Towerpoint Wealth
Monthly Market Lookback

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Are We Having Fun Yet?
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"An Investment in Knowledge Pays the Best Interest"
(Ben Franklin)

Are We Having Fun Yet?

It's not like you to say sorry
I was waiting on a different story
This time I'm mistaken
For handing you
A heart worth breaking
And I've been wrong
I've been down
Into the bottom of every bottle
These five words in my head
Scream
Are we having fun yet?

(From "How You Remind Me", performed by Nickelback, 2001)

Time matters. With investing it is especially important, as it ultimately separates out short-term market "noise" from longer-term investment "signals". The challenge today is that many investors are exposed to constant noise from cable news (little TV screens in elevators, anyone?) as well as mainstream and social media, all on a "must be filled" 24/7 news cycle.
One of the most important responsibilities of advisors, fiduciaries, and stewards of wealth is to help investors stay focused on their longer-term financial plan and whether or not their investment plan is succeeding in helping them achieve those longer-term objectives. Part of this is helping investors separate out noise from signals with respect to market performance.

This is especially true as (1) we approach the end of a decade-long economic expansion; (2) global central banks, to varying degrees, at least consider dialing back their easy money policies; and (3) divisive political discord goes global. All of these phenomena will likely contribute to an increased level of "noise" that can easily frighten and distract investors from their longer-term objectives.

So let's summarize how we see the world in terms of noise – those things that may introduce short-term volatility and anxiety, but which are unlikely to dramatically affect longer-term performance – and signals – those things that may actually affect longer-term market performance.

Noise:

1. **The political dysfunction in Washington, DC.** Yes, the recent government shutdown may shave some growth off of Q1 GDP. And yes, it is difficult to watch the pettiness, immaturity, and divisive partisan acrimony emanating out of Washington these days. But we've been here before (minus, perhaps, the amplifying megaphone effect of social media), and gridlock and name-calling are

nothing new. Historically, the markets tended to shrug off political gridlock and, despite the rhetoric and anger, our political system is stable.

2. **The Robert Mueller investigation.** The news is full of speculation about what Robert Mueller knows, what he can prove, and when he plans the "big reveal". The absolute worst case scenario for the market is that Mueller comes forward with plausibly impeachable offenses against President Trump (and we have no opinion as to whether or not he will), and Trump is, in fact, impeached (or threatened seriously enough that he resigns). This would cause temporary havoc with our government and the markets, but the primary long-term lesson from the Nixon and Clinton scandals is important – time moves on, and so will the government and the markets. Anything less than impeachment will quickly be forgotten as we head into the 2020 presidential election season.
3. **Ongoing trade tensions between the US and China.** Our perspective on this is slightly contrarian. Should the trade disagreements and negotiations continue for a long period of time, there is little question that the markets will react negatively, and there could be knock-on repercussions on global economic growth. But, perhaps naively, we continue to believe that both sides have more to lose than to gain by dragging out the negotiations, and that they will come to a mutually disagreeable compromise within a reasonable amount of time.

Noise / Signal:

1. **Central Bank Policy.** We place this issue as a bit of a "hybrid" between noise and signal. It is noise because, when markets are performing "normally", central bank policy tends to have marginal effects, as investors react with either relief or concern to changes or perceived changes in current policy. Fed Chairman Jerome Powell learned this the hard way when he was perceived as being too dogmatic and "hawkish" in his public statements last fall (contributing to a dramatic market fall-off and a spike in volatility) – statements he then felt the need to "walk back" in a follow-up statement in December (contributing to a remarkable bounce-back in the markets at year-end and largely continuing through most of January).

   Central bank policy does have some longer-term signal potential as well, however, at least in the current market regime. For most of the past ten years, global central banks engaged in massive and synchronized "quantitative easing", and we were told repeatedly and consistently that all that liquidity would be good for risk assets. And it was, as investors enjoyed a bull market of somewhat epic proportion.

   Over the past 12-18 months, however, the story has changed, as the Fed embarks on an unprecedented plan to both "normalize" interest rates *and* reduce its balance sheet (i.e., take liquidity out of the marketplace) at the same time. The rate normalization plan may be on hold for now (or at least slowed down) following the disruption of Q4, but the balance sheet reduction continues. Logic dictates that if pumping liquidity into the markets was beneficial, then pulling it back out will, at the very least, be painful. The increased volatility we experienced in Q4 is likely to become more of the norm going forward, as investors grapple with the loss of liquidity and are forced, therefore, to focus more on fundamentals – economic growth, revenue and earnings growth, balance sheet strength, interest rates, and so forth.

