WEALTH MANAGEMENT MADE SIMPLE

nine points investment management

Fourth-Quarter 2018
Nine Points Investment Management (NPIM) Market Commentary

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2018 BEGAN WITH a continuation of exuberance from the record-setting year of 2017, in which every month generated positive equity returns for the first time ever. The beginning of 2018 was the strongest start to a year on record for global equities; however, that exuberance faded quickly in February and the year ended in a sea of red. December 2018 was the worst month in the U.S. stock market since February 2009, with the S&P 500 down more than 9 percent.

For the year, the S&P 500 was down 6.2 percent and 14.5 percent from the January peak. Only two sectors—health care and utilities—were positive on the year. The Nasdaq was down 3.9 percent on the year and 18 percent from the peak, while the Russell 2000 was down 12.2 percent for the year and 22.5 percent from the peak.

The international markets fared even worse. Overall, the MSCI World index finished with a total return loss of 8.2 percent, while Emerging Markets lost 14.2 percent. Only two countries were positive out of the 47 in the index: the UAE and Saudi Arabia.

Despite some volatility, the Barclays U.S. Aggregate Bond Index was basically flat for the year. Only cash gold had a positive return within the major asset classes in 2018. A deceleration in global growth, interest rate hikes and increased political tension are all to blame for the lackluster returns. International markets also weakened amid a strong dollar and mounting concerns about trade friction between the U.S. and Canada, China and Mexico.

Following the poor end to 2018, roughly half of the global equity markets entered 2019 in a bear market, which was defined as down by more than 20 percent in price. There were also 10 more days with negative 2 percent moves in the S&P 500 than positive 2 percent days. This increased downside volatility is typically more characteristic of periods of crisis than the Goldilocks expansion that we experienced for so many years, perhaps signaling the end to the “buy the dip” mentality of the market; we are certainly wary of this as we navigate 2019.

U.S. GROWTH IS SET TO SLOW IN 2019

Our view for 2019 economic activity in the U.S. is for growth to slow, compared to 2018, and for the first half of the year to be stronger than the back half. Given the ongoing tightening, lag effects of previous tightening and waning activity from tax repatriation, it should be no surprise that 2019 will likely experience a notable decline in GDP growth rates.

The market signs from commodities to credit to stocks are all flashing warning signs. Economically-sensitive areas recently experienced significant hits, particularly commodities like oil and copper, as well as industries like housing and automotive.

Given the slowing growth and sizable market pullback last month, there has been a lot of talk about a recession of late. Most economists believe the timing of a recession could come no sooner than 2020. Former Treasury Secretary Larry Summers recently stated that it was not possible for the economy to slip into a recession only a year after GDP growth of more than 3 percent, meaning that we would avoid a recession in 2019. However, this occurred in seven out of the last nine recessions. The average real GDP growth in the year prior to a recession is 3.9 percent, dating back to World War II (WWII); so, it is entirely possible for a recession to hit later this year, depending on rate hikes and tariffs.

We've been asked, "What would a recession look like this time around?" Well, if there are excesses in the system, and we believe there are, we would point to weaker credits in the investment grade bond sector, high yield, leveraged loans and private equity—which are outside of the financial sector, marking a difference from the last recession. Because of this, we would argue that the next recession would not be as deep as the prior one.

For the time being, U.S. equity valuations are in line with post-crisis averages, albeit with greater future earnings uncertainty. We are also coming off a significant decline, so the equity markets should have a little bit of a tailwind early in the year. However, we do expect concerns to grow later in the year about earnings visibility amidst uncertainty regarding interest rates, inflation and geopolitical issues heading into the 2020 elections.

On the plus side, still-strong employment and consumer spending continue to power the economy and could persist, particularly if the Federal Reserve (the Fed) eases up more than we anticipate on the rate hikes in 2019.

THE FED'S UNCERTAIN PATH

We think the Fed's course of action will be a major driver of market activity in 2019—this should not be a surprise. Central Bank tightening is likely to exacerbate tighter liquidity. Regardless of how many rate hikes the Fed gives us this year, they will likely continue to reduce the size of its balance sheet. At the current pace, estimates project this equates to 0.75 percent in hikes per year. Additionally, the European Central Bank (ECB) completed its quantitative easing in December. Even the Bank of Japan (BoJ) has shifted to a less supportive stance. Liquidity will be an issue in 2019.

The Fed still projects two rate hikes, while market chatter suggests fewer and some are even hoping for cuts. To us, that would not be a good sign, at least for the longer term. It would indicate significant economic weakness coming down the pike. The futures markets indicated no Fed move at all in 2019 and a 50/50 chance of one cut occurring by 2020.

