WealthHealth
Personal Wealth Management

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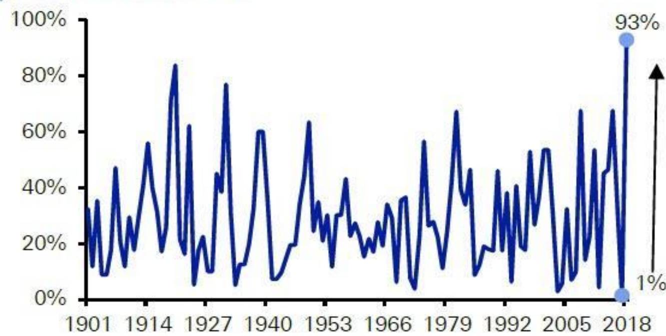
Market Review

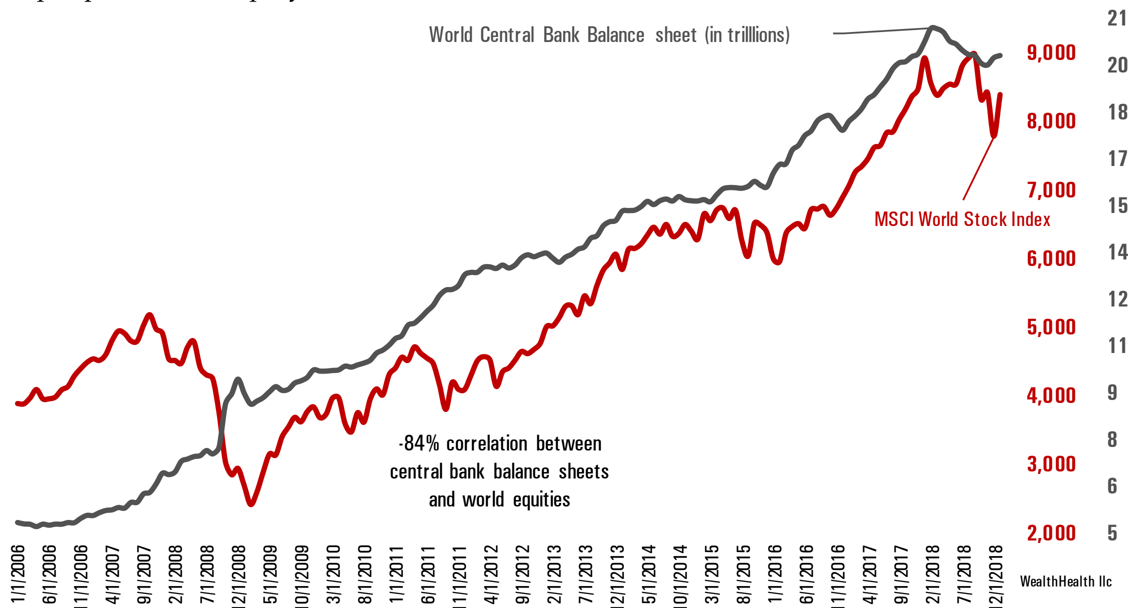
As many have already reported, 2018 ended up being a challenging year for capital markets as most asset classes ended the year with a loss. However, as Deutsche Bank points out, this was a unique year when looking back over the last 117 years.



As seen in the chart to the left, 93% of the 70 asset classes that Deutsche Bank tracks experienced a loss in 2018, a historically *negative* year in terms of diversification benefit. Conversely, the prior year of 2017 was a historically *positive* year where virtually every asset class ended positively. In short and as some have pointed out, nothing worked in 2018 as only a very few assets classes were able to eke out positive returns, such as cash and municipal bonds.

What this implies going forward is that 2019 will likely be a mixed year but with a fair number of assets ending the year on a positive note. It is very unlikely that we will see a repeat of 2018. For example, the month of December 2018 was the worst December since 1931. However, what followed was the best January since 1987 when looking at percentage returns.

