Quarterly Commentary

U.S. Equity

The Standard & Poor's 500 index lost 13.5% in U.S. dollar terms over the fourth quarter and in Canadian dollar terms the index has fallen 8.1%. For 2018 as a whole the U.S. equity benchmark dropped 4.4% in U.S. dollar terms but was up 4.4% in Canadian dollars as the loonie came under pressure. The S&P 500 share index hit a rough patch which was not all that surprising given that we were in the tenth year of a bull market and economic expansion.

Global financial market volatility picked up in 2018 and is pointing to an expectation among some investors that deterioration in global macro conditions is increasingly likely. That suggests the outlook analysis for 2019 should be more about assessing whether underlying economic conditions allow for an extension of the global business cycle. The U.S. may well enter a cyclical slowdown in 2019 and, if so, a key question is whether the Federal Reserve can successfully engineer a soft landing for the U.S. economy. Back in September most Fed officials had predicted at least three rate increases over the course of 2019 but following the December rate announcement they are now predicting the central bank would raise rates no more than twice this year. The mention of any rate increase at all sent markets into a tailspin as many investors hoped that the the Federal Reserve was closer to the end of its hiking cycle.

The Fed's policy trajectory is critical for the extension of the current business cycle. Out of the twelve U.S. rate hike cycles since 1955, eight resulted in a recession. Achieving a soft landing may indeed be a challenge but U.S. economic growth has held up better compared with other major developed world economies thanks to bullish business and consumer confidence, which in turn has been supported by favourable employment numbers. The bigger than expected 312,000 jump in non-farm payrolls in December suggests the U.S. economy still has considerable forward momentum. The only downside in the report was that the unemployment rate increased to 3.9% from 3.7% but that increase was largely due to an enormous 419,000 increase in the labour force, As a result the participation rate jumped to a five-year high of 63.1%. It appears that higher wages are the reason why people are returning to the active labour force. Overall the equity market may have decided the Fed's work is done, but the economic data say otherwise.

A stronger economy tends to push up interest rates, which in turn puts downward pressure on stock prices. In late December the U.S. Bureau of Economic Analysis confirmed that real gross domestic product (GDP) increased at an annual rate of 3.4% in the third quarter of 2018 according to its third estimate. The very healthy real GDP number in the third quarter reflected positive contributions from personal consumption expenditures, private inventory investment and non-residential fixed investment. However headwinds, including restrictive trade policies and tighter financial conditions, are gathering. This should lead to a classic cyclical slowdown in 2019. For 2020, the current consensus forecast, as well as the Federal Open Market Committee's, suggests a soft landing.

Given the sell-off in expensively priced tech shares in October and the trend to higher interest rates, it's not surprising that warning signals began to flash for some traders. In December retail outflows picked up, unlike in the October sell-off, as mutual funds were cashed in and stocks in e-trade accounts were sold which would indicate that relatively inexperienced investors headed for the sidelines. The volatility indicators such as the VIX index don't yet suggest the big money is ready to be swept off the table. It's not the summer of 2008.

There are signs that we are in a classic late cycle expansion as we are seeing an economy with almost full employment and slowing momentum which tends to foretell a decline in corporate profit margins, but while the U.S. may well be in the mature stage of the economic cycle, there is still time and room for equity markets to run.

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www.provisus.ca

18 King Street East, Suite 303
Toronto, ON M5C 1C4

Phone: 416-933-1111
Toll Free: 1-877-768-4787