

ECONOMIC OUTLOOK

Summary

My, what a difference a few months make. Since the October 3 interview with Judy Woodruff where Fed Chairman Powell indicated policy makers were some distance from a “neutral” interest rate, financial conditions have tightened dramatically. After almost three years of gradually tightening monetary policy, the economy and markets are finally showing some recognition that the cumulative impact is having the desired result. Not that it’s much fun. Commodity prices and oil in particular have fallen meaningfully, high yield spreads have widened 1.15% from their tightest levels and some interest sensitive parts of the economy are flattening out.

To be fair, a more vigorous U.S. trade policy, with new and threatened tariffs has raised the level of uncertainty for many CEOs whose first instinct is to reduce controllable expenses. So, the combination of higher interest rates and trade policies are beginning to cloud the outlook for the economy in 2019 and 2020. Although business and consumer confidence levels remain elevated, some forward looking data points hint at slower growth ahead. Core capital goods orders have stalled for three months, pending home sales have declined for 10 months and jobless claims for unemployment insurance hit a six-month high.

We are almost 10 years into this business cycle and it has not behaved much like prior expansions. We’ve been at full employment for 12 to 18 months and wages have barely increased above 3.0% (4.0% has been the norm). In addition, cumulative GDP growth for this cycle has been about half of the prior four expansions. So, now the good news. The Fed has recently indicated that we are “just below” the neutral rate and are aware

that four to five more rate hikes might cause an unnecessary recession. This expansion has more room to run if we secure some form of détente with the Chinese on trade and the Fed pauses after a December rate hike. China, other emerging markets and even many developed economies have all slowed recently. We are not immune to these lower levels of global trade and commercial flows. However, the U.S. does have a solid chance to continue growing with prudent Fed policies and reasonable trade relations.

Positives

Leading economic index continues moving higher, albeit at a slower pace

Conference Board Consumer Confidence Index near multi-year high

Retail sales bounce back this month after negative revisions from prior month

Negatives

Capital Goods New Orders (Non-defense excluding aircraft) drop three months in a row

General Motors cuts 14,000 jobs and proposes shuttering three auto plants

National Association of Home Builders Index hits a 26-month low

EQUITY OUTLOOK

Summary

Equity markets broadly rebounded in November following an October sell-off that marked the worst month for the S&P 500 in over seven years. The November recovery in U.S. stocks wasn't a smooth one, though. Stocks rallied early in the month following the outcome of the mid-term elections, faded mid-month as tariff disputes and a technology sell-off dominated negative headlines and finished strong late month on the back of dovish comments from Fed Chairman Powell and positive jawboning on the trade front. After the dust settled, the S&P finished November 2.0% higher bringing the year to date return to 5.1%.

Oil prices extended losses in November with West Texas Intermediate (WTI) crude tumbling 22.0% for the month after falling 10.84% in October. The losses put WTI firmly in bear market territory and caused energy stocks to be among the worst performing sectors in the S&P 500. Energy's 1.6% decline in November was eclipsed only by a 1.9% drop from the technology sector. Technology underperformance seemed to mainly result from company specific headlines. Tech leader Apple, for example, weighed on the sector after forecasting a weak outlook for iPhone sales. The Russell 1000 Value Index outperformed the Russell 1000 Growth for the second consecutive month advancing 3.0% and 1.1% respectively. Healthcare up 7.1% and Real Estate up 5.6% were the top performing sectors in November.

International markets were largely mixed for the month. The prospect of some trade resolution gave hope to emerging markets with the MSCI Emerging Market Index

rallying 4.1%. However, Great Britain's exit from the EU has been anything but straightforward and the continued angst held the developed MSCI EAFE Index essentially flat at -0.1%.

While the November bounce in equity markets puts a little strut back in the step of investors, we still get the sense that many are taking a more cautious approach. A Santa Claus rally may very well be put on pause this season by continuing trade negotiations, Brexit problems and waning global economic conditions. We view any pullback as a buying opportunity for long-term investors, but continued volatility in the near term should be expected.

Positives

Fed shifting to more accommodative tone

Resilient consumer and business sentiment

Negatives

Rising wages and input costs

Slowing global growth

Unknown

Brexit path and subsequent impact

Duration of the "trade war"

FIXED INCOME OUTLOOK

Summary

Across the yield curve, interest rates reached new cycle highs in early November after the release of the October payroll report showed a sharp snapback from the weak September report. Many strategists increased or confirmed their expectations for three or four Fed rate hikes in 2019. Just a few weeks later stock prices and bond yields were sharply lower under the pressure of the acrimonious U.S.-China trade negotiations and the fear of tighter financial conditions caused by both higher rates and wider credit spreads.

Talk of an eminent slowing in economic activity or even a recession became the new mantra of the same aforementioned experts who were previously concerned about excessive growth and inflationary pressures. Fed Chairman Powell, who back in October stated that the funds rate was a “long ways” from neutral, had to reverse course and follow the chorus of other Fed officials speaking about policy being more data-dependent. They collectively acknowledged that they are not sure exactly where a neutral policy rate would be but the current rate is not likely far away.

Yields continued to decline through the end of the month and into December with the curve flattening significantly. The benchmark 2-year to 10-year spread declined to just 20 basis points (bps) at month’s end and is down to only 11 bps in early December, its lowest in about 11 years. By the end of November, the 2-year to 5-year spread had declined to less than 3 bps and has since inverted slightly in early December. An inverted yield curve is seen as an ominous warning that a recession is on the horizon and reflecting that risk, corporate bond spreads widened by about 20 bps to a multi-year high.

The flattening of the yield curve is sending a message to the Fed that should not be ignored. If after the December rate hike the

Fed stops, or pauses, on their path to “normalizing” interest rates, then the 2-year Treasury yield could actually decline modestly as there are at least two additional rate increases currently priced into the yield. Additionally, the reduction in the probability that the Fed will drive the economy off a cliff should lead investors back into riskier markets and out of longer dated Treasury notes, which would cause their yields to rise. Combined, the slope of the yield curve should increase which would send a green light to capital allocators in both the markets and the real economy. More than ever, the Fed will determine the path of rates from here. We think Powell and company will heed the markets warning and hit the pause button in 2019.

Positives

A flatter curve usually portends future economic slowing

Core inflation has moderated back below target

Negatives

Average hourly earnings above 3% could bleed through to broader inflation

China could reduce Treasury bond purchases

Unknown

Trade negotiations with China

Fed’s willingness to pause on path of normalizing the Fed Funds rate
