Market Commentary

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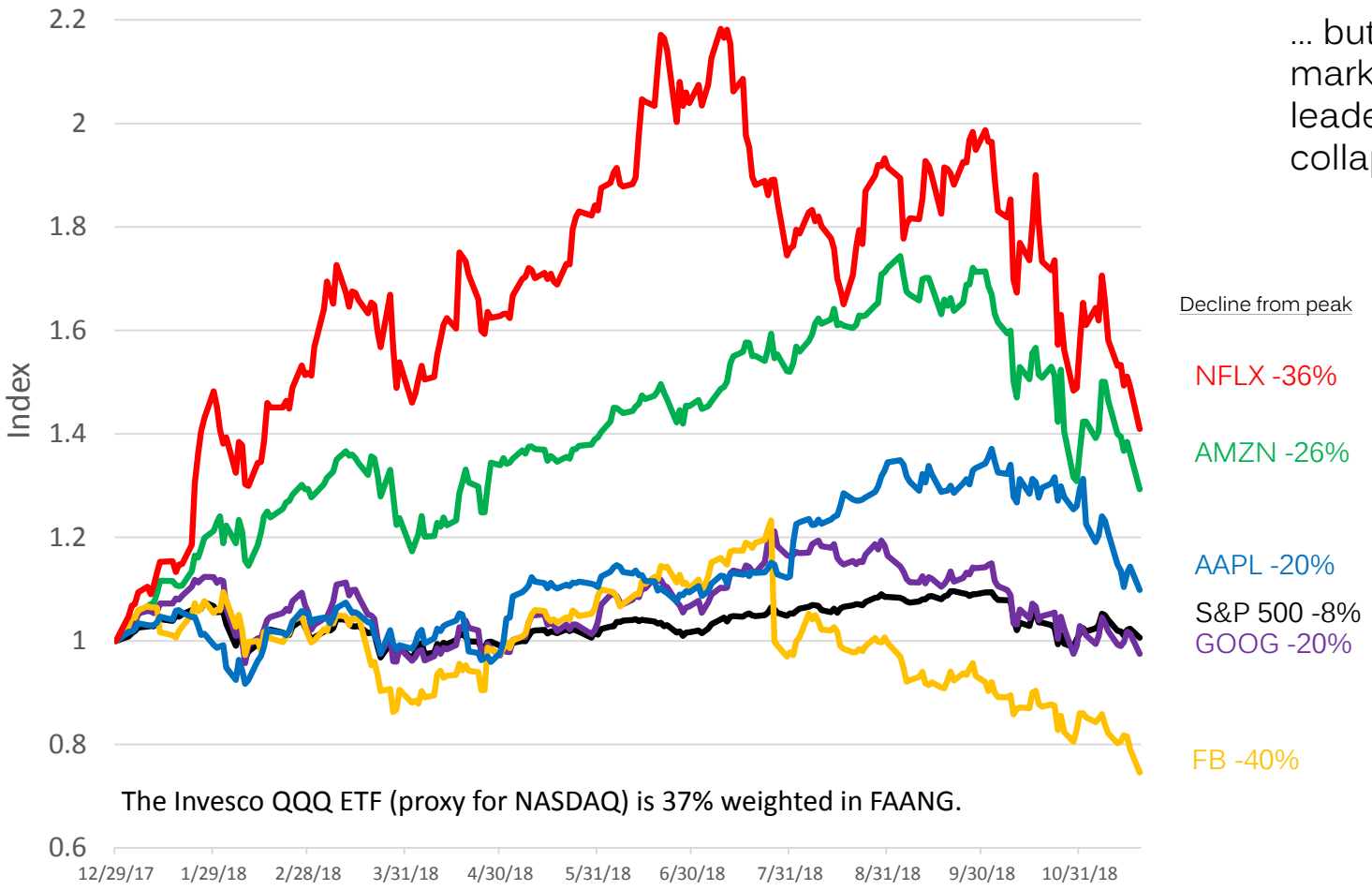
Stock Market

- Near record highs
- Driven by global expansion and earnings surge
- Lower $USD
- Stocks are not over-valued
- Margins are likely sustainable
- Fed is still accommodative
- Inflation is still tame
- lack of irrational exuberance
- Are rising bond yields bad for stocks?

Stock Market Tech Wreck

More specifically, the problem is with the FAANG stocks.



... but, FAANG market leadership collapsed.

The Invesco QQQ ETF (proxy for NASDAQ) is 37% weighted in FAANG.

