MV CAPITAL MANAGEMENT

Weekly Market Flash

Calm Waters Ahead (For Now, Probably)

November 1, 2019

October is typically a month-long Halloween experience in the stock market: sometimes the month is full of tasty treats, as it was in 2017. Sometimes it dishes out some nasty tricks, which was the case last year (not to mention all-time Hall of Infamy years like 1929, 1987 and 2008). With the month now having come to an end we can now say that 2019 was one of the more treat-filled Octobers. After a bit of a rocky start, the S&P 500 regained its footing and added about two percent to the already sizable double-digit gains for the year to date. As it stands now the benchmark index is up close to 25 percent for the year.

Of course, there are two more months to go before the year closes out, and as always there are plenty of bad things that could happen between now and then. More often than not, though, an upbeat October tends to set the stage for a holiday rally as money managers pile into whatever is working to get their portfolios in line for year-end performance reviews. We see that as a plausible case for this year given the state of play in the three factors that been the biggest influencers in market direction for the year to date: namely, the slowing global economy, the US-China trade war, and central bank monetary policy.

Slow But Positive

The global economy is slowing, and everybody knows it. The IMF has reduced its growth outlook several times this year, most recently last week. Europe is shuffling along at about one percent real growth, while the latest US GDP figures show our growth rate to be closer to two percent. China is expanding at its slowest rate in thirty years, India is having all manner of trouble and recession threats loom in usually dynamic Singapore and Hong Kong (political unrest is having a real effect on the latter's fortunes).

Just a couple months ago, this slowing growth trend seemed to have asset markets convinced that a recession was on the immediate horizon. The five percent-plus retreat in US stocks in August was driven in large part by those fears. But good job numbers kept coming in, consumers kept spending, and now it is clear that the absolute earliest arrival date for a recession here at home to be proclaimed would be next year's third quarter. In other words, we would have to see negative real GDP growth for the first six months of 2020 – a scenario almost no one paying attention to the data thinks likely.

So what could send the slow economy off the rails? Enter Factor #2 on Mr. Market's list of influencing factors: the trade war.

Much Ado About Tariffs

The ebbing and flowing of trade war rhetoric and occasional new tariffs has driven some of the bigger moves both up and down on the market this year. Economists have been clear since this issue first came on the scene in early 2018 that tariffs and other protectionist trade weapons could shave whole percentage points off global GDP. From where we sit now, in late 2019, a couple things seem clear. First, the trade war is not going to go away. It won't go away even if Trump is defeated in November next year, because the structural problems that exist between the world's two largest economies are real, and they will need to be addressed by whoever is in the White House come January 2021.

The second thing that seems clear now, though, is that both sides are looking for ways to improve the optics of the situation. "Optics" is the best way to describe the so-called Phase One agreement due to be signed by Trump and his counterpart, Chinese President Xi Jinping, later this month (the venue for this signing was supposed to be the Asia Pacific Economic Conference in Chile, but that event was just cancelled on account of massive street protests in the capital city of Santiago). It won't get at any of the really hard questions such as intellectual property or US access to the domestic market, but it will soften the rhetoric and probably do away with at least some of the tariffs currently in place.

Markets will continue to react to trade headlines, even when the headlines appear to be substance-free or outright misleading. But in the absence of a sharp reversal by either side from the current position of détente, the current optics appear good enough for most investors.

Doves Rule the Skies

Finally we come to the third market-driving factor: central banks. Here there is very little mystery about what is going on behind oak-paneled doors in Washington, Frankfurt or Tokyo: the doves are in power and the doves are going to stay in power, because absolutely none of these economies are in danger of overheating. Inflation is barely two percent in the US (less than that by the Fed's preferred measure of Personal Consumption Expenditures). It is on life support in Europe and Japan. The ECB is still buying bonds, the Bank of Japan is the biggest institutional investor in the Japanese stock market, and the Fed has reduced rates three times this year (and will almost certainly resort to more cuts and/or QE if the macro numbers turn further south).

For now, the coordinated dovishness of the principal central banks should continue to act as a support level, keeping asset prices from falling too far into correction territory. However, of the three factors we have discussed here, this is the one that could potentially go pear-shaped sooner rather than later. Central banks have spent the last decade deploying every weapon in their arsenal – and inventing new ones to boot – in the fight to sustain what has been by historical standards a relatively fragile economic recovery. As long as markets have confidence in the bankers and their tools, that support level should hold. But confidence is not what it was. In Europe there is a very heated debate going on as outgoing ECB head Mario Draghi hands the reins over to incoming head Christine Lagarde. Draghi's move back in September to rev up the QE engine is seen by many, particularly in Germany and other "northern" economies, as misguided. If Europe falls into recession next year (which is more likely than one happening in the US), expect this controversy to become very prominent and potentially damaging.

In summary, then, we would say that 2019 is turning out better than one might have expected. We'll take those calm seas for now, but we are preparing for plenty of potential squalls ahead in the year to come.

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