1/18/2019

Turning More Optimistic

- Markets fell late last year, pricing in many potential risks.
- Global equities have started strong this year.
- We continue to be optimistic for three primary reasons: Fed pause, trade resolution, and strong economy.

In 2018, U.S. equities, as measured by the S&P 500, posted their worst year in a decade. The year was characterized by a return of volatility, marked by several record-setting highs followed by sharp reversals. Despite the strong 2018 start (buoyed by a growing economy and outsized corporate profits), investors became concerned that back-and-forth retaliatory trade tariffs between the U.S. and China would lead to weakening global growth and eventually diminished corporate earnings. Volatility intensified further after the Federal Reserve raised interest rates a fourth time, prompting some fears of a policy mistake. More recently, the ongoing partial government shutdown over border wall funding has exacerbated market uncertainty. While these concerns continue to overshadow the market, investors have become cautiously optimistic and decided that, despite the overhanging anxieties, better valuations reflect most of the potential market downside.

After suffering a dismal end to 2018, U.S. equities have started this year strong. While investor worries around rising interest rates, the ongoing trade war, and weakening global economic growth drove sentiment last year, 2019 is a different story as investors have shaken off these concerns and helped drive U.S. equities to one of the best starts to a year. Since equity markets have rallied despite the lingering concerns, we feel investors are in a state of "cautious optimism." Looking ahead, we feel there are three positives not fully priced into market fundamentals that could propel this current rally: a dovish Federal Reserve, an end to the trade war with China, and a strong economy.

First, we feel the Federal Reserve will continue to move to a more dovish interest rate stance. Since December of 2015, the Fed has raised the federal funds rate nine times to its current level of 2.25% - 2.50%. The Fed has done this to slow economic growth and reduce the chance of a sharp jump in inflation. Investors are concerned that the Fed has been too aggressive in this policy and will continue to raise rates. Based on market expectations (Fed funds futures) and the Fed's own projected neutral rate (the rate that neither stimulates nor restricts the economy), we believe the Fed is dovish and may not even raise rates this year. Our second reason to be optimistic is that we believe the current trade war between the United States and China will end very soon as both countries are economically motivated to come to an agreement. Both the U.S. and Chinese economies have seen weaker data readings. In the U.S., President Trump plans to run for re-election in 2020. Most likely he will run on a campaign of a strong U.S. economy, however, the trade war has started to hinder this plan. In China, President Xi has a long-term plan to turn China from a manufacturing-dependent economy to more of domestically focused, consumer-driven one. Unfortunately, demographics and the lingering aftereffects of the country's three-decade long one-child policy have hampered that plan. The trade war has exacerbated the difficulties of his strategy.

Our third reason to be optimistic is that despite the lingering trade war, the U.S. economy is on a solid foundation and we do not see a recession this year. Late last year, many believed the combination of the trade war and a hawkish Fed would cause a recession. We, on the other hand, do not expect this. For example, the labor market is remarkably strong as the unemployment rate is near 50-year lows. Furthermore, for nine straight months, we have seen the number of job openings exceed the number of job seekers. A strong labor market bodes well for consumer spending. While many are focused on slowing manufacturing data, it is important to remember the consumer represents about 70% of U.S. GDP.

Overall, we have shifted to a more optimistic outlook for markets. We believe three positives have not yet been fully priced in the equity markets. Furthermore, even if we are incorrect, valuations are currently more favorable than they were just one year ago. Also, if we were to have a bear market, keep this in mind. The current peak to trough decline in the S&P 500 is -19.8%. Looking at the bear markets since WWII and removing the three extreme ones, the average bear market decline is -26%. Therefore, if we are wrong in our optimism, we have likely seen most of the market weakness already. Despite our optimism, we expect the increasing volatility in equity markets to continue, making it even more important to diversify risk factors in portfolios and staying focused on long-term risk and return objectives.

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