RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

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STATE OF THE MARKETS

Equities entered correction mode in the fourth quarter as the weight of persistent trade uncertainty and higher interest rates began to take its toll on the global economic outlook. The S&P 500 dropped nearly 20% from its September high through Christmas Day, followed by a subsequent small bounce back to close 2018 down just over 6%.

The primary culprit for the equities volatility and decline for 2018 was trade uncertainty. Despite a much-awaited-for meeting with China at the G-20 summit in late November that produced some progress on a trade deal, delaying an increase of tariffs on Chinese imports for at least ninety days, the markets clearly have become skeptical that the trade spat will soon reach a favorable conclusion. It has become increasingly apparent that the Trump administration views tariffs as a necessary tool to promote the U.S. economy and may continue to press trade wars through the remainder of the president's term. As Chinese economic indicators have shown slowing growth, coupled with similar slower growth in Europe, investors are beginning to see the economic impact of trade wars around the globe.

In addition to trade uncertainty, investors also eyed the Federal Reserve's rate hike guidance in hopes that a more dovish stance would materialize and the Fed would reduce the number of rate hikes forecasted for 2019. Yields continued to rise during the year, further increasing input costs for businesses already grappling with higher costs from potential tariffs. Notably, the U.S. Treasury yield curve inverted in December, meaning that short-term yields were higher than long-term yields, which is a bearish indicator for the economy often observed within two-three years prior to an economic recession. In fact, every recession since World War II has been preceded by a Treasury yield curve inversion. At its December meeting, the Fed projected a slower path of rate hikes for 2019, but in total it signaled a determination to continuing tightening monetary policy.

As a result of the trade and interest rate headwinds, investors drew money out of equities despite strong corporate earnings growth (+23% for the year), GDP growth (~3%) and lower stock valuations than in recent years (~ 14 x Forward P/E for the S&P 500). As discussed in this market letter, we observe that the balance of economic indicators does not indicate an imminent economic recession in the U.S. Yet market sentiment has clearly turned pessimistic, in part because no one can predict the ultimate length and impact of the trade war with China. Therefore, based on fundamental economic conditions and anticipated mid-to-high single digit earnings growth, we feel that 2019 should be a positive year for equities, albeit with the caveat that the cloud of trade uncertainty with China must first dissipate and the Fed must provide a clear path to interest rate normalization before markets recover.

Review of the Fourth Quarter

Markets Weaken Under Strain of Trade Wars; Rate Hikes

We have stressed the negative impact of trade uncertainty in several prior market commentaries in 2018, as well as in the run up to the 2016 election. Prolonged trade wars and artificial trade barriers have a chilling effect on economic activity over time. While the threat of tariffs can obviously be used to extract concessions from trading partners, falling into a prolonged trade war is a dangerous economic game. In the fourth quarter, it seemed that the U.S.-China trade war's impact on the market moved from general, non-specific fears among investors of eventual economic harm to the reality that businesses are beginning to withhold investment and global economic conditions are being harmed. The U.S. cannot insulate itself it from the global economy and markets have begun to worry that the U.S. economy will weaken as a result.

Even if the U.S. can protect certain favored industries against foreign competition more effectively with the real threat of tariffs, it is unlikely that this will ultimately lead to a revitalization of American manufacturing or that other industries won't be harmed more to offset any benefit. For example, the U.S. trade deficit with the rest of the world has only widened during the Trump presidency as recent economic growth has stimulated greater imports, not exports. Further, tariffs on imported goods act as a tax on American consumers as prices rise throughout the supply chain. To this point, steel prices, both domestic and foreign, have increased since the steel tariffs were instituted in 2018.

In this sense, we feel that the market concern over the persistent trade uncertainty is a valid concern that should (and will) be addressed in the first quarter. President Trump is uniquely attuned to market developments as he views the performance of the stock market as a litmus test for his success and failure and the financial health of Americans. Be that as it may, it is unlikely that a complete trade deal will be agreed to within the ninety-day period agreed to on December 1. The issues of intellectual property theft by the Chinese or market access for foreign businesses, for example, are too complex to lend themselves to a written resolution of any specificity in a trade agreement. However, we feel that the parties will seek to show progress within this time period and then ultimately extend the deadline for a negotiated deal.

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The second prong of the stock market's recent correction arose out of concerns that the Fed may be too aggressive in raising interest rates given economic conditions. President Trump has repeatedly blamed Chairman Jerome Powell and the Fed's interest rate hikes for the market unease. However, whereas we feel that the market is justified in being concerned over trade, we do not feel that investors should fear the Fed as much.

The yield curve between the 2 and 5 year notes inverted on December 3, however this phenomenon does not in and of itself cause a recession, but merely is indicative of a late-cycle economy that may experience a recession in the next two-to-four years – a recession time-period that we have repeatedly suggested is probable based on normal economic fundamentals. In other words, yield curve inversions are correlated with recessions within – on average – two to three years, however there is no direct causation. This correlation is because the Fed tends to hike rates on the short-term of the yield curve while investors buy long-term bonds (lowering long-term yields) when they are fearful a recession is about to occur. However, we feel the current yield curve flattening and slight inversion are somewhat misleading as a current indication of economic health.

