



The Time to Panic is Not Yet

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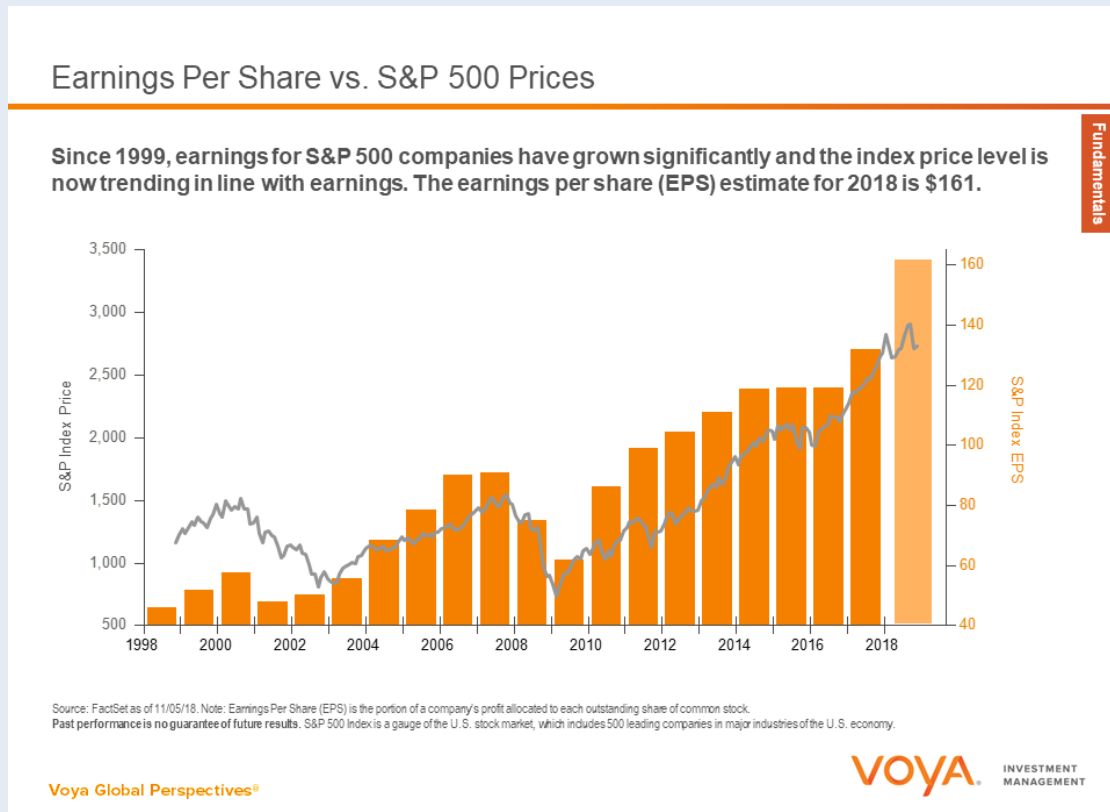
ATLANTA –December 19, 2018—Unless you’ve been on an Amazonian cruise for the last couple of weeks, you’ve no doubt noticed the extreme volatility in the stock markets. There are several reasons stocks have dropped recently—some are fundamental, some are political and even emotional. The markets hate uncertainty, and there is plenty of that to go around right now. So, let’s try to separate the political from the fundamental.

Politically speaking, there are several factors contributing to the uncertainty:

1. The so-called trade war with China has depressed prices there and in many of the other Emerging Markets economies. China has retaliated in some areas and this has affected certain exports.
2. Trump’s presidency has encountered serious headwinds as Democrats have retaken control of the House. There is likely very little that will get done in the next two years. From an uncertainty perspective, that is not necessarily a bad thing, since what you have is what you get.
3. The political parties seem to be at an impasse over border security, and Trump is threatening to shut down the government if he doesn’t get funding for the wall, which the Democrats refuse to fund.
4. The shutdown Trump is referring to is the statutory limit on the national debt--a financial shutdown--unless Congress raises the limit. This occurs every couple of years and has been turned into a political weapon.
5. Teresa May is having a terrible time running back and forth from Brussels to the House of Commons. As the Brexit deadline looms, the fate of Ireland hangs in the balance.
6. Thousands of migrants are camped out on the border with Mexico determined to enter the US, which only exacerbates the border issue. Eventually there will probably be some kind of tragedy which will focus the world's attention.
7. I’m sure that by the time you receive this letter something else will have developed, so just enter that here.

But if you read over the above factors again, you will see that none of them really have anything fundamental to do with the market. Granted, there is a lot going on these days, but most of it is noise. Remember, bad news sells better.

Now for some fundamentals. Here is one you can take to the bank: Corporate earnings drive the market. Take a look at the following chart which shows the correlation between the stock market (the gray line) and corporate earnings (the orange bars).



At the tail end of the line you can see the volatility we have suffered recently and the large block of earnings behind it. I will let you draw your own conclusions.

