Capital Markets Outlook Fourth Quarter 2018 Review

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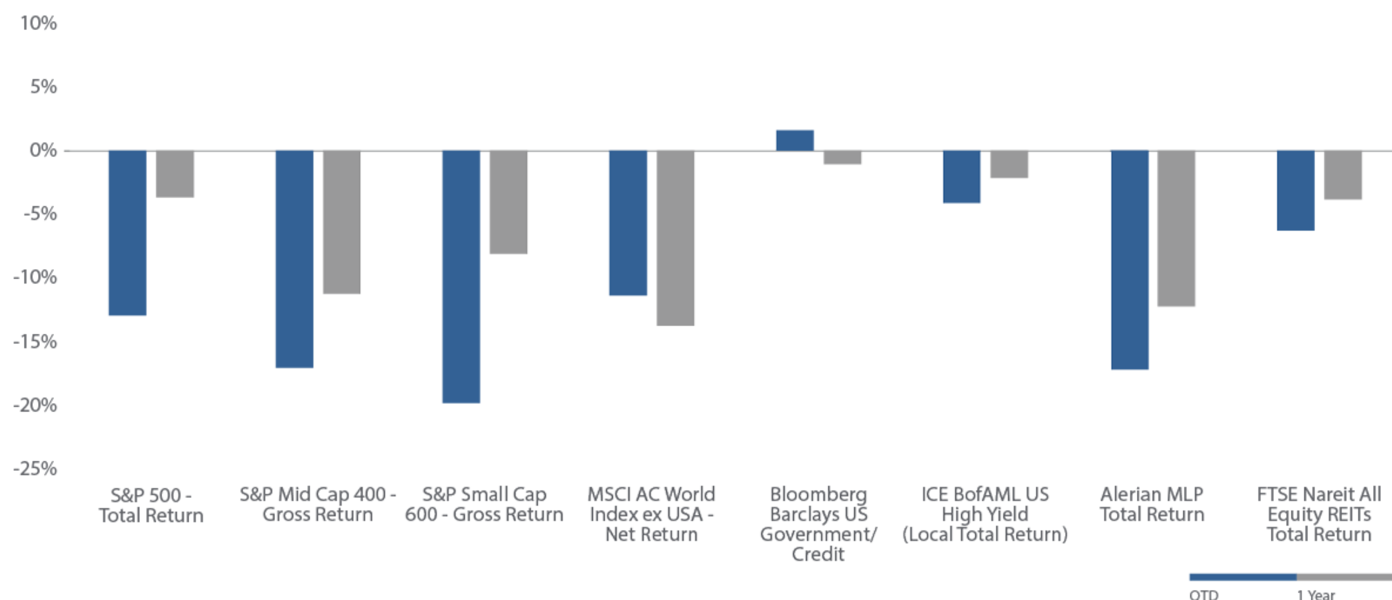
Looking back on 2018, the year began with great hopes for the market to extend the rally that had begun nearly nine years prior. However, by the time December ended, the S&P 500 would suffer one of the worst quarters in the last 50 years, having fallen over 13 percent in the fourth quarter.

This decline threatened to end one of the longest bull markets in history as pessimism reigned supreme including in the FAANG stocks, which had been the darlings of the market, after they officially moved into bear market territory falling over 20 percent from their highs. Several fears, including the potential for a prolonged trade war with China, slowing global growth, and a policy mistake by the Federal Reserve (the Fed), had surfaced far earlier than the fourth quarter but finally boiled over to send equity markets lower to close 2018 with a loss, as the S&P 500 declined 4.4 percent for the year.

In context, however, the market remains up over 22 percent since the presidential election in 2016 and up 50 percent over the last five years. Volatility seemed elevated into year-end, but context is important, as 2017 was abnormally calm with only 3 percent of trading days having market moves up or down greater than 1 percent. In comparison to the median of the last 50 calendar years at 23 percent, 2018 saw 25 percent of trading days with such a move, in-line with historical norms.

2018 Fourth Quarter and One-Year Trailing Returns Across Asset Classes



Source: FactSet

The most recent market gyrations have increased investor concerns over the potential for a recession in the coming years; however, many indicators for such an outcome remain positively skewed toward solid, albeit somewhat moderating, GDP growth in the coming year as we near the anniversary of tax cuts. Labor markets remain tight as unemployment remains low and wage growth remains positive. The yield curve has remained positively sloped, despite fears of an inversion, and has yet to signal the beginning of the end for the current economic expansion. Additionally, the decline seen in crude oil prices during the fourth quarter pushed down gasoline prices, further increasing the potential for consumer spending and dampening overall inflation. In aggregate, the market expectation appears slanted far more negatively than the current economic situation would dictate regarding the potential for corporate profits.

Looking Forward to 2019

As we look forward, our most likely outcome remains one of positive corporate earnings growth in 2019, supported by the strength seen in the labor markets and continued tailwinds from fiscal stimulus. This would push the U.S. into the longest expansion in history, even including the impact from lapping the
“sugar high” seen in 2018 from lowering taxes for individuals and corporations.

The Federal Reserve remains data-dependent and flexible in their pursuit of a measured pace of tightening financial conditions away from crisis-era policies and toward more normalized levels as economic data warrants. However, some progress is needed with regard to the trade tensions currently to improve business confidence to make long-term investment decisions, such as buying new equipment or expanding factory lines, as such decisions likely get drawn out while waiting for more certainty.

In turn, this puts additional pressure on corporate margins as inflationary pressures are more challenging for some companies to offset via productivity gains without such capital spending taking place. While a potential headwind, we believe that this will separate the “haves” from the “have nots” in terms of pricing power and drive performance for those companies best positioned in such an environment.

Given the current landscape, however, there remains material risks to both the upside and the downside to markets. Should a deal be struck by the White House and Beijing before the March deadline where tariffs are raised to 25 percent from 10 percent, this would be a notable positive for global growth. The markets could easily embrace global synchronized expansion as investments resume and fiscal stimulus, enacted to bolster domestic economics around the world during this disruption, provide even more boost to growth.

Almost in mirror opposite fashion, a less favorable outcome would be if Washington adopted an even tougher stance as they dig in against China and their 2025 plan and further disrupt supply chains and cost structures. With companies reeling from higher tariff-related input costs, the Fed's push to continue to hike rates in tandem with initially resilient employment growth creates even more headwinds to growth. This would likely exacerbate populist and protectionist movements, notably in the European Union, as slower growth finds its way to their markets in terms of lower employment and higher costs for consumers.

While those more extreme scenarios are possible, equity markets appear to currently be discounting an unfavorable outcome in terms of these broader risks as investors balance these potential headwinds and tailwinds.

In terms of our view, we remain constructive on equities given the prospects for earnings growth and attractive valuations currently. However, we remain fully aware of the potential for further disruptions and continued uncertainty across asset classes and geographies and remain focused, as we have for over 35 years, on absolute risk and strive to protect client capital during periods of volatility.

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