In the equities market, the S&P 500, EAFE, and emerging markets ended the year with negative prints of -4.4%, -13.4%, and -14.2% respectively. Paradoxically, earnings for the S&P 500, EAFE, and emerging markets *grew* by 24%, 8%, and 10% during that time. Economic data was mixed but generally positive with consumer sentiment remaining strong. Given this, how was it that so many asset classes all underperformed in tandem? Mainstream pundits struggle with an answer but typically ascribe 2018 to a temporary irrational reaction driven by emotion and not economic fundamentals. Or, as we have noted before, perhaps it's possible that there is a more influential force swaying markets. As seen below, a $1 trillion contraction of central bank balance sheets in 2018 put pressure on equity markets.



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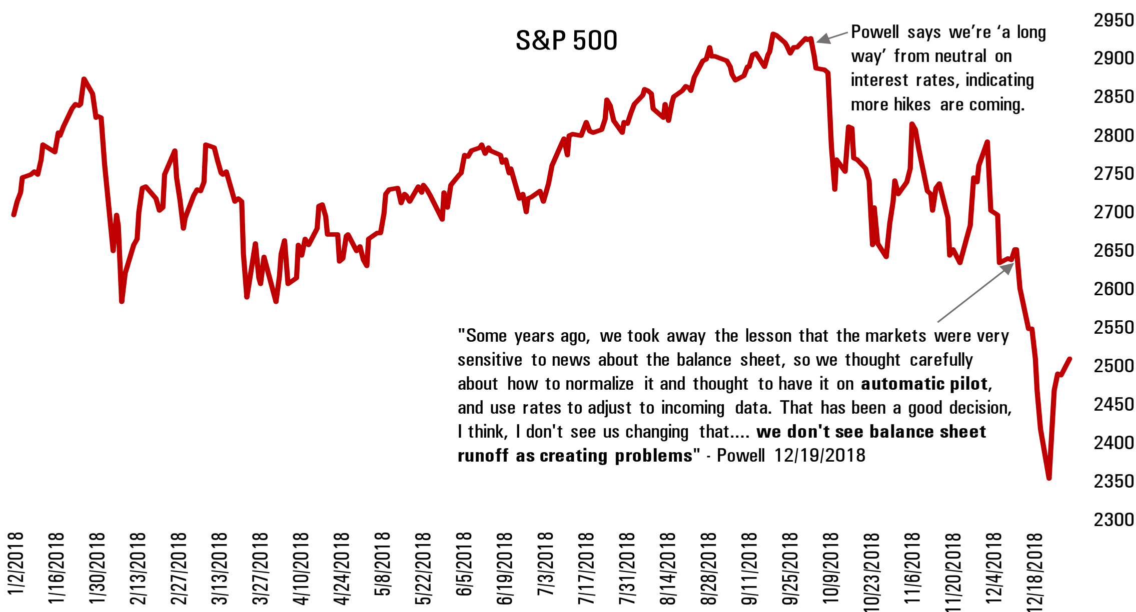
Broad Look

From a mainstream point-of-view it is true that not much changed economically during the last quarter of 2018. The theory further states that since nothing has changed economically, markets should not have experienced the rapid drawdown that they did. However, what is often left out is that markets tend to be *forward* looking and not so much concerned with present or past events. Therefore, the aggressive repricing towards the end of 2018 was a response to expectations of *future* conditions, not current economic data points. And those expectations shifted rapidly when Fed Chair Powell gave his outlook(s).



In response to signals coming from the US central bank, fast-money traders, hedge-funds and algorithms quickly dumped stocks as future economic conditions were repriced lower. Since higher rates and contracting central bank balance sheets are detractors of liquidity, invariably tighter financial conditions were likely to ensue. For example, mortgage, auto-loan, and business activity typically slows during periods of rising rates. This new reality was quickly priced in. The lack of stock buy-backs, sharp moves in interest rates, and sell offs by algorithmic trading likely exacerbated the move.

