VERITY
Asset Management

Commentary

November 2018

The mood of the market can shift quickly. After surging to new highs in September, October's sharp decline sparked talk of an end to the bull market, and the search for early signs of an economic downturn began to escalate.

Severe October corrections are not unusual, but markets are generally prone to rise into the end of the year. Markets also have a very consistent record of positive returns in years that follow mid-term elections, so historical perspective suggests we should not overreact in the absence of clear evidence that conditions are materially eroding.

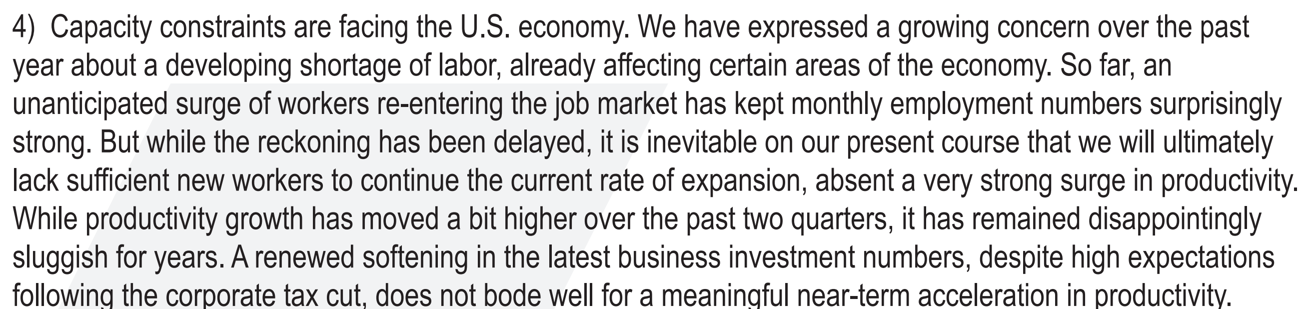
Despite suggestions from parts of the financial community, there are still no meaningful indications of a recession on the visible horizon. Leading economic indicators remain strong almost across the board. Perhaps a more useful question is whether the rate of growth is peaking. Former tailwinds have shifted to headwinds which are gradually gaining strength:

1) The Federal Reserve is tightening monetary policy:

- Real interest rates (net of inflation) have risen by 2% since 2015, with further increases expected.
- Absolute rates remain low by historical standards, but the pace of change could be the more significant factor affecting both consumer behavior and ultimately, financial markets.
- In either case, borrowing costs for both households and companies are rising meaningfully – "Adjusted for inflation, the rise in interest rates charged on a range of household and corporate borrowing has already matched or exceeded the average trough-to-peak increase in [the past four] tightening cycles", and credit card rates, which never materially declined following the financial crisis, are now "in real terms … their highest since 1994" (Capital Economics). On the positive side, consumer debt levels have been falling since the financial crisis, so there is less likelihood of a debt crisis, but rising interest costs still exert a dampening effect on consumption. We are likely already seeing an impact in the housing market.

2) The world economy is no longer in a synchronized expansion. China is slowing, possibly more than official data would indicate. They have begun to stimulate again after tightening in 2017, but that policy shift will take time to have an effect. Europe also is definitively slowing, and continues to face an array of credit and structural issues which could spin out of control at any time.

3) Tariffs have at the very least created considerable and continuing nervousness. The magnitude of their material impacts is impossible to effectively forecast at this stage, but the whole scenario is creating unquestionable psychological headwinds.



4) Capacity constraints are facing the U.S. economy. We have expressed a growing concern over the past year about a developing shortage of labor, already affecting certain areas of the economy. So far, an unanticipated surge of workers re-entering the job market has kept monthly employment numbers surprisingly strong. But while the reckoning has been delayed, it is inevitable on our present course that we will ultimately lack sufficient new workers to continue the current rate of expansion, absent a very strong surge in productivity. While productivity growth has moved a bit higher over the past two quarters, it has remained disappointingly sluggish for years. A renewed softening in the latest business investment numbers, despite high expectations following the corporate tax cut, does not bode well for a meaningful near-term acceleration in productivity.

