Market Outlook 2019

The stock market suffered its worst year since the 2008 Great Recession, with the S&P 500, Dow Jones Industrial Average and NASDAQ Composite declining by 6.24%, 5.63% and 3.88% respectively. Indeed, 2018 was a year when nearly every major asset class suffered broad declines. Small and mid-cap, international and emerging market stocks all met the technical definition of a "bear market" with 20% drops from their highs. Commodities, including perceived safe-haven gold and punctuated by a 35% drop in the price of oil, had a lousy year. REITs, TIPs, U.S. corporate bonds, high-yield bonds, international bonds and emerging market debt all declined. And of the 450 hedge funds monitored by HSBC's alternative investment group, only 16 delivered net positive returns. U.S. Treasuries barely turned positive in a year-end flight to safety trade and cash was 2018's biggest winner with an approximate 2% gain.

As we predicted at the outset of last year, volatility made a vicious comeback. If one were to count the volatility index VIX as an asset class, it turned in the best performance of the year with a spike over 100%. What perhaps made the year most difficult was the rapid speed at which the markets turned south, giving up all gains for the year and then some in the final three months of the year. Santa Claus was nowhere to be found in 2018 as the final month of the year was the worst December for the stock market since the Great Depression.

The reasons for the market's recent difficulties have rarely been so widely telegraphed and well understood. As we published throughout last year, the rising twin risks for Federal Reserve policy error and trade war between the U.S. and China continue to pose the greatest challenges to the decade-long U.S. economic expansion. With the yield curve briefly inverting and the stock market swooning, markets were clearly discounting the probabilities for a looming recession.

The recent surprise earnings pre-announcement from Apple and two-year low read of the ISM Manufacturing Index clearly indicate that the ongoing trade dispute with China is having real economic impact. Apple cut its quarterly revenue forecast for the first time in fifteen years amid falling iPhone sales in China. And while the December ISM Manufacturing Index at 54.1 still implies economic expansion, it was far below consensus and a sharp drop from November's read of 59.3. Meanwhile, retail sales in China hit a fifteen-year low in November and China's fourth quarter GDP is estimated to be the lowest since the Great Recession. With quarterly earnings season on deck, it remains to be seen whether the Apple surprise will serve as the canary in a coal mine.

While there is increased optimism that a trade deal with China is imminent, it already may be too late for corporations with significant China exposure whose visibility for the current quarter has become decidedly murky. After all, if a full trade deal isn't concluded by March 1st, the Trump administration has threatened to raise tariffs on China's $200 billion of exported goods to 25% from 10%. While China seems poised to increase purchases of U.S. goods and services and to open its markets further to American capital, the two sides remain divided on the reduction of subsidies to Chinese companies and the protection of intellectual capital. Further, the U.S. is grappling with optimum means to ensure China's promises are implemented. We believe that the threat of exacerbated economic decline and additional stock market pain will ultimately lead to a reasonable resolution.

Meanwhile, the recent market turbulence has not been lost on Chairman Powell and the Federal Reserve. Speaking at a recent conference, Chairman Powell offered a more dovish approach, stating his case that the Fed can afford to be patient with inflation so muted and, more importantly, suggesting that changes to its balance sheet strategy ("quantitative tightening") would be on the table should circumstances warrant. And more recently published minutes from the Fed's December meeting clearly indicate a growing consensus that the Fed could be close to ending their recent string of rate increases.

Whether or not the Federal Reserve combined with improved U.S. China trade conditions serve to quell fears of imminent recession, there can be little debate that the U.S. economy and U.S. corporate earnings are decelerating from 2018's torrid pace. Consensus expectations for 2019 S&P 500 earnings at $173.63 imply 7% growth from 2018 and a current market PE multiple of 14.9x forward earnings. Our base case is that recession will be averted thanks to a more patient Fed and successful conclusion to trade negotiations with China. Last January, we set a target 1-2 year range for the S&P 500 at 2,900 to 3,200 conditioned upon interest rates remaining low. With the S&P peaking at 2,940 last year, our prognostication proved prescient and unfortunately short-lived. With the interest rate cycle at or near a peak, we are sticking to this target range for the coming 12 to 24 months, implying 15% to 27% upside from year-end levels.

While the year-end market drubbing may have already priced in an economic slowdown and decelerating earnings growth, additional downside volatility awaits should the Fed again turn more hawkish or should negotiations with China crumble.

Lurking behind the economic fundamentals, a recent Wall Street Journal article suggests that "roughly 85% of all trading is on autopilot – controlled by machines, models, or passive investing formulas, creating an unprecedented trading herd that moves in unison and is blazingly fast". Quantitative hedge funds, passive funds, index investors, high-frequency traders and market makers do not buy or sell due to a company's fundamental prospects, instead relying on computer-driven models based on price trends. While we warned of the potential for price-insensitive trading to wreak havoc on the market two years ago, we are surprised by the dominance of such trading models and expect bouts of extreme volatility to persist. With such an abundance of uncertainty, it is not surprising that said computer models are decidedly bearish today and "short everything" with the exception of the bond market.

Not only are the computer models bearish, recent individual investor sentiment indicators reveal lopsided negativity. With so much pessimism in the air, the contrarian streak in us favors the odds for the market to surprise to the upside. A recent provocative article in Barron's illustrates the research of Nicholas Colas, co-founder of DataTrek Research. Colas points to the 5.52% compounded annual growth rate for the S&P 500 over the past 20 years as evidence that market mean reversion is set to kick in and that the next 10 to 20 years ought to be more favorable for equity investors. In the wake of two negative-35% plus bear markets since 2000, markets are coming off 20 of the worst years for compounded returns since the Great Depression. With the average trailing 20-year market compounded annual growth rate at 10.7% since 1928, mean reversion would be favorable indeed.