# Contrary to popular belief

**01-04-2019**
**Panic is increasingly evidenced by headlines** and investor behavior. Why? The hard economic data may be softening but continues to be supportive, suggesting a modest deceleration in economic momentum, not full-bore recession. Jobs and wages are going strong (*more below*). Consumers are going strong (*more below*). Contrary to popular belief, global trade *continues to expand* despite the tariffs and tensions. With inflation rolling over, relatively low interest rates appear here to stay and may even decline—the market doesn't see the Fed making any moves this year and is starting to price in a potential cut. Also contrary to popular belief, private balance sheets are *remarkably healthy*: U.S. household net worth is 60% above its previous all-time high and the U.S. corporate debt-to-profit ratio is below its 48-year average. Yet frightening headlines are everywhere. Just yesterday, when the ISM manufacturing index fell in December to 54.1 (still solidly in expansion territory and consistent with annualized 3.4% GDP growth, *more below*), the news emphasized that this was its biggest 1-month drop in 10 years. This comment has been repeated in similar fashion about numerous other statistics, which sounds terrible. But this comes off a 10-year recovery from the "Great Recession'' and financial crisis. We've heard repeatedly that earnings growth will slow this year, *but from 25%*! It's obviously late in the cycle but recession is not near.

**There has been a lot of talk** about massive algorithmic-driven trades dramatically exacerbating moves in the market. There's some truth to that but contrary to popular belief, we've had market crises and rapid sell-offs long before the proliferation of systematic strategies, derivatives and electronic trading. The century-old sayings "cut your losses short and let your profits run" and "don't put all your eggs in one basket" have found applications in futures trading, equity long-short factors and risk-based portfolio approaches such as volatility targeting. *Market liquidity has become to a large extent driven by market volatility, thus reinforcing a negative feedback loop between volatility and liquidity*. Last year was volatile—the VIX averaged 16.64 in 2018, above the 16.04 *high for all of 2017*. And there were 20 2% daily moves in stocks (including six greater than 3%), vs. none in 2017. Since the Fed's unwelcome December hike, we've seen an inversion of the 5-year/1-year Treasury yield curve, a 100 basis-point widening in high-yield markets and a further decline in the 10-year Treasury yield, which fell 70 basis points the past two months before this morning's sharp climb. This all points to global markets being considerably more fragile than the Fed concluded in December. It's not just its rate plans; its massive balance sheet built up via post-crisis actions and its plans to shrink that has spooked the markets, making traditional oversold measures such as valuation, breadth, etc., less effective.

**BUT the market is a forecasting mechanism**, currently pricing a near-term recession. As earnings growth expectations have fallen to single-digit levels, the steep sell-off has more than discounted this change, with the S&P 500's trailing P/E at 16, its lowest level since 2012. AAII pessimism is above 50% for the first time since 2013 while bullishness is at one of its lowest levels of the entire recovery. Mutual fund outflows and pension fund inflows are accelerating, sending strong contrarian signals. Retail investors historically sell at times of market panic and lows, while pension funds historically have tended to buy at opportune times. Finally, emerging market stocks have been outperforming developed markets, indicating the worst may be behind the global economy, a positive for all stocks. Waterfall declines rarely mark a bottom as market lows tend to be retested once or twice, followed by a multi-month base-building phase. Until this all flushes out, resistance at 2,600 to 2,650 on the S&P is likely to remain a formidable hurdle, while support at 2,350 is a key point to watch. But note that the last time the Dow and S&P troughed in December, in 1974 and 1987, respectively, it represented a great buying opportunity.

