Orlando's Outlook: Will soft patch derail Santa Claus rally? No, no, no!

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Bottom Line *Economic fundamentals have hit a bit of a soft patch over the past few months, certainly contributing to the equity market's malaise. The S&P 500 corrected nearly 12% from mid-September to late October, while the tech-heavy Nasdaq composite and the small-cap Russell 2000 plummeted 16% since late August to their recent bottoms. In a flight-to-safety rally amid the potential for slowing domestic economic growth, benchmark 10-year Treasury yields fell from a 7-year high of 3.25% in early November to 3% this week. The good news is that the labor market remains healthy, with the unemployment rate (U-3) at a 49-year low of 3.7% and the fastest wage growth in nearly a decade of 3.1%. As a result, consumer spending during the Back-to-School (BTS) season rose by a 7-year high of 5.7%, which gives us confidence that Christmas spending this year will be comparably robust. Not surprisingly, many of the business and consumer confidence metrics we monitor are either at or just off multi-decade cycle highs.*

The housing and auto markets have been under increasing pressure all year, and manufacturing trends have weakened considerably across the board in recent months. There are several headwinds, in our view, which may have sparked this economic downshift: the potential fiscal-policy impact from the recent midterm elections; the fear of a monetary policy error from the Federal Reserve; President Trump's growing trade and tariff war with China; a stronger U.S. dollar; and volatile oil prices.

True, the midterm results were not as bad as feared, so there likely will be no change in President Trump's very favorable fiscal policy approach in the next two years. Further, Fed Chair Jerome Powell delivered a well-received speech on Wednesday, stating that the Fed was data dependent, cognizant of the recent economic slowdown both here and abroad, not on a pre-set glide path to hike interest rates and now perhaps just a few more rate hikes away from neutral.

So as we look across the December landscape, there are several critically important signposts ahead. This weekend's G-20 summit in Buenos Aires is at the top of the list, as Trump and China's President Xi will have a sidebar dinner meeting to discuss the state of their trade war. We continue to believe that this meeting ends well, with an agreement to freeze tariff imposition for a quarter or two while the two economic giants hammer out details of a deal, which should also resolve the dispute on intellectual property theft.

Next week's OPEC meeting in Vienna likely will result in Russia and Saudi Arabia successfully proposing a reduction in crude oil production of about one million barrels per day, which should put a floor under the recent 34% free-fall in crude oil prices (West Texas Intermediate) from $77 to $50 per barrel over the past two months.

Finally, the Fed will hold its last policy-setting meeting of the year on Dec. 18-19, at which we expect it to hike rates a quarter point, but pull in their summary of economic projections (dot plots), which suggests they may only need to raise rates one or two more times in the first half of next year to achieve neutral. After hitting a 6-year high at 2% in July 2018, the core personal consumption expenditures (PCE) index, the Fed's preferred measure of inflation, has downshifted over the past three months, falling to 1.9% in August and September and to 1.8% in October, a level which we have not seen since last February's 1.7%. So core inflation is now back below the Fed's oft-stated 2% target, which should give it more flexibility in coming months to be patient with future rate hikes.

After successfully re-testing the 2,600 level it originally hit in late October, the S&P has rebounded more than 4% over the past fortnight, in part due to the less-bad-than-feared election results and Chair Powell's recent speech. If the next few weeks go as planned with the China trade summit, the OPEC meeting, and the FOMC meeting, we believe that will fuel a year-end Santa Claus rally, which will take stocks back up to their September highs.

The equity and fixed-income investment professionals who comprise Federated's macroeconomic policy committee met yesterday and trimmed our GDP forecast on the domestic and international economic slowdown and the challenges ahead:

- Third quarter GDP was unrevised at 3.5% versus 4.2% in the second quarter and 2.2% in the first quarter.
- The strong BTS season suggests Christmas should be strong, too, and the consumer accounts for 70% of GDP. But manufacturing activity has clearly downshifted in recent months, while trade and inventory may prove to be

drags, as well. So we are lowering our fourth quarter 2018 GDP estimate from 3.4% to 2.8%, while the Blue Chip consensus has lowered its estimate down a tick from 2.8% to 2.7% (within a range of 2.1% to 3.1%). The Atlanta Fed's GDPNow model is currently at 2.5%, down from 3%.

- That puts our full-year 2018 GDP down a tick to 2.9% from 3%, while the Blue Chip consensus remains unchanged at 2.9% (within a tight range of 2.9% to 3%).
- We're expecting another brutal winter—the fourth in the past five years—along with the economic concerns relating to manufacturing, trade and inventories. So we are lowering our first quarter 2019 GDP estimate from 2.8% to 2.3%, while the Blue Chip consensus pushes its estimate up a tick from 2.3% to 2.4% (within a range of 1.8% to 3%).
- We are lowering our second quarter 2019 GDP estimate from 3.1% to 2.8%, while the Blue Chip consensus remains unchanged at 2.5% (within a range of 1.8% to 3.1%).
- We are raising our third quarter 2019 GDP estimate from 2.3% to 2.5%, while the Blue Chip consensus stands pat at 2.2% (within a range of 1.5% to 2.7%).
- We are also raising our fourth quarter 2019 GDP estimate from 2.3% to 2.5%, while the Blue Chip consensus remains unchanged at 2% (within a range of 1.1% to 2.5%).
- We are lowering our full-year 2019 GDP estimate from 3% to 2.8%, while the Blue Chip consensus remains unchanged at 2.6% (within a range of 2.2% to 3%).

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

Nasdaq Composite Index: An unmanaged index that measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. Indexes are unmanaged and investments cannot be made in an index.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

Russell 2000® Index: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. Investments cannot be made directly in an index.

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