

## Market comment for the week ending December 21, 2018

### A Not-so-Wonderful Time of the Year

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**Grinched!** Stocks suffered a one-two punch late in the week from what was viewed as a less-than-dovish interest rate hike and from worries over a partial government shutdown (materializing over the weekend and likely to last through Christmas), leaving the S&P 500 Index's 17.5% decline perilously close to the 20% threshold for a rally-ending bear market. Compounding the impact of monetary and fiscal policy uncertainties on market stability have been the festering U.S.-China trade war (aggravated by China President Xi's hardline speech this week), ongoing Brexit concerns, plus the growth slowdown abroad aggravating the slump in oil prices. Even Italy's budget truce with the European Union (EU) was taken with a grain of salt, laying the foundation for future problems by failing to tackle the economy's structural weaknesses and budget problems created by new income-transfer programs.

The end-of-week slump was magnified by quadruple witching expiration of options and futures contracts adding to trading volumes in a jittery market already vulnerable to thinned, preholiday trading. The flight from stocks left the S&P 500 Index at a July 2017 low and with its worst December decline since the 1931 Great Depression year, propelling bond prices higher and yields lower in a so-called bull-market flattening of the Treasury yield curve. More broadly, a classic risk-off response to the latest policy developments extended beyond bonds to gold, the Japanese yen, Swiss francs, and other safe-haven assets, leaving their ratio to a narrow group of highly charged assets at an April 2017 high.

Carnage on the week left the S&P 500 Index down a stunning 7.1% in a broad-based decline across all 11 S&P 500 Index sectors and just one (gold mining) of the benchmark's 126 constituent industry groups. Interest-sensitive utilities unsurprisingly were most resilient in a down market, supported by the drop in competing Treasury yields to less than 2.8% on the 10-year note. Energy stocks were hit hardest by an oil market's freefall propelled by the uncertain outlook for supply and demand. In the corporate bond market, yield premiums to comparable Treasury securities finished off their peak of a week ago but are still hovering near the worst of the oil slump in 2016 for both investment- and non-investment-grade securities. Adding to the tendency of corporate yields to lag those on comparable Treasury issues on the way up and down have been worries over rising corporate debt, signs of slowing economic growth, and a less-friendly Fed policy outlook. Significantly, safe-haven demand didn't extend to the dollar, falling to a one-month low against other major currencies and avoiding added pressure on global liquidity from an increase in U.S. financial stress indices to a February 2016 high. However, dollar weakness wasn't enough to prevent commodity price declines beyond oil to industrial metals and grains, though lower interest rates allowed gold to regain its safe-haven role in the past week.

The Federal Reserve seemingly took the path of least resistance in combining a ninth increase in the federal funds target rate with a more subdued dot plot forecast and more cautious verbiage in the accompanying communique to the rate decision. Market pushback to the Fed's announcement came from at least four concerns, beyond the rate increase itself still largely priced into expectations just ahead of the meeting. First, the upward trajectory to the federal funds rate, though flatter now, remained intact. Second, even more modest rate increases, combined with downward revisions to the Fed's growth and inflation forecast, implied more economically burdensome real (or inflation-adjusted) rates adding to economic outlook uncertainties. Third, the Fed's stay-the-course approach to the balance sheet wind-down was made explicit during the Chair Powell press conference separating it from economic considerations. And fourth, investors were hoping for more than just a stated intention by the Fed to monitor recent financial market volatility edging slowly toward disorderly market conditions, disrupting fund flows and justifying Fed action.

