Special Edition

December 21, 2018

Why Now?

Investors, in the parlance of talking heads, have been on a buyers strike. That, combined with heavy institutional selling, has put the equity market in or near bear market territory. There are plenty of legitimate concerns for investors, but there are also very positive economic signals.

We all know the worries: has the Fed moved rates too high and/or too fast, the China slow down, a possible trade war, Brexit and a slowing Europe. As we wrote, these are important concerns.

The most recent jolt to investor confidence was the Fed's recent move to raise interest rates, and left in language about future interest rate increases. Investors took this as a bearish signal for interest rates. This lead them to assume the Fed would continue to raise rates, cutting off economic growth. This, in our view, is a dramatic misreading of both the move in interest rates and Chairman Powell's remarks. The Fed has not just signaled, but has been explicit in telling all who may listen that they wanted to bring rates back to normal after the exceptionally low rates of the past few years. They never said they wanted to slow the economy, just that they wanted to prevent overheating. Chairman Powell and the governors are also explicit in telling investors that any interest rate moves will be data dependent. It is hard to interpret that in any other way than if the economy appears to be slowing, they will not continue to raise interest rates. None of this should be interpreted as bearish. As for the current Fed Funds rate, we have included a chart of the Fed Funds rate since the 1950's. It is evident that interest rates continue to be historically low.

There is concern that the U.S. economy is currently on a downward path. No one knows the future, but economic statistics do not bear this out. We have pointed out often that employment and wages remain very strong and inflation is under control. Both consumers, 70% of the economy, and business leaders are more than sanguine. Just this morning, the Bureau of Economic Analysis (BEA) reported the third quarter GDP growth was 3.4% and corporate profits grew from $65 billion in the second quarter to $78.2 billion in the third quarter. These are not the first signs of an impending recession.

The fear of a China slowdown and a trade war are related. It is important to remember that when analysts speak of an economic slowdown in China, they are not implying negative growth, they are referring to a slowdown from 6% GDP growth to 3-4.5% GDP growth. Most of the world would be thrilled with those numbers. This is certainly a big concern for China but not a particularly big concern for the U.S. economy. An economic slowdown in China puts President Xi in a difficult bargaining position relative to a trade war. As we have written in the past, China will be hurt more by tariffs than the United States. That, along with the aforementioned economic slowing, makes a major trade war very unlikely.

Both Brexit and a slowing European economy pose a significant economic problem for England and the EU, but much less for the United States. We, and many others, have written that the U.S. economy's exposure to the rest of the world is not great. Much of the U.S.'s economic activity is self-contained.

Special Edition (cont'd)

Therefore, in the unlikely event all the above turn out badly, it would be a drag on the U.S. economy but unlikely to lead to a recession.

Last two points. No one likes confusion. During times like this, investors and all citizens want reassurance from their leaders. This has been lacking. This confusion has led investors to become 'chicken littles' rather than confident investors.

Algorithmic trading funds put tremendous pressure on markets trying to find a balance. When there are heavy waves of selling by these funds, the market clearing mechanism becomes stalled, which leads to very large downward moves.

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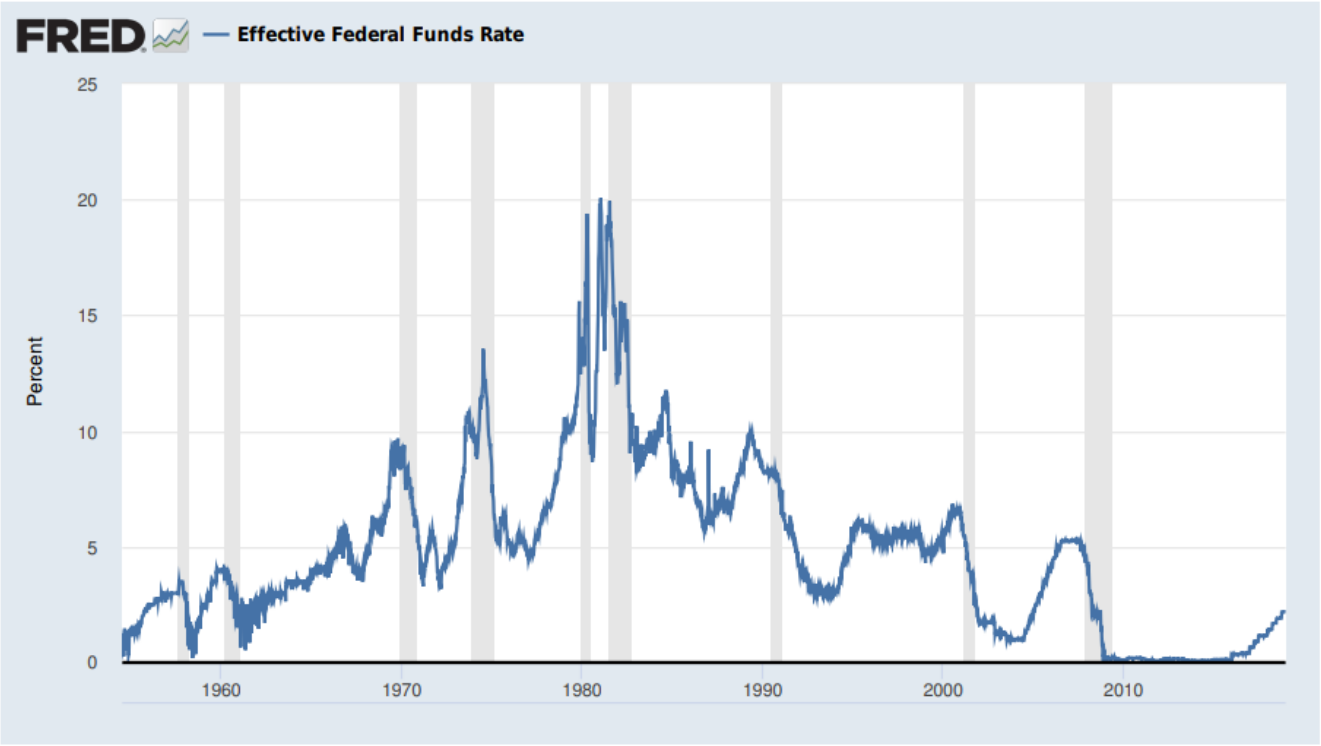

Source: Board of Governors of the Federal Reserve System (US) myf.red/g/mu39

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