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Investment Outlook

Volume 29 Issue 4 December 19, 2019

Then and Now. A Tale of Two Quarters

One can't help but look back a year ago and marvel at the contrast between the current quarter and Q4 2018. Then, the Fed was fully engaged in raising key interest rates, conditions in Europe were eroding along with the prospect for an orderly Brexit, and the U.S./China trade "conflict" was escalating to an all-out war weaponized with tariffs. The resulting market collapse not only wiped out the year's gains, but posted losses ranging from 3% to 14% across the board. Now, with the Fed having reversed direction to an accommodative stance, we've seen a decisive confirmation of regime change in the UK, and a temporary détente has been reached in the Trade War. We are days away from the close of a year that is indisputably robust in terms of market returns and it appears the Global Economy might have turned a corner. What a difference a year makes.

Optimism Abound

While the returns for 2019 reflect optimism among investors, this bull market remains much maligned. That's reflected by data showing that a net outflow of $135 billion has been pulled by investors *from* equity mutual funds and ETFs this year. Despite that, we continue to see the major US indices slowly grind to record highs even as commentators warn of recession in 2020, impeachment, and the headline risks of an election year. We're approaching the close of a year in which the US major averages will post returns in excess of 20%. For baseball fans, we're aware that such comments are likened to talking about a no-hitter before the 27th out. We're simply pointing out how improving economic conditions are being reflected in the market.

As frothy as these returns sound, it's important to put them into a longer-term perspective. Looking back almost two years, from the January 2018 market peak to today, *total* return for the S&P 500 stands at a modest, but respectable, 16%. That's not an annualized figure. The NASDAQ, up 33% this year, shows a 23 - month return of 19%. The remainder of returns for the period from major indices ranged from negative 11% for the EEM to +11% for the DOW. These returns are hardly the stuff of bull market-ending, blow-off rallies.

For us, an extended grind toward new highs, punctuated by the occasional and sometimes harrowing correction, is a welcome respite from the Boom/Bust markets of the past that brought us the memorable bear markets of 1973, 2000, and 2008. Those markets saw the tide come in and raise all boats. Investors replaced analysis with groupthink and bought "the market". Today, we're seeing a divergence among indices that reflects some level of differentiation among countries, sectors, and companies. That's the result of analysis and healthy skepticism from professional investors and advisors.

Has the Global Economy Turned a Corner?

Before we address that question, let's look at the US economy. The Fed's well-intended move to normalize interest rates was rooted in data showing a marked improvement in the US during the 2016-2017 biennium.

At the same time, the Global Economy began to under-perform relative to the US as a result of Brexit, political upheaval within the EU, and the first shots fired in the US/China trade conflict. The matrix of economic data that we've constructed reflected a moderation of industrial growth in the latter half of '17. While consumption remained healthy in 2018, housing began to moderate and business confidence weakened as the Fed tightened. That trend continued and we saw our industrial/manufacturing indicators go negative for the first time early this year.

As good as things were in the US in terms of employment and low inflation, they were burdened by the weight of a markedly slower Global Economy. It was this that prompted the Fed to make a preemptive about-face in monetary policy early this year. The animal spirits in the US economy re-emerged in 2019. The result has been a buoying in the US of consumer confidence, the housing market, retail consumption, and an arrest of the decline in the industrial and manufacturing sectors. Our data matrix indicated that the slowing of the US economy bottomed out in early Q4. The equities markets reflect that improvement. Our mantra has been "where economies lead, the markets generally follow". We're moderately optimistic about the US economy receiving an assist from the Global Economy in 2020.

Update on Risks to Expansion

The Fed: We've crossed this one off our list. They're fully aligned with global monetary policy and serve as an example for other central banks as to their pragmatism and willingness to adapt to rapidly changing conditions.

Trade War: Détente was reached last week with an announcement of intent to sign Phase One of a longer-term trade agreement and suspend negotiations until after the November election. We suspect this is an orchestrated bit of theater that aids the White House in an election year and allows China to bide its time in the hope of seeing regime change in the US. **We lower our risk level to Moderate for now.**

Europe and the Global Economy: While China and the US called an election year truce, Germany avoided recession by an eyelash, buying time for the EU economy. Boris Johnson's resounding victory of last week erases any further doubt about Brexit taking place and strengthens his position in negotiations with the EU. We'll wait to see if it's a deal or no-deal Brexit and whether Scotland presses for an exit from the UK. **We lower our risk level from Significant to Moderate.**

The Election Year: The markets are ignoring the theatrics in the House of Representatives. The election process will play out in the headlines with little effect on the markets *until* a legitimate challenger to the incumbent emerges. Hopefully, the candidates will focus on policy with a degree of economic literacy. Until then, the outlook for any change in fiscal policy remains too speculative to weigh on any investment decision. **We maintain our risk level at Moderate.**

The Outlook

With December 2018 being our last significant correction, we might be overdue for a retracement of the market after year-end. We're speculating that many investors have deferred profit-taking late in the year for tax reasons. An otherwise modest amount of selling *could* be exacerbated by the machines, taking a normal 10-12% decline to near bear market proportions. Given that the data points to a positive outlook for the economy in 2020, any retracement should be transitory.

It's likely that we'll see an increase in volatility next year from headline risk surrounding the election. Ironically, any uncertainty about the direction of longer-term fiscal policy might buy more time for this bull market. We'd prefer to avoid the irrational exuberance that inspires the public to pile into the stock market with little regard for valuations. That usually marks the erosion of healthy skepticism and the end of a bull market.

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