5) Corporate earnings, after an extraordinarily strong 2018, will face challenging year-over-year comparisons heading into 2019, as the jolt from the 2018 corporate tax cut will not be duplicated.

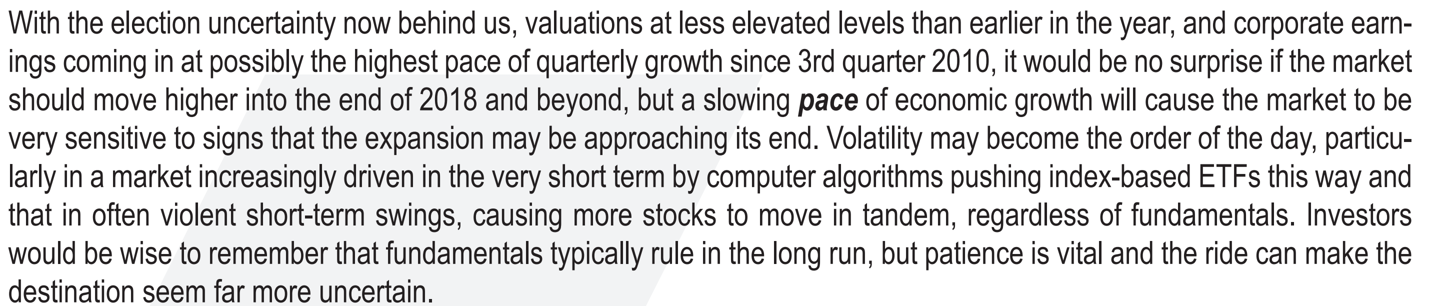
While the economy remains currently quite strong despite these headwinds, it is a concern that the housing market has clearly weakened, in direct reflection of some of the factors outlined above. Monthly housing numbers are volatile, but we are now in a sharp, sequential four month decline in new home sales to the lowest levels in over a year. Labor and materials shortages have continued to hurt supply, and mortgage rates appear to be taking a toll on demand, with the rate of home price appreciation falling significantly over the past six to eight months despite the supply shortages and the strength of the employment numbers.

In sum, it appears the rate of growth of the economy is likely to slow moving into 2019.

The market is clearly wary of all of this, demanding more from companies as they report their quarterly numbers. Third quarter earnings have been excellent, as previously noted, but companies with positive earnings surprises are experiencing relatively muted gains in their stock prices, while negative surprises are being punished severely. Market breadth has deteriorated, with the number of companies experiencing 52-week lows exceeding 52-week highs even before the October sell-off. For the year, headline index returns such as the S&P 500 are being boosted by relative strength from large cap growth stocks, but most individual stocks and most other market segments – with the limited exception of small cap growth - are ***significantly*** trailing. This has become a fractured market.

With the concerns acknowledged, there is still room for optimism:

- The combination of reduced taxes and reduced regulation should continue to fuel corporate profitability, even after the strength of the initial effects fade.
- Valuations are no longer so stretched.
- Though interest rates are rising, they have not yet reached burdensome levels. At present, they reflect an improving economy and are putting higher interest earnings into pockets of consumers.
- Full employment, despite its challenges, is in an immediate sense a very good thing – more people have income, and household debt is low.
- The continuing growth of the huge services sector of the economy is now being complemented by significant strength from manufacturing.



With the election uncertainty now behind us, valuations at less elevated levels than earlier in the year, and corporate earnings coming in at possibly the highest pace of quarterly growth since 3rd quarter 2010, it would be no surprise if the market should move higher into the end of 2018 and beyond, but a slowing ***pace*** of economic growth will cause the market to be very sensitive to signs that the expansion may be approaching its end. Volatility may become the order of the day, particularly in a market increasingly driven in the very short term by computer algorithms pushing index-based ETFs this way and that in often violent short-term swings, causing more stocks to move in tandem, regardless of fundamentals. Investors would be wise to remember that fundamentals typically rule in the long run, but patience is vital and the ride can make the destination seem far more uncertain.

Opportunity remains, but, perhaps to a greater extent than at other times over recent years, investors should be making very clear-eyed choices about the degree of risk they want to assume and the amount of volatility they can comfortably weather.

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