UNCOMMON SENSE

December 2018

Scare Bear: What's Wrong with the Bull Market?

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"There's something happening here. What it is ain't exactly clear."
— *Buffalo Springfield*

After reaching all-time highs earlier this year, the nearly decade-long bull market has been transforming itself throughout the fourth quarter. What it is transforming itself into, I'm not exactly sure. Perhaps like Gregor Samsa from Kafka's *The Metamorphosis,* it's evolving into a giant, oozing insect.

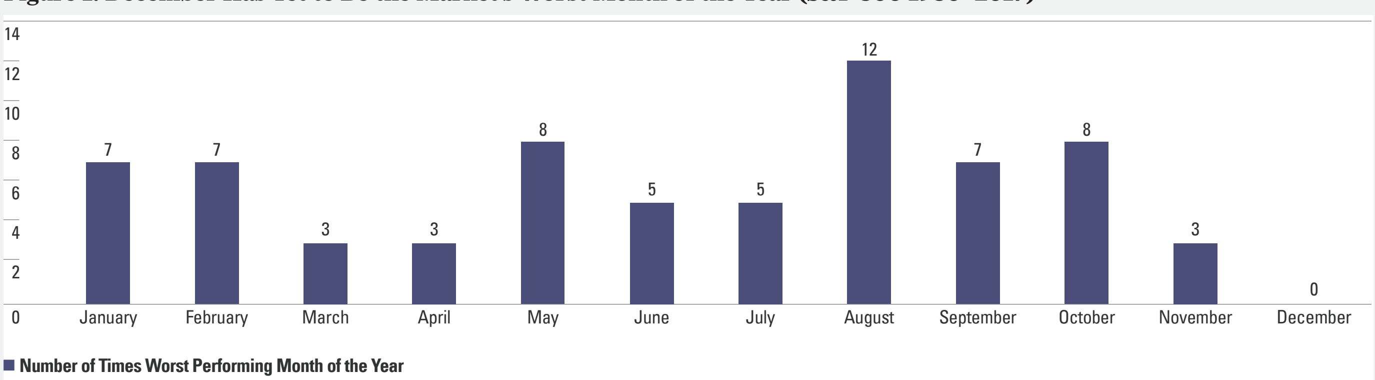
This alarming transfiguration has come at a time when markets are normally at their strongest. Since 1950, the S&P 500 Index has risen 75 percent of the time in December, more than in any other month. But this December has proven to be an anomaly. As of December 17, all three major US stock indexes were down 7.5 percent or more, their worst December starts since 1980.[1] With seven trading days left in 2018, more than half of S&P 500 stocks are in a bear market. Bigger picture, the Dow Jones Industrial Average, S&P 500 and Nasdaq are in correction territory for the first time since March 2016.

All this has investors worried sick and sentiment is plummeting. For the week ending December 12, the American Association of Individual Investors' (AAII) investor sentiment survey indicated that bullish expectations for the stock market over the next six months plunged 17 percent week-over-week. Only 20.9 percent of survey respondents were bullish versus a historical average of 38.5 percent. Bullish sentiment is the lowest since May 2016.

While some risks appear to be receding, others are surging, wreaking havoc on asset prices and investor sentiment. It reminds me of the popular arcade game Whac-A-Mole. US-China trade talks and Fed speak have improved, but a trio of moles has popped up, leaving investors frustrated and exhausted as they flail away to hammer them down:

1. Fears of slowing global growth
2. Turmoil in Europe and the UK
3. Increasing political discord in DC

Figure 1: December Has Yet to Be the Market's Worst Month of the Year (S&P 500 1950–2017)



Source: LPL Research, FactSet, 12/31/2018.

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First, You May Ask Yourself, Well, How Did I Get Here?

December's market mayhem is occurring against a backdrop of progress in US-China trade negotiations and a more dovish Federal Reserve (Fed) — two conditions I thought would result in a Santa Claus rally this month.