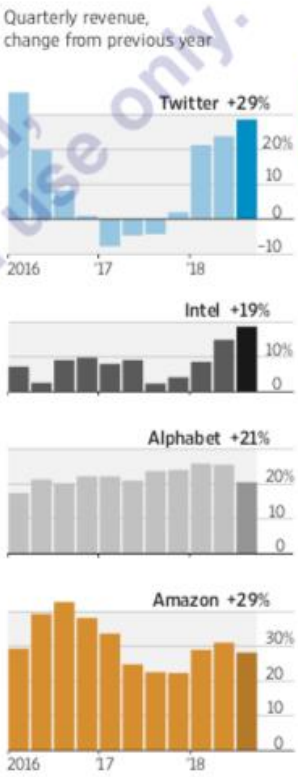
Source: Yahoo Finance, data through November 19, 2018.

Stock Market Arithmetic
Questioning 2019 Revenue and earnings Estimates

Amazon, Alphabet Fall Short on Growth

Alphabet and Amazon.com fell short of revenue estimates.
Twitter and Intel beat expectations, sending those stocks higher.

Sources: Dow Jones Market Data (shares); the companies, S&P Capital IQ (revenue)



THE WALL STREET JOURNAL.

By Laura Stevens
And Douglas MacMillan

Amazon.com Inc. and Google parent Alphabet Inc. on Thursday delivered underwhelming sales growth for the latest quarter, leading investors to punish their stocks.

Amazon said recent acquisitions, like Whole Foods Market, restrained growth, while revenue at Google's core advertising business didn't rise as quickly as expected.

The evening selloff highlighted investors' lofty expectations for a long-reliable corner of the market. While most companies would be envious of year-over-year sales growth of more than 20% and a valuation over $700 billion—as both Amazon and Alphabet boast—the market's reaction shows how unforgiving investors can be for tech giants.

Amazon fell 7.4% after its report, while Alphabet dropped 3.9%. The moves reversed earlier gains Thursday and continued the roller-coaster ride that tech stocks

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◆ Stocks roar back, sparked by earnings B1

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The FAANG stocks led the market in 2018.

With Q3 results, investors are re-thinking 2019 sales estimates.

Alphabet sales *only* up +21%
Amazon sales *only* up +29%
Apple cuts iPhone production

Source: *The Wall Street Journal*, October 27, 2018.

Stock Market Arithmetic
FAANG Significance

Tech Retreat Takes a Toll

By Michael Wursthorn and Tristan Wyatt

Wall Street has been souring since October on one of the year's most popular trades, sparking a selloff that has erased roughly $575 billion in market value from Facebook, Amazon.com, Apple, Netflix and Google parent Alphabet. The quintet—commonly known as the FAANG stocks—has suffered steep losses as investors rethink their lofty valuations and projected growth in the months ahead. But their combined market cap still totals nearly $3 trillion, giving them considerable heft in the S&P 500 index.

Apple's valuation sank below $1 trillion during the selloff, leaving it dangerously close to entering bear-market territory, marked by a fall of at least 20% from a recent high. The iPhone maker's losses have accelerated since the beginning of the month when Apple offered investors a tepid revenue forecast for the current quarter.

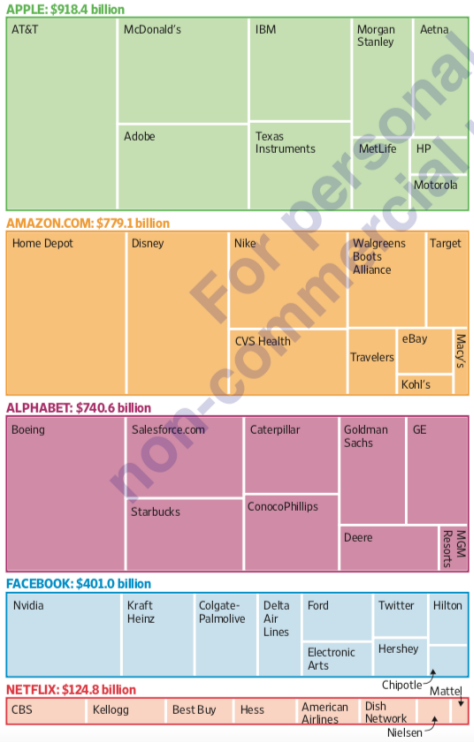
Amazon.com posted its second straight quarter of record profitability last month, but slowing revenue growth spooked investors, sending shares down 20% in October alone.

Alphabet also has shown signs of slowing growth, stirring further angst among investors over tech's durability during an economic slowdown. The search-engine giant has suffered a bruising period after reporting a surging profit on slowing growth in sales, setting up shares of Alphabet for their weakest year since 2014.

Facebook is the worst-performing stock of the FAANG group, shedding 21% so far this year, amid questions over its handling of user data. Losses have been mounting since July, when the social-networking firm warned about slowing growth, putting Facebook on pace for its worst year since going public in 2012.

