Towerpoint Wealth
Monthly Market Lookback

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The Point Of No Return

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***“An Investment in Knowledge Pays the Best Interest”
(Ben Franklin)***

The Point of Know Return?

*They say the sea turns so dark that
You know it's time, you see the sign*

*They say the point that demons guard is
An ocean grave for all the brave*

*Was it you that said, "How long, how long
How long to the point of know return?"*

(From “Point of Know Return”, by Kansas, 1977)

Market capitulation, anyone? We’ve been arguing for months (maybe even years) that investors were “over-buying” any good news – driving valuations to unsustainable heights.

Well, now we believe that investors are “over-selling” any bad news (even if it is only *potential* bad news). The Q4 sell-off has been so significant that it is now probable that most major global asset classes will end the year in negative or only modestly positive territory.

There most certainly are things to be concerned about, but investor sentiment seems to have fallen off a cliff, far below what is warranted given the actual state of affairs.

First, let’s summarize the potential negatives:

- The threat of a US government shutdown and President Trump’s and the Democrats’ squabble over funding for a border wall. This makes for breathless headlines and political brinksmanship but, historically, the markets have shrugged off temporary shutdowns.

- Massive and rapidly growing government debt and deficits. This is a real problem and will almost certainly get worse with a Democrat-controlled House and a President who likes to do deals and declare victory. So far, the markets seem to be ignoring this issue, but it may become more “real” and tangible when arguments over raising the debt ceiling heat up in earnest next March.

- Continuing trade tensions between the US and China. The markets rallied briefly when, during the G20 meeting in South America, President Trump announced there had been “significant progress” in discussions with China. Perhaps, but the devil is in the details, and when it became clear that details were hard to come by, the markets sold off hard. Slow progress appears to be the current path, which the markets generally will view as positive.

- Central Bank Policy. There is a distinct “desynchronization” of global central bank policy, with the US and the ECB tightening (or, at least, reducing the level of easing), while China, Japan, and the UK remain largely accommodative. This has been one driver of current market volatility.

- The US Federal Reserve Bank *wants* to continue a disciplined rate “normalization” policy and, as expected, raised rates an additional 25 bps in December. But recent signals from the Fed suggest it may back off of its planned 3-4 rate hikes next year, as the economy slows and the markets have free-fallen over the past 6-8 weeks. The consensus opinion now is that the Fed may raise rates 1-2 times next year, but will be increasingly sensitive to economic and market indicators going forward.

- We have argued many times that some of the current market anxiety is natural. We were told for almost a decade that “Quantitative Easing” – flooding the global markets with liquidity – was positive and supportive for the value of risk assets – and it was. So now that the Fed (and, to a lesser degree, the ECB) is pulling liquidity *out* of the markets, we somehow are supposed to believe that it will not be *bad* for the value of risk assets? We don’t think it works that way.

- We increasingly are concerned about the state of the public rate & credit markets. The credit quality of the US Investment Grade bond market is deteriorating, with the majority of issuance now rated BBB – the lowest investment grade level. When the next recession eventually comes, if more than even a few of these issuers fall into non-investment grade status, we don’t believe the High Yield market has sufficient liquidity to absorb the volume without significant price disruption. We’ve spoken with multiple fixed income managers over the past few weeks, all of whom are increasing their cash positions in anticipation of this disruption eventually occurring (and positioning themselves accordingly to buy assets at significant discounts).

- Likewise, the Bank (or Leveraged) Loan market has seen a flood of issuance over the past two years, as investors sought shorter duration and / or floating rate exposure in anticipation of higher interest rates. But now both the credit quality and the covenant structures of these largely syndicated loans are deteriorating. This is similar in nature, if not in magnitude, to the state of this space just prior to the 2008 financial crisis, and the collapse of this market was a contributor to the broader market disruption.

- There are certain geopolitical events that have, to one degree or another, generated anxiety in the markets. Specifically, the ongoing fiscal and budgetary disagreement with Italy (the Eurozone’s third largest economy), the ongoing uncertainty over “Brexit” (and accompanying political turmoil for UK Prime Minister Theresa May), the fall from power of German Chancellor Angela Merkel, the riots in France over a proposed fuel tax, and the ongoing tension in the Middle East over the assassination of journalist Jamal Khashoggi. None of these issues individually seems sufficient to overturn a generally positive global economic environment, but collectively they appear to be contributing to heightened investor apprehension.

