Market Perspectives

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November Re-Cap

In the aftermath of October's equity collapse, a nearly-two standard deviation outcome, November produced modestly positive equity returns of 1.5% after a late-month rally. The rally was spurred by dovish Federal Reserve Board (Fed) commentary on November 28, benign U.S. economic news and hopes for a temporary U.S./China trade truce. Despite the positive returns, risk assets failed to stabilize, with volatility remaining at elevated levels. Crude oil was down 22%, Treasuries rallied and high-yield credit spreads widened - all within the context of a continued downgrade of growth prospects overseas (particularly in China) and European political uncertainties. While the resignation of Attorney General Sessions likely serves a precursor for continued partisan rancor, the in-line U.S. mid-term election outcome was welcomed by the markets. The crude crash came about on excess supply concerns as the administration's waivers on Iranian oil export sanctions surprised investors heavily positioned for a tighter market.

Contrary to what one might have heard, U.S. economic news was quite supportive from virtually all perspectives (save trade), whether that be growth, inflation or Fed guidance. The October employment report of a massive 250,000 in job growth in combination with wage gains of only 0.2% set the tone for the month in that growth was slowing but still strong, while wage pressures were growing gradually but with little follow through to unit labor costs and inflation.

While the economy is not as strong as the 0.8% month-over-month gain in retail sales might suggest, it is hard to argue with manufacturing overcoming the strong dollar and weaker auto production to grow at 5% annualized rate (the most in 10 months) or with consumption growth running at more than 3% annualized. With consumer confidence holding near 18-year highs despite October's equity collapse, it should (but probably does) come as a surprise that economists have been forced to upgrade their fourth-quarter growth estimates to north of 2.5%.

Inflation

Inflation developments and (not unrelated) Fed guidance were also reassuring datapoints. While some of the headline inflation-related news might suggest accelerating inflation pressures, the near-term inflation outlook appears quite benign, somewhat to my surprise. For example, while annual wage gains have steadily risen to over 3% and are headed higher, the rise in broader unit labor cost has been much more subdued as total compensation cost growth has moderated from 4% to 3% just as a modest productivity gain has kicked in. Similarly, while the 0.5% monthly Producer Price Index headline looks like a spike, a core measure came in at a more moderate 0.2%.

As to inflation itself, the increase in headline Consumer Price Index (CPI) to 2.5% was entirely oil-related and will soon reverse; core CPI was a more modest 2.1%. Finally, the Fed's monthly core Personal Consumer Expenditures (PCE) inflation was only 0.12%, dropping the annual rate to only 1.8%, a 7-month low. While Fed Chair Powell's November 28 communication that "rates were just below neutral" was characterized as walking back his previous (pre-October crash) guidance that "rates were a long way from neutral," the change seems entirely consistent with less frothy asset markets and benign inflation developments.

International Economies

In contrast, international economic news continued to disappoint, particularly in China and in Europe, the two being somewhat related given the importance of the latter's exports to China. Foreign central bankers remained offstage. European manufacturing weakened for the 11th straight month, while German numbers on manufacturing and exports missed badly. Italy's proposed 2.4% deficit based upon a 2019 growth rate of 1.5% appeared even less believable as its growth fell into negative territory.

While the expectation is that the Eurozone will bounce back from disappointingly weak 0.2% third quarter growth (on one-off auto related inventory issues), concerns remain. The U.K. experienced its strongest three-month growth in over two years, but momentum has stalled as Brexit uncertainty has increased. China's export growth surprised to the upside, but the report was dismissed as being driven more by tariff-front running than by resilient trade partners. More importantly, hopes for a near-term turn in China's growth trajectory were dashed with October's fall in credit growth (total social financing) to 728 billion RMB (versus expectations of 1300 RMB) as manufacturing growth fell to its lowest level in two years. Japan was an outlier as the economy improved on a strong manufacturing report. Central bankers were conspicuous by their reticence, with the European Central Bank (ECB) noting only that growth had moderated and the BoJ simultaneously reducing inflation forecasts while warning of increased financial stability risks.

Equities

U.S. equities gained 2%, bouncing back initially as mid-term election results met expectations and then again late month on Fed Chair Powell's dovish comments. Value outperformed growth by 180 basis points (bp) and was entirely a large cap phenomenon. More tellingly, investors rotated into defensive shares, which beat more cyclic peers by 4 percentage points. The healthcare sector spiked 7%; energy (oil price plunge) and technology (Apple -18%) lagged with losses approaching 2%. Real estate investment trusts responded to interest rate relief with 4-5% gains, while the commodity-impacted master limited partnership sector could not keep pace, falling 1%.

Non-U.S. equities gained 0.85%, led by a 4.3% gain in emerging markets which were propelled by lower interest rates, a weaker dollar, lower oil prices, more dovish Fed commentary and hopes that the G20 summit would provide a pathway to peace on the trade front. Developed market equities were little changed at -0.2%, with smaller capitalization issues and European news restraining returns. While strong currencies boosted New Zealand and Australian markets, core Europe was particularly weak, with U.K., Germany and France losing nearly 2%. Ireland fell 5% on Brexit concerns and Norway fell 6% with the oil complex. Emerging market gains were strongest in Asia and/or energy importers, with India +12%, Indonesia +10%, South Africa +9% and Hong Kong +6% pacing advancers. Russia was flat despite higher oil prices, while Brazil fell 1%.