Netflix had been one of the best-performing stocks in the S&P 500 throughout the first half of the year, avoiding some of the volatility that rattled other tech giants in the early spring. But the video-streaming company reported weaker-than-expected subscriber growth in July, kicking off a decline that accelerated in October.

S&P 500 companies whose combined market value would equal the valuation of the FAANG stocks



Source: FactSet

Source: *The Wall Street Journal*, November 19, 2018.

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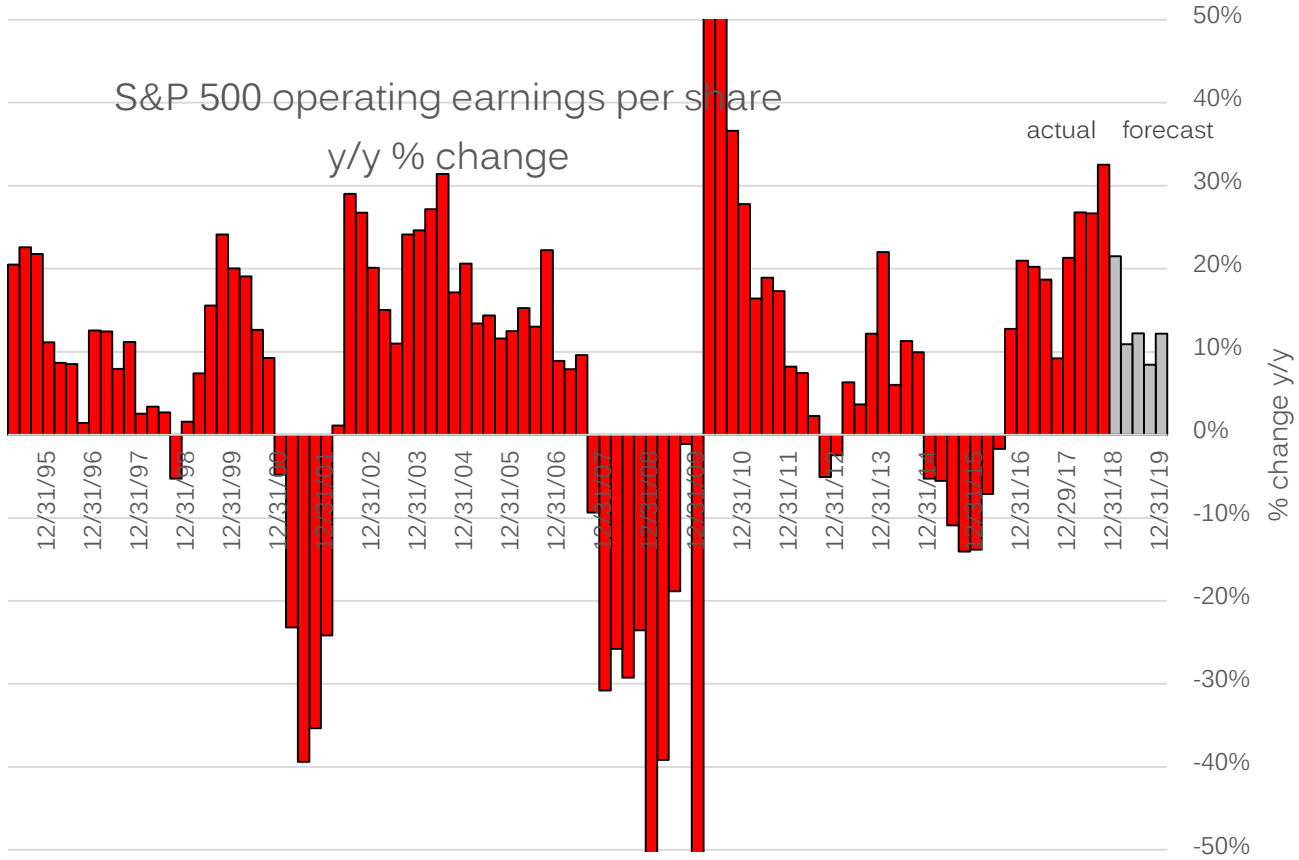
Comparative market caps.

At or near highs:

McDonalds
Disney
CVS
Walgreen Boots
Starbucks
Coca-Cola
Johnson & Johnson
Procter & Gamble

Stock Market
S&P 500 Peaking Earnings Growth



Q3 2018 marks the peak in y/y earnings growth.

Source: Standard and Poor's Inc. Data as of November 15, 2018.

Fed policy

- On a path to 3% fed funds rate
- Fed funds rate close to “neutral”
- The Fed manages the yield curve
- The Fed has created every recession since the 1950s
- The Great Unwinding: bond yields set to start rising
- The entire yield curve is shifting higher

Federal Reserve Policy Moving Dovish?

