UNCOMMON SENSE

November 2018

The Most Wonderful Time of the Year? Bull Market Hinges on a Duo of December Outcomes

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"Seeing isn't believing. Believing is seeing."

— *The Santa Clause,* 1994 film

The fate of investors in 2018 will be determined by two events this holiday season. Imagine that. All the hard work. All the planning. And it comes down to just two events that are beyond investors' control. Maddening.

First, can Presidents Trump and Xi put aside their differences at the G20 summit in Buenos Aires from November 30 to December 1 and outline a US-China trade deal that they can sell to their constituents? Second, after likely raising the target federal funds rate for the fourth time in 2018 by another quarter point on December 19, will the US Federal Reserve (Fed) signal a slowing to planned rate hikes in 2019? It's as if we unknowingly have been waiting all year for these two events that come just 18 days apart. And make no mistake, whatever happens next will be an inflection point of ginormous magnitude. One that could determine if the bull market continues its run.

So, what should investors expect? Recently, financial assets have been pricing in the failure of the US and China to reach a trade deal and much tighter Fed policy. However, for investors to get their holiday wish for a strong Santa Claus rally to close out a tumultuous 2018, we need a trade deal and a walk back from the Fed on rate hikes in 2019. So, let's mix up some eggnog and see if we'll have a joyous holiday season or if the Grinch will finally steal Christmas and leave investors weeping as we enter the new year.

You'll Shoot Your Eye Out, Kid

Things were going so smoothly and then they weren't. US stock market benchmarks reached all-time highs in September and early October. It was shaping up to be another banner year, in a long line of good years. The S&P 500 Index was on track to deliver its 10th consecutive calendar year of positive returns, a feat that hasn't been achieved in more than 90 years. And the US economy and corporate profit growth were accelerating throughout the second and third quarters, fueling the stock market's gains.

At the time, investors widely believed that cooler heads would prevail in the US-China trade spat and that the Fed was inching closer to the illusive neutral rate — the interest rate that neither stimulates nor slows the US economy — signaling a welcome end to the current tightening cycle.

However, in just 24 hours over October 3 and 4 investors were forced to radically recalibrate their views — and markets have suffered ever since as US stock gains for 2018 have been wiped out.

Surprisingly, in a PBS interview on October 3, Fed Chairman Jerome Powell shocked markets by suggesting that we are nowhere near the neutral level for interest rates. He added that accommodative monetary policy was no longer needed, citing the US economy's recent resurgence. The very next day, Vice President Pence gave a scathing speech at the Hudson Institute accusing China of numerous offenses against the US, including political interference. Pence warned of a much tougher approach toward China and its leaders.

These fears were exacerbated when, for the first time in its 25-year history, the Asia-Pacific Economic Cooperation summit ended on November 18 with its leaders failing to agree on a formal joint statement. And now, what was once believed to be contrived negotiating tactics between two superpowers has been replaced by investors' worst fears of a cold war between the US and China.

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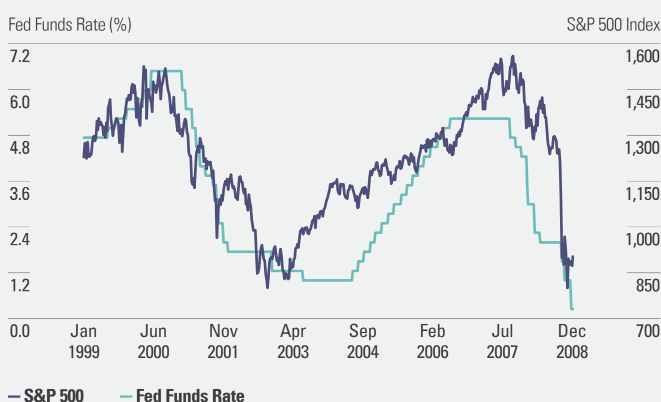
Figure 1: The Fed Held Rates Steady for a Year When Chinese Growth Concerns Dragged on Global Equities in 2016

Source: Bloomberg Finance, L.P., November 26, 2018.

Figure 2: In the TMT and GFC Crises, Greenspan and Bernanke Appreared to Closely Track Equities. Will Powell Do the Same?



Source: Bloomberg Finance, L.P., November 26, 2018.