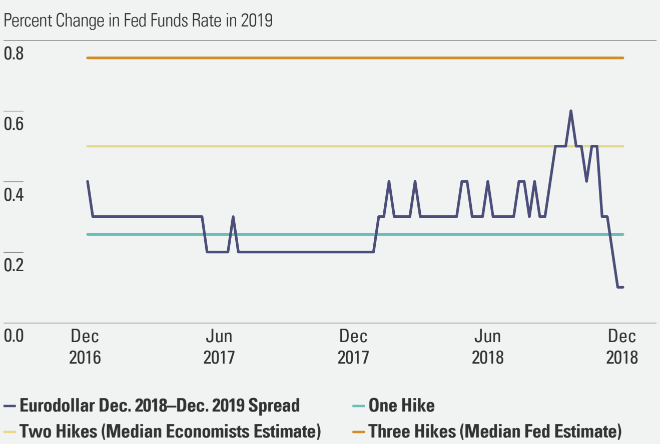
Following the G20 summit, the US agreed to postpone increasing tariffs on Chinese imports from 10 percent to 25 percent for 90 days while the two sides attempt to work out a new trade deal. In a show of good faith, China has responded by lowering tariffs on US autos back to 15 percent from 40 percent, increasing its purchases of US soybeans and liquefied natural gas and strengthening penalties for intellectual property theft.

And, as reported by *The Wall Street Journal* in a December 6 cover story, Fed officials are considering whether to signal a new wait-and-see approach to rate increases that could slow down the pace of increases in 2019. This story conveniently appeared after several Fed officials sought to walk back previous hawkish comments on rates. The article also suggests that under the evolving "data dependent" strategy, the Fed could step back from the predictable path of quarterly hikes it has been on for most of the last two years, raising the possibility it might delay rate increases at upcoming meetings.[2]

Welcome to Bizarro World; Grab a Mallet

Ordinarily, news of thawing US-China trade tensions and a less aggressive Fed would be enthusiastically welcomed by investors. But in the current Bizarro World, reactions to everything are the exact opposite of expectations — up is down, good is bad and wrong is right. And new risks are replacing old ones.

Figure 2: Traders are Pricing in Less Than One Hike in 2019, Far From the Three the Fed Expects



Source: Bloomberg Finance L.P., as of 12/17/2018.

To ease investors' anxieties in this challenging environment, let's knock these three moles upside the head.

#1. Super Mario No More: Growth Continues to Decelerate

Economic figures from both Europe and China on December 14 have fueled concerns that slowing global growth at the tail end of 2018 will carry over into next year. China reported soft industrial production and retail data, while a key business index in Europe fell to its lowest level in more than four years due to violent anti-government protests in France and weak manufacturing activity that has Germany struggling to rebound from a third quarter contraction.[3] Meanwhile, Italy is on the brink of recession.

Not surprisingly, the European Central Bank (ECB) recently cut its quarterly forecast for the third straight time.

The China economic data confirm that the country's downturn deepened last month, hitting businesses and consumers. This will put additional pressure on Chinese officials to stabilize economic growth while contending with trade tensions with Washington.

As economic growth outside the US decelerates, investors are questioning how long the US economy can withstand the global slowdown — especially with the Fed expected to raise rates in December for the ninth time since the end of 2015 and the diminishing effects of the massive fiscal policy package also expected to weigh on domestic economic growth next year. Not to mention the damage that may have already been inflicted on the global economy from the many trade disputes in 2018, most notably the US-China conflict.

According to the US Department of Commerce, the US economy grew at 4.2 percent and 3.5 percent in the second and third quarters, respectively. However, the International Monetary Fund (IMF) forecasts US growth of just 2.5 percent for 2019. US exports have been falling for months, while imports have continued to climb. US factory output is limping into year-end with November flat after October fell. And interest rate sensitive sectors such as housing and auto sales are starting to wither under all those Fed rate hikes.