In the context of all this *potential* bad news, it is understandable that investor sentiment has fallen and anxiety increased.

But now let's examine the other side of the coin – the *positive* news:

- The US economy is going strong, and is expected to remain so through most of 2019 and potentially into 2020. It probably will not maintain its torrid pace of the past 2-3 quarters, but even though this most recent economic recovery has been historically long (though *low and slow*), it still seems to have some legs left.

- Inflation remains under control – wage inflation in the US is increasing only slowly, and commodity prices remain repressed by slowing demand and a strong dollar. US inflation remains well within Fed targets and, outside the US, inflation simply is not an issue.

- Interest rates remain low, and also under control. Rates had begun to grind higher earlier in the year as the Fed tightened fairly aggressively and the economy expanded. But with inflation under control and the recent "flight to quality" rally in prices (reduction in yield), the 10-year Treasury once again is trading below the psychological barrier of 3%. This helps equity valuations as well as corporate (and government) debt servicing.

- The recent market volatility may result in the Fed easing up on its planned rate "normalization" program as we head into 2019, which the markets will view as positive.

- The non-US global economy remains expansionary, though slowing. Many central banks remain accommodative or plan to become more accommodative during 2019 as their local economies decelerate and inflation remains muted.

- US earnings remain strong, though they, too, are expected to decelerate over the course of 2019 as the impacts of tax reform (e.g., repatriation of offshore profits and heavy stock buyback programs) begin to taper off. But, even after stripping out these transitory events, corporate revenues and earnings should show reasonable positive growth.

- It can be argued that the market got ahead of itself through the first three quarters of 2018, raising equity valuations to levels well above historical averages. But the combination of strong earnings, low interest rates, and falling prices have brought down equity P/E ratios to much more "normal" levels, especially outside of the US. At some point, should valuations continue to fall, investor bullishness will return, given the underlying strength of earnings and the economy.

We do not like market disruptions, volatility spikes, or bear markets any more than anyone else but, in our opinion, what we witnessed over the past 2-3 months is a return to *normalcy* – higher volatility, a return of focus to fundamentals, and more appropriate valuations. History suggests that the current market downturn may continue for a while, but we remain cautiously optimistic over longer and more realistic time horizons.

With that as a backdrop, looking out over the current economic and investment landscapes, here is what we see.

The Current Economic Landscape

The global economy continues to grow, though with signs of deceleration, especially outside of the US:

- The Q3 GDP growth in the US came in at a solid 3.5%, in line with expectations. That growth is expected to decelerate to 2.5% in Q4, as the effects of tax reform, regulatory relief, and fiscal stimulus begin to wear off, bringing overall 2018 GDP expectations to 3.0%; (source: *The Wall Street Journal*);
- The GDP forecast for 2019 GDP currently sits at 2.3% – a deceleration but still positive (source: *The Wall Street Journal*). This forecast, of course, remains sensitive to the issues summarized above;
- Both US manufacturing and services remained strong in November, with the PMI (manufacturing index) coming in at 59.3, up from 57.7 in October, while the NMI (non-manufacturing index) increased slightly to 60.7, up from 60.3 in October; any reading above 50 is considered expansionary. The two indexes have now been in expansionary territory for 115 and 106 consecutive months, respectively (source: *The Institute for Supply Management*);
- Inflation (as measured by CPI) fell to 2.2% (annualized) in November, down from 2.5% (annualized) in October, breaking a 4-month up-trend. The price of oil (as measured by WTI) has declined steadily since late September, falling from roughly $76 to $48 per barrel as we head into late December – its lowest level since September of 2017 (source: *TradingEconomics*);
- The *Atlanta Federal Reserve Wage Tracker* showed a 3.9% (annualized) increase in median wages in November, continuing a year-long rally, but a slowing global economy outside of the US, especially in China, as well as a strong US dollar, are combining to keep commodity prices under control (even falling).
- The Personal Consumption Expenditure (PCE) index – the Fed's preferred measure of overall inflation – increased 1.8% year-over-year in October (the most recent reading), down slightly from 1.9% in September – still generally in line with the Fed target rate (source: *TradingEconomics*).
- We continue to believe that inflation will increase slowly, but will remain somewhat dampened by (1) continued slow (but positive) wage growth; (2) a strong dollar; and (3) a decelerating global economy (ex-US), which will dampen demand. As such, we continue to believe that inflation does not yet constitute a primary risk to economic growth;
- As expected, the Fed raised interest rates in both September and December. However, the Fed definitely introduced a distinctly more "dovish" tone to its public pronouncements, and we may very well see a backing off of its proposed 3-4 additional rate hikes in 2019, to perhaps only one or two over the course of the year;
- After rising slowly through most of the year, the yield curve rallied over the past several weeks in a "flight to quality" for many investors during the market downturn. But the curve remains very flat, as the Fed raises rates on the short end but the long end remains "tamped down" by high demand and a lack of inflation fears. As of mid-December, there is less than 20 basis points difference between the yield on the 2-year and 10-year Treasury (source: *YCharts*);

