Market Perspectives

Sentinel Trust Company, LBA
Investment Committee
Bruce L. Swanson, PhD
JANUARY 2019

December Re-Cap

Global equity markets experienced their worst December in more than 50 years, with losses of more than 7%. Investors lost confidence that U.S. growth would remain resilient in the face of the continued slowdown in the rest of the global economy.

Equity declines were U.S.-centric and magnified by a weaker dollar. European, and particularly, emerging market equities were relative outperformers. Outside of the market dynamics themselves, including a Treasury-yield-curve inversion, there was no one particular trigger. There was a seemingly steady stream of negative global news including plunging commodity prices (oil down 11%), an unwelcome trade war surprise (arrest of Huawei's CFO), ongoing Brexit uncertainties, French political protests and disappointing overseas growth. Selling begat selling. Treasuries and other investment-grade bonds finally lived up to their safe-haven reputation.

U.S. equities were sharply lower, with less-dovish-than-expected Federal Reserve Board (Fed) guidance adding to the selling pressure. The broad U.S. equity benchmark fell 9%, with smaller capitalization shares underperforming larger peers by 300 basis points (bp) and growth stocks were 100 bp better than value stocks. While it was not a surprise that financials (-11%, recession fears and flatter yield curve) and energy (-13%, a further double digit oil fall) led decliners, there were some unusual patterns in an equity market that left no place to hide. For example, technology shares outperformed the overall market and even the safe-haven consumer staples sector. While cyclic shares slightly underperformed the value segment, even the Russell 2000 defensive index fell double digits. Only a post-Christmas bounce triggered by strong holiday sales and a drop in jobless claims kept the monthly loss in the single digits.

"While it was not a surprise that financials (-11%, recession fears and flatter yield curve) and energy (-13%, a further double digit oil fall) led decliners, there were some unusual patterns in an equity market that left no place to hide."

Overseas Markets

It was a somewhat different picture overseas, as international equities losses of 4.65% were roughly half those of the U.S. Developed markets fell 5%, while emerging market equities lost only 2.5%. There was little distinction between growth and value as risk aversion and commodity-price moves impacted individual markets.

Of the 94 primary-country markets tracked by Bloomberg, 25% finished in the black (the U.S. ranked 89th). Japan led decliners at -7.7% despite industrial production and retail sales beating expectations. Most probably global growth fears and a spike in the yen spooked the equity market. In contrast, the United Kingdom and the Eurozone lost only 4% in the face of soft growth and ongoing political challenges. Despite currency gains, Chinese equities fell 4% as manufacturing growth weakened to two-year lows. The Mexican market bounced 3.3% as investors thought their negative reaction to new President AMLO's policies might have been overdone. Russia fell victim to weaker oil prices (losing 5%), but energy rich Nigeria

and Indonesia remained in the black.

While December's market action suggested a sudden downturn was imminent, there was no "smoking gun" in terms of economic reports that could be tied to the U.S. equity plunge. Numbers that fell short of estimates were hardly alarming. The December 7th release of the November jobs report was a good example. The 155,000 figure was well short of the 200,000 consensus, but there was nothing to support an extrapolation to the downside. Admittedly, reports were consistent with decelerating growth outside of the red-hot consumer sector, with manufacturing output and capital expenditures on track to slow from 4.0% and 3.4%, respectively, in the third quarter to 1% and 2% in the fourth. Inflation pressures were subdued. The Fed's preferred core PCE inflation gauge fell to 1.1% on a three-month annualized basis, restrained by a modest productivity pick-up.

Interest Rates and Bonds

As expected, the Fed digested the benign inflation news and more pessimistic capital-market-based outlook before announcing a "dovish" rate hike on December 19th. The 25 bp rate hike was accompanied by downgraded 2019 growth (from 2.5% to 2.3%) and Fed funds forecasts (3.1% to 2.9% for 2019 and 3.4% to 3.1% for 2020). The guidance disappointed investors (who were hoping that rate hikes would be officially paused), but Fed officials sounded increasingly dovish thereafter as equities fell further and the futures market began to imply actual Fed rate cuts.