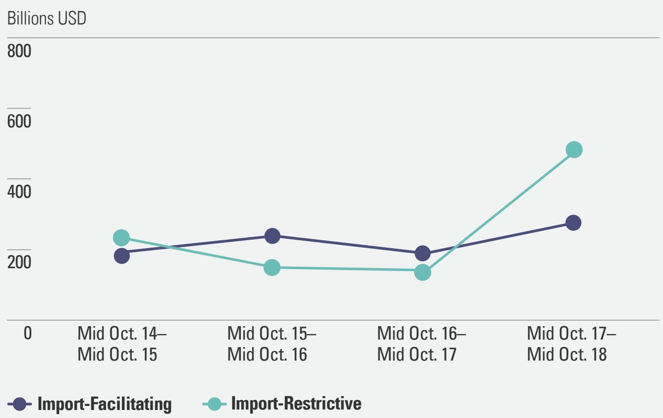
#2. The Kings and Queens of Promise: Populism and Politics Breed Turmoil

The ECB confirmed on December 13 that it will end its 2.6 trillion euro ($3 trillion USD) bond buying program, even though the eurozone economy looks vulnerable at the moment. Although interest rates remain at historically low levels and aren't expected to rise anytime soon, ending bond purchases results in modestly less accommodative monetary policy at a time when the ECB is lowering its growth forecasts. But as bad as the deteriorating economic situation will be for Europe, the political environment may be worse.

Italy's coalition government that formed after elections in March promised voters a universal basic income, lower taxes and a reduction in the retirement age. Those plans were included in Rome's spending plans for 2019. The proposals meant Italy would run a budget deficit of 2.4 percent for the next three years. Brussels raised concerns that Italy, with a government debt-to-GDP ratio of 133 percent already, was abandoning fiscal discipline and asked Italy to revise its spending plans. After months of disputes, Italy's finance ministry announced a compromise with the European Union on December 18 that would target a budget deficit of 2 percent of GDP next year. If confirmed, the deal could prevent Italy from slipping into recession.[4]

In France, President Emmanuel Macron has pledged to put cash in the pockets of everyday French citizens in response to several weekends of violent anti-government demonstrations by the *gilets jaunes*, or yellow vests. Seeking to defuse the protests, Macron promised increased wages and tax cuts on payrolls and pensions and encouraged businesses that could afford it to pay tax-free year-end bonuses.[5] Macron's flagrant disregard for European Union budget discipline rules has angered Italy and other EU countries who see France as getting special treatment.

Figure 3: Trade-restrictive Measures in the Most Recent Year Through October Were 7x Greater than Last Year, Which Could Endanger Global Trade and Growth



Source: WTO Secretariat, 12/17/2018.

These figures represent the trade coverage of the measures (i.e. annual imports of the products concerned from economies affected by the measures) and not the impact of the trade measures. These are estimates based on 2013 to 2017 import data. Liberalization associated with the 2015 Expansion of the WTO's Information Technology Agreement is not included in these figures.

Finally, the UK economy is suffering partially in response to fears regarding the growing risks of a no deal Brexit, a chaotic scenario that all parties claim to want to avoid.

Prime Minister Theresa May is stuck between a rock and a hard place. Even her own party won't back the Brexit deal she negotiated with Brussels. And EU officials refuse to modify the terms that were brokered. The sticking point largely remains the treatment of the border between Ireland and Northern Ireland. Despite the stalemate, UK parliament must vote to approve the Brexit deal by January 21 if it is going to apply when Britain makes its planned exit from the eurozone on March 29. Although May survived a December leadership challenge from her Conservative Party, her inability to pass the deal at home or negotiate new terms in Brussels has left untold risks and much work to be done in a narrowing timeframe.

#3. Another Brick in the Wall: Divisive Politics Brings Us Down

The contentious battle over funding for a wall along the southern border of the US has divided Republicans and Democrats and left Congress struggling to keep the government funded as the clock ticks toward a partial shutdown on December 22. A two-week spending Band-Aid has been discussed by Republicans, but that pushes the budget conversation into next year when Democrats will have a majority in the House. Meanwhile, Democrats aren't eager to help President Trump claim victory on one of his key campaign pledges. For his part, Trump has boasted that he would be proud to shut down the government over border wall funding.