Signals:

1. **Economic Growth.** Global economic growth remains expansionary, but is decelerating, especially outside the US. We are in the late stages of the current economic cycle, which tends to drive increased market volatility as weaker economic players become more visible (the tide is no longer high, and therefore no longer lifting all boats, as the expression goes). The general consensus is that we will not enter into a recession in 2019, and perhaps not until later in 2020 – but that day is coming, and corporate and government balance sheets remain bloated from the fiscal responses to the *last* recession.
2. **Revenues and earnings.** For now, corporate revenues and earnings remain in solid shape. The consensus estimate here in the US is for high single digit growth in earnings as we move through 2019, but with a deceleration of those growth rates as we get to later in the year. Investors will respond accordingly.
3. **Interest rates.** Interest rates remain under control, and we expect only a modest increase for most of 2019, both in the US and abroad. We believe there simply is not enough economic growth or inflation to warrant any dramatic increase in rates.
4. **Inflation.** As with interest rates, we simply do not see enough upward pressure to warrant much concern. Global input prices have fallen due to slowing global demand and a stabilizing dollar, and wages are increasing only slowly. We expect both rates and inflation to "grind higher" in 2019, with rates experiencing periodic pullbacks during times of "flight to quality" market anxiety.

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 is still expanding but clearly decelerating:

- The consensus estimate for Q4 GDP growth in the US is 2.6%, bringing 2018 GDP growth to 3.0%. Growth is expected to remain positive but decelerate through 2019 (2.2%); (source: *The Wall Street Journal*);
- There remains some uncertainty regarding this forecast, however, as the US government shutdown and the outcome of ongoing trade negotiations could change the economic outlook for the US over the course of the year;
- Both the US manufacturing and services sectors remain in expansionary mode (54.1 and 57.6 in December, respectively; any reading above 50 is considered expansionary), but appear to be slipping;
- The manufacturing index has been in expansionary territory for 116 consecutive months, while the non-manufacturing index notched its 113th consecutive expansionary month (source: *Institute for Supply Management*);
- Inflation (as measured by CPI) fell to 1.9% year-over-year in December, in line with market expectations, driven largely by a decrease in gasoline costs. That is the lowest inflation rate since August 2017;

- The Personal Consumption Expenditure (PCE) index – which is the Fed's preferred measure of overall inflation – came in at 2.40% year-over-year in November (the most recent reading), in line with the Fed target rate (source: *TradingEconomics*);
- We believe that inflation will tick up slowly over the course of 2019, but that it does not yet constitute a primary risk to economic growth;
- After raising rates (as expected) in December, the Fed seems to have backed off its previous fairly aggressive "normalization" plan, as the economy cools and inflation remains under control;
- Markets reacted very negatively to earlier public statements from Fed Chair Jerome Powell, but he seemed to "walk back" those statements in late December, and turn more "dovish";
- After initially anticipating 3-4 rate hikes in 2019, the current Fed projection is now no more than 2, with the first probably not until Q2. Some market professionals do not believe the Fed will raise rates at all in 2019;
- Severe market volatility drove a "flight to quality" rally in Treasury yields over the course of December, and the 10-year once again is trading below the psychological barrier of 3%;
- We maintain our outlook that rates in the US generally will inch steadily higher, with periodic reversals during market disruptions;
- The yield curve remains very flat as the Fed raises rates on the short-end but the long end remains "tamped down" by high demand, lack of inflation fears, and periodic "flights to quality";
- Through the second week of January, there is less than 20 basis points difference between the yield on the 2-year and 10-year Treasury. We do not anticipate (or fear) an inverted yield curve – should one occur, we believe it will be because of investment flows and Fed actions, not necessarily a harbinger of an imminent recession;
- In the wake of a slowing US economy and the more "dovish" tone by the Fed, the US dollar stabilized in late 2018, and actually has lost some ground to the yen and the euro;
- We believe the dollar will remain stable or modestly strengthen through 2019, as the US economic growth rate continues to exceed those of non-US economies;
- As the Q4 reporting season gets into full swing in the US, earnings for S&P 500 companies are expected to increase 11.7% on 5.3% higher revenues. While this represents solid expansion, the consensus forecast is for a deceleration in US earnings growth as we head through 2019 (source: *Zachs Earnings Report*);
- Manufacturing all across the Eurozone remains expansionary, but slipping, with the Markit Manufacturing index falling slightly from 51.8 in November to 51.4 in December, continuing a slow month-over-month deceleration in manufacturing growth in Europe;
- Likewise, the Euro area Services index fell to 51.2 in December from 53.4 in November. This is the lowest reading since November 2014 (source: *TradingEconomics*);
- Eurozone unemployment fell to 7.9% in November (the most recent reading), the lowest level since 2008;
- Eurozone annualized inflation slipped to 1.6% in December, down from 1.9% in November, with most of the decline coming from falling oil prices (source: *TradingEconomics*);

