CONWAY• JARVIS LLC
Investment Outlook

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Can the US Expansion Float the Global Economy?

The period following the posting of our September 18th Outlook has been eventful, to say the least. Following an upbeat finish to the third quarter, the Fed laid an egg in early October with the release of a policy statement that left the impression among investors that it had abandoned its data-dependent approach and was on a mission to raise rates not only this month, but through all of 2019. That left a significant dent in the major averages, wiping out all of this year's gains and leaving the market on a path to finish flat for 2018. That story eclipsed other risks to the continued expansion of the US Economy. We see that expansion remaining intact, though at a lesser rate of growth. We're hopeful the Fed notices and moderates its hawkishness. If they do, that could set the stage for another leg up in equity prices in 2019 after this second correction of 2018 runs its course.

The Fed Speaks and Investors Pay the Price

The fourth quarter opened with the Fed delivering a blow to the markets with its release of the details of its September meeting where it raised key rates for the third time in 2018. It made clear its intention to raise rates a fourth time in mid-December and stated that it was no longer implementing an accommodative monetary policy. The statement implied it would continue along a path of normalizing, i.e. raising, rates through all of next year. Traders didn't like what they heard. The announcement shifted the stock market into reverse and triggered a correction in place of what had been expected to be an earnings-fueled advance of the major averages through the end of the year.

Unfortunately, this occurred at the same time Brexit negotiations began to unravel and the US/China trade skirmish threatened to escalate. The result? Slower global growth was rapidly priced into markets around the world to varying degrees. However, earnings and valuation for many domestic companies remain rational and attractive, explaining the divergence in performance of the US indices as compared to the Rest of the World ("RoW"). The US is now alone in seeing its economy expand at a healthy rate while Europe and the Emerging Markets are struggling to avoid contraction.

Ironically, this has come in handy for the Fed while it offloads its balance sheet and foreign capital has filled in demand for treasuries. The Credit Bubble outside the US has fueled a rally in Treasury bonds that has pushed the 10-year back down to 2.85% from last month's 3.05%. The Fed's taken heed of this and they're once again preaching "data dependency" while adding "patience" to the narrative in describing their perspective. While it remains likely they'll raise rates on the 19th of this month, implications for future rate hikes are fading. Investors will approve.

An Update on Risks to Expansion

The mid-term election result is unlikely to move the needle on current fiscal policy initiatives and, for now, has been dropped from our list of proximate risks to the economy and markets. The Fed, Global Economy, and the China/US trade conflict remain on the list.

***The Fed*:**
In late November, Chairman Powell clarified the FOMC's approach and reeled in some of the stronger language in the statement of intention that had spooked the markets in early October. He shared that the Fed would stress patience in evaluating the effects of past interest rate hikes and Quantitative Tightening ("QT") as they formulated policy for 2019. Investors viewed that as an affirmation of remaining data-dependent, something that had been cast into doubt earlier. Investors liked what they heard and the markets rallied significantly into December before attention was turned to the other risk factors that we're monitoring. While we still expect a hike in key rates to be announced next week, the Fed's approach looks to be prudent and the outlook for tightening has returned to one of rationality. **We maintain our risk level to the economy and markets as Moderate.**

***Trade War*:**
What we had previously described as a skirmish has escalated in recent months to a war of words punctuated by the occasional mention of the nuclear option: an all out exchange of tariffs across the entirety of the China/US trade landscape. While that's an improbable outcome, the possibility can't be ignored. Currently, *new* tariffs have been suspended for the next 90 days following the G20 summit and we believe both parties are gaming the tariffs in place by delivering through third-party countries. At this point, we think the damage to earnings has been minimal. However, the markets have reacted negatively to the headlines.

Both leaders have publicly refused to blink. Last week's arrest of the Huawei CEO was a provocation. This week's adjudication of the Apple/Qualcomm dispute by a China court is another. While there is a cost to both sides in any trade dispute, the US had no alternative but to press its case now for reciprocity with China while it still holds an advantage. Our best hope for a near-term resolution would be a joint effort by both to create, at least, the *perception* of an agreement and get on with business. Absent that, both economies will suffer and threaten recession for all in the Global Economy. While the outlook for resolution remains uncertain, the situation hasn't worsened….yet. **We maintain our risk level at Moderate at this time.**

***Europe and the Global Economy*:**
This week, it was announced that the Parliamentary vote on Brexit would be deferred into the New Year. That roiled the stock and currency markets Monday morning. At the same time, much of Paris was declared off limits due to rioting. We're also awaiting the response of the ECB to Italy's resubmission of a fantastical budget and a request for support. This gives us cause to question what the EU will look like in a few years. Regardless, none of this is good for trade and when combined with the China/US stalemate, presents a substantial threat to unfettered trade across the Global Economy. We can't begin to predict the outcome for Europe over the next couple of months other than to say that the *probability* exists that regime change for France, the UK, and Germany may occur next year. That has the potential to further destabilize the European Economy. **We're raising our risk level from Minimal to Significant.**

The US is Alone in Driving the Global Economy

In our September Outlook, we advised that a lot would be happening in Q4 that would generate significant headlines and investors would be challenged once again to parse the news from the noise. Little did we know how high the decibel level would rise. We encourage clients to remain focused on news that can tangibly impact the course of markets in the longer run. In the short-run, institutional investors such as hedge funds and systematic algo-traders can briefly push markets irrationally in either direction. That's what we're seeing now, much as we did during the correction of the first quarter of this year. We expect that volatility to subside as this consolidation runs its course.

The global markets inevitably reflect their respective underlying economies in the long term and the US is the best positioned to lead through this period. That said, we're acutely aware of exigent risks from the "RoW". While the S&P 500 flirts with correction (-10%), China and the Emerging Markets are firmly in a bear market. Europe (STOXX 600) could be headed that way, currently occupying middle ground with a decline of roughly 14%. There lies the distinction among global markets between slowing growth and recession. Despite grave predictions of doom from short-sellers and TV analysts, there are no US asset bubbles on our radar and none of the euphoria that usually precedes recession and a bear market. While our economy experiences a slower rate of growth, Europe and China will struggle to maintain any level of expansion until risks to their economies are resolved.

The question for us is: Can the US pull the RoW through the challenges to international trade that the China/US and Europe present? We'll have to wait and see if cooler heads prevail in those theaters of the Global Economy before answering that question. If forced to make that wager, we'd answer in the affirmative. We believe we'll know for sure sometime in the first quarter of 2019. For now, we advise clients to remain over-weighted in the US markets and plan ahead for their longer-term liquidity needs.

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