Warm sunshine does wonders for your mood

China and the unwinding of post-crisis policies likely will weigh on markets for some time. But short of a recession, it's still a bullish story for stocks.

Published 01-25-2019

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I left Pittsburgh shivering in 5-degree weather, and spent the week in south Florida—brilliant scheduling! Starting advisor meetings in high-strung Miami, a veteran noted that clients are "much more aware" these days than ever in her career. I enjoyed predominantly "chill" visits for the balance of the week. The decor at an office in Ft. Lauderdale featured a surf board; elsewhere we were greeted by a gentleman with an infectious smile. Off to Boca Raton, one meeting spent considerable time discussing the popularity of Girl Scout cookies and investments in cannabis. A majority of markets across the globe have started to exhibit signs of fatigue (unfortunately, not chill) after rallying right back into significant resistance levels, with many of these oversold rallies taking us back into what had been strong support. Take the S&P 500, for example. Its sharp run-up out of one of the deepest oversold conditions in years has brushed shorter-term resistance levels (i.e., 2,532, 2,600) aside;

however, prior long-term support levels now weigh mightily overhead. Both the 50-week moving average and trend line off the 2009 lows are converging around the 2,730 level. Global measures of stock market liquidity continue to worsen, and the economic numbers keep weakening in response to the past several months' tapering/tightening activity. For all of the talk about the Fed's dovish turnaround, the annual rate of decline in its adjusted monetary base (the sum of currency in circulation plus bank deposits) accelerated to almost 12% at year-end from just 3% six months earlier.

Soft landings in the U.S. are rare, helping explain why investors increasingly are fretting about recession risk amid softening data and downward growth revisions (*more below*). But might these fears be overdone? Goldman Sachs notes three typical causes of recession have become structurally less threatening: 1) Better inventory management and the shrinking output share of most cyclical sectors have reduced the impact of industrial fluctuations; 2) The decline in the economy's energy intensity and the rise of shale have reduced the impact of oil-price shocks; and 3) Better monetary policy has led to a flatter, more anchored Phillips curve, reducing the risk of inflationary overheating. If anything, says Goldman, the current global slowdown probably means the expansion will last longer. So the key question facing investors is whether 2019 risks were fully discounted by December's steep sell-off. Consensus surveys show S&P forecasted earnings for this year have slumped from double-digit growth in October to the mid-single digits, a range that's rare historically but not during this post-crisis expansion. Comparisons are difficult because last year's tax bill fostered a short-lived capital spending boom (*more below*) that boosted the top line. Earnings-to-date have been slightly better than expected, with the tax-law benefits accounting for roughly half of trend earnings-per-share growth of 13.5%. Technical indicators imply December represented the worst of the decline, with recent breadth and sentiment suggesting a bottoming phase. Correlations across the equity

market spiked in Q4, consistent with their behavior in other stressful periods—of 21 episodes of high stress since 1950, equities produced above-trend returns in the next year following 19 of them, the exceptions being 1973 and 2007. Not bad odds. All of these spikes in stress had to do with concerns about the sustainability of the world economic order. Surely not a concern this time (*although see third 'What else' below*).

After posting its worst year for growth in 28 years and its eight straight year of decelerating growth, China (my key fundamental worry) is entering a news blackout period, with most economic data releases on hold through the Chinese New Year (Feb. 5). This won't help nervous markets, particularly after President Xi's cautious and urgent-sounding speech this week at an unusual Communist Party seminar where he said the party "is facing long-term and complex tests in terms of maintaining long-term rule, reform and opening up a market-driven economy." Among his concerns: "sharp and serious dangers of a slackness in spirit, lack of ability, distance from the people, and being passive and corrupt." Noting that when one of the world's two largest economies is troubled, everyone loses, Evercore ISI viewed the comments as being consistent with asymmetric risks to the downside. Wolfe Trahan, on the other hand, believes an improving Chinese growth outlook on the back of a trade deal and new stimulus efforts already underway could prove to be key drivers of the bullish investment case for this year. As with so much these days (a possible trade deal, an end to the government shutdown, a Brexit solution), we'll see. The week's last stop was in tony Palm Beach, home to wealthy retirees and Mar-A-Lago. "It was fortunate that Trump didn't come down this week," I was told, because every time he does, traffic gets seriously gummed up. Chill. Once again, no one asked about the acrimonious stalemate government shutdown. Rather, I was told that when China's President Xi visited Mar-A-Lago, locals saw how much bigger his version of Air Force One was, sitting there near Trump's plane. "Trump probably had 'airplane envy,'" an advisor joked. The

