Review & Outlook

Fourth Quarter 2018

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To say the fourth quarter of 2018 was volatile would be an understatement. Early in October, the stock market fell sharply, which was a surprise since the drop didn't appear to be triggered by any disturbing news or particular economic developments. Of course, there were people concerned about a possible trade war with China, and others who were worried that the Fed might be raising short term interest rates too quickly, but nothing specific happened to trigger the drop. The market continued to struggle in November, then suffered another large drop in December, including a particularly ugly Christmas Eve. Broad market indexes like the CRSP were down almost 20 percent off their highs from late September, and the news filled with theories about why the market continued to drop and offered predictions of an imminent recession.

Some people have pointed to interest rates to explain the market's poor performance in the fourth quarter. In October, yields on 10-year U.S. Treasuries climbed above 3%, so investors moved money from stocks to bonds. Stock prices fell, but the flow of money to U.S. Treasuries pushed bond prices up and yields back down. The resulting drop in 10-year Treasury yields helped bond funds, providing a positive component for diversified portfolios.

Fortunately, the upward trend in stocks that we saw at the end of the fourth quarter carried into the new year. Data suggest the labor market is strong and consumer confidence remains high. Volatility is likely to continue, but increasing wages, inflation close to the desired rate, and the Fed saying it will be patient with additional rate hikes suggests something better than what we had at the end of 2018.

Index Performance Data: Total Return as of 12/31/2018

Indices[1]	Q4 2018	Trailing 12 Months
CRSP US Total Stock Market Index (Total Return)	-14.26%	-5.17%
MSCI Global ex-US Total Stock Market Index	-11.81%	-16.45%
Bloomberg Barclays US Aggregate Bond Index Composite	1.64%	0.01%

Looking back, it seems that some of the selling in December was due to investors rebalancing to realize gains or losses for tax purposes and other year-end housekeeping matters, so the drop was not entirely a reflection of their confidence in the markets. The day after Christmas, markets rebounded sharply, recovering some of the losses experienced earlier in the quarter. The S&P 500 index, down roughly 20% at Christmas from its value in late September, recovered a bit, finishing the quarter down 13.5% and down 4.4% for 2018. Unfortunately, most other asset classes did not perform as well. Small cap indexes suffered, with the Russel 2000 falling 20% in the fourth quarter and finishing the year down 11%. Mid-cap and global stocks also fared poorly in the fourth quarter and in 2018.

The Federal Reserve has increased its forecast for GDP growth in 2018 and 2019 from 2.8 and 2.4 percent, respectively, to 3.1 and 2.5 percent. The Fed is also calling for 2.0 percent growth in 2020, as well as unemployment under 4 percent for the next several years and inflation close to 2 percent. That's a rather rosy outlook, with no mention of a recession or downturn on the horizon. However, the Fed has expressed concern about having unemployment below a sustainable level for an extended period as it can signal an overheating economy, noting that periods of unusually low unemployment are typically followed by a recession.

Speaking of recessions, chatter spiked in December as part of the yield curve inverted. We've discussed in previous newsletters how an inverted yield curve often precedes a recession, however, only a portion of the yield curve recently inverted, and, more importantly, a recession is neither guaranteed nor immediate when the yield curve does invert. There is often a significant lag between when indicators of a recession start to appear and an actual recession occurs. For example, most economists on the Blue-Chip forecasting panel do not expect a recession until 2020, but recently, we have been more concerned about weakness in various sectors of the economy (like auto sales), Brexit troubles, and accumulating debt, since tensions between the U.S. and China have subsided for now. We also worry about the possibility of a prolonged government shutdown. We don't think an official recession will start in the next twelve months, but we expect the fairly positive economic outlook estimates to be revised downward during the year.

In Focus

In April 2007, the well-known statistician and former risk analyst Nassim Taleb wrote a book titled, "The Black Swan"[2]. According to Taleb, a Black Swan refers to an event that is highly improbable to occur and totally unpredictable by nature, then later incorrectly rationalized as something that could have been predicted. For years the English claimed something impossible to be as "likely as a black swan". Then some adventurer found a large flock of them, which surely put a dent in the phrase. Taleb's book, published just before the recent financial meltdown, revitalized it, and in recent years, "black swan" has become commonly used in the investment world to describe an especially bad event with a low probability of occurring.

A variation of the "black swan" is the "grey swan", a term attributed to the economist and lawyer Robert Walker[3], who wanted to describe events that are bad and "somewhere between probable and highly improbable". The distinction from Taleb's black swan is that grey swans are potentially predictable, and, as Walker put it, "just likely enough that they should be anticipated."

We think it is prudent for an Investment Advisor to put some thought into potential grey swans and have a plan for how to respond. A grey swan may not be one big event, but a mosaic of small ones. It is a confluence of trends and/or events that points to trouble in a particular asset class or sector. If we think an event or potential set of circumstances is both sufficiently worrisome and likely to occur, we act, shifting your account to a more conservative position. However, we do this with great caution, as part of the nature of acting on a low probability event is that most of the time you will be wrong. The grey swan we now see potentially manifesting is a recession, and we worry because financial markets tend to fall prior to those events. Right now, we think there is enough evidence indicating that a recession will occur within the next 18 months that we feel it prudent to make some adjustments in most of our clients' portfolios.

