New Albany Investment Management

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Market Insight: Fed and Markets Do a U-Turn

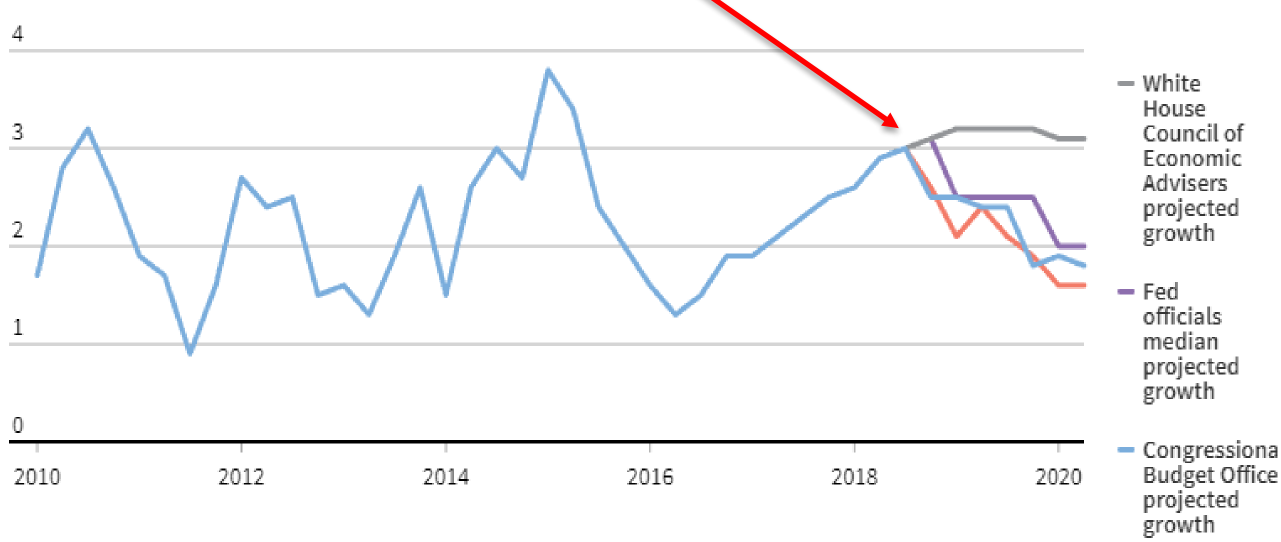
The financial markets have greeted 2020 with a radical change in attitude. Around the globe, stocks have rebounded strongly from the severe oversold conditions in December as concerns of an oncoming recession have eased. In contrast, the Fed has abruptly halted its plan of higher rates, due to their heightened concerns of a weakening economy. Both the markets and the Fed have done a remarkable U-turn in a very short period of time and in affect have 'traded places' on their view of future growth. This dichotomy of views and the velocity of change is quite unusual. However, the uncertainty and volatility is actually quite normal and symptomatic of the late stages of the economic cycle where both headwinds and tailwinds prevail. Everyone agrees global growth is slowing. The question is **how much will growth slow and how will it affect earnings?**

Growth is slowing, but by how much? Global growth has definitely slowed. European businesses started 2019 on a very weak note with growth at its lowest rate since 2013, and China is growing at its slowest pace in 30 years. At the same time, US growth is also slowing from the tax cut boost implemented last year. With the US being the largest economy in the world, any decline in growth will have a big impact on the world economies and global markets. Hence all eyes are watching intently on any changes in monetary and fiscal policy and how it may affect growth.

The chart below shows US GDP since 2009. GDP peaked in 2015 at 3.7%, benefiting from exceptionally low interest rates and then GDP fell to 1.7% by 2016. Growth picked up again in 2017 in anticipation of the tax cut impact and peaked at near 3% in 2018. Now GDP is expected to fall again back below 2% by 2020 as the tax cut impact wanes.

Forecast GDP: White House = gray; Fed = purple; Congress Budget = Blue; Reuters poll = orange