The Powell Fed always was expected to be operating in a more challenging environment, navigating a policy sea change from aggressive stimulus engineered by his two predecessors, consistent with the decade-long adjustment to the financial meltdown. The shift to rate normalization was bound to trigger bouts of market volatility, as distortions created by years of artificially low interest rates were unwound. (Hence, Powell's dubious distinction of presiding over stock market sell-offs after each of the past seven rate hike decisions.) Slowing economic growth and subdued inflation have complicated the task by adding to investor sensitivity over the timing and trajectory of future rate increases. Bridging financial market turbulence to economic growth is its impact on market liquidity, itself vulnerable to unwinding values of risk assets and deleveraging threatened by the second big decline in risk assets this year. A more existential threat to market stability—and to the Fed—were reports Friday of a presidential move to fire Chair Powell. Legal or not, the threat to the Fed's independence from sustained White House pressure on the central bank likely would add to unsettled market conditions.

Still to be penetrated behind the market's wall of worry is core support from growth, interest rate, and valuation fundamentals. The economy is strong enough to support mid-single-digit earnings growth in the coming year, as artificial support from tax cuts washes out of the year-to-year calculations. The S&P 500 Index's valuation, based on Friday's closing price and its forward price/earnings (P/E) multiple, was down to a September 2013 low of 13.8 times next year's earnings, based on 7% growth, according to the IBES consensus, or right on top of its 14.8 times long-term average assuming no earnings growth at all. At Friday's yield of less than 2.8% on the 10-year note, the S&P 500 Index's relative value against bonds was as close to its

long-term average than at any time since July 2016. Assuming no earnings growth next year, it would take a 10-year yield of 3.6% to reestablish November's premium of stock to bond valuations. All this to say that the market is discounting an array of challenges next year, truly tested if market fundamentals succumb to this year's sum of all fears in 2019.

**A half-full, half-empty economy.** Investors and the Fed debating the economic outlook through the fog of mixed economic data may be looking at two sides of the same coin. Clear to all is a batch of economic data coming up short of expectations, leaving the Citi-group Economic Surprise Index (measuring actual versus expected data results) at its weakest since early September. Also clear, however, is that consumer-led growth remains intact at a respectable 2.5% to 3.0% rate, confirmed by the Atlanta Fed's GDPNow real-time estimate of a 2.7% pace in the fourth quarter based on data through Friday.

Balanced support for consumer spending is coming from slowing—but still respectable—gains in inflation-adjusted incomes (or purchasing power) and in household wealth, all reinforced by elevated consumer sentiment through late December well above its long-term average. Also encouraging has been broadening growth beyond the consumer, extending to an accelerated rise in late-cycle state and local spending picking up the slack from an investment spending slowdown hamstrung by oil price declines from crimping energy producers and from more general uncertainties over the outlook for world trade and its effect on broader economic growth. Even hard-pressed housing is getting relief from recent declines in mortgage rates easing affordability pressure on demand.

A more legitimate concern among Fed critics is the absence of an inflation buildup, leaving the economy vulnerable to burdensome increases in real (inflation-adjusted) interest rates if policy is geared to further interest rate normalization. Modest increases in both the November headline and core personal consumption expenditures deflator (the latter excluding food and energy), the Fed's preferred inflation gauge, left both below the official 2% target. Looking ahead, the bias is toward steady to lower inflation, despite an accelerated rise in wage increases to a two-year high of nearly 4%, by one measure, in November. First, wage pressures are having an unexpectedly mild effect on selling prices, including those in labor-intensive services industries. Second, oil prices face greater downside risk from slowing global growth weighing on energy demand and from increased U.S. supply as expanded pipeline capacity comes online next year. And third, slowing overseas growth weighing on oil demand also could create enough unused capacity to dampen price increases for imports and for trade-sensitive consumer goods in the Consumer Price Index, countering any pressure from a steady to weaker dollar.

Looking ahead, updates on consumer confidence, manufacturing, foreign trade, and housing will cap a back-loaded data calendar in a holiday-shortened week. Vying with the data for the market's attention will be a \$131 billion sale of 2-, 5-, and 7-year Treasury notes straddling Christmas Day and Tuesday and, perhaps, fallout from the partial government shutdown if it extends beyond Christmas Day. Investors will be scrutinizing activity releases closely for signs of growth strong enough to support the Fed's bias, expressed in Wednesday's policy communique, toward modest restraint next year.

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