Weekly Market Flash

Breathe In, Breathe Out, Repeat

December 21, 2018

The month of December opened with the continuation of a relief rally that started just after Thanksgiving. The S&P 500 had dipped into correction territory but was clawing its way back up. The index closed on December 3 just 4.8 percent shy of the last record high set on September 20.

And that was as good as it would get. In the 12 trading days since then, the benchmark large cap index has registered only three up days, and those could charitably be described as anemic at best. As the opening bell rings in the last trading day of this tumultuous week, the S&P 500 sits more than 15 percent below that September 20 close. The Russell 2000 index of small cap stocks is in a bear market, down 24 percent from its early September peak. The Nasdaq Composite of erstwhile high-flying technology powerhouses is also on the cusp of that 20 percent bear threshold.

The suddenness and magnitude of the turnaround, in the absence of any obvious turn for the worse in economic and corporate financial data, has caught many hedge funds and other sophisticated investment vehicles, particularly those driven by quantitative trend methodologies, flat-footed. The natural question on investors' minds is: how much worse can it get?

Making Sense of the Senseless

The intensity of this month's drawdown in equities seems to derive from the confluence of three strands of worry: the prospects for a global economic slowdown, the apparent end of the "Fed put," and the eye-popping level of dysfunction in Washington, illuminated most recently by the looming likelihood of a government shutdown and the departure of the widely respected Secretary of Defense James Mattis. Let's take these in turn, summing up with our argument for taking a deep breath and staying disciplined.

Recession Somewhere…Sometime…

There's a tried and true old saw among market wags that economists have predicted nine of the last five recessions. To be fair to practitioners of the dismal science, recessions are fiendishly difficult to predict in advance. That being said, there continues to be very little in the monthly macro releases to suggest that growth in the US will turn negative any time soon. But the "harmonious convergence" story of 2017—with the US, EU, developed Asia Pacific and emerging markets all moving up together – has faded. The trade war sits over the globe, Damocles sword-like. China, the EU and Brexit-addled Britain all have their own particular problems. With the current recovery cycle being long in the tooth as it is, expectations are building that is as good as it will get. The same story plays out in corporate earnings: the go-go days of 25 percent earnings growth will end when the tax cuts lap one year in January. Earnings are still expected to grow in high single digits in 2019 , but the end of the sugar high brings a glass half empty mentality.

Greenspan's Punchbowl Is No More

To put it mildly, the market was not at all pleased with Jerome Powell's Fed this week. Wednesday was the conclusion of the December FOMC meeting. Ahead of the customary 2pm press release and subsequent press conference, investors seemed primed for at least a little good old-fashioned happy talk. After all, it wasn't all that long ago that a stock market pullback of a lesser magnitude than the current one would elicit comforting reassurances from the Fed's dove wing. But that was then. That was when the Fed's stimulus program depended on shaking investors out of low-risk assets into equities and other higher risk asset classes. True – expectations for 2019 dropped from three rate cuts to two, and true also that the language was somewhat more measured about global growth prospects. But rate hikes are still on the table, and so is the winding down of the Fed's balance sheet. Think of the "Fed put" as an opioid, and the market as a morphine addict. In the long run, weaning off that artificial stimulus will be beneficial. But those first few days (i.e., now) are rough sledding.

Whoville On the Potomac

And that brings us to Washington, which appears to be vying hard for the title of "world's most dysfunctional political capital." For most of the past two years the market has largely ignored the political gyrations that have consumed those inside the increasingly weird Beltway snow globe. Now, the prospect of a government shutdown, which seems likely to happen at midnight tonight, by itself is not something that normally spooks the market. The resignation of a major cabinet official – even when that official happens to be arguably the most respected personage in the present administration – is likewise something that normally gets more eyeballs from readers of the Washington Post than those of Bloomberg News. And the prospect of complete policy gridlock once Democrats retake the majority in the House next month is something that almost never freaks investors out (if no policy is getting made in DC then we can sleep well at night, go the usual thought bubbles over Mr. Market's head).

This time, though, there are concerns – reasonable ones, sadly – that the dysfunction has the potential to become genuinely destructive in the weeks and months ahead. Anyone who has closely followed all the goings-on in the executive branch for the past two years can quite easily construct a plausible worst-case scenario that looks – well, really worst-case. There is at least a taste of that sentiment getting priced into the market right now.

What Tomorrow Brings

If one is convinced that the most likely scenario to play out is the worst-case one, then the rational thing to do is to reduce all exposure to risk assets and willingly accept zero percent real returns as the trade-off for sleeping well at night. If one sees a higher likelihood for something other than the worst case to emerge, then a stronger case could be made that the current market is quite oversold.

Always remember this: the price of any company's stock is nothing more and nothing less than a collective estimate as to the net present value of all the future cash flows that company can generate. Of all the things out there that have the potential to impact those cash flows – recession, trade war, actual war – what magnitude will that impact likely be? On any given day, the collective wisdom may be wildly off the mark – either unrealistically pessimistic or too giddy in optimism – but over time share prices should converge to a realistic assessment of value.

We have plenty of concerns about the year ahead, and we will be discussing these in detail in our forthcoming annual outlook. These concerns will very much factor into our specific asset allocation decisions, and they anticipate a continuation of market volatility. But conditions like the present call for discipline and for perspective beyond the short-term sentiments buffeting daily market swings. Breathe in, breathe out, repeat.

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