- Although the 10-year Treasury rate has fallen below the psychological barrier of 3%, we still do not anticipate (or fear) an inverted yield curve (though the middle of the curve inverted briefly in late November) – should one occur, we believe it will be because of investment flows and Fed actions, not a harbinger of an imminent recession;
- The US dollar remains strong, though it seems to have stabilized (for now) as the market seems to be pricing in a less aggressive Fed policy in 2019. Starting in April, the dollar rose fairly steadily against the euro, the Japanese yen, and (especially) the Chinese yuan. The Chinese are actively devaluing the yuan in an attempt to kick-start their slowing economy and mitigate the impact of the ongoing trade tensions with the US. It is hard to see any catalyst (except perhaps a reversal of Fed policy, which we do not anticipate) that would reverse the dollar's current strength over the near term (source: *YCharts*);
- After a strong Q3 earnings season, the market is beginning to look forward to the Q4 season, which will begin in earnest in early January 2019. Q3 saw earnings increase more than 28% on almost 9% higher revenues. The earnings and revenues "beat rates" (i.e., reported numbers higher than expected) were 77.2% and 61.6%, respectively. Both are good levels and in line with historical averages (source: *Lipper Alpha Insight*);
- Many companies continue to use financial engineering (stock buybacks, etc.) versus top-line organic revenue growth to generate earnings growth. Growth is expected to decelerate as we head finish up Q4 and head into 2019, with Q4 earnings growth estimates of 12.3% and 2019 earnings and revenue growth estimates in the mid-to-upper single digits (source: *Zachs Earnings Report*);
- Manufacturing across the Eurozone remains expansionary, though the Markit Manufacturing index fell to 51.4 in November, versus 51.8 in October, continuing a general YTD decline. Likewise, the Services index fell slightly to 51.4 in December, down from 53.4 in November – the slowest services expansion rate since November 2014 (source: *TradingEconomics*);
- Eurozone unemployment remained at 8.1% in October (the most recent reading), the same level as in September, and it remains at its lowest level since November of 2008. Annualized inflation edged down to 1.9% in November, down from 2.2% in October, and is the lowest recorded rate in six months (source: *TradingEconomics*);
- Japan's GDP fell 2.5% (annualized) in Q3, far worse than the previous estimated decline of 1.9%, due to sharp declines in capital spending, personal consumption, and net export demand. The Japanese economy is expected to continue to decelerate, and there is a possibility it will post negative overall growth in 2018 (source: *TradingEconomics*);
- China's (official) GDP growth in Q3 was 6.5% (annualized), down from previous quarters, and the lowest (official) growth rate recorded since Q1 2009. There are other (non-official) signs that suggest the Chinese economy is slowing faster than the official numbers indicate. For example, the Chinese Caixin Manufacturing Index came in at 50.2 in November (barely expansionary and only slightly higher than the October reading of 50.1), the Chinese stock market is down roughly 22% YTD, and the yuan continues to weaken against the dollar (source: *TradingEconomics*).

