Quarterly Newsletter

Fourth Quarter Review: The Rule of 19.8 Strikes Again

The fourth quarter was barely underway when a sharp pullback occurred in equity markets that would wind up extending through the entire quarter. By all accounts the lowlight of this dismal three months was Black Christmas Eve, when the S&P 500 collapsed to close 19.8 percent down from the previous high point set on September 20. However, as is more often than not the case, 19.8 percent was as a bad as it got, and a solid rally took place after the Christmas holiday to regain some of the lost ground by year-end. Why 19.8 percent? Because that level is ever so close to the technical bear market threshold of 20 percent, without actually crossing over into bear territory. A similar development played out during the recession of 1990, the Russian debt default of 1998 and the Eurozone crisis of 2011. Each time, 19-plus percent down from the high; each time, stopping before moving into bear country.

Why does this happen? After all, there is nothing special about these "technical" definitions of market corrections and bear markets. But for much of the money that circulates in and out of shares on a daily basis, the fact that these numbers aren't magical doesn't matter. They are triggers coded into computerized trading programs for buy and sell decisions. They happen because they are programmed to do exactly that. When the market bottomed out on Christmas Eve there was no recession in sight. There was no unexpected new salvo in the trade war. Sure, there were some ham-handed, vacuous comments from a vacationing Treasury Secretary that muddied the waters a bit, but there was nothing of substance to suggest that things in the world were bad enough – right then, right at that moment – to merit a full-on bear market. Perception once again became reality.

The constant theme of worry throughout the Q4 2018 pullback was the Fed. Arguably the whole thing started back at the Federal Open Market Committee (FOMC) meeting in September when the Fed affirmed its expectation to raise rates as many as four times in 2019. This was not necessarily news – the Fed had been saying the same thing one way or another for months. But it seemed that after the September meeting the market "got the memo" and promptly sold off. After a partial relief rally in November, it was the December FOMC meeting that once again got markets to thinking that the "Fed put" – the security blanket of having the monetary authorities come in and bail out investors whenever things start to look dicey – was gone. The Fed has some communication challenges ahead with the market.

First Quarter Outlook: Expect the Unexpected

The new year started much the way the old one ended – extending the relief rally that bounced off the floor of the Christmas Eve trough. Sentiment could best be described as warily optimistic, with daily news headlines being seen through a glass half full lens and potentially bad news being shrugged off. Expect this to change in the not too distant future. There are plenty of factors out there with the potential to disappoint, the most important of which is probably the diverging fortunes of the world's leading economies. The Eurozone is starting to look more like the anemic old Eurozone of mid-decade, and less like the robust performer of 2017. China is facing a number of growth challenges, even apart from whatever potential fallout lies ahead from the trade war. A massive $84 billion stimulus announced earlier this month is attempting to inject some animal spirits into consumer and business behavior, but the mandarins in Beijing have their work cut out for them.

Credit markets present another challenge. The US Treasury yield curve remains flat, which is concerning because when yields invert (i.e. longer term yields fall below shorter-term ones) it is frequently a sign of an approaching recession. Having said that, we do not see a recession looming in the near term here in the US; in fact, if we see positive real GDP growth between now and July, which is likely, then the current expansion will become the longest on record, surpassing the great growth cycle of the 1990s. Still, the absolute flatness of the yield curve will keep observers guessing. The other risk in credit markets lies in the corporate bond sector. Credit risk spreads between investment grade corporate bonds and Treasuries have widened recently. Not alarmingly so – they have been wider in recent years – but this time widening spreads might be accompanied by declining profit margins after reaching historical highs in 2018.

Corporate performance, indeed, will figure importantly into the mix of variables at play this year. Top line sales continue to grow at a faster clip than they were several years ago, which will help drive overall performance even when the bottom line of after-tax earnings starts to feel the effect of coming down off the sugar high of tax cuts. The windfall effect of those cuts, which were implemented in December 2017, will vanish away in the first quarter. Any sign of flagging performance will strengthen the confidence of those who see this growth cycle in its waning days. It may go one way or the other – but it will likely be a volatile ride.

MVCM 2019 0007
DOFU: Jan 2019