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Heads or Tails

Q4 2018 COMMENTARY

While 2018 should finish on a high note, 2019 may provide many challenges, including the fading of fiscal stimulus, peak earnings and intensified scrutiny of the yield curve as concerns mount over the strength of the expansion. Choosing heads or tails correctly will matter as liquidity continues to be drained from the global financial system and accommodation wanes.

Highlights

- Seasonality, coupled with solid earnings, suggest positive market finish to 2018
- Fed continues to promise gradual rate hikes through 2019
- Complex China tariff issues could disrupt supply chains

The most common definition of "heads or tails," according to the Merriam-Webster dictionary, refers to "a simple gambling game in which a coin is tossed and won by the player who successfully calls the side that lands upward." Betting on the direction of the markets since the Federal Reserve began its quantitative easing (QE) program at the end of 2008 until completing the many phases of QE in 2014 meant either side of any coin won the toss. That's hardly a gamble. How could it be, with the Fed providing an extraordinary amount of liquidity as its balance sheet grew to approximately to $4.5 trillion in 2014 from $850 billion at the end of 2008, and with the European Central Bank (ECB) launching QE in March 2015, joining the Federal Reserve and the Bank of Japan to envelop global markets in unprecedented monetary liquidity—all providing the underpinning and a sure bet that markets would thrive?

To be sure, a few detours along the way through eurozone-related pressures, geopolitical worries, Brexit, mounting tariff concerns and an assortment of headline issues occasionally engulfed markets in fear that soon subsided thanks to the fungibility of global central bank largesse. The tax package passed by the U.S. Congress in December 2017, coupled with broad deregulation, has also helped cushion U.S. markets as the Fed continues to raise interest rates.

U.S. markets, in particular, have thrived with a Federal Reserve that has declared, in terms of forward guidance, that its policies remain "accommodative." Forward guidance, while taking different forms among central banks, essentially telegraphs the trajectory of monetary policy. However, during a May panel discussion in Stockholm, Fed Chairman Jerome Powell made it clear an important change was coming: "I think forward guidance was very useful in the crisis, and I think it will have a much smaller role going forward."

And almost on cue, at the September Federal Open Market Committee (FOMC) meeting, the word "accommodative" was removed from the Fed statement. Mindful of how traders—and algorithms—parse every word and nuance, Powell followed up at a press conference by emphasizing that policy remains accommodative. Further, as discussed in Stockholm, "accommodative" used as forward guidance when the Fed had begun raising

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rates in December 2015 had done its job and was no longer necessary. "This change does not signal any change in the likely path of policy," he said. "We still expect, as our statement says, further gradual increases in the target range for the Fed funds rate."

The FOMC looks toward another rate hike in December and a series of moves in 2019. The question for investors is whether the economy can withstand higher rates, and whether Chairman Powell can negotiate the elusive "soft landing." Although he emphasized the strength of the economy is being heavily supported by fiscal policy, with household spending and business investment expanding and financial conditions remaining accommodative, questions remain regarding how long the expansion can last. The tug-of-war within the market is focused on when the next recession begins, with 2020 the consensus estimate.

The fourth quarter, statistically, and in terms of seasonality, is the strongest for the year absent an unintended shock. But given that markets look ahead, we may begin to hear more discussion regarding a shift toward international markets where valuations are increasingly more attractive. Uncertainty surrounding the effect of a higher interest rate environment, the underlying longevity of fiscal stimulus, tariffs, and midterm elections could make the climb to the end of the year choppier than usual. Still, on a fundamental basis, solid leading economic indicators, combined with strong earnings growth, should propel the fourth quarter to a favorable finish. Over the past 27 years, the S&P 500 has registered a positive return 85 percent of the time. The returns are usually clustered during November and December, many times following a difficult October.

HEADWINDS AND TAILWINDS

Momentum going into the fourth quarter is strong, as the third-quarter finish for the S&P 500 indicates a gain of 7.2 percent. Although trade-related headlines have been strident at times, it has had a fairly muted effect on markets. Still, Chairman Powell said at the September FOMC press conference that a "rising chorus of concern" from companies throughout the country worry about disruption of supply chains and materials cost increases. Moreover, he warned that if this, "perhaps inadvertently, goes to a place where we have widespread tariffs that remain in place for a long time, a more protectionist world, that's going to be bad for the United States economy."

Across Main Street America consumer confidence has reached an 18-year high, household wealth is strong and the National Federation of Independent Business (NFIB) saw its Small Business Optimism Index set a new record in the survey's 45-year history. Juanita Duggan, the president and CEO of the NFIB, said that the groundbreaking numbers demonstrate "what I'm hearing from small business owners—that business is booming. As the tax and regulatory landscape changed, so did small business expectations and plans."

The widely followed Institute for Supply Management (ISM) manufacturing and non-manufacturing (service sector) series reported that business conditions for U.S. manufacturers surged to a 14-year high in August, with new orders climbing, along with increased hiring expectations. U.S. services grew for the 103rd consecutive month according to the ISM's September index.

"Overall, the respondents remain positive about business conditions and the economy," noted the Institute. Prices for raw materials are rising, however, and the "primary metals" group, which includes steel and aluminum producers, contracted because of tariff-related difficulties sourcing key metals at reasonable prices. An executive with a company that manufactures fabricated-metal products commented, "the toughest thing we deal with is the unknown. Dealing with tariffs on steel purchases and not knowing if or when they will end makes planning difficult."