- Japan's Q3 GDP contracted 2.5% (annualized), its second negative quarter in 2018 and the steepest contraction since Q2 2014 (source: *TradingEconomics*);
- Japanese exports may face continued headwinds in the face of a slowing global economy and the recently strengthening yen;
- China's (official) GDP growth in Q4 was 6.4% (annualized), the lowest reported growth rate since the Financial Crisis in 2008;
- Other indicators suggest that the Chinese economy may be decelerating at a rate much higher than the official reported number. For example, the yuan has depreciated significantly as the Chinese central bank attempts to stimulate the internal economy, and the Chinese manufacturing index fell to 49.7 (below expansionary) in December, the first contraction since May 2017 (source: *TradingEconomics*).

The Towerpoint Wealth Economic & Market Outlook:

- ***The global economy continues to expand, though there is an expected deceleration of growth, including in the US;***
- ***US inflation is trending higher, but we maintain our belief that it (as of yet) does not represent a problem for continued economic expansion. Wages finally are starting to increase, though slowly, but this is being offset by stable or falling oil and commodity input prices;***
- ***Outside the US, inflation simply is not a problem, due to slow growth and (currently) low oil prices;***
- ***In the US, the stimulative impact of tax and regulatory reform are beginning to taper off, and the government shutdown could diminish Q1 economic growth if it were to begin again in February;***
- ***We are in fairly unprecedented "market waters", as the Fed attempts to "normalize" interest rates AND reduce its balance sheet simultaneously;***
- ***Globalized and synchronized central bank quantitative easing was beneficial to risk assets, and we enjoyed a years-long bull market. As central bank policies now "de-synchronize", and as the US Fed both tightens and reduces its balance sheet, it most likely will have a detrimental effect on risk assets, or at the very least drive higher market volatility (which we have already witnessed);***
- ***Continued (but slowing) US GDP growth, and solid earnings and revenue growth, make for a generally positive market environment, and we still think stocks can move up from current levels. However, decelerating earnings growth and rising interest rates will most likely combine to push valuations down and volatility up;***
- ***Market volatility will also be affected by what seems to be a continuing series of geopolitical events, specifically ongoing trade tensions between the US and China, Brexit, the Italian fiscal discussions, changing political climates in France and Germany, and so forth;***
- ***We still like EM and EAFE valuations relative to US valuations, and like them as longer-term positions, but investors must accept increased volatility. US investors in non-US markets may benefit in 2019 from a generally stable or only modestly increasing dollar;***

- ***The US yield curve remains incredibly flat (there is currently less than a 20 bps difference between the 2-year and 10-year yields), as lower longer-term expected growth rates and technical investment flows combine with only modest inflation expectations on the long-end of the curve, but we believe the risk of inversion is low;***
- ***There currently is not a great deal of upward pressure on rates, but we maintain our view that rates will "grind higher" over the course of 2019, with periodic market corrections and a corresponding "flight to quality" response from investors;***
- ***Despite the recent increase in credit spreads (especially in high yield, which spiked in late December and then fell back fairly quickly over the course of January), the public credit markets still look very expensive to us. Further, we are concerned about high yield liquidity and refinancing risk and the growing level of "covenant lite" bank loans. We are nearing the end of the current credit cycle and risks are increasing;***
- ***For investors who can access the private markets and handle some degree of illiquidity, we still believe there are better opportunities in the private markets versus the public markets, though investors face compressed premiums versus historical levels, driven by huge investment flows over the past 18-24 months;***
- ***Alternative investments, both Hedge Funds and Liquid Alts, disappointed investors in 2018, and both spaces witnessed extensive investment outflows as a result (as we predicted). 2019 will be a litmus test for alternative investments, as rising rates, higher volatility, and a better opportunity set for active management should be conducive for improved performance;***
- ***We believe the real assets and the commodity complex may have been oversold in 2018, and we could witness a bounce back in 2019 as attractive valuations and a more stable dollar bring investors back to the table.***

While we are cautiously constructive on the global economy and overall market potential, investors should probably expect a fairly soft market environment, increased volatility, and more frequent periods of extreme investor sentiment and market movement as we move through 2019.

With that in mind, clients need to have their expectations managed as to what a globally diversified portfolio can deliver over a full market cycle, they need to understand *where we are* with respect to that market cycle (i.e., later stages), and they need to be reminded to keep their investment horizon aligned with their long-term financial objectives.

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