November 24, 2018

Market Insight: Wall Street vs. Main Street, Conflicting Stories… Caution Ahead

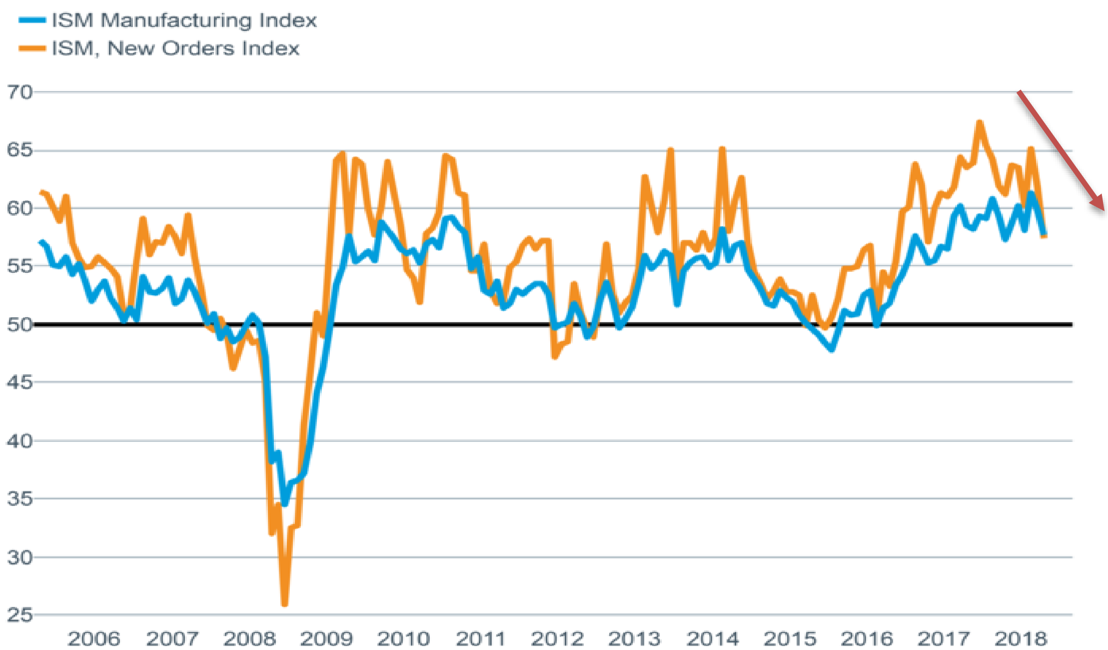
Despite the healthiest economy since 2005, the stock market is looking rather ill. Stocks and commodities have taken a major hit this quarter, with most sectors hitting correction (-10%) territory, and many high profile stocks in bear market (-20%) territory. The election gave a short lived rally, but was quickly overcome by negative sentiment, pushing the markets back down again. Though the fundamentals remain quite strong, the nasty price action (Technicals) may be signaling weakness lies ahead. And because these two factors strongly conflict, the current market environment is quite treacherous and unforgiving.

The **root cause of this sell-off** is concern that the economic and earnings growth rates may be peaking, while at the same time a tight labor market will lead to higher wage growth and inflation. Higher inflation will prompt the Fed to raise rates even further than the current expectations. Net, **slowing growth and rising rates is a toxic environment for stocks**. Will this actually happen? No one knows but this is what is creating uncertainty and feeding the selloff in stocks.

Wall Street vs. Main Street: The stock market is the ultimate leading indicator of the economy and it often sniffs out turning points long before it is evident on Main Street. In this case, though the consumer is feeling quite confident, as indicated by very low unemployment, rising wages and confidence, Wall Street is saying a slowdown is ahead. So even though there is currently solid economic growth, which is usually very supportive for stocks, the stock market is saying future growth will be slowing. Fear of slowing growth has drastically eroded investor confidence and that is what is driving the recent huge volatility. So who is right? Only time will tell.