Despite rising mortgage rates and affordability concerns, the chairman of the National Association of Home Builders (NAHB), Randy Noel, said builders continue to report "firm demand for housing, especially as millennials and other newcomers enter the market." The NAHB's chief economist, Robert Dietz, added that the growing economy and rising incomes, "combined with increasing household formations, should boost demand for new single-family homes moving forward." On the other hand, Dietz said housing affordability is becoming a challenge, "as builders face overly burdensome regulations and rising material costs exacerbated by an escalating trade skirmish. Interest rates are also forecasted to keep rising."

According to the influential Conference Board, its leading economic index is now considerably higher (104.3) than its previous peak (102.4), registered in March 2006. Ataman Ozyildirim, director of Business Cycles and Growth Research at The Conference Board, said "The leading indicators are consistent with a solid growth scenario in the second half of 2018 and at this stage of a maturing business cycle in the U.S., it doesn't get much better than this."

However, if gasoline prices climb substantially following the implementation of U.S. sanctions on Iran, consumer confidence could suffer going into the important holiday retail spending season, and global growth could be vulnerable to the higher cost of oil. Expectations are that President Donald J. Trump could call for the release of oil from the Strategic Petroleum Reserve, and/or put increased pressure on OPEC to deliver more supply. In an earlier tweet this summer, the president issued a veiled threat that the "OPEC Monopoly must remember that gas prices are up & they are doing little to help. If anything, they are driving prices higher as the United States defends many of their members for very little $'s. This must be a two-way street. REDUCE PRICING NOW!"

U.S. retailers, including Walmart, have issued warnings that product prices across the board must rise if additional tariffs continue to be imposed on all Chinese imports. Currently, the trade conflict is filled with uncertainties and diplomatic friction, showing few signs of abating. Beijing appears determined to cushion its weakening economy with a raft of monetary and fiscal measures should a protracted trade war ensue. At the same time, China has actively engaged and expanded its global trading network as it shores up its supply chain and export markets. In addition, the Chinese press continues to discuss and dissect their interpretation of the U.S. rationale to escalate the tariffs conflict. On the most basic level, the argument is that the U.S. seems intent on curbing China's rise as an economic and military power.

In the latest round of tariff threats, President Trump said the U.S. was prepared to impose tariffs on all imports: "For months, we have urged China to change these unfair practices, and give fair and reciprocal treatment to American companies. We have been very clear about the type of changes that need to be made, and we have given China every opportunity to treat us more fairly. But so far, China has been unwilling to change its practices." Of major importance to the U.S. is to have China forgo demands that American companies share their key technologies with their Chinese partners, long a requirement for American companies to enter the Chinese market. Also, high on the U.S. list of demands is to have China halt its active and aggressive program of cyberespionage, designed to steal commercial and defense secrets.

Clearly, the newly rebranded NAFTA agreement should help remove a trade-related obstacle that hovered over markets for most of the year. However, China-related issues are far more complicated and complex, and most likely will require a longer path toward resolution.

As the U.S. midterm elections draw closer, consensus expectations currently project the Democrats to take control of the House of Representatives. Infrastructure spending could become a possibility should the margin of victory be stronger than currently projected, although concerns over the budget deficit have become a theme increasingly embraced by Democrats. A broader victory for Democrats would also highlight expanding health care spending. A clean Republican sweep would be the preferred outcome by most investors as it would maintain the tax cuts and continuation of regulatory rollback.

Once the elections are over, the market typically enters an optimistic period. Helping markets enjoy a strong finish to this year will be the continued effect of the lower tax rate, real GDP between 3 and 3.5 percent, and continuation of share buybacks, which could reach as much as $900 billion to $1 trillion by the end of the year, helping to support earnings per share. Above all else, top-line and bottom-line Q3 earnings should be strong, although it's important to keep an eye on top-line revenue growth, which provides a clear picture of demand. Given the strength of the markets, it's not unreasonable to expect profit-taking on the back of a strong fourth-quarter performance. Despite increased Treasury supply as the budget deficit increases, interest rates should remain anchored because of continued foreign buying, as approximately 37 percent of U.S. Treasuries are foreign-owned. Lower yields in the developed world continue to require the higher yields offered in the U.S. market. Mergers and acquisitions, which have been eclipsing previous records, should continue strong into the fourth quarter, offering yet another catalyst to the market's performance.

Trade could push markets lower if the strident headlines devolve into the stark reality of a deep, protracted trade war. So far, markets themselves, including the Chinese market, are suggesting, at least for now, that negotiations will continue, albeit with the high drama we've become accustomed to—and which the market has thus far discounted heading into 2018's final quarter. Meanwhile, 2019 will provide many challenges, including the fading of fiscal stimulus, peak earnings and intensified scrutiny of the yield curve as concerns mount over the strength of the expansion. Choosing heads or tails correctly will matter as liquidity continues to be drained from the global financial system and accommodation wanes.

If history is any guide, call it. Heads or tails, 2018 should finish on a high note.

References include the following: Barron's, Bloomberg, Capital Economics, CNBC, Cornerstone Macro, DoubleLine Capital, The Economist, Evercore ISI, FactSet, Federal Reserve System, The Financial Times, Goldman Sachs, JPMorgan, MarketWatch, Morgan Stanley, The New York Times, Renaissance Macro, The Wall Street Journal

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