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Bonds and Interest Rates

In line with global markets, Treasury yields declined with the 10-year yield falling 16bp Longer-dated issues returned 1.9%, more than twice the Treasury aggregate. Despite the risk-free rally, credit markets were weak for the second consecutive month. Corporate bonds returned -0.6%, with spreads widening 20bp as the Fed labeled the sector a systematic risk. High-yield bonds fell 0.9%, with particular weakness in the lowest rated segment as CCC-rated issues returned -3.5%. Emerging market debt was mixed, with the 28bp spread widening, causing dollar sovereign bonds to return -0.6%. In contrast, local currency debt gained 2.8% as currencies bounced and yields fell 14bp. Municipal bonds were also an outlier, gaining more than 1%. Elsewhere, German, French and U.K. yields fell around 7bp, with the latter trading in a wide 20bp range reflecting Brexit developments. Italy was an outlier, with yields falling 21bp on hopes that the coalition government might be open to a budget compromise.

Currencies and Commodities

Despite the dovish inflation news and Fed guidance, the dollar was little changed against advanced economy countries, with the yen and pound sterling modestly weaker. In contrast, emerging-market currencies bounced back 1.5%. Energy importers, like Turkey, India and South Africa, saw 6-7% currency spikes, with the latter helped by a rate hike and encouraging growth. With a stable Chinese yuan, related Asian currencies also rallied, with Australia +3%, New Zealand +6% and Korea +1%. In contrast, the Russian ruble fell 2% with energy prices and the Brazilian real gave back some recent gains, falling 4%.

November was a volatile month for commodities, not just for the constituents themselves, but as among alternative indices, with the Commodity Research Bureau index's 5% decline splitting the difference between the Goldman Sachs commodity index (-11%) and the Bloomberg index (-1%). The variance is explained by differential weights to and within the energy complex. An unexpected supply imbalance drove crude oil down more than 20%, while natural gas spiked more than 40% as unusually cold weather entering the heating season came at a time of already below-average inventories. Record levels of U.S. oil production and the surprise announcement that waivers were being granted to major importers of Iranian oil blew-up positions predicated on a sanction-induced fourth-quarter price squeeze. While the price decline was based upon a revised supply/demand outlook, technical factors also played a role as speculative long oil positions started at an all-time high and many simply liquidated. Elsewhere, base metals weakened on China growth fears. Copper was an outlier, gaining 4%. Precious metals were little changed.

December Positioning and Outlook

While volatility never really receded in November, it has found a second wind over the first week of December. The VIX equity volatility metric has increased by 35% (18 to 24) and the bond-equivalent index has approached first-quarter highs. More conventionally, U.S. equities have fallen up to 5% in December while touching year-to-date late October and November lows. There has been little differentiation between U.S. growth and value stocks. Foreign shares are outperforming by around 2 percentage points. Long-dated Treasuries have continued their recent rally, tacking on an additional 2.5% gain. The dollar was slightly weaker. Crude oil was up 2% after a modest OPEC production cut. Interestingly enough, both high yield and emerging market debt returns have remained in the black.

Setting aside the all-important caveat about the U.S./China relationship, there has been no obvious news to “explain” this month’s renewed downdraft. If anything, the economic news has ranged from positive to benign with November’s strong manufacturing report reversing much of October’s fall, consumer confidence maintaining an elevated level and a November jobs report that fell well short of expectations at 155,000, but showed no real pockets of weakness.

Minor Correction or Major Deleveraging?

While the increasing share of quantitative, algorithmic and systematic trading strategies has weakened the signal-to-noise ratio, it is still worth asking what the markets have been trying to tell us. More specifically, is the October equity downturn that has resumed in December simply a minor correction that became a major deleveraging event or is it the harbinger of a 2019 recession?

Investors recently have reassessed their sanguine view that the still strong U.S. economy (and thereby its stock market) could continue to diverge from an international economic environment characterized by steadily declining growth rates (with China at the epicenter), coupled with a range of related political developments, from Brexit outcomes, to Italian budget issues and the overriding U.S./China trade disputes. Not surprisingly, a) the quarterly double-digit fall in equities, b) the 30% crude oil plunge, c) the related relentless decline in 10-year Treasury yields from 3.24% to 2.84% and d) inversion of a part of the Treasury curve have raised recession fears despite the Fed’s obvious communication effort to walk back the hawkish language that precipitated the October decline.

While markets initially rallied on an apparent trade-war truce that came out of the Buenos Aires summit, the U.S. arrest of a leading Chinese technology company’s executive has fueled fears, justified or not, that the U.S. objective for China may be more one of strategic containment than simply fair trade. To quantify the risks, the New York federal reserve model of 12-month recession odds spiked 4-fold since February to 16% as of Nov 30. It is probably close to 20% today (versus over 40% in March, 2008).

