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INVESTMENT MANAGEMENT

Was 2018 just a bump in the road… or is 2019 the end of the road?

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Call it superstitious, but we in Applied Equity Advisors are always uncomfortable producing our market outlook commentary for the following year until the current year is complete. Much can happen in December that could impact our projections about the coming year. Certainly December 2018 is a case in point!

So here is our analysis as we sit at the end of December 2018, albeit emotionally exhausted after quite a month. (*And please also listen to our 2019 Market Commentary webcast, originally taped Thursday, January 3rd, 2019)*

In summary, we believe the short-term outlook for the market immediately past the treacherous December 2018 is a decent recovery. Sentiment and breadth is so stretched that if the market is consistent with history, we should see rallies from these levels.[1] But that does not necessarily mean we have resolved many of the issues that caused this recent correction. That will take time, likely with more weakness to come. Nevertheless, as we contemplate returns for the 2019 full year, we think it would be emotionally easy but intellectually foolish to be LESS optimistic. 2018 washed out many of the excesses, setting up 2019 to be a better year.

We believe the US stock market's December 2018 gyrations are reflecting a crisis in confidence, but not a 2019 economic recession.

During rocky times for the stock market, we are reminded of Ben Graham's famous commentary that the stock market is a voting machine short term, tallying up who is popular and who is not, and a weighing machine long-term, assessing the substance of companies.

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Are the fundamentals rolling over, or has the stock market's popularity simply plummeted? As I stood in unusually long lines both at my local Starbucks on Christmas Eve morning and later in the day at Nordstrom Rack (the checkout line snaked halfway through the store), it sure did not feel to me as though the world was crashing. But then there is the stock market.

Of course, it's important to consider that the stock market is a leading indicator. Consumer spending is not. So is the market screaming recession in 2019? Is it the end of the road for this cycle? Or was this truly one heck of a bump in the road?

We believe the stock market is reflecting the stresses of:

1. ***Fears of a trade war*** and the unrepentant verbal assaults which appear naïve to the corporate uncertainty they cause.
2. ***Fed policy*** that appears to be determined by peering through the rear view mirror.
3. ***Increased risks of geopolitical mistakes*** given the resignations of key Trump administration leaders.
4. ***A government shutdown*** and the potential for a protracted battle.

In brief, Trump's and Powell's policies and actions are not currently being perceived as market friendly (nor are those of European politicians), and the market's short-term voting machine has reflected that.

FedEx CEO Fred Smith said succinctly on his December quarterly call:

> *And I'll just conclude by saying most of the issues that we're dealing with today are induced by bad political choices, making a bad decision about a new tax, creating a tremendously difficult situation with Brexit, the immigration crisis in Germany, the mercantilism and state-owned enterprises in China, the tariffs that the United States put in unilaterally.*[2]

Will these issues cause negative GDP growth? While we certainly agree that policy errors can lead to a decline, we do not conclude that is what faces us currently.

We could pull out an arsenal of predictors that are **not** suggesting recession. Our personal favorite is that the 2-10 year yield curve has ***not*** inverted yet. Historically, a yield curve inversion has always preceded a recession. Additionally, as I will explain later, it is simply mathematically difficult for there to be a recession.

So does a -19.8% decline fully reflect a crisis of confidence? In the 1998 and 2011 crises in confidence (without economic recessions) 19% peak to trough declines were triggered. ***We suspect this is currently happening.***

Finally, it's important to consider the calendar. Year-end tax loss selling undoubtedly exacerbated the declines.

Now, on to 2019.

Many of the excesses appear to have been washed out in 2018, and that is a good thing.

Therefore, as we consider the outlook for the full 2019 year, we believe it would be a classic behavioral mistake to be LESS optimistic toward 2019 than 2018. We felt 2018 was going to be a "pause" year and are therefore more positive on 2019.

However, there are some key short-term hurdles the market must first overcome, and we believe that will take some time.

In our opinion, the story of the market in 2018 was one of mean reversions. Where excesses existed entering into 2018, they have now corrected.

Consider:

1. We have experienced above average volatility, following below average volatility in 2017.
2. We have experienced a subpar year of market returns, following two above average years.
3. Economic expectations have regressed lower, having started 2018 at sky high levels.
4. Investor sentiment (a contrarian predictor) is substantially lower today than it was at the beginning of 2018.

Therefore, we do believe it's important not to frame a 2019 outlook based on "rear view mirror" driving.

Likewise, just because the calendar turns does not mean that the issues that originally caused these mean reversions simply go away. That will take time, and the associated uncertainty will likely cause more volatility.