A New Trade Deal: A Cup of Holiday Cheer

The prospects for a trade deal with China are likely to increase because US presidents usually seek to ignite economic growth ahead of their re-election campaigns. Typically this occurs in the year before the national election. According to Strategas Research Partners, the greatest boost President Trump could provide to the economy would be to lift the tariffs on China and negotiate a new trade agreement.

On November 16, President Trump suggested that China was ready to make a deal on trade and the US might not need to impose further tariffs, explaining, "They sent a list of things that they're willing to do, which was a large list ... I think we'll have a deal." The president's comments were met with huge relief from investors that day.

In an interesting coincidence, China announced plans on November 18 to accept applications early in 2019 from foreign insurers seeking to take control of their local joint ventures. Reuters reports that Chinese regulators are even weighing giving them full ownership earlier than originally anticipated. Having set an agenda to open up its financial sector, China has already taken steps to relax foreign ownerships in securities ventures. However, doubts about Beijing's commitment to opening up the sector have crept in amid an escalating trade war and a regulatory overhaul. Plans for the insurance sector, the world's third-largest insurance market, show the liberalization efforts have not been derailed.[1]

This is a clever approach from China. Opening up the insurance sector for all foreign insurers eliminates the impression that China is giving in to US bullying on trade. Despite the politically-charged rhetoric, Presidents Trump and Xi have every incentive to put aside their differences and begin to make progress towards a trade deal.

Two Turtle Doves: The Fed Changes Its Tune

I feel bad for the Fed. It's wearing the ugliest of holiday sweaters. Raise rates too much and get blamed for ruining Christmas. Slow down the pace of rate hikes and it looks like President Trump's Grinch-like bullying tactics are working. There are no good choices.

In fact, could it be that the Fed has already made a policy mistake by tightening too much? Earlier this year, the US economy was firing on all cylinders, oil prices were climbing and the US dollar was weak. Now, the US economy is slowing, oil prices are in a bear market and the US dollar is at 18-month highs. All will combine to keep inflation measures well anchored as we enter 2019. And with the US economy slowing and business spending sputtering, Fed rate hikes have already shown signs of weakening interest rate sensitive sectors such as home and auto sales.

The need to tread carefully with future rate hikes seems to resonate with Chairman Powell. Following an appearance at the Dallas Fed on November 14, he commented on the Fed's decision-making framework, "So, you know, a good example is — a noneconomic example would be you're walking through a room full of furniture and the lights go off. What do you do? You slow down. You stop, probably, and feel your way."[2] Richard Clarida, Powell's right-hand man at the Fed, further emphasized the analogy during an interview on CNBC on November 16, commenting, "As you move into the range of policy that, by some estimates is close to neutral...it

is appropriate to sort of shift the emphasis towards being more data-dependent. I think Chair Powell the other day made the analogy … if you're in a dark room, especially without your shoes on, you want to go slow so you don't stub your toe. So I think data dependence makes sense right here."[3] And at The Clearing House and Bank Policy's annual conference in New York on November 27, Clarida's remark that rates are "much closer to the vicinity" of neutral than when the Fed began hiking rates in December 2015 further supported the possibility that the Fed's pace for hikes may be slowing.[4]

Yet, even as other Fed officials — Patrick Harker, Raphael Bostic and Neel Kashkari — voice concerns similar to Powell's and Clarida's regarding raising rates too aggressively in 2019, investors are still pricing in tighter policy conditions.

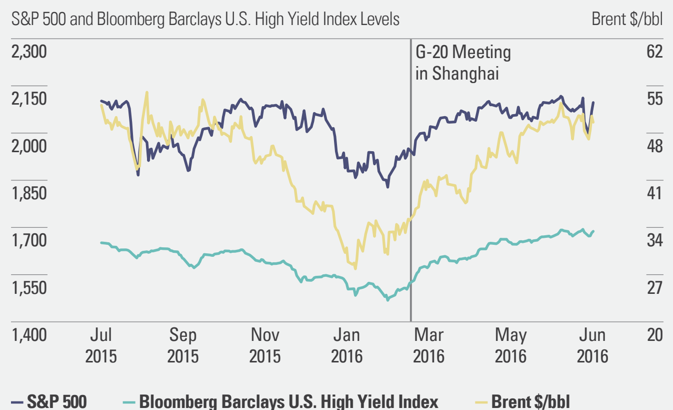
The Fed is likely to raise rates a quarter point at the conclusion of their meeting on December 19. The question is whether it gives investors the gift of signaling slower rate hikes in 2019. If not, markets could be in trouble. Given that Powell said at the Economic Club of New York on November 28 that rates are "just below" the so called neutral range,[5] I expect the Fed to slow down the pace of rate hikes considerably in 2019 — paving the way for a Santa Claus rally.

