

*Market Outlook
December 2018
Managing Shifting Expectations*

The market correction in recent weeks has reacquainted investors with more normal volatility levels that have not been seen for quite some time as concerns about trade policy, the Fed, and a few corporate earnings reports light on revenue outlook have reminded us what can happen when results fall short of expectations. This bull market has ridden a nine year wave driven by quantitative easing, massive balance sheet restructuring, and corporate tax reform each of which has fueled more earnings growth and higher expectations. It's important for us to remember how far we've come from the depths of March 2009 when the S&P 500 was at 680 to reach its current level around 2,700. This is a cycle that was born out of despair amidst the financial crisis when the only expectations were for further losses. Bull markets bring with them greater and greater expectations until something happens and those expectations can no longer be met. Then, ultimately, they die from over investment, excessive leverage and investor complacency. As we go forward, our job will be to gauge whether expectations are shifting in a way that will expose investors to greater risks since it is expectations that will change ahead of the economic fundamentals and earnings reports.

Last year at this time stocks were getting a big push from the passage of corporate tax reform yet have struggled since to make significant progress higher. This year investors seem to be focusing on the resolution of the trade situation with China as a potential catalyst, but the question lingers as to whether this will be enough in the face of some growing headwinds. One of the oldest market adages advises, "Don't fight the tape." This teaches us not only to align our investments with the market's prevailing trend, but also to be aware of signs in the tape that indicate a trend is reversing. The Fall 2018 correction looks much the same as several prior ones within the bull market in percentage terms, but it has done more damage to the momentum of some key market internals such as the Advance/Decline ratio (see attachment), New 52 Week Highs/Lows, and Upside/Downside volume on the NY Stock Exchange. These barometers present a valid concern to us as they suggest that the average stock is not doing as well as the major averages which is consistent with late cycle bull markets historically. When we consider that international stocks are underperforming the U.S., it becomes reasonable to conclude that the tape is telling us that risks are rising.

Gaining insight into Federal Reserve policy is always foremost on the minds of investors, especially now that the Fed has taken interest rates closer to neutral with a series of increases that are expected to continue into next year. While there is some debate as to when the Fed finishes the tightening cycle, the impact of tighter policy is beginning to be seen in the rate of change for M2 money supply growth which is likely to be felt in the economy next year. There is also the issue of unwinding the quantitative easing

program as the Fed will need to continue selling Treasury securities further out the curve over the next several years to return its balance sheet to more normal levels. The likely result of this will be rates that are higher than they would be otherwise which will present further headwind for the economy in the months ahead. The reason that so many market strategists tell their clients “don’t fight the Fed” is that every bear market recession since World War II has been preceded by a Fed tightening cycle that at its end slowed down the rate of money growth and subsequently the economy. This is a reality that we have to respect as we look for signs of slowing growth in the economic data.

It has been the resiliency of the U.S. economy to this point that has kept investors in the stock market along with the fact that returns available in other asset classes have been meager in comparison. Both manufacturing and employment data (see attachment) have been strong driving corporate profits higher which has given investors reason to stay the course. The key phrase that should be reiterated is “to this point” as there has been no smoking gun on the economic front that would indicate a near term slowdown though the uncertainty on trade policy could be a factor in shifting expectations. We are left with a situation where the economy is a positive, but the Fed is getting tighter and the tape suggests there is growing skepticism in the market. While the valuation excesses of 2000 and 2007 are no where near as extreme in today’s market, we still need to be careful recognizing that debt levels in the developed world are significant. This combination of factors has caused us to bring the equity allocations in client portfolios to a neutral position eliminating the overweight that we have maintained for several years. We think that our position recognizes that risks have risen while allowing for the possibility that markets could rally in the near term should sufficient progress be made on trade policy. It also builds in the flexibility to get defensive more readily should a smoking gun present itself on the economic front which is an important consideration during times of growing uncertainty.

Charlie Mathews, CFA

Advance/Decline Ratio



U.S. Unemployment Rate