October 3, 2018
Chairman Powell:
"Interest rates are still accommodative, but we're gradually moving to a place where they will be neutral. We may go past neutral, but we're a long way from neutral at this point, probably. [PBS interview][stock market plunged]

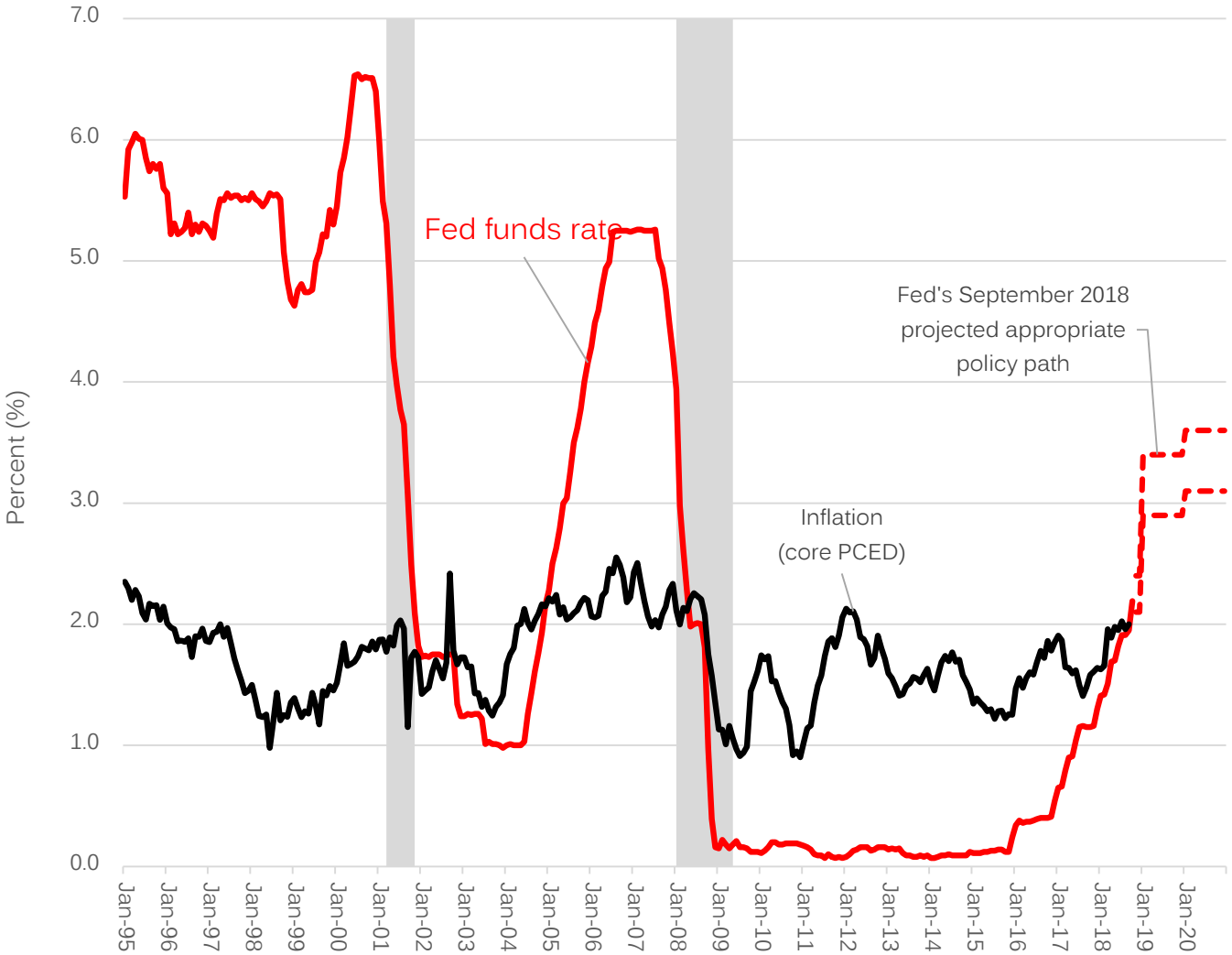
October 25, 2018
Vice Chairman Clarida:
"However, even after our September decision, I believe U.S. monetary policy remains accommodative." [Speech at Peterson Institute]

November 15, 2018
Atlanta Fed President Bostic
"I don't think we are too far from a neutral policy, and neutral is where we want to be," Bostic said in prepared remarks for a speech in Madrid. "We may not be there quite yet, but I am inclined to think that a tentative approach as we proceed would be appropriate." [CNBC]

November 16, 2018
Vice Chairman Clarida:
"As you move in the range of policy that by some estimates is close to neutral, then with the economy doing well it's appropriate to sort of shift the emphasis toward being more data dependent." [CNBC]

November 15, 2018
Chairman Powell:
"With labor market conditions close to maximum employment and inflation near our 2 percent objective, now is a good time to take stock of how we formulate, conduct, and communicate monetary policy," said Federal Reserve Chairman Jerome H. Powell. [Federal Reserve press release]

Federal Reserve Policy Heading toward "neutral"



Source: Federal Reserve and BLS, monthly data. PCED through September 2018. Fed funds rate through October 2018.