Nothing Wrong with Repeats: Holiday TV Specials Are My Favorite

How can I be so sure we'll get a trade deal and slower rate hikes? History rarely repeats itself but it often rhymes. If you listen closely to today's holiday songs, you'll hear the familiar rhythm of a song we've sung before. That is, today's headlines are eerily similar to those from another make-or-break G20 summit in 2016: Fears of a Chinese hard landing fray nerves. The Fed threatens more interest rate hikes next year. Oil prices plummet on a mix of oversupply and slowing global demand. Stocks suffer a correction. Credit spreads show signs of stress by widening to levels investors haven't seen in some time.

Of course, a lot has changed since 2016's fateful G20 summit in Shanghai. Populism and protectionism have exploded globally. Nationalism has replaced globalization. And ironically, in a season that celebrates giving to others, world leaders seem to be focused on saving themselves because their jobs are at stake. President Trump may have been winning early, but things have taken a turn for the worse. The US economy's growth rate has slowed from a solid 4.2 percent in the second quarter of 2018 to a below long-term trend rate of just 2.5 percent forecasted for the fourth quarter of 2018. That's a problem for a president who measures his success by the strength of the economy.

Figure 3: In 2016, G20 Finance Ministers and Central Bankers Met and Boosted Confidence. Investors are Hoping they Will Have the Same Effect in December



Source: Bloomberg Finance L.P., November 26, 2018.

China has also suffered. The Chinese economy is growing at the slowest rate in decades and its stock market is in bear territory. Clearly there's plenty to learn from the Ghost of Christmas Past.

The Best Way to Spread Christmas Cheer Is Singing Loud for All to Hear

As is often the case, investors have overreacted to new information in the short term. Many are missing important signposts from both the US-China relationship and the Fed. Therefore, asset prices reflect little chance of a trade deal between the US and China. And investors are pricing in much tighter monetary conditions than seem warranted in the aftermath of Chairman Powell's early October comments. Asset prices are now woefully mispriced after the recent selloff, this excessive reaction has created an interesting opportunity for investors willing to take the risk.

In three weeks, we'll know where we stand. Will we see a repeat of 2016 where things worked out and the bull market kept rallying? Following the 2016 G20 meeting in Shanghai, China took measures to address its domestic economy. And, despite threatening four rate hikes in 2016, the Fed only raised rates once, in December no less. OPEC and non-OPEC countries reached a deal to cut oil production which helped stabilize oil prices in 2016. Coincidently, today rumors are percolating of another OPEC oil production cut. Stocks also recovered from the correction and had a splendid year. And credit spreads narrowed as the most aggressive fears were avoided. The question is whether nationalistic pride, populism and protectionism have gone so far that a repeat of 2016 is impossible today.

The outcomes of the G20 summit and the Fed meeting will determine if investors ring in the New Year with a bang or if trade strife and rate hikes will be like the jelly of the month club — the gift that keeps on giving in 2019.

I'm no optimist, so maybe it's the eggnog talking, but I have to believe that the US and China know that there is too much at stake not to make a deal. And that the Fed, although proud of its independence, will not allow pride to end the economic expansion too early. Should my forecasts be accurate, expect global markets to rebound, particularly cyclical stocks, international developed markets and emerging markets.

[1] Sumeet Chatterjee and Shu Zhang, "China moves closer to allowing foreigners to control insurance ventures: sources," Reuters, November 18, 2018.

[2] Greg Robb, "Here's what Fed officials are saying about the interest rate outlook," Marketwatch, November 26, 2018.

[3] Ibid.

[4] Craig Torres and Jeanna Smialek, "Fed Vice Chair Clarida Backs Gradual Rate Hikes," Bloomberg, November 27, 2018.

[5] Christopher Condon, Rich Miller and Jeanna Smialek, "Powell Sees Solid Economic Outlook as Rates 'Just Below' Neutral," Bloomberg, November 28, 2018.

Glossary

S&P 500 Index A popular benchmark for US large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

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