And there are some other fundamental factors that you rarely hear about. These are facts that actually matter, for they go right to the heart of the issue that really counts: corporate earnings.

1. The corporate tax rate has been reduced to 15% from 35%. We have not even seen one tax year completed yet. Mathematically, this can only boost earnings.
2. Dividends have hit an all-time high. Payments are up \$55.5 billion year-over-year. S&P Dow Jones announced that the indicated dividend net increases (increases less decreases) for U.S. domestic common stocks increased \$19.2 billion during Q3 2018, up from the increase of \$13.0 billion for Q2 2018 and up from \$15.0 billion for Q3 2017. Average Q3 2018 dividend increase in the S&P 500 was 17.15%, up from 13.55% during Q2 2018.¹

¹ Factset 3rd Quarter 2018 S&P Dow Jones Indices

3. In the third quarter 2018, of the 500 stocks on the S&P 500, a whopping 77% of them beat their earnings estimates. Only 13% were below estimates.² That's astonishing. And there's no reason to believe that they won't continue.
4. American consumers gave the holiday shopping season a strong start in November. U.S. retail sales rose 0.2% from October, better than expected. Department store sales rose 0.4%, while electronics and appliance-store sales rose 1.4%. Sales at online retailers such as Amazon.com increased 2.3%.³
5. Finally, S&P Dow Jones Indices just announced on December 18th that preliminary Q3 2018 S&P 500® stock buybacks, or share repurchases, surpassed the \$200 billion mark for the first time to set a record \$203.8 billion. This is the third consecutive record, displacing the prior quarterly record of \$190.6 billion, set during Q2 2018 and a 57.7% increase from the \$129.2 billion reported for Q3 2017. For the first three quarters of 2018, buybacks are up 52.6% to \$583.4 billion from the prior year's \$382.4 billion, and stand 1% away from the annual record, set in 2007, of \$589.1 billion with a full quarter yet to report.⁴

How can this market be falling in the face of facts like these? This is not to say that we think the market is impervious and will continue on this path forever, but these are certainly not bad indicators—they're good indicators.

Nonetheless, there are a couple of fundamental factors that are worrisome.

The first and most obvious is that the Federal Reserve has been raising the key interest rate, the Fed Funds Rate, as we knew they would. If you've been reading my letters, you know that this is one of the key factors we follow.

Today, as expected, the Fed announced another .25% rate hike to 2.5%. This is our warning track. And thus, for our clients, we will soon begin migrating out of our more vulnerable positions such as emerging markets and small cap stocks. Earlier this year we jettisoned all our high yield bonds and took a third of our small cap gains off the table—and just in time.

Obviously, we will wait for a more opportune time to sell the other positions, as we believe there will be a recovery from here. Today, the Dow was up over 350 points before the Fed announcement, which quickly erased the day's gains. Though the Fed announced only two more rate hikes in 2019, they often change their mind.

The second factor that we believe will be the culprit this time—as the dot.com's were in 2000 and sub-prime mortgages were in 2008—is the corporate debt.

Citigroup Inc. recently issued a warning about the U.S. corporate bond market: "High-grade non-financial companies have seen their total debt burdens rise 10% year-on-year since 2010— double the 5% growth rate of their earnings. The backdrop for Corporate America's debt now looks 'foreboding' as foreign investors beat a retreat."⁵

² Refinitiv S&P 500 2018 Q3 Earnings Dashboard, December 6, 2018

³ Voya Global Perspectives Weekly Update, December 17, 2018.

⁴ Dec. 18, 2018 /PRNewswire/ -- S&P Dow Jones Indices

⁵ <https://www.bloomberg.com/news/articles/2018-12-10/u-s-credit-faces-a-warning-sign-with-ominous-debt-rating-trend>

According to our research, of the 500 companies on the S&P 500, a surprising 180 of them—36%—are rated one notch above junk, BBB. Still considered investment grade at that rating, one downgrade puts them in the "junk" or "high-yield" rating category, which is BB and below.⁶

Though this might not seem like a big deal at first, large institutional and retail mutual funds that are "investment grade only" by virtue of their prospectus and SEC filing statement will be forced to sell these lower grade bonds, potentially causing a severe depression in that market, and possibly the broad market as well. We believe this is the impending "Sword of Damocles" that could be the first casualty of the Fed's rate raising game.

In any event, we believe the current market volatility is—from a fundamental perspective at least—unfounded, though continued rate hikes will almost certainly have a devastating effect if unabated. This is fully what we expect for late 2019, early 2020.

For now, though, we believe the time to panic is not yet. Not until we see those rate hikes begin to affect corporate earnings, and earnings begin to drop off. Note that our landmines are buried in the mountains of debt of the corporate bond market, and the recent global selloff has proven once again that treasuries are the "go-to" asset when things get rough.

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⁶ <https://www.businessinsider.com/risks-are-quietly-piling-up-in-the-us-bond-market-2018-6>

About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through Voya Financial Advisors (member SIPC).

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- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

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