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Equities have discounted soft patch

Expect volatility until investors get clarity on China trade and Fed, which should push S&P to 3,100 by year-end.

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BOTTOM LINE

While the labor market and consumer spending are strong, autos and housing remain in the doldrums, manufacturing trends have stumbled recently and many of the business and consumer confidence metrics we monitor have fallen sharply over the past few months. There are numerous reasons for this, such as the market's overblown fear of recession, rising interest rates and confusion surrounding the Federal Reserve's monetary policy plans, and the ongoing trade and tariff skirmish with China. In addition, the lengthening government shutdown, volatile oil prices and concerns about geopolitical risk—with Brexit at the top of the list—are contributing to investor angst.

The S&P 500 plummeted 20% from Sept. 21 to an oversold Christmas Eve trough at 2,346 to price in these concerns, but stocks have enjoyed a powerful 14% V-bottom recovery ever since. Surging stock prices have shattered the critical 2,600 resistance level in the process, and the perma-bears are now scrambling to cover their shorts. At the same time, benchmark 10-year Treasury yields have risen from an overbought 12-month low of 2.55% in early January to 2.77% today, and the volatility index (VIX) has halved itself from an overbought 36 at Christmas to 17 today.

So while stocks have recovered 70% of their stunning fourth-quarter collapse over the last month, heightened volatility likely will continue through the first quarter, until we receive some clarity on several of these key investor concerns. Ultimately, we expect a positive outcome on the trade deal with China and the Fed's monetary policy path, which should drive the S&P up to our 3,100 target by year-end 2019.

Tweaking our GDP forecast The fixed-income and equity investment professionals who comprise Federated's macroeconomic policy committee met yesterday to discuss the risk of recession, China trade, Fed policy, Brexit, the government shutdown and a host of other issues:

- Third quarter GDP growth was revised down a tick to a final gain of 3.4%, versus 4.2% in the second quarter and 2.2% in the first quarter. Fourth quarter GDP is scheduled to be flashed on Wednesday, Jan. 30, but that may be delayed due to the ongoing federal government shutdown. We are keeping our estimate unchanged at 2.8%, the same as that of the Bloomberg consensus. The Blue Chip consensus remains unchanged at 2.7% (within a range of 2.2% to 3.1%), and the Atlanta Fed's widely followed GDPNow model recently raised its estimate from 2.5% to 2.8%. Although the release of December's retail sales were delayed due to the government shutdown, we are expecting a strong Christmas on the basis of October and November data, suggesting that holiday retail sales overall could rise by about 5%

y/y, the strongest pace in six years. Because the consumer accounts for 70% of GDP, that strength should offset weakness in manufacturing, net trade and inventory accumulation.

- Our full-year 2018 GDP estimate remains unchanged at 2.9%, and the Blue Chip consensus also remains unchanged at 2.9% (within a tight range of 2.9% to 3%).
- As the longest government shutdown in history closes in on a month, Kevin Hassett, chairman of the Council of Economic Advisors (CEA), now estimates GDP will be roughly 0.1% slower for every week the government is shut and 800,000 furloughed workers are not getting paid. In conjunction with brutal winter weather for the fourth time in the past five years, along with the economic concerns relating to manufacturing, trade and inventories, we lowered our first quarter of 2019 GDP growth estimate from 2.3% to 1.8% at an ad hoc committee meeting in December, and we trimmed another tick to 1.7% yesterday. The Blue Chip consensus lowered its estimate from 2.4% to 2.2% (within a range of 1.6% to 2.9%).
- We lowered our second quarter of 2019 GDP growth estimate from 2.8% to 2% at December's ad hoc meeting, due to the residual effects from the aforementioned issues. But we restored a tick to 2.1% yesterday, as we expect the government to reopen by then and to make progress on the China trade deal. The Blue Chip consensus remains unchanged at 2.5% (within a range of 1.9% to 3.2%).
- We are keeping our third quarter of 2019 GDP growth estimate unchanged at 2.5%, as we're still expecting a rebound from softer first-half trends, while the Blue Chip consensus is standing pat at 2.2% (within a range of 1.6% to 2.7%).
- We are raising our fourth quarter of 2019 GDP growth estimate from 2.5% to 2.6%, while the Blue Chip consensus remains unchanged at 2% (within a range of 1.4% to 2.5%).
- We lowered our full-year 2019 GDP growth estimate from 2.8% to 2.5% at December's ad hoc meeting, and we left that estimate unchanged yesterday. Similarly, the Blue Chip consensus remains unchanged at 2.6% (within a range of 2.3% to 2.9%).

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

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