Market Update

December 17, 2018

Themes Driving the Markets

Major Market Driving Themes

1. Federal Reserve Interest Rate Policy Decisions
2. China-Trade Negotiations and Economic Slow Down
3. Yield Curve Flattening

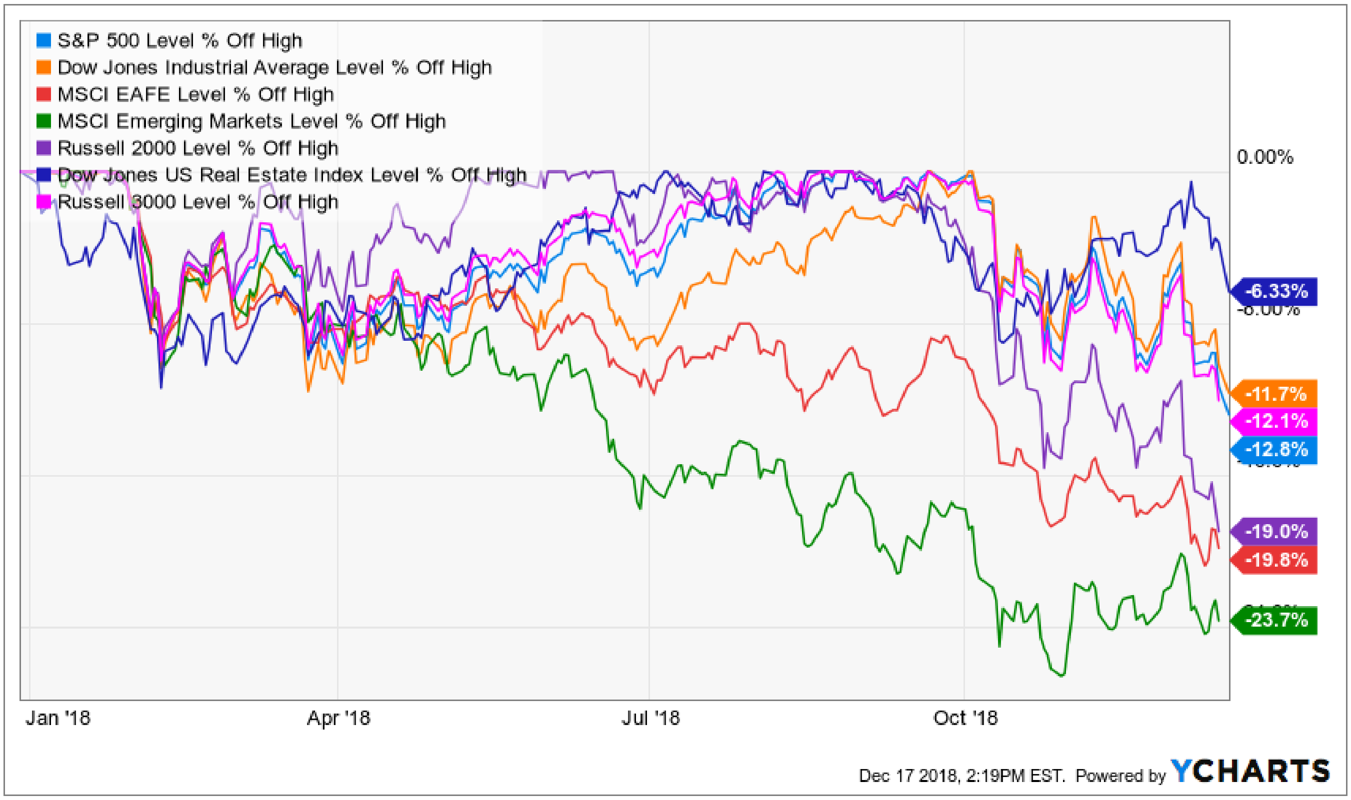
Other Important Market Drivers

1. Government Shut Down
2. Paris Riots
3. Brexit
4. Algorithmic Trading
5. Length of US Recovery
6. 2019 Economic Slow Down in US
7. Prospect for more investigations

The U.S. Economy is poised for a slow down according to broad sentiment. Of the above themes, the Major Themes listed are driving the headlines the most. The biggest issue right now, is that the markets are telling the Federal Reserve that they may have made a mistake and raised rates too quickly. An economic recession is determined historically by two quarters of negative GDP growth. Many believe we are far from that, but we will see a slow down in GDP for 2019. Federal Reserve interest rate policy and balance sheet policy have had a strong impact on the yield curve. The yield curve has flattened, very quickly, which suggests that the Federal Reserve should consider stopping interest rate hikes, especially in light of a global slow down. There is plenty of bear market mentality going around and rallies have failed right in the middle of trading days. Interestingly enough, we have gotten some positive news initially on trade negotiations and the Federal Reserve has signaled it will likely back off on further interest rate hikes, after this coming week's decision. China Trade issues and a fast-moving Fed have created the flattening yield curve and concerns over a slow down in the United States economy. The question markets are trying to answer is what the magnitude of a slowdown or recession may look like. We have seen the longest bull market run is US history. This had been back by a still growing labor force and the lowest unemployment numbers in decades. Another positive point has been that inflation has remained relatively tame and wages have recently shown signs of growth, which is outpacing the rate of inflation. This means that workers buying power is modestly increasing.

These second set of themes are also impacting the markets, as well. Algorithmic trading tends to fuel the downside and the upside to a market, because it looks at technical levels and headlines as its inputs for trading. These algorithmic trading programs are what has increased the volatility in intra-day price movements of individual stocks, and the over all markets, in general.