Exaggerated Recession Risks

Although these elevated fears over recession risks are not totally misplaced, to my mind they are highly exaggerated. While U.S. growth inevitably will slow from 4.5% in the second quarter towards a long-term trend level, given our favorable current conditions, it is hard to find excesses in the economy that would cause growth to deteriorate much below 2%, let alone a negative number. Last month, I highlighted the much-overlooked reality that U.S. growth is actually surprising to the upside, with 2.7% being a reasonable fourth quarter estimate. Conceding that the economic expansion is already late stage at a near-record 114 months, the question becomes one of the timing and depth of the next recession. At this point, at or above trend 2% growth seems likely into 2020, with recession more a 2021 phenomenon than anytime earlier.

My relative economic optimism, particularly as to recession risks, is based upon considerations that:

- the reduced risk of an inflation spike removes a potential boom/bust scenario and extends the potential expansion;
- growth should be sufficient for the labor market to continue to tighten, lifting real wages, particularly after the 30% oil price decline;
- interest sensitive sectors such as housing may weaken further but from only unusually low levels;
- financial conditions, while admittedly tighter, are by no means restrictive; and
- global economic divergence may actually be a good thing.

The most recent significant change in our outlook is that U.S. inflation and wage pressures have certainly increased, but not nearly to the levels I had expected and feared. As discussed in last month’s memo, that lack of follow-through in inflation increases (core inflation has actually receded in recent months) has greatly reduced the risk of a boom/bust cycle where inflation spikes to 3%, causing the Fed to tighten aggressively and thereby triggering a recession. Whereas 2018 saw headline inflation hit 2.7% with core inflation bracketing 2.0%, much of 2019 will see the effect of oil prices take headline inflation to the 1.6% range, with the lower imported prices keeping core inflation below 2%. While the tightening labor market will take core inflation back over 2.0% by the end of 2019, the Fed has the flexibility to tweak its gradualist glidepath.

Labor Market

The labor market and the household sector in general is in rude health with the wealth-to-income ratio at a record high. The recovery in home prices has boosted middle class wealth at the same time as a strong labor market has boosted real median household income by over 10% from 2014-2017, the strongest reading in the series' 50-year history. With unemployment below even the lowest estimates of full-employment, any growth in excess of 1.8% going forward should be sufficient to drive increasing real wages. This continued wage growth should sustain consumption growth and mitigate the decline in household durables purchases, given the healthy 6% savings rate, debt as a percent of income being close to a 15-year low and generally declining new delinquency rates on student loans, credit card and auto debt (even for millennials).

A housing downturn, both in terms of its potential direct drag on gross domestic product (GDP) through homebuilding (with its multiplier effects) and its indirect effect as potential loan losses ripple through the banking system, is unlikely to trigger the next recession. This is not 2006. Residential investment is only 3.9% of GDP, not 6.7%, so little excess needs to be wrung out, particularly as homebuilding levels have not kept up with underlying demographic trends. Home prices are not out of line with rents and incomes. Home vacancy rates and inventories are at near-record low levels. (As an aside on non-residential investment, while it is true that corporate capital spending does not seem to have responded to the corporate tax incentives and is actually decelerating, the downside seems limited as our capital stock is the oldest it has been since 1963).

Financial and Economic Conditions

Overall financial conditions are little changed from October-end levels, as the additional negatives in the form of the subsequent lower equity prices, wider credit spreads, and higher volatility have been fully offset by the benefits of lower Treasury yields and oil prices, as well as a weaker dollar. I had estimated that October's market moves were equivalent to roughly 40bp of Fed rate increases. So, it is believable that the Fed might remove two rate hikes from its 2019 plans, especially given benign near-term inflation prospects. Assuming that the core inflation rate rebounds above 2% within a year, it is hard to see a real (after inflation) Fed funds rate of only around 50bp appreciably slowing the economy.

While much has been made of the potential benefits of globally coordinated economic policies, economic divergence has its virtues. China's debt-fueled fiscal stimulus cushioned the post-global-financial downturn for the rest of the world. Perhaps, in a much smaller way, the seemingly inappropriate Trump stimulus package at the time of a U.S. cyclic peak has served a similar role over a period in which China's growth has deteriorated (ironically as a function of a policy response to the debt-driven excesses of the past). While international growth estimates continue to be marked down (with capital spending particularly weak), the starting point was relatively high: more than 80% of the 34 Organization for Economic Cooperation and Development countries at or past full employment and the share of countries with expanding manufacturing falling from 95% (but still at 75%).

Most importantly, the rest of the world is more leveraged to trade and to China than the U.S. Hopes for a near-term rebound in Chinese growth are premature given still deteriorating credit conditions, particularly for the private sector. However, an expected fourth-quarter rebound in Europe (unemployment and wages are better than European Central Bank forecasts) might shift sentiment in front of an expected recovery in China's growth after mid-2019. While the debt overhang might create multiple years of subsequent sub 5% growth, the Chinese recovery might prolong the U.S. expansion.

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