One point of concern is that there appears to be stress in the expanding credit cycle. The U.S. government has financed much of the recent tax cuts through borrowing money, and we think that increased borrowing supports a classic "short-term gain, long term pain" dynamic. A lot of U.S. debt is financed globally, and if foreigners get tired of buying U.S. bonds, interest rates will go up.

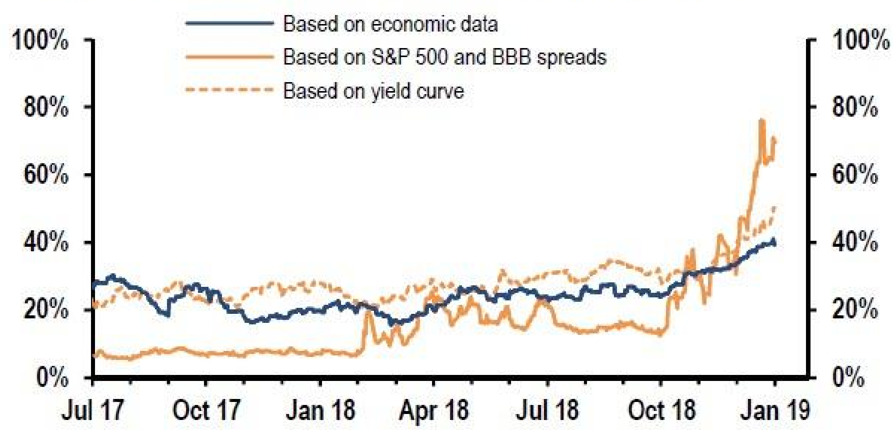
Another big buyer of US Debt has been the Federal Reserve Bank, but they are cutting back on that significantly, which should push bond prices down and interest rates up. This removal of liquidity from the market is putting pressure on the valuations of other assets, like stocks. Now that bond returns are higher than zero, holding assets in short-term fixed income instead of stocks seems like a sensible option.

We also see the Federal Reserve Bank tasked with a mandate of low unemployment and low inflation facing record low unemployment and potentially rising inflation. The policy tool they have to fight rising inflation is raising short-term interest rates. This would temporarily put pressure on the economy, but that consequence has to be weighed against losing control of inflationary pressure and expectations. However, the stock market's recent reaction tells us that raising short-term rates is a problem.

Another indicator of a grey sawn is the uncertainty surrounding trade policy. Currently there has not been much impact from 10% tariffs on Chinese imports because the

Chinese Yuan has depreciated almost 10% since April 2018. However, if tariffs were raised to 25%, the margins of many companies would be damaged in the short term. It would take a number of years to relocate their supply chains from China, and some might not survive that process. Without question, most companies would pass along their increased costs to the consumer through higher prices, which would lead to inflation. Our view is that this path is so problematic that the U.S. and China will seek to find a compromise. We expect deadlines for scheduled tariff increases to be pushed back, to allow more time for negotiations, but the uncertainty will continue to be challenging for the stock market.

Figure 1: Probability of recession beginning within one year



Source: Various government and non-government sources, J.P. Morgan

We also see some troubling sector performance in the stock market that is at odds with the idea of a thriving economy. For example, stocks in the banking and home building sectors are down about 14% and 30%, respectively, through 2018, which you would not expect to see if the economy was booming.

Lastly, we see that over the past six years, the major U.S. stock market indices have expanded at rates significantly higher than the growth of the underlying economy. For the last six years, real U.S. GDP has been growing at about 1.6% per year; global real GDP growth at 3.6%; and the stock market, as measured by the S&P 500 index, at about 8% in real terms. Sustained higher stock market prices generally depend on higher economic growth that allows for rising corporate earnings. With year-over-year earnings gains from corporate tax cuts washing out this year, and GDP forecasts looking stable to negative, stock prices still remain high relative to historical and expected economic performance. The implication of this lofty level is that either GDP grows a lot or prices measured by market cap come down. This readjustment could happen quickly if things unravel on the trade front. The chart below illustrates this idea.[4]

We see the potential for pressure on company earnings from higher financing costs, higher intermediate input costs, higher labor costs, and a slowing global economy pushing towards a significant slowdown or recession. Whether such problems become visible in late 2019 or later depends somewhat on policy factors like Brexit, the process of trade negotiations, and what the Federal Reserve decides to do.

In late 2018, we took steps to slightly decrease our clients' exposure to U.S. stocks, moving some of what is normally allocated to stocks and mutual funds to money market funds and fixed income. We are now reinvesting in global stocks, since we think stock prices in emerging and developed economies already reflect the economic weakness. The solid economic foundation we have right now (a strong labor market and low inflation) means there is no cause for panic. Moreover, our long-term perspective means that we do not react to 5 to10 percent swings in the market. But we think it is wise to have a portion of what is normally exposed to stocks in more conservative investments given the current risk of a downturn in the U.S. The large market correction in October and November means that we could see stock market gains in 2019, so we want our clients to be exposed to that, but we also want to be conservative looking forward because a recession could happen sooner than most anticipate.

1. Index price data is downloaded from ICE Data Services. Index performance data is calculated by Axys portfolio accounting software, a product of SS&C Advent.
2. Taleb, Nassim N. The Black Swan: The Impact of the Highly Improbable. New York: Random House, 2007. Print.
3. https://www.huffingtonpost.com/robert-walker/beware-the-grey-swan_b_863237.html
4. https://www.zerohedge.com/news/2019-01-05/jpmorgan-sees-60-odds-recession