Until now, the Fed has kept the fed funds rate well below the rate of inflation – which constitutes stimulative monetary policy.

Historically, the fed funds rate was far higher than inflation immediately preceding recessions.

Federal Reserve Policy
Yield Curve

THE OUTLOOK | By Nick Timiraos

Fed Debates Signal From Yield Curve

Atlanta Fed President Raphael Bostic and some of his colleagues are laying the groundwork to slow down the Federal Reserve's interest-rate increases if they foresee a bond-market development that has traditionally been a harbinger of recession.

At issue is the narrowing spread between short- and longer-term Treasury yields, a difference known as the yield curve.

The gap typically shrinks when the Fed raises short-term rates. But when short-term Treasury yields rise higher than longer-term yields, a so-called inverted yield curve, a recession has almost always followed within a year or two.

Mr. Bostic's concerns are taking on new urgency because the spread, which compares yields on two- and 10-year Treasurys, has fallen to levels last seen in 2007. It dropped below 0.3 percentage point last week, down from 0.5 percentage point three months ago and 1 percentage point one year earlier.

"Any inversion of any sort is a surefire sign of a recession," said Mr. Bostic in an interview last month. "I want us to avoid being in a situation where" the curve inverts.

Mr. Bostic, an economist, took office one year ago and is a voting member of the Fed's rate-setting committee this year. The group has voted to raise rates twice so far this year, both times unanimously, to keep the expanding economy on an even keel.

While the Fed's policy shouldn't focus explicitly on "manipulating the yield curve," Mr. Bostic said, an appropriate approach "will be consistent with there not being an inversion."

His unease is shared by others, including Dallas Fed President Robert Kaplan, St. Louis Fed President James Bullard and Minneapolis Fed President Neel Kashkari.

The degree of importance others place on the signal could determine whether the Fed raises rates once or twice more this year.

Fed Chairman Jerome Powell has said the yield curve is important to watch, but he said in March the flatter curve didn't appear to be a recession warning.

Inverted yield curves have preceded recessions in part because "inflation was allowed to get out of control, and the Fed had to tighten, and that put the economy into recession," he said at a news conference. "It's really not the situation we're in now."

Mr. Powell flagged a separate concern: A narrower spread can complicate bank profitability and raise financial stability risks. Banks pay short-term rates on deposits and earn long-term rates on loans. The prospect that banks might engage in risky behavior as the spread flattens is an issue "that we'll be watching carefully," he said.

Minutes of the Fed's June meeting released last week showed the debate heated up. The discussion revealed a willingness on the part of some officials and staff economists to tamp down concerns about the yield spread.

Some officials have said the spread isn't as reliable an indicator of future growth because bond purchases by the Fed, the European Central Bank and the Bank of Japan in recent years—designed to spur economic growth by forcing investors to buy stocks and other riskier assets—have depressed long-term bond yields.

The so-called term premium, or the extra compensation an investor demands for owning a 10-year bond rather than a shorter-dated instrument, has been slightly negative in recent years, according to one Fed estimate.

A lower term premium "may temper somewhat the conclusions that we can draw" from the historical relationship between an inverted yield curve and recession, said Fed governor Lael Brainard in a May speech.

Her willingness to consider alternate explanations is noteworthy because last year she was one of the leading voices for caution in raising rates, citing stubbornly soft inflation. Those concerns faded this year with inflation returning to the Fed's 2% target.

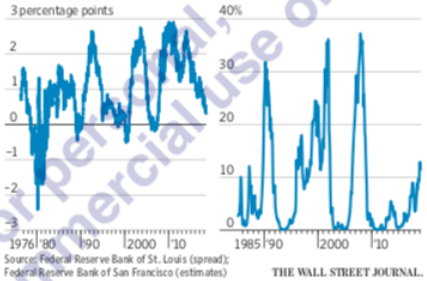
Research published last month by Fed staff economists said a more reliable gauge of market-derived recession probabilities can be found by comparing the difference between the yields on short-term Treasury bills and the yield implied by futures markets for the same bills some six quarters later.