Since then however, Fed Chair Powell expectedly changed his stance on the balance sheet question and instead opted for a more market-friendly position. Specifically, Chairman Powell has recently said that "the central bank would likely stop trimming its $4.1 trillion balance sheet sooner, leaving it with more assets than previously expected". An incredible detraction from his previous statement made on December 19, 2018 (seen in the chart above). Chairman Powell further cemented this newfound stance by pausing the path of higher rates as announced during the most recent meeting on Jan 30th, 2019. Instead the US central bank has signaled that "it will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate." As of 1/31/2019, the S&P 500 has recovered 60% of its losses since its peak on Oct 2018. While this provides a welcome temporary reprieve, it does not resolve the buildup of risk that we have been writing about for the past year and a half.

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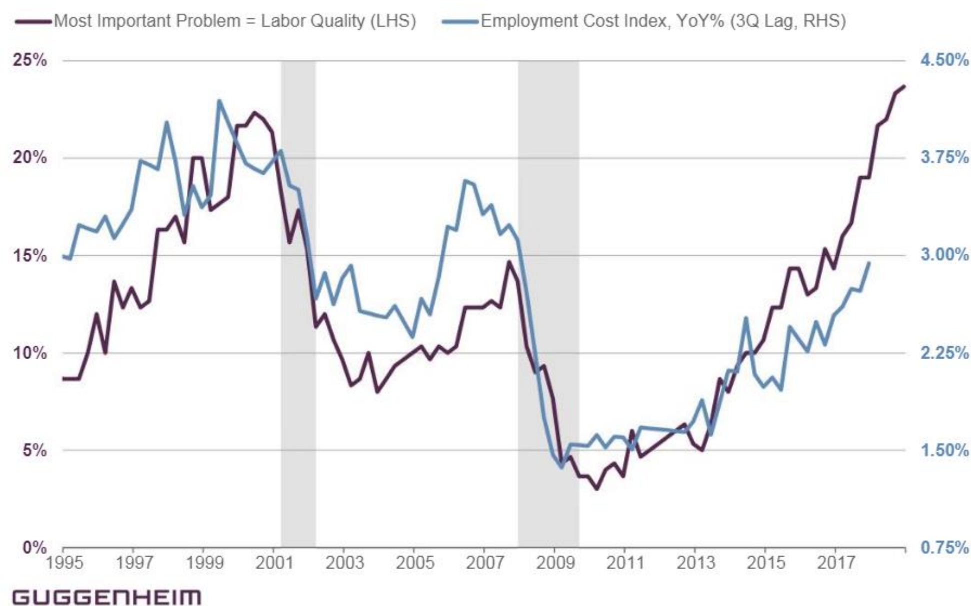
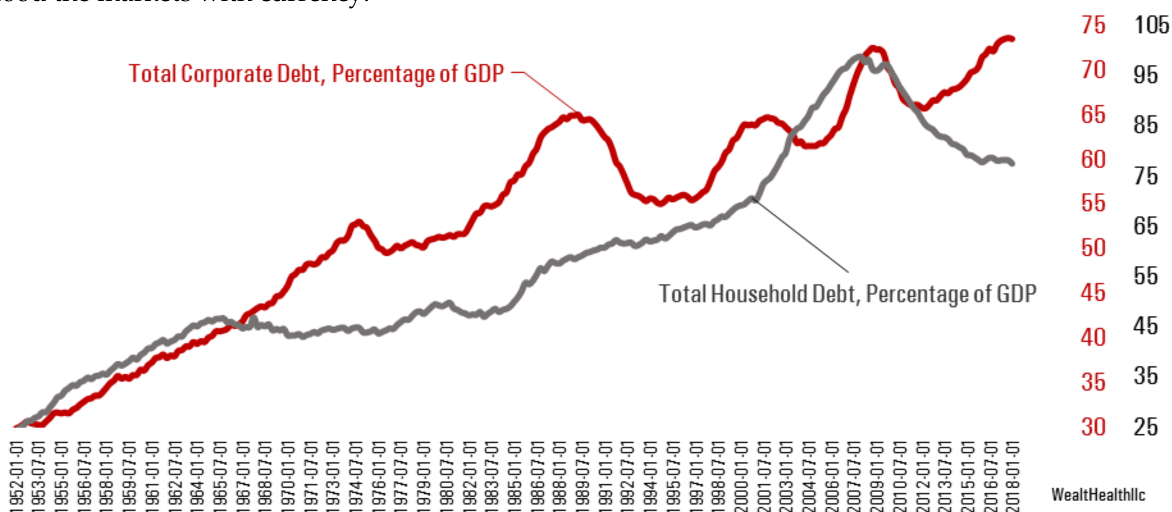
Outside the machinations of central banks, the economy does continue to do well. Unemployment rates are near historical lows, albeit climbing a few points to 4% from 3.7% on account of an increase in labor force participation (a positive sign). Retail sales, business optimism, and industrial production are still strong and show no immediate signs of a recession. Inflation is moderate at 2% and not prohibitive.