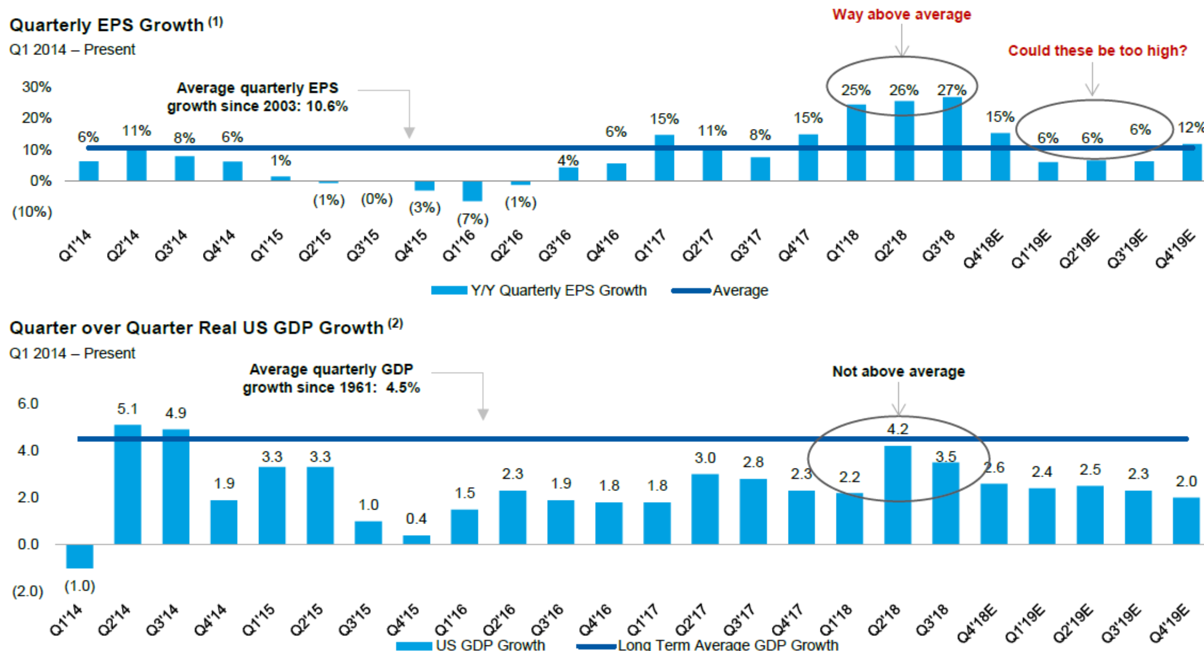
Two major issues worry us for 2019:

1). ***We believe there is a better than 50/50 chance of an earnings recession in the US in 2019, even if an economic recession is unlikely.***

Very simply, the key reason we doubt an economic recession is around the corner is the math. If a recession is technically defined as two quarters of negative year over year growth, then it is important to remember that the higher the growth in one year, the greater the likelihood of negative growth the next. Likewise, low growth lessens the likelihood of recessions.

Take a look at the difference between earnings growth and economic growth. Which looks vulnerable to you?

DISPLAY 1



1. Refinitiv, S&P, Morgan Stanley Research, Full year EPS is sum of 4 quarters, Based on data available as of December 18, 2018
2. Bloomberg as of December 12, 2018.

Past performance is no guide to future performance and the value of investments and income from them can fall as well as rise. Indices are unmanaged and not available for direct investment. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Simply put, Q1-Q3 2018 was substantially above average for earnings growth but not for GDP growth. ***We believe that makes Q1-Q3 2019 very vulnerable to negative earnings growth.*** But as you can see, current consensus is for 6% EPS growth. So those numbers would have to come down. With the market recently down 19.8% peak to trough, we would argue that negative earnings growth is already reflected in stock prices. However, a market rebound prior to earnings season could make the market more vulnerable to conservative corporate guidance and the resultant estimate cuts from the research analyst community.

So why do we believe these 6% earnings growth numbers won't be met? The inner working of the stock market, which famed hedge fund manager Stanley Druckenmiller calls "the best economist out there"[3], is screaming slowdown. The economically sensitive sectors, particularly the early cycle sensitives (financials, industrials) have been brutally punished. When utilities are the best performers, it's never a good sign.

There is precedent for an earnings recession without an economic recession.

DISPLAY 2

Earnings recessions without economic recessions.