This measure hasn't flattened in recent years and implied a low probability of a recession. Boston Fed President Eric Rosengren said in an interview last month he is paying more attention right now to such measures.

The debate over how much importance to place on an inverted yield curve could grow more fraught in the months ahead if U.S. economic growth remains strong and global growth falters. That could spur a flight to safe assets such as long-term Treasurys, pushing long-term yields below short-term yields.

Flattening Out

The shrinking spread between two- and 10-year Treasurys is at its lowest level in 11 years.



Source: Federal Reserve Bank of St. Louis (spread); Federal Reserve Bank of San Francisco (estimates)

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"An appropriate approach 'will be consistent with there not being an inversion.'"

Bostic repeated this on August 24th at Jackson Hole.[1]

Source: *The Wall Street Journal*, July 9, 2018. [1]The Wall Street Journal, August 28, 2018.

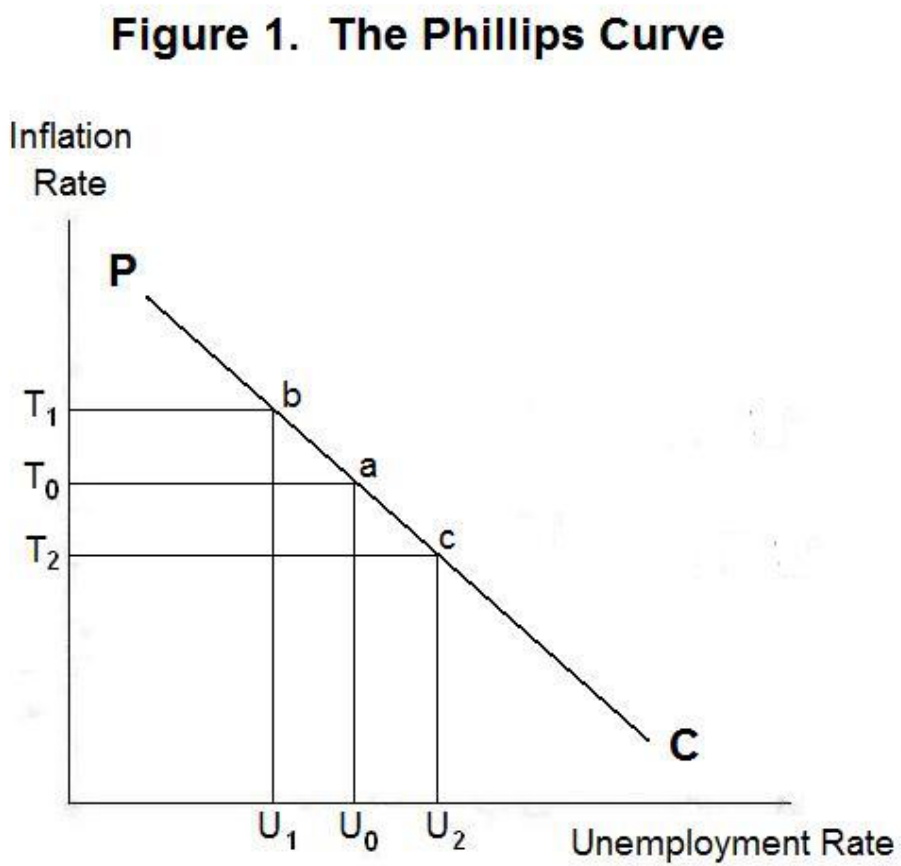
Bond Yields

- Recent lowest yields in history
- Yields don't make sense fundamentally
- Fed's QE took yields to those levels
- Yields might be higher absent the ECB's QE
- The wind-down of the ECB's QE will remove a weight on U.S. Treasury yields

Inflation

- What Phillips curve?
- Headline PCED +2.0%, +2.0% core
- Headline CPI +2.5%, +2.1% core
- Employment cost inflation rising
- Productivity drives declining unit labor costs
- Inflation expectations are gradually rising

