Cautious Optimism Ahead

2018 started well but ended poorly

Although 2018 on the whole showed strong macroeconomic data and, for the first three quarters, a healthy U.S. stock market, a difficult fourth quarter led to the worst market returns since the financial crisis (and the worst December since 1931). As 2018 came to a close, almost every major global asset class finished the year in negative territory. For example, the MSCI All Country World Index, the standard benchmark for global equities, fell over 13% with nearly all of the losses coming in the final three months of the year. Compounding the problem, fixed income investments generally did not provide any relief for weak equity prices.

What explains this dichotomy? Why were strong Gross Domestic Product (GDP) numbers and corporate earnings growth met with selling pressure? As we've mentioned in previous letters, we view financial markets as imperfect but also highly efficient and forward looking. Starting in September, global economic data started to trend lower. In the United States, anecdotal data suggested slowing growth as well. At around that same time, the Federal Reserve sounded a somewhat hawkish stance on future monetary policy, indicating a willingness to continue raising rates.

As asset prices had already priced in a significant portion of robust economic and earnings news, the market was somewhat surprised by the rapid deceleration in growth expectations, with trade tensions heightening uncertainty. As a result, in late 2018, markets began to focus on several late cycle economic forces, and soon the correction began to intensify as recession fears rose.

Despite this recent weakness, we are cautiously optimistic as we believe that both the sell-off and recession concerns are overdone.

Slowing growth but no recession in 2019

To be clear, we do believe that 2018 will mark the peak in economic activity for this expansion, now the longest in post-war history. The global economy however remains on solid footing. For example, the latest real GDP report in the U.S. shows growth at a healthy +3.4%. The unemployment rate is at a 50-year low at 3.7% and wages are rising, while inflation seems to have peaked near the Federal Reserve's target of 2%. Lower oil prices, stable interest rates, strong corporate earnings and bank lending at a respectable rate all set the stage for a decent economic backdrop as we begin 2019. Although recession fears have recently gripped the markets, several recession indicators we consistently monitor have the odds of recession over the next twelve months at around 20%. After a thorough review of U.S. economic conditions, we believe the expansion will continue throughout 2019, albeit as a reduced rate, and we look for full year U.S. GDP to be in the +2.5% range with corporate earnings growing mid to upper-single digits.

We also look for global growth to slow moderately in 2019 from +3.8% to +3.5%, but here too we see reasons to be cautiously optimistic. Looking at the world's second largest economy, China, Beijing continues to focus on stimulus. Recently, China held their Central Economic Work Conference where they highlighted fiscal policy and pledged "even larger scale" tax cuts, extending a trend they started in 2018. Over the past six months we estimate about 50 easing moves designed to spur economic activity. We believe China's slowdown in 2018 was the main driver of the international slowdown. Should China begin to show some reacceleration in the first quarter of 2019, then activity in the Eurozone and Japan, for example, should also pick up.

Fed Watching

As the economic cycle ages, moves by the Federal Reserve become increasingly impactful, and we are closely tracking both their actions and messaging. Despite the slowing economic outlook, the Federal Reserve currently maintains their tightening bias. In December, they raised the Federal Funds Rate for the fourth time in 2018 and the ninth since 2015. However, the Fed did cut their projection for 2019 rate hikes to two from three and recent more accommodating comments by Federal Reserve chairman, Jerome Powell, were well received by a nervous market. Last week, Chairman Powell said that low inflation would allow the Fed to be patient in deciding whether to continue raising interest rates as well as quantitative tightening. He also reassured the markets by stating that the overall economy is in good shape. It is also worth noting that although the Fed has been tightening monetary conditions, the real Fed Funds Rate is still only about 25bps. Looking back at the last eight recessions, all began with the real Fed Funds Rate at greater than 2.0%.

Equity Outlook

After peaking in September 2018, equites weakened throughout the last few months of the year with declines significantly accelerating into year-end. The sell-off has removed the elevated valuation conditions that began 2018 but concerns about future growth prospects are currently weighing heavily on investor sentiment. We are now in the midst of the third stock market correction of this expansion. After the previous two (2011 & 2015), equities regained their footing and moved higher. It is rare for equities to sustain losses while both the economy and corporate earnings continue to grow. Although expectations have been reduced, consensus now looks for mid to upper single-digit earnings per share (EPS) growth, acceleration which would seem to suggest a floor on valuations. The pullback in equity prices has also served to improve the equity risk premium, a measure which helps to assess the attractiveness at a given point in time of risk assets such as equities. Historically, when the equity risk premium has been at today's levels, returns over the following 12 months have exceeded 10%.

Globally, emerging market equities are now trading at even cheaper valuations than at their low point in 2015-2016, when the Chinese economy was in much worse shape and fears of a Chinese "hard landing" were widespread. Longer term, we favor the risk-return of international developed and emerging market equities and believe the positive lagged impact from Chinese stimulus, a resolution to trade tensions and a more dovish Federal Reserve (leading to a weaker U.S. dollar) can help provide a much-needed catalyst during the first half 2019 to equities broadly speaking. Overall, we are more constructive on equities than were at this time last year, especially relative to fixed income, given the current disconnect between solid fundamentals and valuations.

Fixed Income

2018 began with a steady rise in interest rates which in turn put pressure on prices of traditional fixed income assets. After 10-year Treasury yields peaked in early November, rates rapidly reversed course as credit spreads widened with investors selling risk assets and buying U.S. Treasuries in a flight to safety. The year ended with rates slightly higher having moved from 2.45% at the beginning of the year to 2.69%. We believe rates can grind higher during the year but not significantly so. While the multi-decade bull market in core fixed income is most likely over, the bear market that comes from rising rates will probably not begin over the coming quarters given continued uncertainty and slower growth.

Strategically, we prefer an underweight allocation to core fixed income and believe that traditional fixed income vehicles can return their yields but little more. We are less concerned about rising rates than we were a year ago as the pace of economic growth and inflation moderates. Credit conditions remain stable as banks continue to lend. Non-traditional, broadly diversified and private lending opportunities continue to offer significantly more attractive risk-adjusted return.

Alternatives

Alternatives continue to play an important role in our long-term asset allocation strategy. Despite our cautiously optimistic approach for the start of 2019, uncertainty and recession fears have led to an increase in overall market volatility. Should this continue, quality alternative managers are well positioned to preserve capital and deliver compelling risk-adjusted returns over a full market cycle. We anticipate that the current economic expansion will continue into 2020, but that periods of volatility will be a persistent occurrence. Our focus remains on alternatives that can both reduce downside risk and provide returns independent of the general direction of stock and bond markets. Our alternatives strategy includes both a multi-strategy, diversified approach and a more directional approach.

Political Climate

The government shutdown, should it continue for an extended period, would hurt GDP growth and confidence. An unclear end game with China on trade adds to uncertainty. Our conjecture is a temporary solution will emerge but that issues will remain. We believe noise out of Washington is unlikely to decrease in the months ahead, which in itself is a reason for some degree of appropriate caution as it relates to the capital markets.

Conclusion

Despite a difficult end to 2018, we believe that 2019 will generally stabilize due to the recent valuation reset and slowing, but still positive, growth. Our belief is that active management and thoughtful asset allocation is critical as the macro and political climate both become more tenuous. Gries Financial Partners continues to focus on appropriate and strategic risk-return for client portfolios, in the name of long-term outperformance.

Please let us know if you have questions or comments. We look forward to being in touch.

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