The Chart below shows how far from the recent Market Highs, hit in late September early October, the market has gone. As of the time depicted from this chart, we can see that several of the indices are in correction territory being down more than 10% from recent highs. Emerging Markets are in bear market territory down more that 20%, with Developed International markets and the Russell 2000 small cap US stock indices within 1% of a bear market.



Information in the chart above was taken from sources we believe to be reliable; however; we do not guarantee its accuracy or completeness.

For some perspective on how the year has turned out so far, the chart below provides year-to-date rates of returns for some of the most widely used equity indexes as benchmarks. Not included in the charts below, but worth mentioning, is that the price movements in bonds has for the most part been downward. Even with a flattening yield curve, bond prices have come down in general for the year, as the Barclay's US Bond Aggregate Index is down close to 1%. Some areas of the bond market are more susceptible to changes in interest rates than others, and the Federal Reserve has certainly been instrumental in the price movements in bonds overall.

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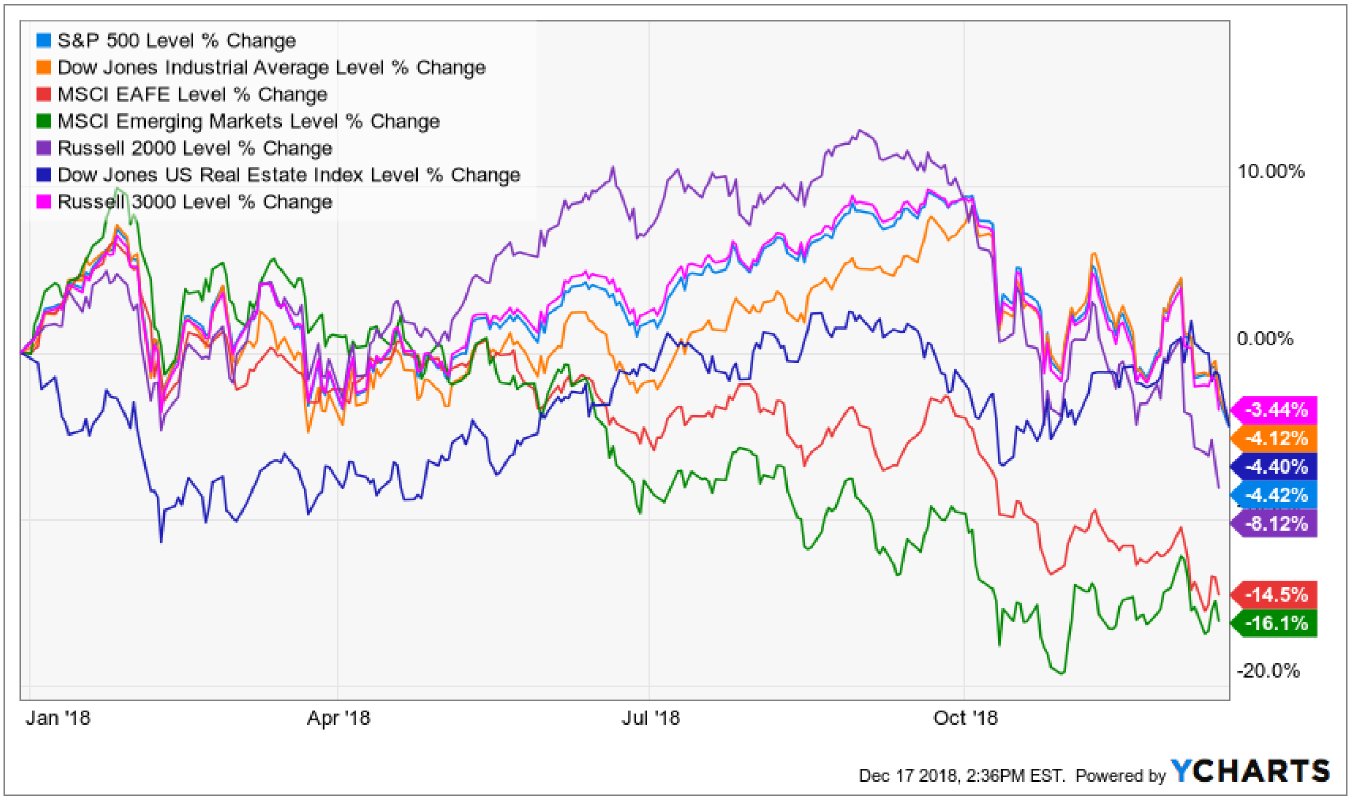

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The information in the above chart shows that international investment in equities has been the biggest underperformer, impacting well diversified global portfolios, more so than domestic equities.

We continue to feel that there are signs of a later stage economic environment. The biggest concern for the economy in the next 12 months is still the Federal Reserve increasing rates too quickly, which can stifle growth. The two biggest remaining themes impacting the markets today are the negotiations with China on tariffs and interest rate policy. How well negotiations go with China and what Jerome Powell and the Federal Reserve do this week will be critical.

Overall, we prefer domestic equities over international equites although, some international markets may become more attractive as the U.S. economic cycle continues to mature. One area that we are starting to look at making some shifts in domestic equities is between growth and value stocks. Value stocks tend to move more slowly in either direction, when the markets react to stimulus. In later stage economic environments, a tactical shift to overweighting value type stocks will reduce portfolio risk. This is an area we are now looking to make tactical changes over the course of the coming months into next year. We are currently neutral to bearish on fixed income and interest rates. It is important to maintain discipline regarding strategic asset allocation. Tactically, we recently have raised some cash from equities holdings and bond holdings that are more sensitive to price movements. Maintaining asset allocation percentages and making some small tactical changes, such as holding a little bit more cash, are important to disciplined portfolio management during times when the markets are volatile.

If you have questions or would like to discuss this further with regard to your personal portfolio, please contact me at 310-433-5378.

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