Inflation
Phillips Curve

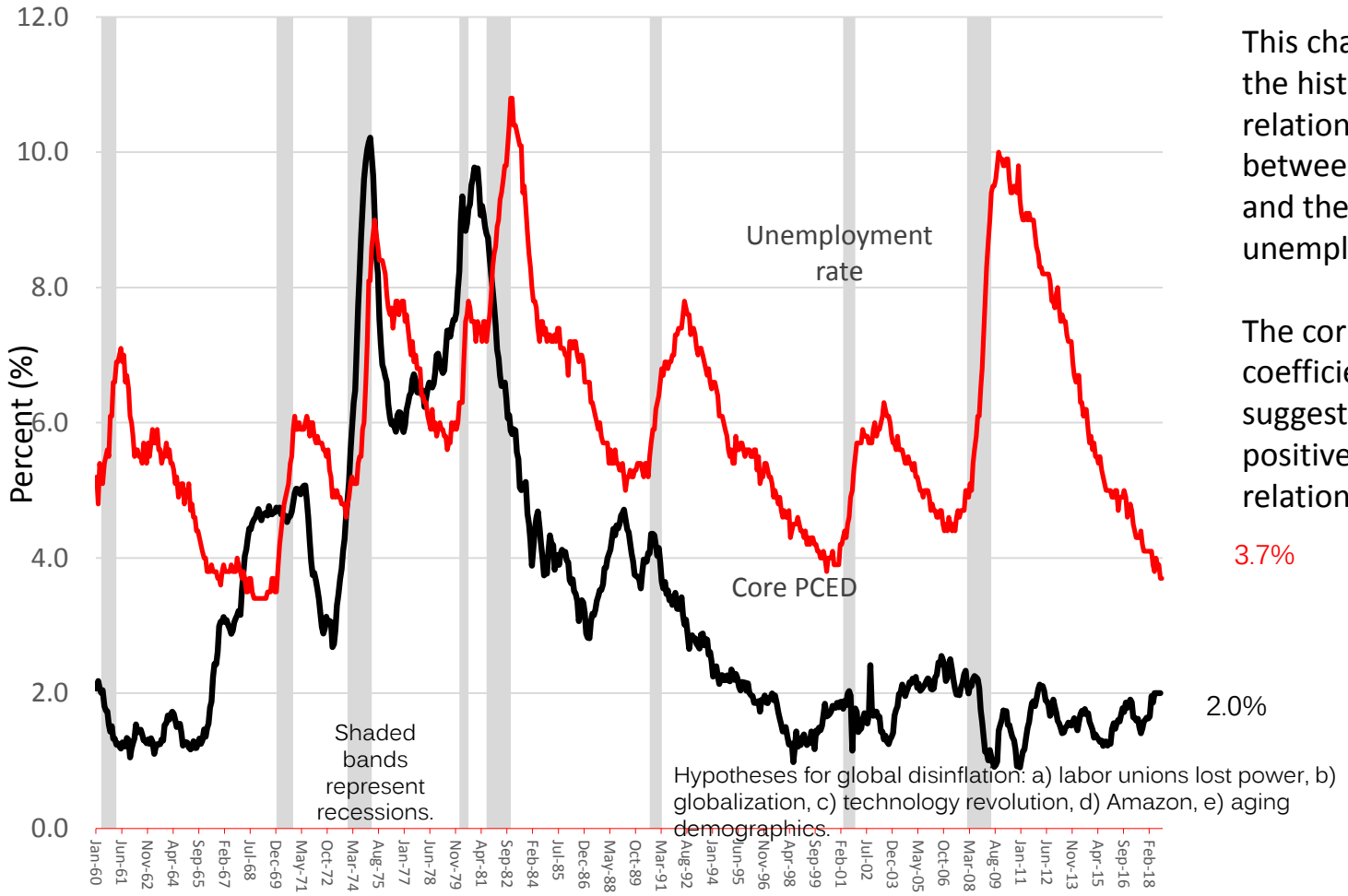


This simple schematic illustrates the common notion of an inverse relationship between inflation and the unemployment rate.

The theory behind the Phillips Curve: as labor becomes scarcer employers bid up wages, which are passed through to consumers in the form of higher prices.

This discussion is relevant at present because to the extent the Fed believes the Phillips Curve exists, today's record low unemployment rate might push them to head off higher inflation with more aggressive monetary tightening.

Inflation
Phillips Curve – Unemployment vs. Inflation



This chart illustrates the historic relationship between inflation and the unemployment rate.

The correlation coefficient is +0.28, suggesting a positive, not inverse, relationship.

Source: NBER, BLS, Federal Reserve Bank of St. Louis. Unemployment data through October 2018; core PCED data through September 2018.

Economy

full-employment economy operating at full potential

+2.7% GDP growth forecast, compared to post-recession +2.2% average

surge in LEI, small business optimism index, recovery in business investment
healthy growth in personal income, real DPI, strong retail sales
strong household balance sheets, savings rate, record FICO scores and low household financial obligations ratio
record high PMIs, strong hiring, record high job openings, new low unemployment rate, record low weekly unemployment claims, flat vehicle sales, flat housing starts

inflation expectations are anchored

"Our economy is strong. Growth is running at a healthy clip. Unemployment is low, the number of people working is rising steadily, and wages are up. Inflation is low and stable."