However, as employers continue to struggle to fill positions, they will increasingly have to turn to raising wages, which will in turn increase company costs and will likely lead to an increase in inflation. Furthermore, any additional tariffs enacted by either the US or China will also likely send inflationary signals which could cause the central bank to inadvertently respond with higher rates. Higher rates and higher costs can hinder business activity and can lead to a discernable slowdown in economic activity.



Any potential slowdown in economic activity will likely have repercussions seen across the investment landscape. It is also possible that with corporate leverage at all time highs, a slowing economy could morph into a recession, at which point central banks will likely step in once again to flood the markets with currency.



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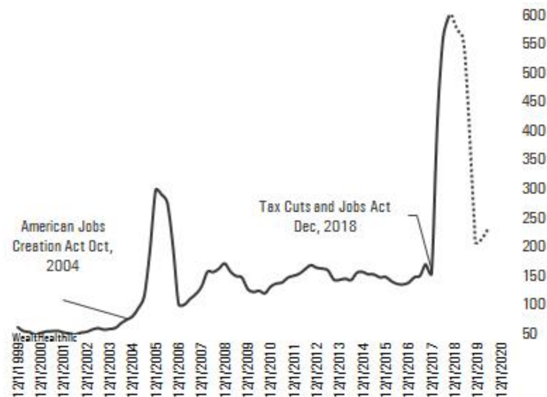
Looking Ahead

We see no signs of an immediate recession at the moment. To the contrary, there are still many positive factors from an economic standpoint and equally positive signals from a liquidity standpoint. Central banks have relented their hawkish stance and have since reversed the contraction of the global central bank balance sheet. In addition, the repatriation of overseas cash from abroad, spurred by the Tax Cut and Jobs Act, is still only 40% complete assuming firms will repatriate the remaining $1 trillion which we believe is possible to an extent. Seen below is the U.S. International Transactions Account, a way to track cash movements that take place when such tax cuts are passed. If history is any guide and if we model out the previous path of repatriation, there is still more cash to be brought back for share repurchases, although we expect this activity to taper off by the end of this year.

Figure 19: #3: Overseas Cash Balance Still ~$1 Trillion
$ in billions

S&P 500 Sectors	Overseas Cash 1Q	Current	Delta
Energy	$33	$29	($4)
Materials	$23	$14	($8)
Consumer Staples	$77	$59	($19)
Consumer Discretionary	$85	$60	($25)
Industrials	$103	$75	($28)
Health Care	$190	$114	($76)
Information Technology	$765	$585	($180)
Total	$1,275	$937	($338)

Source: J.P. Morgan US Equity Strategy and Quantitative Research, Bloomberg



The overall factors outlined above from US corporates and world central banks are indeed still positive to risk assets in the near term and will likely lead to higher valuations in stock prices this coming year.

In Summary

While the near term outlook is positive, we are very aware of the continual build-up of risk across the globe. The level of excessive debt, lax lending standards and growing global political imbalances will need to be addressed and priced in at some point.

At the moment, corporations are able to contend with current interest rates and costs. Business are able to obtain loans and expand. Commercial and residential real estate prices continue to improve. However those scenarios may become challenged next year and beyond. As such, we continue to take advantage of opportunities when possible while being extremely cautious and mindful of the growing abundance of risks.