Weekly Market Insights

January 22, 2019

What a Difference a Digit Makes!

Investors' attitude towards equities between 2018 and the first month of 2019 is nothing less than startling. The equity markets were in bear territory as 2018 came to a close. The beginning of 2019 has been nothing short of a strong bull market.

Has the world changed that dramatically? No, most likely not. Facts don't change that much, but opinions do. So the important question is, of course - is this a return of the bull or a temporary respite from the bear? Investors, as always, should reexamine the perception of the facts.

We believe investors focused on a number of points, both political and economic, during the last half of 2018 and concluded that the risks were so great that they should reduce risk in their portfolios. This selling was exacerbated by hedge funds, whose principal object was, and continues to be, follow momentum. In our view, the principal concerns were: will the Fed tighten too fast and too far, what will be the effect of ending QE, the impending U.S. trade wars with China, the EU, Mexico, and Canada and, of course, the government shutdown. All are important, but taken together, are very disturbing.

For most of the second half of 2018, investors took a negative view on all the above. As the old year faded, so, it seems, did investors' concerns. We have argued that, in our view, although not trivial, the odds favor a sensible conclusion to these concerns. This will be a shorter article than usual, since we will be repeating much of what we have written in the past. As usual, readers can review these by going to our website, www.1919ic.com. We will, however, go over each point and interestingly demonstrate that they don't exist in a vacuum. They have interesting influences on each other.

Federal Reserve policy is certainly a vital consideration. In some respects, the Fed was its own worst enemy. In a valiant attempt to be transparent, they gave a message which was widely misinterpreted by the investing public. As we all remember, they laid out their vision for future rate hikes. The problem being that was the dominant part of the message that investors read. A very important part of that message was, and remains, that future rate hikes are data dependent! The Fed is telling us that if economic growth falters, that forecast for rate hikes will be shelved. Clearly, investors did not pay attention to that vital part of the report, because as some less than positive economic statistics were released, investors started to eliminate risk, because a slowing economy combined with a tightening Fed is certainly bad for equities. The end of QE and the reduction of the Fed's balance sheet, if done slowly and wisely, should not adversely affect the economy.

The most disconcerting of the fears mentioned above is an escalation of the China-U.S. trade war. China's GDP growth was reported over the weekend and as suspected, China's economic growth continues to slow. It has been our opinion that because of the slowing growth, China is in no position to enter a full-fledged trade war. A trade war will hurt many parts of the U.S. economy, as well. Although the U.S. is far more able to withstand a trade war than China, no administration wants an economic slow-down on their watch, particularly when they are up for reelection in two years. It is very much in both sides' interests to come to a reasonable conclusion. We wrote earlier about how so much in economics is entwined. Here is an obvious case. If there is an amicable conclusion to the China-U.S. tariff war, that is a positive for the U.S. economy and investors will have to rethink if higher interest rates are in the near future.

Weekly Market Insights (cont'd)

The U.S.-China trade dispute is not the only one in town! There are two others. The U.S., Mexico and Canada agreement is still not settled, but it appears as if that agreement will be reached soon. The other is U.S. vs. the EU. Unfortunately, the common denominator is the United States. Our view on this particular dispute is not dissimilar to our view on the China-U.S. dispute. The EU's economy is growing at a slow rate and there are worries that it will continue to slow. That, combined with Brexit, puts the EU in a very difficult bargaining position.

The U.S. appears to hold the best hand in this game, so we think that there will be much posturing, but settlements will be reached.

The government slowdown will end, not for any good reason or settlement of issues, but because each side is starting to lose politically, and that, of course, is the name of the game.

- Michael Olin Clark
moclark@1919ic.com