How the Fed Stole Christmas?

December 20, 2018

In the wake of the most recent rate decision by the Federal Reserve (Fed) and increased market volatility, the Investment Strategy Committee shares its thoughts:

Larry Adam, CFA, CIMA®, CFP®, *Chief Investment Officer*

December has not been kind to investors as several equity markets have neared or entered the traditional definition of a bear market (defined as a decline of 20% or more). Some of these include the NASDAQ (~20%), Russell 2000 (~25%), Eurostoxx 50 (~19%), Hang Seng (~23%) and S&P 500 (~17%).

After an unprecedented rally since the 2009 lows, this year has been beset by a litany of headwinds both domestic (Fed policy, the Mueller investigation, potential yield curve inversion, and the threat of a government shutdown) and global (trade tensions, European politics, Brexit). While the market largely ignored these risks throughout most of the year, current valuations seem to be pricing in the worst case scenario for all of these events. Optimistically, I do not believe that the worst case will be realized because, at a minimum, the economy remains robust (which should help corporate earnings), the Fed is "data dependent" and unlikely to "overtighten," and some progress is likely to occur with China in regards to trade.

The movements we have seen over the last 12 trading days (S&P 500 lost ~11.8%) are rare, and have only occurred 1% of the time dating back to 1928. In modern times (post World War II), this is the 11th worst 12-day stretch of the S&P 500. Interestingly, most of those were coincidental with a recession, extreme valuations (e.g., the "dot-com" bubble), and a downgrade of U.S. debt (see Figure 1). Our base case does not foresee any of these events.

Since the last Thoughts on the Market (December 14), sentiment indicators have become incrementally more bearish, which tends to set the equity market up for a near-term reversal or bounce:

• VIX (Volatility Index) has spiked above 28, the highest level since February and the second highest level since September 2015.

• RSI (Relative Strength Index) fell to 26. Historically, levels below 30 suggest "oversold" conditions which lead to a near-term "contrarian" reversal.

• The put/call ratio intraday rose to its highest level (1.89) since January 2016 suggesting an elevated number of "fearful" investors hedging their positions.

• Sentiment remains bearish with the American association of Individual Investors (AAII) survey continuing to show the number of bearish participants outnumbering the bulls by a ratio of almost 2:1.

From a fundamental perspective:

• Valuations continue to get more attractive, with the S&P 500 NTM P/E below 15x (at 14.4x). It was 18.3x at the beginning of the year.

• Fourth quarter S&P 500 earnings are expected to remain healthy at ~14% year-over-year which would help 2018 achieve annual earnings growth of ~21%, the best annual pace since 2010. Fourth quarter earnings season begins in earnest January 14, 2019.

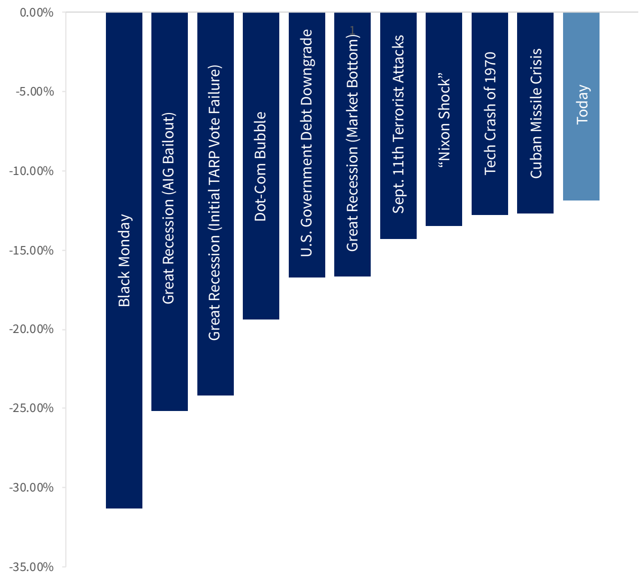
• The S&P 500 dividend yield is 2.1%, the highest it's been since November 2016.

• The Atlanta Fed GDPNow Indicator still estimates fourth quarter GDP growing at 2.9%, which would be the seventh consecutive quarter of growth in excess of 2%.

• The probability of a Fed rate hike in 2019 is below 50% (see Figure 2).

