Monthly Update

November 2019

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November's themes were the same seen in prior months; continued hopes for a China/US trade deal and Federal Reserve monetary easing again helping stock markets around the world rally. The S&P 500 jumped by 3.4% in the month and, notably, the small cap Russell 2000 index finally did some catch up with its 4% rise[1]. Looking overseas, the German DAX, whose economy is highly dependent on China, bounced by 2.9%, while the Nikkei was higher by 1.6%[2]. I want to emphasize that the enthusiasm for stocks hasn't been based on the current corporate earnings picture or the trajectory of economic growth rates, rather on the hope that a China/US trade deal, along with Fed policy, will be enough to inflect higher the pace of business activity and earnings growth.

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Along with these hopes came higher longer-term interest rates around the globe, as yields continued to rise off the recent August lows. The US 10 yr yield, which dipped as low as 1.45% in August, ended November at 1.78%[3]. The German 10 yr bund yield finished the month at -.36% vs -.70% at the end of August[4]. The Japanese 10 yr JGB yield got very close to zero in November and is just off that now, after getting as low as -.28% in August[5]. Central banks are very good at pinning short-term interest rates at levels they desire, but longer term interest rates will likely be more driven by the markets.

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The US dollar index closed the month higher by about 1%, but remains in a multi-year trading range[6]. Commodity prices were little changed, notwithstanding the optimism in equity markets that growth will improve upon a trade deal and Fed rate cuts[7]. The demand for oil, industrial metals, or particularly agriculture products such as soybeans should be an important indicator when gauging the state of global economic activity and the China trade talks.

Trade Talks

It seemed that each day in November, as we heard about "a good tone" to the trade discussions with China, stocks would rally. Regardless of what the substance of the headlines were, anything that gets us closer to a deal was embraced by the stock market. We are now at a crucial moment because the December 15th tranche of tariffs, yet to be implemented, are right upon us if there is no deal.

1. – 7. Bloomberg

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If there is no deal by December 15th, I believe they will be temporarily postponed under the guise that the talks are still going well, and they just need a bit more time. The worst case scenario is that the talks fall apart and those tariffs are implemented, which means the US will have tariffs on all China exports into the US. I don't expect this to happen.

The Federal Reserve

The Fed ended October with its 3rd rate cut of the year, and continued to expand the size of its balance sheet in November. Between mid-September and late November, the Fed added almost $300b worth of US Treasury bills to its balance sheet, bringing the total value back above $4 trillion[8]. They have done this, along with short-term repurchase agreements, in order to supply the financial system with enough liquidity as we approach year-end. This all sounds like 'inside baseball' stuff, but many in the stock market equate an expansion of the Fed's balance sheet as another round of quantitative easing……call it QE4. Stocks rallied in all of the previous QE rounds. I believe this current round, whether we call it QE or not, is having the same psychological impact. I say 'psychological,' because we don't know how much of the money actually makes its way into the stock market.

Economic Growth

The third quarter GDP report was revised slightly higher to a growth rate of 2.1% from the initial print of 1.9%, versus 2% in Q2, and 3.1% in Q1[9]. Things are expected to moderate further in Q4, as the Atlanta Fed's GDPNow forecast is currently at 1.3% and the NY Fed's Nowcast estimate is for just .8% growth[10]. Global trade is the main point of weakness and that has negatively impacted manufacturing and capital spending. The bright spot in the US economy has been the US consumer, who is enjoying low unemployment and a good rate of wage growth, which have combined to lift consumer confidence. Thus, right now, the state of the US consumer is keeping the economy on its current 1.5-2% pace[11]. This needs to continue.

Economic growth rates overseas are very muted with China's growth slowing, Japan seeing only modest growth, and Germany's GDP growth rate flat lining[12]. Those are the 2nd, 3rd and 4th largest economies.

8. – 9. Bloomberg
10. Atlanta Fed and NY Fed
11. – 12. Bloomberg

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Part of the weakness in European economies is the result of the uncertainty with Brexit and the UK's removal from the EU.I do believe that, based on the polls, with a likely resounding win by Boris Johnson as Prime Minister, a Brexit resolution will soon follow.

Corporate Earnings

The rally in the S&P 500 this year has been solely driven by an expansion in the multiple of its price to earnings ratio. This is because earnings for the first three quarters of 2019 saw year-over-year declines and Q4 earnings are expected to see the same trend. Expectations for 2020 have receded, but are still expected to be up 5-7% from its 2019 and 2018 pace[13]. The S&P 500 is now trading at a 2019 earnings multiple of 19 times, which is rich, so it's very important that we get that earnings expansion next year, so we can better grow into the current valuation[14].

Conclusion

After a very good year-to-date in the stock market, it is now important that the hopes we've been rallying on become reality. We should know the status of the December 15th tariffs very soon, and thus, the state of the talks in terms of what's been agreed upon. As of this writing in early December, it still remains an open question whether anything is resolved by year-end with China.

We hope that upon a deal, if we get one, the current sluggish global economic growth, particularly with trade, manufacturing and capital spending, will improve. The stock market's response to a deal, if one were to occur, will most likely depend on where interest rates go as a result of the deal, with rates still amazingly low.

With all these different cross currents, we try to construct portfolios for our clients that are well-diversified, and with a long-term time horizon in mind; an investor's two best friends. Of particular importance is making sure our clients have their liquidity needs met over the coming 24-36 month period, which then makes market gyrations much less relevant during this time frame.

Please never hesitate to reach out at any time with questions, or for any discussion on the economy or markets. We also want to wish you and your family an amazing holiday season and a Happy New Year!

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11. – 12. Bloomberg

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