Monthly Update

January 2019

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Wow how the investing world turns. After that brutal December, which was the worst since December 1931, down 9.2%, we just had the best January since 1987, up 7.9%[1]. The two key factors that had worried many saw clarity and relief. First, the Federal Reserve and its Chairman Jay Powell expressed a shift in their stance on both interest rates and the balance sheet to a more "flexible" approach. Second, the trade talks between the US and China seem to be going well, as both sides are very invested in coming to terms with a deal of some sort.

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The Fed

The Federal Reserve frustrated the markets with their mid December 2018 rate increase, the 4th of the year, at the same time they hinted that higher rates would continue in 2019. Also, at that meeting the Fed said the reduction in the size of their balance sheet will continue on 'auto pilot.' This double barreled form of tightening was what predominantly weighed on markets in the 4th quarter last year, particularly in December. Rate hikes were slowing the interest rate areas of the economy, like housing and autos, while the balance sheet roll off was impacting asset prices.

Well, the Fed gave both the markets and the economy what it wanted in January. In both speeches from Fed members and codified in the late January FOMC meeting, the Fed shifted to a more "flexible" stance towards further tightening[2]. With respect to interest rates, the direction from here will be determined by the economic data. With regard to the Fed's balance sheet, in my opinion, an ultimate size of $3.5 Trillion from the current level of $4 Trillion, is where it might end up, instead of what I believe to be, the market's perceived possibility of something closer to $2.5 - $3 Trillion.

Trade

On December 29th, 2018, which was the Saturday before the New Year, President Trump tweeted this: "Just had a long and very good call with President Xi of China. Deal is moving along very well. If made, it will be very comprehensive, covering all subjects, areas and points of dispute. Big progress being made!" [3] This was then followed up by more conciliatory comments in the following weeks from both sides and an eventual trip by Vice Premier Liu He to the White House at the end of January.

1. Bloomberg
2. Federal Reserve

I'm optimistic that a deal will happen, but uncertain as to its substance. I believe that there will be a commitment on the part of the Chinese to further implement a court system and laws that protect, not just US technological intellectual property, but for every company that does business in China. Also I expect to hear that China will crack down on the forced transfers of technology. As for the trade deficit between the two countries, the Chinese will commit to buying more US products, but products they were going to buy anyway.

Earnings

The main catalyst for the equity and bond market rallies in January came from the comfort of the two biggest headwinds for stocks, monetary policy and trade tensions, finally seeing some relief. Of huge importance too were many Q4 corporate earnings reports that will continue thru February. What we've seen so far has been somewhat lackluster in part due to the very tough comparisons of last year when companies benefited from the cut in the corporate tax rate.

So far about 65% of S&P 500 companies are beating earnings estimates, which is slightly below the average of 70%[4]. Of those companies beating, the rate at which they are is about half of the average. Also, the percent of companies beating revenue forecasts is only at 35%[5]. Due to these results, the consensus estimate for earnings per share for the S&P 500 in 2019 has fallen to $168 per share vs $172 per share coming into the year[6]. This implies a 5% growth rate vs 7.5% previously. The estimate last October for 2019 was growth of over 10%[7], according to Bloomberg's consensus estimate.

Global Economy

The other noteworthy story about January was a continuation of what was seen in 2018; that being a growth slowdown in overseas economies, particularly in China, the rest of Asia, and in Europe. China's economy is juggling the desire to deleverage their companies, both public and private, at the same time they want to manage the moderation in growth via targeted lending. It's not an easy balance but the end result is still a GDP growth rate that continues to rise at a slower pace.

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Because of the large size of the Chinese economy, it is now impacting the rest of Asia, and Europe who is a big trading partner with them. Germany, whose exports make up 40% of their economy, has been particularly impacted[8]. Growth for Germany is expected to be just 1% this year[9]. The UK economy, the 5th largest in the world, is continuing to struggle with Brexit and whether there will be a deal or no deal. I believe we'll see a deal of some sort.

The US remains the strongest developed economy in the world, but is still not immune to the slowdown in foreign economies. Thus, domestic demand is carrying the day as exports slow, and that demand is coming mostly from the US consumer. The US consumer is experiencing a solid labor market and wage growth that is the best in 11 years. The estimate for US GDP growth this year is about 2.5%[10].

Bonds

Along with the rally in the stock market in January, corporate bonds were higher as well with yields falling and spreads narrowing. This was important because the rise in yields in Q4 2018 resulted in a higher cost of capital for many companies that limited the overall volume of capital market activity. In January, with the better landscape, corporate issuance has picked up again.

As for US Treasuries, yields ended the month not too far off from where they started. The spread between the 2-year and the 10-year started the year at 19 basis points and it ended January at 17 basis points[11].

Commodities

Oil prices rallied back above the $50 per barrel level and in the mid $50's is at the highest level since mid-November[12]. A hoped for change in government in Venezuela led to additional major disruption concerns, in a country that is already experiencing them. Also, the Russians and the Saudi's have been more disciplined with their supply. Copper prices also rallied on hopes that a China trade deal would be inked. Copper prices are highly sensitive to Chinese GDP growth. Soybean prices also went up, as China has recommitted to buying US soybeans again.

Finally of note, gold and silver continued their rallies that began in mid-November. During January, gold was up 2.9% and silver was up 3.4% based upon the January Actively Traded Front Month Futures Contracts, and were particular beneficiaries of the market turmoil in December. With the Fed now backing off from its aggressive tightening stance, the US dollar has weakened in response, and that has been the main reason for the rise in precious metal prices.

8. – 12. Bloomberg

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Conclusion

What a difference a month makes. Add some visibility into the market's two biggest concerns and voila, a market rally of substance ensues. The questions now in sustaining this rally are; how does the global economy unfold from here and whether corporate earnings can still grow. After all, the reason why the Fed is now more "flexible" is because they were shaken up by the Q4 volatility in markets and the weak economic data seen overseas.

Notwithstanding the January rally, the S&P 500 is pretty much where it was a year ago. Thus, I'm going to repeat that the investing landscape has become more challenging, but to also state again, this highlights the importance of having a plan for your capital in terms of meeting liquidity needs, being appropriately positioned, and understanding that opportunities always abound.

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