Figure 1: Worst 12-Day Stretches of S&P 500 Performance

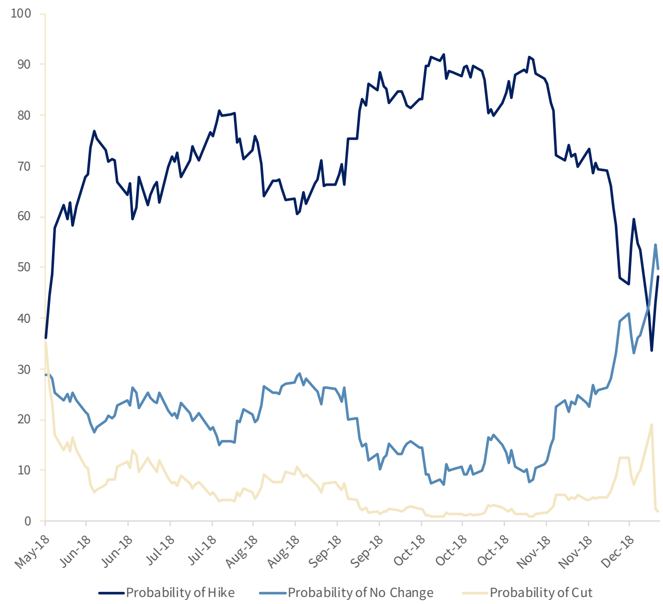
The Current 12-Day Stretch is the 11th Worst on Record, Post WWII



Source: FactSet, Bloomberg as of 12/20/2018

Figure 2: Fed Rate Hike Probabilities

The Probability of a Fed Rate Hike in 2019 is Now Below 50%



Source: FactSet, Bloomberg as of 12/20/2018

Scott Brown, Ph.D., *Chief Economist, Equity Research*

Financial market participants were expecting a "dovish" Fed rate hike in mid-December, and got one, just not as dovish as anticipated. The Fed raised short-term interest rates, as expected, but said that "some further gradual increases" would likely be warranted. Prior to the Fed's policy meeting, the federal funds futures market had all but priced out any rate increase in 2019. The revised dot plot (senior Fed officials estimates of the appropriate federal funds target for each of the next few years) showed most officials expecting one-to-three hikes next year, with a median of two.

In his post-meeting press conference, Fed Chairman Powell noted that "the economy has been growing at a strong pace, the unemployment rate has been near record lows, and inflation has been low and stable." He acknowledged the emergence of "some crosscurrents," principally a slowing in global growth and a tightening in financial conditions. However, "these developments have not fundamentally altered the outlook." Fed officials lowered their outlooks for GDP growth in 2019 and reduced their expectations for inflation, but only slightly. If the economy evolves as anticipated, the Fed would likely raise rates twice in 2019, bringing the overnight lending rate to what most officials believe to be a neutral level. However, Powell emphasized that "actual policy will, as always, be adjusted as incoming data shed light on the state of the economy, the outlook, and the changing balance of risk."

The economy appears to be in good shape heading into 2019. While it is possible that the U.S. economy could enter a recession in late 2019 or in 2020, that is far from the expected outlook. The economy should remain supported by fiscal stimulus (tax cuts, increased government spending) in the first half of the year, although that impact will fade over time. There are number of potential risks for investors in 2019, including trade policy disagreements, geopolitical developments (Brexit, Italy), the federal budget impasse, and the Mueller investigation. More importantly, while economic growth was strong in 2018, it was beyond a sustainable pace – we know that because the unemployment rate has continued to trend lower (and that can't go on forever). The transition to a more sustainable pace of growth, driven largely by demographic constraints, may be a challenging environment for investors in the next couple of years.

Michael Gibbs, *Managing Director of Equity Portfolio & Technical Strategy,* and **Joey Madere, CFA,** *Senior Portfolio Strategist, Equity Portfolio & Technical Strategy*

The U.S. equity market continues to be under pressure. Uncertainty regarding the trade war with China, concern over U.S. economic growth sustainability, a focus on the

Fed's tightening cycle, moderating economic growth abroad, and government shut-downs keep investors on the defensive. Where the market finds the absolute price low is nearly impossible to gauge when the selling happens so rapidly. Nonetheless, the selling will cease at some point, and a sharp counter rally will develop. From there, expect retests of the ultimate low as investors assess the issues of the day. An extended period is likely required to rebuild an uptrend.

Adding to the negative tone for equities are bear market readings for the NASDAQ, Small Caps, Mid Caps and numerous sectors on an intra-day (12/20). We recognize the heightened risk environment, but feel the current weakness presents an attractive risk to reward proposition for investors with a 12-month time horizon and beyond (see our base case scenario for 2019 below).

Selling Appears Extreme

- Violent Counter Bounce Rallies are Likely to Occur -

The market has cascaded lower in December. If the month ends at the current loss (-11.55% at the intra-day low on 12/20) it will be the worst December (historically the strongest month of the year) on record since 1950. The 17% intra-day peak (9/21) to intra-day decline (12/20) decline is also a rare two standard deviation move (re: happens in less than 5% of all occurrences). This has been consistent with lows in non-bear market pullbacks, and short term bounces during bear markets Other contrarian indicators, such as the CBOE put/call ratio finally spiked, which is also usually consistent with at least short term bounces.