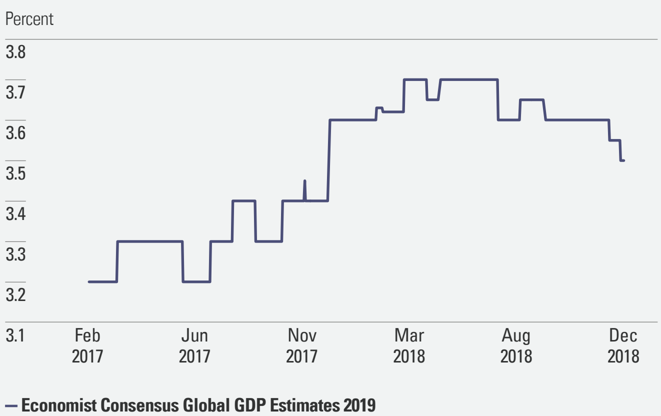
Of course, markets have survived past government shutdowns and will survive this potential partial shutdown, too. More importantly, this exhausting and ugly standoff is an early indication of what to expect from our leaders in Congress in 2019 and sets the tenor for the national election in 2020. This bipartisan bickering is raising larger concerns for investors about whether a divided government can handle more important issues. Investors will likely be cautious of this vitriol going forward and that may be reflected in lower asset prices — call it the discord discount.

Should I Stay or Should I Go Now?

So, is this a harmless correction in a long-running bull market or a long overdue inflection point finally signaling the end to the market's solid run? Although the end of the bull market may be in sight, I believe this December of our discontent is likely a normal correction and the bull market may stagger its way through 2019.

Taking a step back from the growing number of risks outlined in this article, it's important to remember peaking is not contracting. The IMF still forecasts global growth of 3.7 percent for 2019 and for the US economy to expand by 2.5 percent next year.[6]

Figure 4: Consensus Global GDP Estimates for 2019 Have Moderated as Trade and Geopolitical Risks Have Increased



Source: Bloomberg Finance L.P., as of 12/17/2018.

FactSet calculates that earnings-per-share growth for S&P 500 companies will be north of 8 percent in 2019.[7] Inflation measures are plateauing and interest rates remain at historically low levels; both should support higher valuations. Speaking of valuations, the S&P 500 is trading at a reasonable 15.5x next 12 months earnings. Lastly, expectations regarding Fed rates hikes in 2019 have been reduced from maybe four to probably just one or two.

Think about it. These are the same conditions that have prevailed for much of the last decade in the aftermath of the global financial crisis. And stocks have performed well for investors in such an environment. Progress on US-China trade talks and a more dovish Fed have yet to translate into investor optimism but fresh signs that the US will avoid a partial government shutdown in December and Italy's compromise with the EU may lend support to stock prices in the new year. The bull market will end sometime, it's just not likely to get whacked in 2019.

Happy Holidays!

1 Bloomberg Finance L.P., as of 12/17/2018.

2 Nick Timiraos, "Fed Weighs Wait-and-See Approach on Future Rate Increases," *The Wall Street Journal*, December 6, 2018.

3 Paul Hannon and Josh Zumbrun, "Slower Overseas Growth Fans Worries on U.S. Expansion," The Wall Street Journal, December 14, 2018.

4 Giovanni Legorano and Marcus Walker, "Italy Says It Struck a Budget-Deficit Compromise With EU," *The Wall Street Journal*, December 19, 2018.

5 Sylvie Corbet and Angela Charlton, "Macron vows tax cuts, pay rise; will France's anger subside?" The Washington Post, December 10, 2018.

6 IMF World Economic Outlook, October 2018, "Challenges to Steady Growth"

7 FactSet Earnings Insight, December 14, 2018

Glossary

Gross Domestic Product (GDP) The monetary value of all the finished goods and services produced within a country's borders in a specific time period.

S&P 500 Index A popular benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

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