Jerome Powell
Chairman of the Federal Reserve
September 27, 2018

Trade
Latest View on China Tariffs

THE OUTLOOK | Bob Davis

China Tariffs Not Short-Term Strategy

WASHINGTON—While the White House is progressing on trade deals with allies including Canada, Mexico, Korea and Europe, its dispute with China looks increasingly intractable, with tariffs between the world's two largest economies likely cemented in place for years.

In other trade fights, President Trump used tariffs as leverage to reach deals. Threatening car tariffs helped convince Canada and Mexico to concede to U.S. demands for a new North American Free Trade Agreement, the president boasted. "Without tariffs, we wouldn't be talking about a deal," he said Oct. 1 in the Rose Garden.

China is different. Tariffs aren't simply a negotiating tactic for the U.S., but a way to change economic incentives.

The Trump trade team believes U.S. firms need protection from a predatory Chinese state, which Mr. Trump says coerces U.S. companies to fork over technologies and subsidizes Chinese firms to expand globally.

Using tariffs to make it more expensive for companies to export from China, Trump trade warriors figure, will encourage foreign firms to take their know-how out of the country.

This isn't a short-term strategy.

"We have changed the paradigm," U.S. Trade Representative Robert Lighthizer said last month. "We have tariffs in place, and the president is not going to let this go along when you have forced transfer of intellectual property."

So far, the U.S. has imposed tariffs on about half of the $505 billion that the nation imported from China in 2017. Mr. Trump has threatened to hit the other half with levies too.

For the first half of this year, Treasury Secretary Steven Mnuchin and his allies tried to cut deals with the Chinese that focused mainly on China buying more U.S. goods. Doing so, this camp argued, could address Mr. Trump's complaints about the $375 billion trade deficit with China. The president rejected the Chinese offers, undermining Mr. Mnuchin with the Chinese and strengthening Mr. Lighthizer's hard-line position in White House trade fights.

Now the U.S. team is more unified, but only because they are pushing for the kinds of changes sought by Mr. Lighthizer.

They include reducing the role of state-owned firms in China's economy, allowing U.S. firms to get majority stakes in businesses in China and dropping pressure on U.S. tech firms to reveal their secrets. These are the types of changes that China finds most difficult to accept.

China is a "socialist market economy," said Zhang Xiangchen, China's representative to the World Trade Organization, in July. "For those who speculated that China would change and move onto a different path...that was their wishful thinking."

President Trump is planning to meet Chinese leader Xi Jinping at the Group of 20 leaders' summit in Buenos Aires at the end of November. A failure there, says Myron Brilliant, the U.S. Chamber of Commerce's executive vice president, is bound to mean that the U.S. goes ahead with plans to increase tariffs on a tranche of $200 billion of Chinese goods from 10% to 25%. It could also lead to Mr. Trump making good on his threat of tariffs on another $250 billion worth of imports from China, if he hasn't imposed them beforehand.

Some Wall Street analysts said the trade fight won't have much economic impact. Jesse Edgerton, a JPMorgan analyst, likens tariffs to a tax. A 25% tariff on $500 billion of Chinese goods produces $125 billion in costs. Some of those costs will be absorbed by Chinese exporters, while some will be borne by U.S. importers and U.S. consumers.

In a $20 trillion U.S. economy, JPMorgan figures it should be manageable. It forecasts tariffs would reduce U.S. output growth by just 0.1 percentage point in 2019 and 0.3 percentage point in China. The Chinese, JPM expects, will respond by stimulating their domestic economy and cheapening their currency.

Others argue the impact could be deeper. Seth Carpenter, a UBS analyst, says tariffs hit U.S. manufacturing hard, especially newer firms which depend on China for components and as an export destination.

A lengthy trade war could tip the U.S. into recession, he said.

Tariffs have a kind of inertia, says Derek Scissors, an American Enterprise Institute China expert. Once they are put in place, companies and countries eventually adjust to them by shifting investment and policies. Removing the tariffs rejiggers the trading system again. Even if Mr. Trump should lose the 2020 election, he figures, tariffs could remain in place.

"Both parties are anti-China, and that's the way protectionism works," he said.

Some Wall Street analysts said the trade fight won't have much economic impact.

Paying the Bill

Consumer goods get hit harder as U.S. levies tariffs on more Chinese imports.

Share of tariffs on Chinese imports

	Intermediate goods	Capital goods	Consumer goods	Others*
1st round (‡50 billion in tariffs)	53%	42	1	5
2nd round ($200 billion in tariffs)	50%	25	24	1
3rd round† ($267 billion in tariffs)	15%	44	40	1

*Threatened, but not carried out yet.
Note: Numbers don't equal 100% due to rounding. 'Others' includes transport equipment
Source: USITC via Peterson Institute for International Economics

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$125 billion tariffs compared to $20 trillion GDP

Source: *The Wall Street Journal*, October 8, 2018.

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