Sector rotation has heavily favored the more defensive, "risk-off" areas of the market during the pullback. There has been plenty of deterioration, and many cyclical industries have sold off sharply. Valuation has gotten attractive, but it will likely take time for these areas to rebuild momentum for the renewed sector and market upside. If our belief of a favorable risk to reward plays out over the next twelve months, the beaten up and inexpensive cyclical sectors should fare the best.

In our base case scenario for 2019, we expect U.S. economic concerns to be proven premature as U.S. GDP will likely reach at least 2% growth in 2019 (Raymond James Chief Economist Scott Brown forecasts ~2%). Earnings growth for the S&P 500, while slowing from the unsustainable 20+% growth rate of 2018, will still be healthy as we project 5-6% growth for the year. Valuation further supports a positive bias with the S&P 500 price to earnings ratio (P/E) of 16x on trailing 12 month earnings attractive versus a fifteen year average of 16.2x. This is also 26% lower than the January peak P/E of 21.5x and 15% lower than the September peak P/E of 18.8x.

Our base case S&P 500 target of 2957 by year end 2019 renders 18% upside from the 12/19 close of 2507. Despite our bullish posture, we admit a lot needs to go right in the year ahead to achieve our target. With delicate issues, such as the U.S./China trade war in-play, volatility is likely to remain elevated.

Jeff Saut, *Chief Investment Strategist*

Hedge funds typically send out letters on November 15 advising their investors they have a 6 week "window" to pull their investment funds from said hedge funds. That is exactly what is happening now, as the guess is approximately 150 hedge funds will close their doors at the end of this month. In combination with long-only mutual fund liquidation and tax loss selling, the aggregate effect is that participants are selling into a vacuum of no buyers. According to a NYC-based portfolio manager:

> *"The Pension Rebalancing Model estimates there will be ~$90bn worth of inflows into equities and out of fixed income from pensions through the remainder of December, which would put it into the 95th percentile since 2005 and the largest estimated inflow to equities since May 2012."*

And, that feels about right to us. We continue to believe this decline is due to the Mueller investigation and the aforementioned "selling into a vacuum." When it ends is unknowable, but selling stampedes tend to last 17-25 sessions, and today is session 13 in the skein. Speaking to the current selling squall, Bespoke had this to say:

> *"Bullish sentiment among individual investors has tanked to its lowest levels in more than a year as stock prices have declined. The spread between bulls and bears is the most negative it has been since 2016. Over the intermediate to longer term, these prior drops in sentiment have set the stage for above-average returns going forward."*

The fundamentals remain decent with bond yields declining, oil prices rolling over, Chinese trade talks quieting down, Italy reaching a budget agreement with Brussels, and valuations falling to their cheapest levels in half a decade. Still, in selling stampedes, rationality tends to go out the window. As Chesapeake watermen say, “You can’t change the direction of the wind, but you can adjust the sails!”

Ed Mills, *Washington Policy Analyst, Equity Research*

The China trade war, Mueller investigation, Fed policy, and government shutdown fights dominate the headlines coming out of DC, and all of them are providing negative news for the market to digest. From the 2016-2018 election, DC was almost universally seen as a tailwind to the market. Not anymore. DC is now a headwind and we are in an unusually uncertain time. The China trade war has provided some modest positives coming out of the G20 meeting, but significant differences remain and new fronts continue to open, making it hard for either side to gain trust of the other to sustain any momentum. A deal could still be accomplished and a continued selloff places considerable pressure on the Trump Administration to cut a deal. The Mueller investigation is gaining steam (and guilty verdicts) as it heads towards its conclusion. We have seen a significant shift in the investor focus related to the investigation. For too long, the market hoped that it would have no market impact, but there is a renewed fear that the investigation could reveal an unforeseen revelations and increase the impeachment risks for the President. As for the Fed, President Trump’s increased political pressure on monetary policy has subjected attention/game theory upon their actions. Finally, while the government shutdown would only impact a small portion of the government (most agencies are funded through 9/30/19) the fight is an insight into negotiations with China and a potential preview of the next two years with a Democratic-controlled House of Representatives.

Chris Bailey, *European Strategist, Raymond James Euro Equities**

Developments in the rest of the world have also contributed to recent volatility. Last week, the European Central Bank (ECB) downgraded its economic growth estimates for 2019 and estimates for the timing of the euro zone’s shift back to positive interest rates have been pushed back to around a year’s time. However, at least the ECB is stopping new quantitative easing at the margin, unlike in Japan (where seemingly omnipresent stimulus continues reflecting a backdrop of muted growth and continuing negligible inflation). Recent Chinese economic data in important areas such as retail sales and industrial production have shifted to multi-year proportional growth lows (albeit still at absolute levels that are high compared to much of the rest of the world). Finally, the lack of clarity over Brexit continues to overhang the UK economy. Collectively, these developments have seen global corporate earnings per share estimates come under pressure, lessening investors willingness to pay a premium for stocks, inducing investment outflows towards cash and leading to financial market volatility.

