Monthly Commentary

November 2018

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The Markets received the ‘stick save’ they were hoping for as we closed the month of November. Unfortunately, certain events and a large increase in market volatility has since resulted in an alteration of our discussion, and therefore some early December events are included in this piece on November.

As of the day after Thanksgiving, the S&P 500 was down 3% for the month[1]. The rally in the ensuing week resulted in a monthly gain of almost 1.8% after Jay Powell, Chairman of the Federal Reserve, said the fed funds rate was “just below” what they consider a ‘neutral rate’ that neither speeds up nor slows down the economy[2]. The Fed dot plots tell us that is around 3%[3]. This implied that the Fed is almost done raising interest rates, with the fed funds rate next month likely going to 2.25-2.5%. That news was followed by the hint on the last trading day of the month that the Trump/Xi meeting the next day was going to be productive. What we ended up seeing from the dinner between the two parties was a détente where each side gave the discussions another three months of time to come to an agreement. As part of this agreement, the 10% tariff rate on the last batch of $200b of goods that the US has on Chinese imports will not increase to 25% during this negotiation. We hope that this could be the start of a resolution.

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What followed though was more uncertainty about what actual substance came out of the dinner, whether 90 days was going to be enough time to come to an agreement of significance, and fears that both sides were still going to only give a little. This was then followed by the George H. W. Bush Washington, DC memorial and then the arrest of the CFO of Huawei (the largest telecom company in Asia) in Canada, on the instruction of the US for allegations of violating US sanctions on Iran. This further drove worries that any goodwill created over the dinner was now going to be poisoned again.

Prior to this important news on both the monetary and trade front was the continued worries about a tightening of monetary conditions and the trade battle escalating in 2019. Both factors have slowed global growth, mostly seen in China and in Europe , and markets in Asia and Europe this year have been pressured by those concerns. October brought those worries to the shores of the US, along with worries about a peaking of US corporate earnings growth.

1-5 Bloomberg

At least thru year end, we now have some clarity with respect to the direction of interest rates and hopes for a trade deal in 2019. We do expect earnings to slow next year as we cycle out the tax cut and profit margins begin to recede, but markets should begin to focus on that in Q1 2019.

Equities & Indices

As stated, market friendly comments from Chairman Powell and a temporary truce in the trade spat with China saved us from the 2nd month in a row of stock market declines[4]. Overseas markets rallied too when looking at the MSCI world index ex US, which rose by 1.4% in the month after a brutal 8% decline in October[5].

That performance was still bifurcated, as the Chinese market as well as the German DAX both ended the month in negative territory[6]. The challenge China faces is a slowing economy, irrespective of the trade issues with the US, while Germany's export dependent economy is very sensitive to changes in global trade.

The real outperformance in overseas markets in November came from the emerging world as the MSCI Emerging Markets index was higher by almost 5%, as the dollar softened against many emerging currencies which was a nice catalyst[7].

"China faces a slowing economy irrespective of trade issues with the US"

Interest Rates and Monetary Policy

While Fed Chair Powell really helped the stock market late in the month with his comments on rates, the bond market was well ahead of him in believing that the Fed only had a few more rate hikes in them.

This was due to concerns with slowing economic growth overseas and the moderation being seen in the interest rate sensitive sectors of housing and auto's. The 2 yr yield, a proxy for Fed expectations, started the month at 2.87% and ended it at 2.79%[8]. As of this writing on the first trading day of December, it stands at 2.82% after the Trump/Xi dinner[9].

The US 10 yr yield also saw a decline in rates for reasons stated. The yield in the 10 yr Treasury note fell from 3.14% to 2.99% and is back above 3% as of the first December trading day[10]. This also means that the yields spread between the 2 yr yield and the 10 yr yield is now at only 19 basis points, the lowest in 11 ½ years[11].

"The yield spread between the 2 year and 10 year treasury is the lowest in over 11 years."

6-11 Bloomberg

Commodities

The other big story this past month was the collapse in oil prices and spike in natural gas prices. After dropping by 10% in October, crude oil crashed by 22% in November[12]. The main factor was oversupply worries, after the Trump Administration gave multiple waivers to countries buying oil from Iran which has been subject to new sanctions. That was unexpected, and ahead of it Saudi Arabia ramped up production to cover any Iran related export shortfalls. As nothing of significance followed because of the waivers, the market was left with too much crude oil. On the demand side, there are some concerns with a moderation due to the slowdown in economic activity, but that is more difficult to confirm.

There is an interesting debate over whether a drop in oil prices is good or bad for the US economy in the aggregate, and I don't believe there is a clear answer. It's obviously very positive for the US consumer as they spend less at the gas station and thus have more money for other things. Businesses that use oil and gasoline as an input benefit as well. On the other hand, we are a dominant global producer of crude oil, and an investment might get negatively impacted if prices hover around $50 per barrel.

Just ahead of the winter, natural gas spiked by 40% in November due to below average inventory levels as we head into this crucial demand phase[13]. Heating bills will certainly be going up in coming months, possibly offsetting the benefits of lower gasoline prices for the consumer.

Economic Outlook

After increasing by 3.5% in Q3, after 4.2% growth in Q2, and a 2.2% rise in the pace of economic growth in Q1, the fourth quarter is expected to expand by about 2.5% if we look at the estimates from the Atlanta and NY Fed surveys[14]. Exports and capital spending are expected to moderate while US spending continues to carry the day.

I've talked about the slowing in activity overseas and that's been seen in a variety of figures. Economies in Japan, Germany, Switzerland and Sweden all contracted in the third quarter[15]. In November, the Organization for Economic Cooperation and Development did trim its 2019 economic growth forecast to 3.5% from 3.7% previously given in September[16].

12-16 Bloomberg

Conclusion

The two main concerns this year, the Fed and the trade spat with China, saw a nice respite around months end. While interest rates are still expected to be raised in mid-December, the markets have dramatically lowered the odds of another one in 2019, and Chairman Powell helped to confirm this positioning.

The Fed, ideally, wants to get to a 3% fed funds rate from a level of 2.25-2.5% after the December hike, but the question is at what pace they get there from here. Behind the scenes though, the tightening continues with respect to their balance sheet as it's shrinking at a monthly pace of $50b and should continue at that level in 2019, annualizing at $600b[17]. We will also face an end to the expansion of the European Central Bank balance sheet at the end of December. This reduction in liquidity will continue to be a close focus of ours.

With respect to trade, let's hope that something substantive comes of the Trump/Xi negotiations with respect to what we really should care most about, US technology secrets and protecting them. For now though, it is a good thing that the temperature of the room has gone down and at least at the end of December, we won't see an increase in the tariff rate to 25% from the current 10% on $200b of goods.

I'm hopeful that on any trade deal, we will see a nice recovery in international markets that have suffered the most this year as many overseas markets are very dependent on the health of global trade. Possible dollar weakness if the Fed is really close to being done would also help.

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17 – Federal Reserve