Chart Source: Reuters Howard Schneider

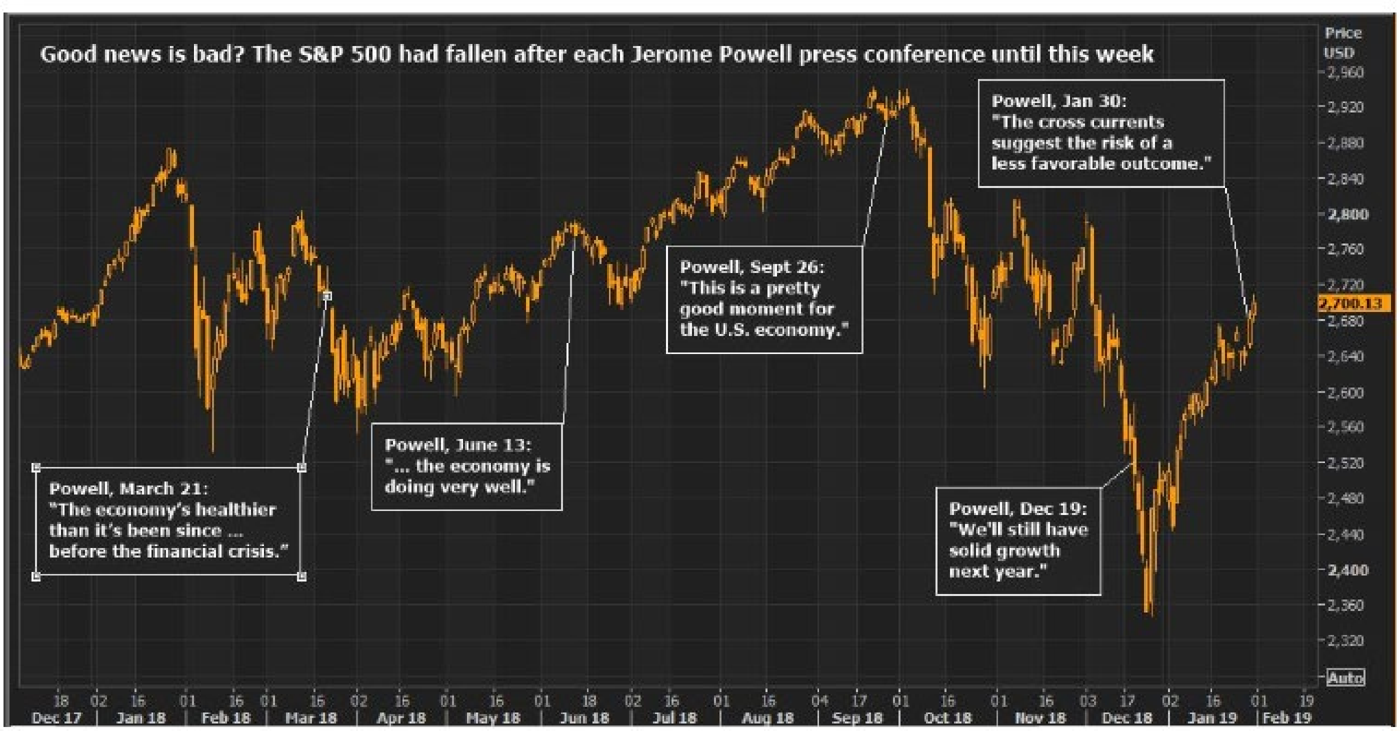


It is becoming increasing evident that outside stimulus (either monetary or fiscal) is needed to keep GDP above 2%. Low growth makes a modest investment environment.

The Fed Factor: The Fed raised rates four times last year, the first three of which were accepted by the markets. Then things changed dramatically in October, when the Fed indicated it still had 'along way to go' before rates were neutral. This sent the markets reeling and fueled fear that higher rates would induce a recession. But that did not stop the Fed from raising rates again in December to 2.25-2.5%, a level still well below historical averages. At that time, the Fed stated the economy was on solid footing. But now, just 30 days later, the Fed made a dramatic shift, stating rates are now near neutral and they are concerned growth is at risk. <u>This is a radical change in the direction of policy and demonstrates the challenges of assessing the growth potential in the late stages of an economic cycle</u>.

Following or Leading? The relationship or connection between the Fed and the markets has always been complex. Sometimes the Fed leads the markets, and sometimes the markets lead the Fed. When the Fed and market are in sync about their view of the economy, the markets rise, but when their views differ, there is much confusion and volatility. This has been the case since September, when the Fed and the markets view of future growth diverged.

The chart below shows the daily S&P action over the last 13 months and when the Fed raised rates. The first three rate hikes were 'accepted' by the markets, and the S&P continued to push higher through September. During this period the Fed and the market were in agreement on future growth. But then the markets changed course and a rapid sell-off began in October. Then, the Fed and the markets view of the future diverged significantly, which caused chaos and more selling. The dramatic capitulation on Christmas eve perhaps squelched the Fed directive to keep raising rates. Since that time the markets have rallied sharply and the Fed has responded with a more dovish tone. Thus, it appears the Fed lead the market through 2018, and now the markets are leading the Fed.



So for now at least, it appears the Fed factor has been neutralized. The markets and the Fed are in agreement the economy is slowing. This consensus is giving comfort to the markets and is allowing equity prices to rise again. But the underlying concern of slowing growth and earnings is still out there. What this means for interest rates is that they will likely hang here for a while until there is further clarity on the direction of the economy. However, with the yield curve already very flat, the markets are biased towards lower rates in the future and thus are vulnerable if indeed the economy does accelerate and the Fed raises rates again.

The next few months will prove crucial to the direction of the markets as some key macro policies play out.

- March deadline looming over U.S.-China trade talks
- Negotiations over Britain's departure from the European Union on a rocky track
- U.S. elected officials battle over the budget, the Wall, government shutdown.
- 2019 Earnings growth forecast come into focus.

The Neutral Zone: In sum, the late stages of the economic cycle are very challenging. Monetary and fiscal policy have 'spent their bullets' so to speak. Interest rates are neutral, world growth ex-US is slowing rapidly, and US fiscal policy - with a split congress- is stuck in neutral. The question is where/what is the next engine of growth? Only time will tell us. The good news is that the US labor market is quite strong and consumer spending, which accounts for about 65% of GDP, is solid. Though spending is not a leading indicator, it is indeed a strong tailwind for the economy. So given this backdrop, we are likely in 'Neutral' zone which means the markets could be in a large trading range for 2019 – 2020.

Investment Strategy is "Neutral". Stock exposure was reduced mid-4th quarter to 'neutral' within the risk bands and will remain there until there is more clarity on the direction of the economy and interest rates. Bond duration was increased recently given the change from tightening to neutral on interest rates.

These are my thoughts. As always, please contact me with any questions or concerns.

Kind Regards,
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