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A Liquidity Recession, Not an Economic One

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Clearly, the market was expecting the Federal Reserve's (Fed) comments to be more accommodative for 2019. Investors are not necessarily looking for fewer than two hikes as a projection for next year; but rather they are looking for the Fed's commentary to indicate an understanding that financial conditions are tighter than they realize. In addition, weakness overseas and inflation that has ticked below their own target rate, do not seem to be factored into their commentary about future policy in any meaningful way. This is likely the main reason why the Dow Jones Industrial Average dropped more than 800 points, from up over 360 points prior to chairman Powell's comments, to down over 500 during the communication.

In addition, further equity market weakness is suggesting that investors believe a hard economic landing scenario is more likely for 2019 than they believed earlier in December. The S&P 500, at 2506, is down over 10 percent from two weeks ago and down more than 14 percent so far in the fourth quarter. The most recent downdraft has begun to price in a rising probability of a U.S. economic recession and much slower growth overseas. Equity mutual fund outflows for the week ending 12/12/18 were about $45 billion, according to AMG data, which is the highest outflow on record for any one week. Not only are we in the midst of a "buyer's strike" but the market is being overwhelmed by a wave of tax-loss selling as we close out the year.

With forward-looking economic data still suggesting that economic growth is tracking at 2.5 percent or better for 2019, we view this major downturn in equities as overdone and clearly driven by a variety of excessive concerns centered on the level of growth globally. We believe this downdraft can be better described as driven by a liquidity recession, not an economic one.

With so much headline and event risk no doubt encircling the markets in the next few months, we continue to expect volatility to remain elevated and investor risk appetite to stay low. In order for investors to begin to allocate some of their investment liquidity back into equities, three events need to happen, in our view.

1. The Fed needs to pause and allow the current hikes to filter through the broader economy before they resume future rate increases.
2. Geopolitical risk needs to fade, starting with the U.S.-China trade relationship. A short-term trade agreement is needed to provide clarity on supply chain management for those multinationals that have material exposure to global trade.
3. Corporate earnings need to show resiliency to the forecasted slowdown in economic growth for 2019. Earnings each quarter will need to maintain a trend that is positive, around 5 percent growth, and not fall close to zero growth.

Given the significant decline in price-to-earnings multiples of more than 20 percent from their highs, we believe much of the worst-case scenario is priced into the broader market. With our view that the Fed stays balanced to dovish, rather than hawkish, in the next twelve months, we remain constructive in equities for the longer-term investor. We would have a disciplined plan ready to add to equities in three separate re-balancing episodes in the first half of 2019.

Where Do We Stand?

When capital-market activity has a hard time rallying on good news, or stabilizing on less bad news, and falling on no "real" news, it's important to ask the question, "What are we missing?"

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Consider The Following Points:

The Fed

- The Fed has raised the funds rate up to 2.25-2.50 percent (200-225 basis points) while engineering a prescriptive path of balance-sheet-roll off. Bumping rates higher, albeit at a moderate pace in the last couple of years, coupled with quantitative tightening of the balance sheet, has created an environment of declining liquidity and higher cost of capital - although it is still low relative to previous cycles.
- Although the overnight rate is just barely positive on a real basis, the tightening or roll-off of the Fed's balance sheet is a major headwind to financial conditions. Balance sheet roll-off, combined with rate hikes, is creating a liquidity recession that is impacting asset markets, in our opinion.
- We expect the Fed to remain data-dependent through this cycle; but we believe that, including the quantitative tightening, financial conditions are too restrictive, given recent expectations for inflation. Therefore, we expect the Fed to pause while staying balanced in their assessment of the economy, inflation and employment data.

The Economy

- The U.S. consumer remains strong, in light of solid employment data and rising real incomes. We expect the consumer to remain the primary engine of the economy and to induce real economic growth at or above trend, around 2.5-2.7 percent, in 2019.
- The global economic landscape is much less clear. Europe's growth has risk to the downside while Japan remains a slight positive. The emerging markets should benefit from fewer rate hikes than expected, low oil prices, a weaker dollar, and potential stimulus from China.

Earnings and Valuation

- The current downdraft is now pricing in zero to negative earnings growth for corporate America next year. We still expect earnings growth of 5 percent. Therefore, given the low base of 2506 on the S&P 500, relative to our fair value price of 2900, we could see the potential for 12 -15 percent returns for 2019, from current levels. Volatility is not expected to subside, however, until there is full clarity on rates (Fed fully capitulates), trade, and earnings.

We will be reviewing our asset allocation viewpoints through year-end and throughout 2019. Our barbell approach to a slight overweight in the U.S. and emerging markets is maintained. The emerging markets have outperformed in the last few months (still down relative to the U.S.) as U.S. equities have undergone significant weakness. In the new year, we expect both regions to grind higher as the buyer's strike ends. The emerging markets will need a weaker dollar and a general peak in rates, and should benefit from the move lower in oil prices. And the U.S. is likely to go where the U.S. consumer goes.

In fixed income, we view shorter-term fixed income and cash yields as attractive relative to dividend yields and longer-term debt. We also believe credit spreads are likely to remain at around current levels; and we prefer investment grade relative to high yields. We are getting more constructive on government bonds relative to credit, and we still believe long-term municipal bonds are attractive. In terms of commodities, we are not ready to upgrade until the non-U.S. growth picture improves and we are in a more attractive demand versus supply equation across the complex.

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