Why might conditions be different this time around? For one, the Fed is attempting to unwind the largest bond buying stimulus in history and conclude the rate hike cycle in the U.S. while central banks around the world have not yet even begun to raise rates and still maintain negative interest rates in some countries. Therefore, as the Fed unwinds this historic stimulus effort, there will naturally be pressure for short-term rates to move higher. On the long-end, rates are being pressured lower by two factors – panic over a recession in the near-term as well as strong international demand for higher yielding safe-haven bonds. We also feel that the Fed is near the end of the rate hike cycle. At the December meeting, the Fed signaled two rate hikes for 2019, yet since that time, investors have priced into Fed Funds futures an expectation of zero rate hikes for 2019. If uncertainty abounds in the first quarter, we expect the Fed to soften its stance more in line with this market expectation.

To summarize, yield curve inversions are usually a symptom of an economy over-heating, pushing the Fed to raise rates on the short-end quickly while investors begin to fear an imminent recession and buy bonds on the long-end. However, currently, the Fed's rate hike cycle is skewed by the need to unwind the tremendous bond – purchase programs of the economic recovery and is not actually a response to an over-heating economy (see discussion of economic conditions below). Further, long-term bond yields are not being pushed higher in lock-step with short-term bonds in part because the rest of the world is still in post-crisis low-yield environment. Therefore, while we feel markets are right to be concerned over trade, we feel that the fears over interest rates will likely subside when the Fed softens its stance in the quarters to come.

Outlook for 2019

Differentiating Between "Slowdown" and "Recession"

Looking ahead to 2019, consensus expectations for economic growth and corporate earnings growth currently hover around 2% and 7%, respectively. While both data points would mark a slow-down from 2018 growth numbers, they do not indicate a recession. Consensus GDP growth expectations are still generally above the Fed's 1.8% long-run projection. However, many investors seem to be conflating the concepts of an economic or earnings "slowdown" with an imminent economic or earnings "recession". A year with a slowdown in the rate of growth is still a year in which the economy is growing. A recession is reflected by a contracting economy. Growth numbers achieved in 2018 were abnormally high and likely not sustainable over the long-term. Bolstered by fiscal stimulus via corporate tax cuts, the U.S. economy grew at ~ 3% for the year and corporate earnings surged over 20%. While strong growth is always welcome, this is not to be expected every year. Rather, mid-to-high single digit earnings growth supported by 2-3% GDP growth is reflective of a mature, strong economy with low unemployment, moderate inflation and support from corporate earnings growth.

Importantly, there are no current indications of financial excesses such as were seen prior to the Great Recession in the housing markets or prior to the dotcom bubble in internet stocks. Some have pointed to the rise and fall of cryptocurrencies like Bitcoin as an area of mania reflective of prior excesses, however this is much more of a niche bubble than the aforementioned housing and dotcom related excesses. Nevertheless, it seems that markets are clearly being driven by emotion and negative sentiment derived from trade and interest rate related uncertainties.

We believe that the combination of the dominance of quantitative hedge funds that employ algorithmic based trading strategies, as well as retail investors that increasingly rely solely on passive investing through ETFs, have led to greater market volatility. A substantial amount of market trading is now being driven through quantitative hedge funds. Through computerized trading, large blocks of the market can swing drastically at a moment's notice due to headlines or daily trading indicia. Further, a large portion of the market is also driven by bets on indices or strategies through ETFs rather than analysis and selection of fundamentally-sound businesses. Often, these two tools are combined so that large traders can use automated trading to quickly move markets with bets on large indices, sectors or strategies. These areas are ripe for greater regulatory scrutiny in the future, but their combination will likely continue to drive market volatility over the short-term.

Conclusion

We feel that market sentiment can turn back towards the positive if the headwinds from trade and interest rates discussed above subside. If these headwinds do subside, we expect equities to push higher. We also see a stabilization in energy markets after the substantial slide in crude prices in 2018 to be a potentially positive development during the year as supply-demand imbalances correct through coordinated action of OPEC and others. To this end, we recommend emphasizing the financial, energy, and healthcare sectors with select exposure to technology stocks given current market valuations. Industrials and consumer discretionary stocks could also rebound well if global macro-economic uncertainty subsides and the consumer remains healthy in this late-cycle economy.

Over the long-term, equities out-perform other asset classes but should be devoted solely to investors' long-term wealth accumulation goals. It is important to remember that the Dow hit an all time high of 14,000 prior to the financial crisis and today sits at over 23,000. Investors that took a long-term view of their equity holdings and stuck with their investment planning back then are much better off today than prior to the financial crisis. Investors that panicked during the financial crisis and exited the market only to attempt to buy back in as the situation improved were hurt the most.

Nonetheless, we encourage all clients to consider a review of their financial and retirement planning to ensure proper investment allocation moving forward. In the current environment, it is imperative that clients do not have assets devoted to equities that are needed for fixed, short-term living expenses. Further, as the market's risk profile and investors' risk tolerance change over time, regular periodic financial planning reviews are always advisable. We are happy to meet with clients to discuss their financial planning needs for the short-term so that any market fluctuations do not affect your day-to-day lifestyle.

As usual, all comments are welcome.