Weekly Market Flash

Relief, Risk and the Big Unknown

November 9, 2018

There were lots of think pieces leading into the US midterm elections earlier this week. We didn't contribute to the genre, mostly because there is nothing statistically meaningful to say about an event with a very small sample size (n = 10, if you want to go all the way back to 1982 for your midterms data set) and lots of variables highly specific to each observance. Not that shoddy statistics ever got in the way of mainstream financial punditry…but we digress. In any case, the day came and went with relatively few real surprises of note. The "known unknowns" of the midterms now join the headline macroeconomic and corporate earnings trends as "known knowns" propelling what might be expected to be a net-positive narrative while the clock runs down on 2018. Always allowing, of course, for the sudden appearance of an "unknown unknown" to spoil the applecart (and thanks to Donald Rumsfeld for his contribution to the lexicon of predictive analytics).

Good Cheer and Relief?

The relief rally that began last week would seem to have some seasonal tailwinds to carry it further. The holiday retail season gets underway in a couple weeks, and it is shaping up to be a decent one. The latest batch of job numbers released at the end of last week suggest that higher wages are finally catching up to the rest of the good cheer in labor market data points. Consumer prices are still in check, despite the gradual encroachment of new tariffs onto consumer goods shelves. A good showing between Black Friday, Cyber Monday and the ensuing week or two could keep investors focused on the growth narrative.

Risk Headwinds

Potential headwinds to that growth narrative are also at play, however. The Fed will meet again in the middle of December and is expected to raise rates for the fourth time this year. That by itself is not new news. In their little-publicized (non-press conference) meeting this week the FOMC reiterated confidence in the economy's growth trajectory, which sets the stage for next month's likely increase to the Fed funds target rate. What the Cassandra side of the investor world has in its crosshairs now is the US budget deficit, which is positioned to climb above $1 trillion in the near future.

Again – not a new fact, as this figure was well known when the Republicans implemented their sweeping corporate tax cuts one year ago. What is known with more certainty now, though, is that the higher levels of debt servicing that accompany this swelling budget deficit will happen at the same time as interest rates are heading off the floor towards levels closer to historical norms. Now, the newly known fact of a split Congress may mitigate some of the debt concerns – after all, further fiscal profligacy is unlikely in a Congress that will be hard pressed to get even the simplest pieces of legislation passed. And some optimists still maintain (without much in the way of supporting evidence) that the net effect of the tax cuts will be an unleashing of business productivity. But the debt servicing issue has the potential to be a decisive influence on US credit markets heading into 2019, which could mean trouble for risk assets.

The Big Unknown

Now we come to the part of the discussion where the specific risk factors become harder to pin down, but have the potential to overwhelm conventional wisdom. We're talking about politics – world politics, to be sure, not just US politics. Assets in developed markets typically ignore, or at least give very short shrift to, socio-political developments. Even singular events that at the time seemed momentous – the Cuban missile crisis and the Kennedy assassination in the early 1960s come to mind – scarcely had any effect on prevailing stock market trends. The same goes for Watergate – the losses sustained by US stocks in the summer of 1974 were largely in line with the broader forces at play in a secular bear market that lasted from 1969 to 1982.

Markets don't ignore these events because they are Pollyanna whistling her merry tune – they ignore them on the basis of a well-grounded assumption that the political institutions of modern developed nation-states are robust enough to withstand the impact of any single imaginable happening. The institutions though – and we are speaking here primarily of the US, the EU and the latter's soon-to-be divorced partner across the English Channel – are being challenged in ways unknown since the post-Second World War Bretton Woods framework came into being.

How could the further dissolution of Western institutions affect investment portfolios? One can speculate, but with little in the way of hard data for modeling alternative scenarios. It may well be that nothing much impedes on investor sentiment in 2019 beyond the usual store of data regarding economic growth and corporate sales & profits. Those numbers may be strong enough to keep the good times rolling for a while longer. But the tension will likely form at least a part of the contextual background. However the numbers end up, we do not expect calm seas along the way.

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