Monthly Outlook for December 2018: "A Good Man…"

"I wanna be the one, when all is said and done, who lived a good life, loved a good wife, and always helped someone in trouble. On the day they lay me down, I want everyone to gather 'round, and say, 'He was a father, brother, neighbor and a friend, He was a good man' ".

("A Good Man" by Emerson Drive, from their album "Countrified," released March 2006).

The world lost a good man in ***President George H.W. Bush*** when he died last week. Having lived a full life, President Bush epitomized the kind of person that the Canadian group Emerson Drive sang about in their single ***"A Good Man."*** If only politicians of all stripes and persuasions, hewed to this ideal, we are certain the world would be a much better place!

Financial markets continue to remain volatile as they deal with ***myriad uncertainties***: An ***inversion*** in the front end of the US Treasury yield curve (more on this later), ongoing worries about a ***trade skirmish*** between China and the US, an upcoming ***Brexit*** vote in the UK Parliament, ***Italian budget*** woes, violent protests in France (the "***Gilets Jaunes***"), and oh by the way, a ***Federal Reserve*** that is likely to raise interest rates next week, amidst a continued shrinking of its bloated balance sheet.

Regardless of the reason, financial market participants are starting to wonder if the ongoing weakness in equities is just a plain vanilla ***correction*** (within a longer-term uptrend), or the beginning of something more ***sinister***: Clearly, the ***fundamentals*** of reasonable economic growth, elevated earnings expectations, but sensible valuation multiples would have us argue that this is a version of the former. However, volatility in equity prices does feel terrible and is quite ***frustrating***.

US economic growth remains ***reasonable:*** The economy added ***155,000 jobs*** during November with the private sector (+161k) creating all the jobs and then some for the month. Indeed, Trade, Transportation and Utilities (+53k), Education and Health Services (+34k), and Professional and Business Services (+32k) were the leading sectors. ***Average Hourly Earnings*** rose 0.1% (m/m; ***y/y: 3.1%***) during the month, and Average Weekly Earnings gained 0.4% (m/m; y/y: 2.8%), implying that the labor market remains quite tight.

The politically sensitive ***unemployment rate*** remained unchanged at ***3.7%*** while the U-6 measure of underemployment increased two-tenths to 7.6% for November. The labor force participation rate stayed steady at 62.9%. Another interesting measure of labor market strength is the Median Weeks Unemployed – which this month posted a slight decline to 8.9 weeks (from October's reading of 9.4 weeks).

Survey data – the Institute of Supply Management's Manufacturing as well as Non-Manufacturing (or service) surveys – do depict a US economy that appears to be ***"firing on all cylinders."*** Indeed, many of the components of the Manufacturing Report showed robust increases with New Orders (62.1 in November vs. 57.4 in October), Employment (58.4 vs. 56.8), and Backlog of Orders (56.4 vs. 55.8) leading the way. Similarly, the Non-Manufacturing Report also had such gems with Business Activity (65.2 in November versus 62.5 in October), New Orders (62.5 vs. 61.5) and Prices (64.3 vs. 61.7) leading the way.

The Federal Reserve's ***Beige Book***, released last week, also painted a picture of an economy that appears to be growing reasonably. The Twelve ***Federal Reserve Districts*** (the eyes and ears of the Board of the Governors in Washington DC) reported that growth remained modest to moderate, although there appeared to be some ***"slowing"*** in selected sectors (like housing and autos) across the entire spectrum. The Beige Book was also keen to note that labor markets had "tightened further across a broad range of occupations" while "prices rose at a modest pace in most districts." The tighter labor market (which is often a harbinger of ***incipient inflation***) is a key, as this implies that the FOMC will likely raise rates again when they meet next week (Dec 18th/19th).

There is much speculation that the FOMC might back-off some from its previous avowed path of raising rates and the EuroDollar futures curve is now building in ***no rate hikes for 2019.*** We believe that this is a touch too optimistic – as the FOMC is unlikely to be swayed by a mere swoon in equity markets – especially if such a correction is healthy and does not appear to be leeching into Main Street. All in all, we still think the FOMC will likely ***raise rates one or two more times next year,*** but much will depend on the evolving nature of contemporaneous economic data.

Financial markets were also in a ***kerfuffle*** last week as the US Treasury yield curve saw its ***front end invert***. The yield on a two-year US Treasury rose ***above*** that of a five-year Treasury in an unusual pattern on the term structure of interest rates. Normally, the Treasury yield curve is upward sloping with longer maturities demanding a higher yield than lower maturity tenors. An inversion is often a ***signal*** that either the Federal Reserve has tightened too far or the economy is about to come unglued and fall into a recession.

The "economist" in us wants us to ***ignore the warning*** from the yield curve: the lags between an inversion and a recession are varied (6 months to 28 months), and besides, the inversion is only in the front end of the curve and is therefore not yet a "true" inversion. However, the "traditionalist" in us wants us to believe that such a signal from the Treasury yield curve is indeed a true one, and the FOMC has overdone it (yet again!).

Crude oil prices have seen a round-trip to $80 per barrel (on West Texas Intermediate) and back to $50 per barrel on worries of slowing global growth (and therefore global demand for energy). All the work we do suggests that the problem with crude oil has not been a lack of demand, but one of excess supply – which we feel will self-correct itself - especially as some of the weaker players leave the industry or get consolidated into larger players. Besides, valuations in this sector are ***certainly attractive*** from a longer-term perspective.

Last week, Texas and the Nation said goodbye to a favorite son: the 41st President of the United States, George Herbert Walker Bush. A one-term president (blame H.Ross Perot for that), President Bush was ***"a good man."*** Eulogies and speeches by President George W. Bush, former Canadian Prime Minister Brian Mulrooney and a long time confidant James Baker III, all pointed out the enormous arc of history that Bush had been a part of. Indeed, he presided over the collapse of the Soviet Union and the first Gulf War, all the while staying a steely, yet ***"kindler and gentler"*** leader. May His Soul Rest In Peace!

Farther afield, the British Government has delayed a vote in the House of Commons on the Brexit deal between the UK Government and the European Union which was scheduled for Tuesday, Dec 11th. The ***Withdrawal Agreement and the Political Declaration*** are densely worded documents – which do not appear to place the UK in a better place after March 2019. In other words, divorce is hard, but continuing the sham seems even worse! We have said this before, Prime Minister May and her band of advisors have ***thoroughly muddled the situation***. The prospects of a "no deal" Brexit, while scary as it May seem (pun intended!) are quite real.

France has also been in the news lately, with widespread protests against a diesel price hike instituted by the Government. The so-called ***"Gilets Jaunes"*** or "yellow vest" protests have been seen as a protest by mostly "rural, middle and lower income" folk who rail against the ***"urban elites"*** – particularly as President Macron is viewed as a "President of the rich." The indignation of "blue-collar" citizens against the smug "we know what is good for you" attitude of the upper classes does suggest a ***far deeper malaise*** within French Society. However, it will be interesting to see how all this plays out – and whether this will have any lasting impact on financial markets.

In summary, while equity markets continue to remain ***volatile*** as they are ***buffeted*** by myriad uncertainties, the fundamentals of reasonable economic growth, low inflation, and sensible valuation multiples will likely stay our hand from knee-jerk reactions to such short-term gyrations. It is important to take a ***longer-term view*** during such unsettling periods to ensure favorable investment outcomes, painful though these periods might be.

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