The Towerpoint Wealth Economic & Market Outlook:

- ***The global economy continues to (slowly) expand, though there is a distinct deceleration and "desynchronization" of growth. The US economy shows continued growth, though forecasted to slow in 2019. At the same time, the rest of the world appears to be decidedly decelerating – still expansionary, but slowing down (especially in Europe, Japan, and China);***
- ***US Inflation remains stable and in line with Fed targets, and we maintain our belief that it does not represent a threat to continued economic expansion. Wages in the US are increasing only slowly (though showing signs of acceleration), oil prices have fallen significantly over the past three months, and overall commodity prices remain repressed by slowing demand and the strong dollar. Outside the US, inflation simply is not a problem and, in fact, Europe may soon have to worry once again about entering into a deflationary regime;***
- ***The positive impacts of fiscal stimulus, tax reform, and regulatory relief remain in place, but should begin to taper as we head into 2019. The Fed previously had a laid out a fairly aggressive tightening program over the next 12-15 months, but there is now some belief it may "back off" of that plan in the face of the recent market correction and expectations for a slowing economy in the latter half of 2019;***
- ***Solid US GDP growth, as well as respectable earnings and revenue growth, make for a generally positive market environment and, despite the recent sell-off, we maintain generally optimistic for US stocks over medium- and longer-term time horizons (though the current correction and disruption may continue over the short-term);***
- ***Ongoing trade tensions between the US and China, European tensions over Italy's fiscal state and the UK's struggles with "Brexit", and decelerating non-US economic growth seem to be the largest potential threats to the current economic and market regimes;***
- ***EM and EAFE (Developed International) markets continue to be hurt by a generally strong US dollar, slowing economies, trade tensions, and a corresponding "risk off" mentality driving investment outflows.***
- ***That said, due to relatively attractive valuations following the steep price declines earlier in the year, investors are beginning to reconsider these markets from a longer-term perspective. These markets will post strongly negative performances in 2018, in both local and US terms, and will continue to exhibit higher volatility, but we still like them as longer-term positions, from both a valuation and economic growth perspective;***
- ***At current interest rates and credit spreads, the public credit markets continue to look very expensive to us, and our return expectations are muted accordingly. We are nearing the end of the current credit cycle and risks are increasing, especially in the high yield space (where spreads have increased almost 150 bps since early October), which is often a harbinger of an impending market correction;***
- ***The leveraged loan market (i.e., floating rate bank loans) has seen a decided deterioration in both the credit quality of borrowers and in loan covenant structures – both distinct warning signals;***

- ***Likewise, the traditional investment grade bond market has seen a downturn in the average credit rating of borrowers. This could have dramatic implications if / when the next recession hits and corporate revenues decline;***
- ***Many investors are turning to shorter-duration bond strategies and even cash solutions, which finally have a positive real yield again due to the Fed rate hikes. The curve is so flat that investors simply are not being sufficiently compensated to take on term or duration risk, despite the recent "flight to quality" rally;***
- ***We expected that rising rates, increased volatility, and greater security price dispersion would create a more positive environment for both traditional active managers and for alternative investments, but this thesis has proven slow to develop during the recent market disruption;***
- ***We muted our short-term expectations for real assets and the overall commodity complex, due to lower than expected global inflation, slowing demand, falling oil prices, and the strong US dollar. That said, we are beginning to believe (and this is our most contrarian view) that this market has been over-sold, and may be poised for a comeback as we head into 2019;***
- ***While we generally are constructive on the global economy and overall market performance, the public markets are "rationalizing", and the market volatility we long expected has materialized. We still believe that the market can move higher over the next 6-12 months, but it will not be a smooth ride.***

In summary then, we believe that investors "overbought" good news through the first three quarters of 2018, and now are "overselling" bad news. There are risks in the marketplace, to be sure, but the US economy is strong, the global economy is slowing but still expansionary, interest rates are low, inflation is low, and corporate earnings are solid.

What we are witnessing in Q4 is a return to more *normal* market conditions – a renewed focus on fundamentals and higher volatility – than we experienced in almost 10 years of global central bank accommodation.

It can be painful to endure, but discipline and continued alignment of your investment plan time horizon with your long-term financial objectives remains the appropriate course of action.

We wish you a blessed and peaceful Holiday season, and a healthy and prosperous 2019.

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