The combination of recession fears, benign inflation, plunging equity markets and firmer-than-expected Fed guidance propelled a powerful Treasury rally. The rate curve flattened markedly, with long-term yields plunging 30 bp versus 8 bp at the shorter-end. This translated into meaningful Treasury returns, with 5% gains at the long-end and 1.6% for even for 4-year maturities. Foreign bonds did even better in the global flight to safety as dollar weakness contributed to a 2.2% gain. Japanese bond yields fell back into negative territory, while Italian yields fell 47 bp after a budget compromise with the European Union (EU).

U.S. credit markets were bifurcated by quality, with the investment-grade-corporate-bond index riding the Treasury rally to a 1.5% gain, as spreads widened only 15 bp. Similarly, even high-quality 5-year municipals gained 1%. In contrast, non-investment grade issues fell victim to recession fears, risk aversion and plunging energy prices. Leveraged loans lost 2.5% as investors woke up and sold after noticing frothy valuations and deteriorating credit metrics at a time when protection against Fed rate hikes was no longer in demand. U.S. high-yield bonds returned -2.1% (with the CCC-rated segment losing 4.4%), but the global high-yield benchmark lost only 0.75% as dollar weakness and the lower energy sector weight limited the damage. Emerging market debt outperformed. Investment-grade issues experienced a 1.5% gain as dollar sovereign spreads widened only 20 bp and local-currency yields actually fell 16 bp. The higher yielding municipal market also proved resilient (gaining 1.2%). The combination of wider credit spreads and plunging energy prices hurt master limited partnerships which lost 9% (real estate moderately outperformed with the global benchmark losing 5.6%).

"non-investment grade issues fell victim to recession fears, risk aversion and plunging energy prices"

Currencies and Commodities

While the dollar index officially fell 1.1%, individual moves were largely driven by risk aversion, carry-trade unwinds and commodity price declines. The Swiss franc gained 2% and the Japanese yen spiked 3.5%, as year-end illiquidity magnified the flight-to-quality bid. Commodity and global growth concerns triggered 2-4% declines in the dollars of New Zealand, Canada and Australia. While the emerging market index was modestly lower, China's renminbi actually gained 1.5% as greatly reduced Fed rate-hike fears lessened China disorderly capital-flight fears. Among the major emerging market currencies, only commodity-exposed South Africa and Russia fell. At the other extreme, Argentina and Mexico gained 4%. Eastern Europe also was strong as the Czech koruna, Hungarian florin, Polish zloty and Romanian leu were up as much as 2%.

Commodities fell 7-8% regardless of the chosen benchmark as the weakness was broad-based. Precious metals were a noteworthy exception. Gold was up 5% on falling Fed rate fears and the associated weaker dollar. Silver gained 10% despite industrial-slowdown fears. Oil fell 11% as new worries over a demand falloff exacerbated pre-existing oversupply concerns. The OPEC/Russia decision to cut production failed to support prices. Not even Mother Nature came through as warm weather dashed hopes for a polar-vortex driven price spike, with natural gas falling 36% (giving up all of its quarterly gains). Cyclical metals weakened on growth concerns with copper, nickel and zinc falling 4-5% and aluminum down 7%.

January Positioning

Through the first two weeks of January, risk assets have partially recovered, with global equities up 4% and high-yield bonds up 3%. Most importantly, the release of an unusually strong December employment report has caused market consensus to rapidly flip towards our view that near-term recession concerns were overstated. Coincident with the Fed's not surprising admission that financial-market tightening was in fact a partial substitute for 2019 interest rate hikes,

our preferred tilt towards more cyclic sectors (in direct opposition to the universal call for high quality defensive shares) has played out, at least for now.