warm Florida sunshine was just what the doctor ordered. And thanks to even more brilliant scheduling, I am returning next week!

POSITIVES

- **U.S. soft landing watch** Even with mounting claims from laid-off federal workers, initial jobless claims fell in the latest survey week to 199,000—a 50-year low! At 38, the share of states with expanding economies in December remained consistent with broad-based expansion and above-trend growth. The Kansas City Fed survey of manufacturing held steady in expansion territory, although new orders slowed.
- **The consumer continues to spend** Same-store sales rose a very strong 7% in the week ended Jan. 19, according to Redbook's survey, continuing a strong month off late December's 9% surge.
- **One good housing indicator** Purchase applications for home mortgages slipped in the latest week but continued to run 13% above year ago levels, just off their 9-year high. Lower mortgage rates are the primary driver, helping lift builder confidence off its 3-year low and beaten-down home-builder stocks.

NEGATIVES

- **U.S. soft landing watch** Conference Board leading indicators slipped a second time in three months, while Evercore ISI's truckers survey—for ISI, it has one of the highest correlations with GDP of any single-sector survey—declined sharply and is now nearly 10 points below its peak of 66 six months ago. The Richmond Fed survey of factory activity improved but remained in contraction.
- **Global soft landing watch** Eurozone growth almost ground to a halt as manufacturing and services PMIs came in just above 50—Germany's manufacturing PMI actually contracted. In Asia, Japan's initial read on

January manufacturing was breakeven, while forecasters expect China GDP growth to dip below 6% annualized before a significant loosening of fiscal and monetary policies help stabilize growth in the second half. The International Monetary Fund lowered its 2019 global GDP forecast to 3.5% from 3.7%.

- **Unfortunately, another bad housing indicator** December existing home sales fell more than expected to a 3-year low, closing out a year that saw year-over-year sales plunge 10.3%, their steepest decline since May 2011. Higher mortgage rates and prices, and tight supply were factors. Inventory stood at 3.7 months at year-end, well below the six months that's representative of a balanced market.

WHAT ELSE

A lot of consumers count on those refunds Thanks to the government shutdown, zero refunds have been issued since Jan. 7, putting refunds $419 million behind last year's pace so far—a difference so small it really is having no impact on growth forecasts. Filing season begins in earnest next week, however, and if the refunds don't resume then and stay near zero, the hit to Q1 consumption could be meaningful.

We are still hopeful about capex Falling global growth expectations and increasing policy uncertainty have poured cold water on an anticipated mini-boom in capital expenditures (capex). Just a year ago, many were expecting to see a surge, as many economies globally were recovering from the 2015-16 mini-recession and U.S. tax reform seemed tailor made to spur more business spending. But after a brief bump up, U.S. capex has stalled.

Maybe 'policy uncertainty' is to blame It sits at a record high, three times above its historical average, according to Bloomberg data that goes back to 1997. Leuthold Group wonders if this reflects the unprecedented post-crisis

policy actions (near zero interest rates, massive central bank balance sheet expansion, record fiscal deficits) and doubts regarding how the unwinding of all this will work. Arguably policy uncertainty, and not traditional warning signs such as an inverted yield curve, is the key recession worry weighing on markets.

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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.

The Conference Board's Composite Index of Leading Economic Indicators is used to predict the direction of the economy's movements in the months to come.

The Markit PMI is a gauge of manufacturing activity in a country.

The Markit Services PMI is a gauge of service-sector activity in a country.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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