# Weekly Market Flash

## Narrative Battle Comes into Focus

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Be careful what you wish for, because it might come true. A couple weeks ago, bond investors were wishing upon their stars for a retreat in yields from the 3.25 percent the 10-year Treasury had just breached. Well, retreat it did, falling below 3.1 percent in early Friday morning trading. But these falling yields were clearly of the risk-off variety, dragging down everything else with them. The S&P 500 is flirting in and out of correction territory (a peak to trough decline of 10 percent or more) and may well have settled there by the end of the day, while the Nasdaq has already gone full correction.

As we noted in our commentary a couple weeks ago, corrections aren't particularly rare events. We also noted the Tolstoyan flavor of these events – each one has its own unique story of dysfunction to narrate. "Okay, fine, so what's the sad story accompanying the current situation?" is thus quite naturally a question that has come up in conversations with our clients this week. The narrative for the glass-half-empty crowd has indeed started to gel, but it is yet by no means clear that this will be the narrative that dominates for the remainder of the quarter (we will remain on record here as believing that it will not).

What we still have is a battle between two narratives, each looking at the same set of facts and drawing different conclusions, as if they were so many Rorschach inkblots. Let's look first at the case for negativity.

### Europe and China and Rates, Oh My

Several strands of thought weave together the bears' case. In last week's commentary we had an extensive discussion about the malaise in Europe, first with the Italian budget standoff that has sent yield spreads on sovereign debt soaring, and second with the spread of political unrest from the continent's periphery to its dead center. Germany will have another round of regional elections this weekend, this time in Hesse (the region that includes financial capital Frankfurt as well as a delightful-sounding tart apple wine called Ebbelwei). The establishment center-left party, the SPD, is expected to fare poorly as they did two weeks ago in Bavaria. A really bad drubbing for the SPD could lead to the party's exit from being the junior partner in Angela Merkel's national grand coalition. That in turn could ratchet up the growing uncertainty about Merkel herself at a time when steady leadership from the EU's strongest member is of critical importance.

China forms the second strand of the pessimist case. The national currency, the renminbi, is at its lowest level in a decade and poised to break through a major technical resistance level at RMB 7 to the dollar. After China's GDP growth numbers last week came in slightly below expectations (6.5 percent versus the 6.7 percent consensus) Beijing economic officials coordinated a set of emphatic verbal assurances to investors that renewed growth measures were in place. That was enough to give beleaguered Chinese stocks an upward jolt for one day, but the lack of any specificity in the officials' assurances didn't hold up for a rally of more extended duration, and shares resumed their downward trend.

With the rest of the world looking particularly unappetizing, attention then turns back to the domestic environment, specifically the prospects for continued monetary tightening by the Fed and concerns that the run of news for corporate financial performance – capped off by earnings growth expected to top 20 percent for 2018 – is about as good as it's going to get. Higher rates will tamp down the currently rambunctious confidence among consumers and small businesses, while widening spreads will also spell trouble for the corporate debt market at a time when S&P 500 companies have record levels of debt on their books. Margins will be under pressure from upward creep in wages and input costs, and weaker economies around the globe will have a negative effect on overall demand for their products and services. Faltering leadership from high-profile tech and consumer discretionary shares is the canary in the coal mine, portending a more protracted period of market weakness.

It's not a weak case, to be sure. But there is a strong argument on the other side as well, with opportunists scouring an expensive stock market for bargains made available in a 10 – 15 percent correction environment. This is the "song remains the same" crowd.

## The Big Picture Hasn't Changed

The glass-half-full argument always starts from the same point: the unrelenting sameness of US macroeconomic data month in and month out. The latest of these is fresh off the presses of the Bureau of Economic Analysis as of this morning: a Q3 real GDP growth reading of 3.5 percent, which translates to a 3.0 percent year-on-year trajectory. Same old, same old – healthy labor market with unemployment at decades-low levels, prices modestly but not dangerously above the Fed's 2 percent target, zippy consumer spending and continued growth in business investment.

On the subject of corporate earnings, the optimists will point out that top-line sales expectations for 2019 are actually increasing. Yes – the tax cut sugar high will lapse once December comes and goes, so bottom-line earnings won't repeat their 20 percent gains of '18. But if sales continue to grow at a 6-7 percent clip it underscores the ongoing health in consumer demand, here as well as abroad. And yes – to that point about weakness in China, the adverse effects of the trade war have yet to show up in actual data. China's exports grew at a 14 percent clip in September, and the $34.1 billion trade surplus it recorded with the US for the same month was an all-time record.

The Fed is likely to continue raising rates. The reason for that, as Fed officials themselves repeat time and again, is because the economy is growing well and (in their view) cans sustain growth while interest rates rise gradually to more normal levels. It's worth remembering that yields on the 10-year Treasury averaged over 6 percent during the growth market of the mid-late 1990s, and around 4.5 percent during the mid-2000s. There is no particular reason (despite many reports to the contrary) that money managers "have to" rotate out of equities into bonds at some notional 10-year yield threshold (3.7 percent being the number bandied about in a recent Merrill Lynch / Bank of America survey).

To be sure, there are plenty of X-factors out there with the potential to add fuel to the present nervousness in risk asset markets. There are plenty of others that could accelerate a pronounced recovery of nerve heading into the peak retail season that begins next month.

It is also possible that we are seeing the first early hints of the next real downturn – much like those occasional days in August where there's enough crispness in the air to suggest a seasonal change, even while knowing that autumn is still many weeks away. Just remember that while the timing of seasonal equinoxes is predictable, market transitions do not operate on any fixed calendar.

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