While the Fed has hiked into virtually every recession, we do anticipate their becoming more cautious; we think a pause is very possible in March. Even if the Fed reverses course and starts cutting rates,

history shows it is more prudent to buy closer to the final rate cut, not the first one. Since WWII, the S&P 500 averaged a bottom roughly a year after the first rate cut.

DEBT REFINANCING IS A KEY RISK

As we assess the fixed income markets, certainly the Fed's outlook and actions will play a significant role. That being said, we think the market may be surprised by how important the debt refinancing cycle will be in 2019. This year begins the start of a five-year rollover calendar that totals roughly $4 trillion of debt maturities, roughly two-thirds of which are only one notch above junk status. We suggest this will prove to be a formidable headwind for investment grade and high-yield borrowers alike—about 20 percent of the $485 billion of BBB 2019 debt maturities are in the lowest rung (BBB-), which could prove problematic. What's more, about $1.5 trillion of global high-grade debt is due to mature this year. When looking at U.S. denominated debt, maturities are set to increase by nearly 7 percent as compared to last year.

How will these companies allocate capital going forward? It appears likely that debt pay down—due to concerns over credit ratings and financing costs—will take precedence over growth initiatives, such as CapEx and acquisitions (maybe even employment/new hires), and share buybacks and dividends, the latter of which has provided significant support for the stock market, but may not continue in 2019.

We expect high-yield fixed income to underperform in 2019, due the significant rollover that needs to take place. Leverage is also becoming stretched and we expect late-cycle concerns to weigh on the sector.

CHINA AND THE OVERSEAS MARKETS

Global synchronized growth is no longer the case. Global manufacturing data has been lackluster as of late. Recent U.S. ISM data fell to a two-year low. China and the Eurozone are experiencing similarly-weak performances. This, coupled with cheap valuations, but ongoing uncertainty with tariffs between the U.S. and China, makes for a cloudy picture in the international markets.

Given the temporary truce that took place between the U.S. and China, a new deal doesn't appear imminent; but, more likely to occur, if at all, late in Q1 or Q2. The tariff increases totaling $200 billion in Chinese goods has been postponed until March. While this short-term truce is welcome, there are no certainties that a deal gets done. Concerns over intellectual property rights are certain to be a main sticking point.

International assets are cheap, but need a catalyst. We believe this catalyst will be a U.S. trade deal with China, as well as a pullback in the U.S. Dollar. We believe a positive outcome would boost all equity markets, but favor the international markets, particularly those in emerging economies, given those markets' correlations to China and current valuations. Volatility is likely to remain highly correlated to the ebbs and flows of the trade talks, but significant weakness has already been priced in. While the risk-reward appears favorable to us, we are watching the growth picture closely for signs of a more dramatic slowdown.

THE U.S. DOLLAR

Conditions are mixed for the U.S. Dollar, but we believe a weaker dollar environment will persist in 2019. This is due to an extremely bullish sentiment that is likely to wane, the degree of interest rate hikes is likely to slow and fiscal deficits are likely to expand.

We expect the combination of a peak in U.S. growth and interest rates, along with the start of tighter monetary policy in Europe and Japan, to result in a weaker U.S. Dollar in 2019. This would be a positive for commodities, international equity and fixed income markets.

PUTTING IT ALL TOGETHER

We expect another year of difficulty and volatility, albeit not without opportunities. While valuations are certainly more attractive, having ended the year near its lows, earnings expectations are also declining. Our sense is that for those who don't forecast a recession in 2019, the recent pullback will be a perceived buying opportunity as equities already price in growth deceleration.

We are more confident in the potential for positive investment returns in the first half of the year than the second because we believe there is a potential short-term tailwind from the year-end 2018 pullback, coupled with a decent economic growth outlook and the potential for a trade deal with China. In the back half of the year, we may have to contend with one, if not two, interest rate hikes, a downtick in growth and a shift in corporate use of capital away from share buybacks. That being said, no one knows what the full impact will be from the government shutdown, which could weigh on economic activity early in the year.

Risk remains in terms of the Fed tightening too much, tension escalating with China and the government slowdown potentially hurting the economy more than anticipated. While a recession might not manifest in 2019, recession risk is rising, as is the probability that rolling bear markets tear through economically-sensitive sectors rather than the entire market. Lastly, we are more likely to fade rallies than buy dips in the U.S. equity markets in 2019 and expect the markets to be more volatile in the year ahead than last year.

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QUESTIONS AND COMMENTS

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Sources:

[i i] All index returns are total return figures accessed using Morningstar Direct on Jan. 1, 2019. You cannot invest directly in an index. Index returns do not include trading or other investment costs.
[ii] Morningstar Direct.
[iii] https://www.cnbc.com/2018/11/15/larry-summers-50-percent-chance-of-a-us-recession-by-2020.html
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[v] Bloomberg Research
[vi] https://tradingeconomics.com/country-list/industrial-production?continent=g20