However, the muted current sentiment among global investors towards their local equity markets may provide opportunities too. Dividend yields remain attractive versus fixed income, and cash markets and many individual corporations have responded to the uncertain environment and lack of political reform initiatives by taking matters more directly into their own hands. Encouraging entrepreneurial zeal remains an important counterpart to current pessimism, as it leads directly to more jobs and, hence, more consumer spending. Valuation levels in the rest of the world markets are also typically lower than in the United States, and any fade in the value of the dollar may also encourage investors to consider increasing global allocations.

Pavel Molchanov, *Senior Vice President, Energy Analyst, Equity Research*

Ever since OPEC and Russia announced a joint agreement to curtail oil production on December 7, the supply side of the oil market equation has been generally clear – and yet spot prices have continued to plummet, falling to fresh 52-week lows as of this week. What this tells us is that the oil market is trading largely on the same macroeconomic fears that have caused the free-fall in equities. Simply put, if the U.S. (and/or other major economies) go into a recession in 2019, oil demand will, by definition, be negatively affected. To be clear, even in a recession scenario, global oil demand is likely to show some growth, bearing in mind that the last time demand growth turned negative was in the depths of the financial crisis a decade ago. In a “normal” recession, demand might grow 0.5% to 1%, as compared to our baseline assumption of 1.5% for 2019. While it will take time for the demand picture to become clarified, we still see a broadly supportive fundamental backdrop for oil: the larger U.S. producers are exhibiting restraint in capital allocation; OPEC and Russia’s production cuts should contribute to inventory draws in 2019; there are still supply declines in several non-OPEC geographies; and the IMO 2020 low-sulfur regulations are looming on the horizon.

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*Affiliate of Raymond James & Associates and Raymond James Financial Services

Doug Drabik, *Senior Strategist, Fixed Income*

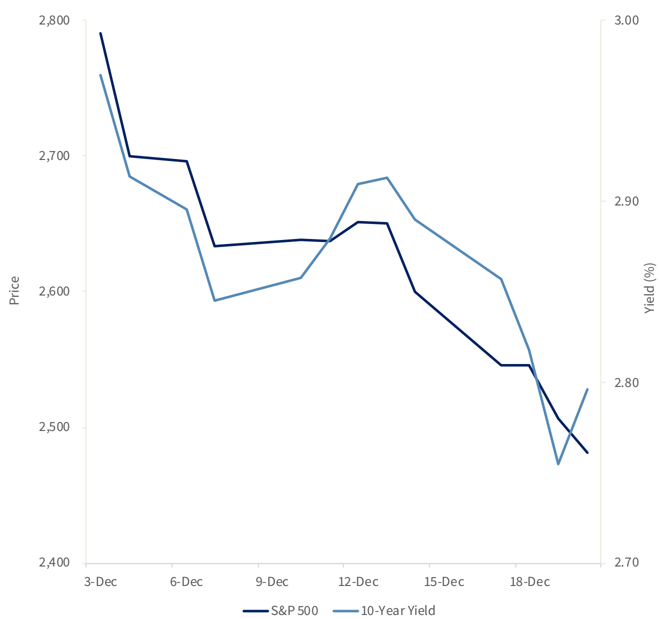
• Much of the recent volatility may be attributed to the language in the Fed's most recent statements, which were ultimately less "dovish" than the markets had hoped for. The flight to quality sees an exit from equities and into less volatile investments. Adding fuel to this is the budget impasse and the lack of progress in talks with China and trade.

• Yields have remained intact within fixed income spread products, as spreads have remained wide relative to earlier this year (and slightly elevated over a 5-year time horizon).

• The following graph depicts the highly correlated move between equities and Treasury rates:

Figure 3: S&P 500 and 10-Year Treasury Yields

Equities and Yields Have Become Increasingly Correlated



Source: FactSet, Bloomberg as of 12/20/2018

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VIX is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. The VIX is a widely used measure of market risk. The NASDAQ Composite is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The Russell 2000 index is an unmanaged index of small cap securities which generally involve greater risks. The relative strength index (RSI) is a momentum indicator that measures the magnitude of recent price changes to evaluate overbought or oversold conditions in the price of a stock or other asset. The EURO STOXX 50 is a stock index of Eurozone stocks designed by STOXX, an index provider owned by Deutsche Börse Group. The Hang Seng Index is a freefloat-adjusted market-capitalization-weighted stock-market index in Hong Kong.

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