has many worried going forward.

"As a sea of liquidity helped to lift asset markets globally, the reversal is what has many worried going forward."

3- Atlanta Fed, 4- NY Fed, 5- Federal Reserve

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Trade Impacts

At the end of December, we got a tweet from President Trump that said talks with the Chinese have been productive so far, which was followed up by comments from the Chinese. As March 1st is the self-imposed deadline for a deal, we hope that we are close to a deal. The US is sending a delegation to Beijing on January 7th to, hopefully, hammer out details. For the sake of global trade, not just between the two largest economies but for many others that depend on us, we remain optimistic that a deal of some sort will take place and we can lift this veil of uncertainty over the global economy.

Corporate Earnings

January will be important in how markets quantify the economic and earnings impact of the tumultuous final quarter of 2018, as we hear from Corporate America in delivering their Q4 earnings reports. Also, corporate guidance for 2019 will be hugely influential on where markets trade early in the new year. What will likely be tough comparisons to the strong earnings growth in 2018, which were helped by the corporate tax cut, consensus expectations for 2019 are for mid to high single digit earnings growth[6]. The real test for the S&P 500 companies is that 40% of revenue for these big stocks are sourced outside the US, which as stated, has seen slowing activity. Also in question is whether or not profit margins hold up in the face of rising costs, particularly as they absorb higher labor costs.

Conclusion

It seems that the markets and the economy are at an important inflection point as monetary policy is becoming more restrictive, but we are possibly approaching the latter stages of the liquidity absorption. The global economy has slowed, but its direction from here remains in question as to whether this is a temporary moderation or the early stages of a longer term contraction.

Rather than having any concrete opinions of what comes next, we have focused on the big picture issues that are most important and will wait to see how things play out. The investing landscape has certainly become more challenging, but to state again, this highlights the importance of having a plan for your capital in terms of meeting liquidity needs, being appropriately positioned and understanding that opportunities always abound.

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