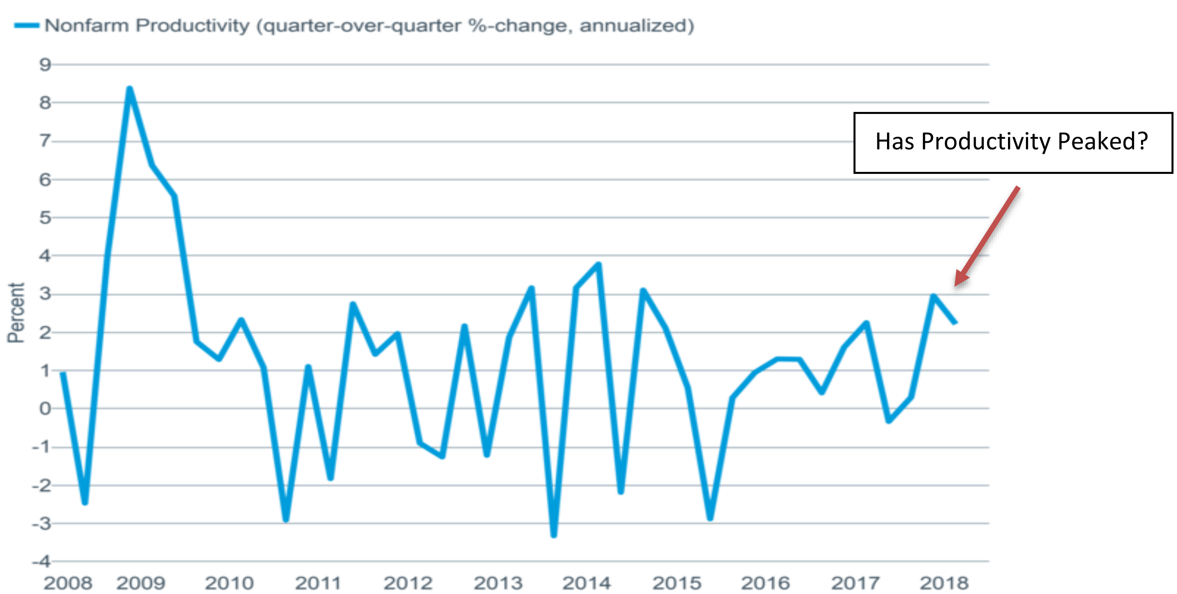
Main Street: The chart below shows **Consumer confidence at an 18-year** high (blue line) indicating a healthy consumer. At the same time, this high reading may not be a particularly great sign for the future of economic growth because peaks have historically occurred fairly close to recessions (grey bar).

Wall Street: Meanwhile, Wall Street is more forward looking and it watches indicators like the **Institute of Supply Management's Manufacturing Index** which shows new orders are well off the recent highs and indicating slower growth ahead. Some of this decline may be due to uncertainty over the trade/tariff uncertainty.



Source: Charles Schwab, Macrobond, Institute for Supply Management (ISM) as of 11/6/2018

Flat Productivity and Tight Labor Markets will cap economic growth. Low unemployment is obviously good for Main Street. But in order to expand the economic growth rate, some combination of an increase in workers and/or an increase in productivity needs to occur. Productivity peaked in late 2017, and has since decline, indicating slower growth is likely ahead.



Source: Charles Schwab, Macrobond, U.S. Bureau of Labor Statistics (BLS) as of 11/6/2018

Earnings Growth Rate will Slow: Of course the big elephant in the room cannot be overlooked. The impact of lower corporate tax cuts has had a huge positive impact on earnings and stock prices. But this cuts both ways. As the positive impact fades, the source for earnings growth must come from core economic growth. So going forward, corporate earnings will once again be highly dependent on organic economic growth.

The data below shows the actual annualized earnings growth rate of the S&P 500 and GDP since 2009. The effects of quantitative easing (very low rates) helped spur both economic and earnings growth from 2010 thru 2015. The effect of low rates on earnings and GDP began to wane by 2016. But by 2017, the certainty of lower tax rates encouraged businesses to expand and economic growth began to accelerate. By 2018, the full effect of the tax cut is realized and both economic and earnings growth have risen strongly. However, the forecast for 2019 -2020 (blue) shows the expectation of a dramatic drop off in growth.

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Earnings	-7.3%	40%	14.7%	6.1%	5.7%	7.5%	-0.3%	0.5%	11.8%	22.7%	4.9%(F)	5.5%(F)
GDP	-2.8%	2.5%	1.6%	2.2%	1.7%	2.6%	2.9%	1.5%	2.3%	3.1%	2.5%(F)	2.0%(F)

NOTHING NEW HERE! The amazing part of all this is that the above forecast is virtually the same forecast the market has been expecting since May. That is: *Growth is solid and expected to slow by some degree next year. Meanwhile, inflation and interest rates are expected to rise*. So why have the markets gone into a tailspin? Simply put, the **Technicals are in contro**l. What does this mean?

The market Technicals refer to sentiment, price level and volatility. Sentiment has soured as the reality of slower future earnings has been confirmed in the recent forecast of many companies. This sour mood lit the fuse, so to speak, and gave a reason to sell stocks. And as prices begin to move lower, sentiment becomes more sour and prices are pushed even lower. *Selling begets selling and the price action turns into a nasty downward spiral*. ***Price action is chaotic, volatility is wicked***. This is where we are now. Some may call this a Bear market, others may call it a severe correction. I call it no fun! *So until the fears are alleviated (sentiment turns), the market will continue to experience fierce downdrafts.* It is unlikely the bottom has been found. How long will this continue? No one knows, **but it would not be unusual for the markets to be unsettled for many months if not through most of 2019. It will take time to discover and get comfortable with slower growth in a higher interest rate environment- something we have not experience in over 10years!**

Investment Strategy: It has been a tough seven weeks and a few fitful nights! Given the shift from a fundamentally driven market to a technically driven market, I have been implementing a very cautious investment strategy. Specifically, risk has been reduced by both lowering total exposure to stocks and shifting risk to low volatility, defensive sectors. Also, with large intraday moves expected to continue, most stock mutual funds have been swapped with exchange traded funds (ETF's) to give further flexibility to make intraday changes if need be. On the bond side, exposure remains in the very short term to capture a good yield and remain insulated from yield curve volatility.

It is important to remember the markets are just doing what markets do and to keep it in perspective.

I am thankful for our Country and Community; I am thankful for You. HAPPY THANKSGIVING!

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