From the desk of the CIO
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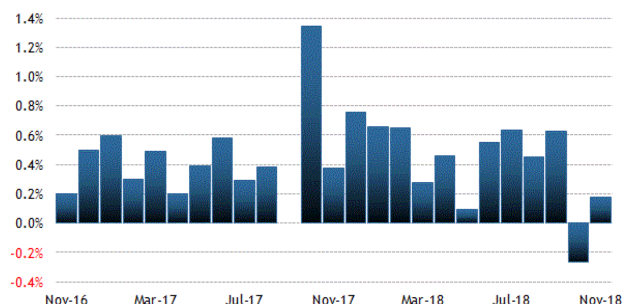
Summary

Fed rate hikes, China trade deal, oil prices, debt ceiling and fears of slow growth have investors thinking like they'll get coal in their stocking this Christmas. While these challenges work themselves out in some way, we continue to take a more defensive posture in portfolios. I remember speaking to a group in early 2010, when the Dow Industrials Average was trading below 10,000. I boldly claimed this benchmark index would likely reach 20,000 within 10 years. It was as if I had committed blasphemy! At the time, the 2008 – 2009 Financial Crisis was still fresh in our minds. After a 19% correction in 2011, the Dow not only reached 20,000, but went to over 26,000 in 2018. The current correction, at about 16% from the market's last peak is not fun, but it is also quite normal. In time, we expect the stocks markets of the world to recover, as they have always done, but the wild ride of the last three months may not quite be over yet.

Continued Defensive Glide Path

As markets continue their decline, we continue to increase defensive posturing through the sale of more volatile securities in favor of higher levels of cash or cash equivalents such as money market funds. It's important to understand that we are not getting defensive because a recession is imminent (at this point we don't believe one is), but rather to limit downside capture during a period in which the factors cited above are causing high levels of volatility in a still relatively strong U.S. economy. In fact, just this week a better than expected housing starts report was received and jobless claims fell in the most recent reporting period. Consumer sentiment and spending was still high and robust. Employment rates are at all-time highs and inflation is low. Interest rates even dipped for consumer loans over the past several weeks. Any determination on where we really go from here depends on additional data in the coming weeks and months. We are in a non-committal stance, monitoring the date and direction of the markets. The topics below that follow are brief comments on the underlying reasons we decided to get more defensive in the near term. The Conference Board's Leading Economic Index (LEI) for November just came out and the 0.2% increase continues the uptrend of the last few years, and is a positive indicator for now.

Leading Economic Indicators – Monthly Change



Mutual Funds Leave Santa (or the Santa Claus rally) Hanging

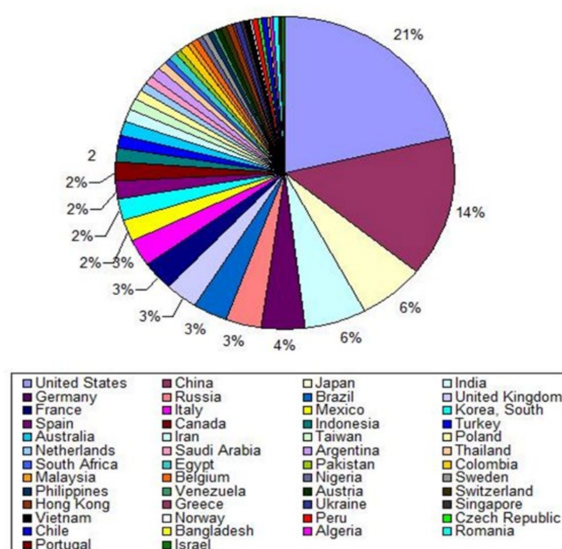
A significant dynamic in markets since around mid-October is a lack of participation from mutual funds. You see, stock mutual funds (at least U.S. focused equity funds) were sitting on modest gains year to date 2018 prior to the October selloff. To avoid seeing those gains disappear, some fund managers began to sell in mid-October. To exacerbate the situation further, fund managers have been reluctant to buy back into the stock market before year-end, for fear of posting negative returns for the year. Imagine looking at a negative mutual fund performance report, and at the same time staring at a capital gains tax bill for the same fund. Not a pleasant pill to swallow. For now mutual funds buying activity has been reduced making for a thinly traded market this month.

The Debt Ceiling

Yet another non-business operations related issue is this week's debt ceiling debate. Congress and the President must act by today (Friday) to either raise the limit on the amount of debt the folks at Treasury can issue to pay for government spending or shut down non-essential government functions. They are both using this deadline as a bargaining chip in their theatre of politics. Senator Mitch McConnell (R) says there is no chance of a government shutdown, but it sure doesn't seem like markets believe him.

Winning The Trade War is Painful for Investors

While most experts agree action should have been taken against China's legal and illegal theft of intellectual property and technology along with unfair trade arrangements long ago, the process of "negotiating" these issues has made markets nervous and could be dragging global economic growth down. Tariffs that have been in place for several months have had a negative impact for sure, but it's the bulk of tariffs to be imposed if an impasse between the world's two largest economies ensues beyond the administration's 90-day extended deadline that markets fear most. We are of the view (hope) that a deal will get done. It's not a matter of if but when. Fact is both countries need each other economically. Perhaps China needs us a little more than we need them right now, but it's really a draw longer term. Global trade is essential for economic growth at home and throughout the world.



Is The Fed Out of Touch?

The Fed has a dual mandate; first, to foster economic conditions that achieve both stable prices (inflation) and maximum sustainable employment. The unemployment rate is at a rock bottom low. Employers report more job openings than qualified applicants to fill those positions. Check. Second, the Fed targets a long-term inflation rate of 2%. Check. So, why the need to increase rates? Some would say, there is no need to increase rates and missteps by the Fed could force the economy into recession despite currently favorable economic conditions. Others who support the Fed's monetary policy argue that to keep the dual mandates on track rate increases are needed to prevent the economy from over-heating and inflation running amuck. The President obviously disagrees with the Fed and the tighter purse strings. However, he has an agenda. Rising rates at the same time he is negotiating a trade deal with China provides no cover whatsoever for the negative short-term impact of his bargaining stick, tariffs. The Fed did throw the President a very small bone as Chairman Powell expressed a softening of policy next year relative to the original plan a few months ago. It wasn't enough in the near-term to calm markets.

Lower Oil Prices is Positive, Right?

Lower oil prices leading to cheaper gas at the pumps certainly feels better (especially for those of us who still drive V8 gas guzzling SUVs to hall our children around to sporting events and school). In theory, less money spent on gas means more to spend on Christmas, right? So, why are markets sweating lower oil prices? Many economists and forecasters use the price of oil to gauge the level of economic demand globally. Lower prices result from less demand. I think this is a very difficult calculation to interpret. The boom in U.S. oil and natural gas production through technological advances has also created a larger global supply. This dynamic caused the selloff in global energy beginning back in October of 2014. Supply cuts then reduced output and allowed energy markets to settle. Fears right now are focused on the demand for oil as a measure of global economic activity, but this is an incredibly difficult conclusion to draw with certainty.

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