First Negative Quarter	Last Negative Quarter	Market Peak Date	Market Trough Date	Peak to Trough Decline in S&P 500
Q2'51	Q2'52	6/12/1950	7/13/1950	-13.5%
Q1'67	Q3'67	2/9/1966	10/7/1966	-25.2%
Q1'85	Q4'86	11/29/1983	7/24/1984	-15.6%
Q1'98	Q4'98	7/17/1998	8/31/1998	-19.3%
Q1'13	Q3'13	5/1/2012	6/4/2012	-8.9%
Q2'15	Q3'16	5/19/2015	2/11/2016	-14.5%
Average				**-16.2%**

Source: St. Louis Fed, U.S. Bureau of Economic Analysis, Bloomberg
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Our conclusion is that the recent -19.8% decline reflects simply an earnings recession.

2). We believe there is a risk that the Fed might NOT back off from their rate increase policy stance as quickly as the market wishes.

The Fed closely observes the Chicago Fed Financial Conditions Index.

DISPLAY 3

Chicago Fed National Financial Conditions Index

2014 - present

Source: Bloomberg as of December 19, 2018
The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. The NFCI is constructed to have an average value of zero and a standard deviation of one over a sample period extending back to 1973. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.
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In February 2016 when then Fed Chair Janet Yellen reversed direction and announced further rate increases would be on hold, the Financial Conditions index was much more stressed than today.

Do conditions need to worsen before the Fed gets more cautious?

So again, our conclusion is that the -19.8% decline already priced in worsening financial conditions. However, as said before, any significant rally would only make the market vulnerable to a Fed that appears more hawkish than the market wishes.

We do believe the trade war will find some resolution in early 2019. Why? Because both sides desperately want and need a deal. The Chinese economy has slowed significantly (December Chinese Manufacturing PMIs were the weakest since early 2016) and President Trump's litmus test of success, the stock market, has just taken a broad-side hit.

As much as we do believe that 2019 will be a better year, we need to remember just where the US is in the economic cycle: late stage. We are reminded of this quote:

> *Don't tug on Superman's cape. Don't spit into the wind. And most definitely, don't fight the Fed. That's what they say on Wall Street. When the central bank is printing, get your money in stocks.*[4]

Financial conditions are actually tightening in the US. The Fed is gradually taking the punch bowl away. That is more analogous to spitting ***into*** the wind than ***down*** wind.

Yet there is a place in the world where the economy is weaker, where the stock market reflects even deeper pain BUT ***central bank policy is fueling a recovery***. Here the wind is behind us.

CHINA.

China is using ***both*** monetary and fiscal stimulus to reignite their slowing economy. And with a market that has experienced a 32% peak to trough decline in 2018, we believe 2019 could potentially be a repeat of 2016 when China's recovery led the momentum in the global recovery.

This is a major reversal from our 2018 outlook piece where we warned that:

> *the inflows into Emerging Markets and into EM Asia in particular have been red-hot recently, making them potentially the most vulnerable to significant pullbacks as market volatility increases in 2018.*[5]

Finally, in full disclosure, not all of our mean reversion projections for 2018 occurred. ***Non-US Developed Markets did not outperform the US in 2018***. We felt that given their recent underperformance and given the US was likely to have a less stellar year, 2018 could be the year for global non-US relative performance to mean revert.

Nothing doing. Non-US Developed Markets lagged the US in 2018, ***yet again***.

It would be so easy to throw in the towel. But in particular, Europe is flashing a very high level of bearishness. Our MSIM colleague Matthew Leeman penned an excellent piece titled ***Europe – forever the ugly duckling?*** With over $50 billion of net outflows from European funds just through October, 2018 is on track to surpass 2016 as the worst in 15 years.[6]

Could some positive resolution on Brexit be the ignition for a rally? We will see shortly, but we do observe that most European economically sensitive stocks are dirt cheap versus their history. That tells us there is plenty of bad news imbedded in the prices.

In conclusion, as we enter 2019, there is no question that it is emotionally easier to be more bearish today than at the outset of 2018, a classic human behavior known as recency bias.

Therein lies the conflict we often discuss. The most powerful concept of investing is mean reversion, but that conflicts with human tendency to put greater weighting on what has just occurred.

Given 2018 appears to have cleared out many excesses, we are ultimately in the camp that believes 2019 will be a better year, as 2012 and 2016 were similarly better than most expected. Unquestionably, there are serious issues to overcome, but after a year like 2018 and removing the emotional toll, a higher level of optimism is warranted.

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[1] Sentiment Trader December 2018
[2] CBS News December 19, 2018
[3] Bloomberg December 2018
[4] Casey Research, January 2014
[5] Remain Calm and Carry On, January 2018
[6] Morgan Stanley Investment Management. 2019 Market Outlook, Europe-forever the ugly duckling?