Conclusions based upon a single data point are fraught with risk. However, the January 4 release of the December employment report re-set the macroeconomic context along several dimensions. The headline jobs gain of over 300,000 compared to estimates of 185,000, with the prior two months revised upwards by 60,000. In addition, wages grew faster than expected, with the annual change increasing to 3.2%. The magnitude of these gains in employment and household income, particularly given lower gasoline prices, suggests sustained strength in consumer spending, rather than any imminent falloff. Perhaps most impressively (and surprisingly), 420,000 people entered the workforce as the participation rate increased to 5-year highs. While this inflow caused the unemployment rate to actually increase from 3.7% to 3.9%, it is demonstrably good news in reducing the risk that we were on the cusp of a recession-inducing boom-bust in the labor market. It suggests that the labor market was less overheated that I had thought.

The timing and content of this employment report was most welcome. However, it is also a reminder that, with investors hyper-sensitive to downward inflections in the economy, data-dependent markets are likely to remain volatile, with every data release potentially extrapolated into a new narrative. Looking through the likely economic noise, I think the single biggest question is, "At what point in 2019 (if at all) will employment growth slow to the extent that upwards pressure on the labor market is removed?" More particularly, if the market is correct and the Fed pauses for all of 2019, would the economy naturally slow on its own and "land" safely and softly?

Fed Predictions

My sense is that the market is overly complacent in thinking the Fed has completed this rate hike cycle. Expectations had even briefly moved to forecasting a rate cut in 2019. With the post-Christmas rally, U.S. financial conditions have significantly loosened and are now back down to pre-December levels. While the possible inclusion of financial markets into the Fed reaction can make it seem that the Fed is chasing its tail, it is hard to see current conditions as sufficiently restrictive given the still strong growth and late stage of the economy.

"the market is overly complacent in thinking the Fed has completed this rate hike cycle. "

As discussed in last month's report, what has changed is that the likelihood of benign upcoming headline inflation gives the Fed the luxury of postponing the next rate rise until the second quarter. That hike will become seen as necessary, as above-trend near-term growth contributes to continued wage pressures, sticky core inflation of 2% and a steeper yield curve. An additional 2019 rate hike is likely at year-end, particularly if prospects for international growth have improved.

China

If the December jobs report told us little about where the U.S. economy might be in a year, at least it gives us a good sense of where we are today. In contrast, given the tendency for Chinese economic data to be smoothed, particularly in downturns, it is harder to know where the China and, by extension, the global economy is today. The trade war has complicated this issue, as tariff front-running caused Chinese exports to temporarily spike as trade tensions escalated. In recognizing our limitations, we have sought only to qualitatively call direction and inflection points, but if pushed would assume current growth of 3-4% (300 bp less than official numbers).

A problem with even my 3.5% current estimate is that I judge China's potential intermediate-term growth to be only of that same magnitude, as the hangover from their debt bubble will be long-lasting. But if the numbers are the same, where is the recovery? In mid-December, an economics professor at China's Renmin University may have provided an answer when he caused a stir in suggesting that China's current growth was less than 2%. If true, that is both good news and bad news: bad in that the global economy is weaker than we might think, particularly as China's growth rate has continued to fall; good in that non-U.S. growth might be stronger in the second half of the year as China growth inflects to a higher but relatively subdued new trend level. Such a growth pattern in 2019 would also be supportive of the Fed hiking only once in the first half of the year and then a second hike towards year-end in the context of sticky core inflation and recovering international growth.

Equity Valuations

It is worth remembering that U.S. equities remain overvalued. While the forward price-to-earnings estimate has declined to a seemingly innocuous 15X, the market is actually selling at a premium (when adjusted for non-operating charges) at a late cycle period of near-peak operating margins, especially in the technology sector. While market-capitalization-to-gross-domestic-product percentages overstate the downside risk, it is hardly reassuring that, while down from a 44% peak, the current 39% reading compares to dot-com and pre-financial crisis peaks of 30% and 25%.

One tip-off that some froth remains in the market is that the most shorted technology stocks have not yet underperformed after gaining 40% through September 30th versus only 15% for global technology shares. Far from giving back those gains in the subsequent market correction, they have outperformed by an additional

200 bp, including 600 bp in 2019. This suggests that some degree of short-covering is contributing to this year's rally and that selling into strength makes some sense.

Together, families prosper℠

Sentinel Trust
2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com