## Positives

- **What will a 'data-dependent' Fed do?** Today's very strong employment report and wage gains lend much-needed support to the Fed view that the domestic economy ended the year in generally solid shape in spite of market turmoil and weakening global growth. The same could be said of ADP private payrolls, which posted their largest gain since February 2017. Still, mindful that jobs reports tend to be lagging indicators and taking into account inflation is trending down, the Fed has latitude to be careful (*more below*).
- **Main Street's been shopping** Redbook and International Council of Shopping Center surveys indicate that retailers had their best holiday season in six years, while automakers reported surprisingly robust auto sales the final month of the year. The Bloomberg Consumer Comfort Index had its best year since 2000.
- **Rental housing hot** While headlines surrounding the U.S. housing market have fixated on sputtering home sales due to declining affordability, apartments are going strong. The median U.S. gross-rent level is surging, eclipsing the $1,000 threshold for the first time in Q3 2018, while rental vacancy rates remain around 7%—lows not seen

since the early ’90s.

## Negatives

- **U.S. recession watch** ISM’s manufacturing fell to in December to a 13-month low, led by a sharp drop in new orders. Markit’s separate gauge of manufacturing also declined for the fifth time in seven months to its lowest reading in 1½ years. The findings reinforced drop-offs in seven regional Fed readings of factory activity, with two actually dipping into contraction territory.
- **Global recession watch** Manufacturing activity contracted in China in December, according to the closely watched Caixin survey, while slowing iPhone sales suggested Chinese consumers are growing cautious. In Japan, the 10-year sovereign yield appears stuck in negative territory while in Europe, Italy continues to slide toward recession, Germany’s PMI is at a 33-month low and the yield on its 10-year bund has plunged below 0.17%. Eight countries now have a PMI below 50 vs. none at the start of 2018.
- **Services slip** Markit’s final services PMI for December came in three ticks below November, but it easily remained expansionary and was actually up from the month’s initial read. New orders were the biggest drag, coming in at a 14-month low.

## What else

**Contrary to popular belief** Corporate debt has trended higher as occurs in business cycles, but financial leverage is at worst nonthreatening if not actually improving. In fact, net corporate bond issuance has slowed sharply in the last three years, from $460 billion per quarter in early 2015 to $125 billion. Clearly corporate executives are not rapidly increasing risk-taking by leveraging the corporate balance sheet.

**Contrary to popular belief** So much for the Fed’s commitment to maintaining its $50 billion monthly pace of quantitative tapering. In the past two weeks, it actually added just over $1 billion to its balance sheet. And at speech in Atlanta this morning, Chair Powell said muted inflation readings give the Fed greater flexibility to set policy in the year ahead and that the central bank isn’t on a fixed path to push rates higher, indicating it’s listening to the markets and willing to make adjustments accordingly.

**The tax cuts keep coming** Evercore ISI estimates late 2017’s tax-cut legislation will boost this year’s refunds by about $75 billion, with the average refund about $420 higher. The bulk of this should come in the current quarter, although delays as a result of the government shutdown could push a chunk of this out into the spring.

Connect with Linda on LinkedIn

**Linda Duessel, CFA, CPA, CFP**
Senior Equity Strategist

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Dow Jones Industrial Average ("DJIA"): An unmanaged index which represents share prices of selected blue chip industrial corporations as well as public utility and transportation companies. The DJIA indicates daily changes in the average price of stocks in any of its categories. It also reports total sales for each group of industries. Because it represents the top corporations of America, the DJIA's index movements are leading economic indicators for the stock market as a whole. Indexes are unmanaged and investments cannot be made in an index.

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

High-yield, lower-rated securities generally entail greater market, credit, and liquidity risk than investment-grade securities and may include higher volatility and higher risk of default.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging-market and frontier-market securities can be significantly more volatile than the prices of securities in developed countries, and currency risk and political risks are accentuated in emerging markets.

Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

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 American Association of Individual Investors (AAII) Bulls Minus Bears Index is a measure of market sentiment derived from a survey asking individual investors to rank themselves as bullish or bearish.

The Bloomberg Consumer Comfort Index is based on weekly telephone survey of consumers seeking their views on the economy, personal finances and buying climate.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

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.

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

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.

Federated Equity Management Company of Pennsylvania

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Federated Investors Tower

1001 Liberty Avenue
Pittsburgh, PA 15222-3779
Telephone: 412-288-1900