Monthly Outlook for November, 2018: “Out of Nowhere…”

“You opened up the door, I crashed into the wall, didn't touch the bricks at all, never wanted something more,
I started looking back, life's like a racing track, these moments end so fast, let's make the moment last….

How you came out of nowhere, there is nothing I can do with this step we got here,
Crossing roads until it showed, breaking all the rules to know, how you came out of nowhere”.

(“Out of Nowhere” by Seafret, from their Album, “Tell Me It’s Real”, Released Jan, 2016).

The ***“correction”*** in equity markets that started last month and appears to be ongoing this month, seemed to come “Out of Nowhere” – in our paean to the German group ***Seafret.*** We are using a relatively newer band to show the Millennials that our taste in music remains ***eclectic,*** although our comfort leans more to the glorious Seventies genre! In our opinion, the correction in equities, is ***quite healthy***, and certainly represents an opportunity to ***position portfolios*** ahead of likely market moves over the next twelve to eighteen months.

While the correction did seem to come out of nowhere, the reasons are many and not that hard to find: ***Rising interest rates*** as the Federal Reserve seeks to “normalize” the cost of funds and also reduce the size of its balance sheet simultaneously, worries about ***slowing global growth*** – particularly in China, a ***trade spat*** between the US and China with rising fears of protectionism, a change in the House of Representatives at the US Congress after the ***mid-term elections*** and fears that ***earnings expectations*** might also be ahead of reality.

US economic growth remains ***robust:*** The economy added ***250,000 jobs*** during the month of October with the private sector (+246k) accounting for most of the increase. Indeed, Education and Health Services (+44k), Leisure and Hospitality (+42k) and Professional and Business Services (+35k) were the leading sectors. ***Average Hourly Earnings*** rose 0.2% (m/m; ***y/y: 3.1%***) during the month, and Average Weekly Earnings gained 0.3% (m/m; y/y: 3.4%), all but ensuring that the Federal Reserve will not hesitate to increase the Fed Funds Target at their meeting in December, as expected.

The politically sensitive ***unemployment rate*** remained unchanged at ***3.7%*** while the U-6 measure of underemployment declined one-tenths to 7.4% for October. The labor force participation rate also ticked-up one-tenths to 62.9% - a noticeable gain, especially since many economists have bemoaned the lack of broader participation in the labor force from a stronger economy. Another interesting measure of labor market strength is the Average Weeks Unemployed – which this month posted a nice decline to 22.5 weeks (from September’s reading of 24 weeks).

The Bureau of Economic Analysis of the Department of Commerce pegged its preliminary reading of ***GDP growth for 3Q at 3.5%*** (seasonally adjusted annual rate), which follows ***2Q’s robust reading of 4.2%*** (also SAAR). Personal Consumption Expenditures rose 4.0% during the quarter and Gross Private Domestic Investment rose an outsized 12.0% during the quarter. Exports posted a surprising decline of -3.5% while imports gained an massive 9.1% during the quarter – as firms rushed to fill orders (from their global supply chains that include China) ahead of the imposition of tariffs against that country in late October on a variety of goods.

Overall, the economic expansion that began in the spring of 2009 appears to have received a proverbial ***“shot in the arm”*** as a result of the tax cuts passed by the US Congress late last year. Add to that recipe the deregulatory fervor of the Trump Administration and you have a brew that has caused both consumer as well as business confidence to hit new cyclical highs recently. The real question remains whether the tax cuts were a mere ***sugar high*** or are more sustainable – especially as their effects flow through the economy.

Speaking of fiscal policy, the news cycle has been dominated by the potential for an ***infrastructure deal*** between a Democratic House of Representatives and the Trump Administration. While we still think this is possible, we worry that wanton spending by a profligate Government (both the Executive branch as well as the Legislative Branch are to blame here), could well raise interest rates substantially and the cost of servicing such debt might well become prohibitive under the right (***"wrong?"***) circumstances.

The afterglow from bipartisanship lasted all of one afternoon last week – when it became clear that the mid-term elections would result in a change in the House of Representatives. President Trump's news conference was ***combative as usual*** and contained a self-congratulatory tone. Statements from some of the Democratic leaders were about wanting to ***investigate*** the Administration's actions and perhaps even some suggestion about ***impeachment*** of the President.

The ***political discourse*** has continued to ***deteriorate***, with the environment resembling some of the dysfunctional times this country has faced in politics like at the turn of the 19^{th} century. One only needs to read some of the newspapers and magazines from that period to realize that what we are seeing is ***not unusual***, but a function of cumulative distrust and tactics that are borderline illegal! Indeed, we find it deplorable that the country has so called leaders (***on both sides of the aisle!***) who cannot do better for the Nation than to carry out their own narrow partisan actions to further their party's chances.

Separately, ***technology shares*** – particularly the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) – have been beaten-up this quarter, especially after Amazon (AMZN) guided lower on the upcoming quarter's sales and revenue numbers. Indeed, while the high-flying FANG stocks had led the way for most of the past two years, both the prices as well as the P/E ratios appear to be coming down to earth currently. Nonetheless, AMZN currently still has a ***P/E ratio that is 103 times*** (compared to the S&P 500 index at around 19 times!).

The Federal Open Market Committee of the Federal Reserve for its part left interest rates unchanged at 2.25% last week. We still believe that the FOMC is likely to ***"snug"*** interest rates by another notch (25bp) when they meet the next time in December. We are convinced that given inflation and wage data (which appear to be deteriorating at the margin), the FOMC will likely continue to tighten – especially if economic growth continues unabated.

Farther afield, the British Pound Sterling continued to lose value relative to both the US Dollar as well as the Euro, driven primarily by fears of a ***hard Brexit.*** It is quite clear that the UK Government led by the phlegmatic Ms. May has botched the negotiations with the European Union and positions appear to be hardening on both sides of the divide.

Our regular readers will recall that the original ***Brexit vote*** actually occurred in June, 2016 – over two years ago. The British PM triggered Article 50 – for Britain to leave the EU – on March 29, 2017 thus setting a deadline next March (March 29, 2019) by when both the EU and the UK have to agree to terms of the Brexit. There is also a "transition" period that runs from the March, 2019 date through to December, 2020 by when the new rules will have to be implemented. Confused? We are too – and we suspect so is the average Brit!

We have made ***some moves in your portfolio(s)*** recently: We have used the ongoing sell-off in equities to add to positions in Mid-Cap equities ("SFMIX") and energy ("XLE") – as the fundamentals do not appear to warrant the pummeling that these sectors have taken in the past month. We have also lowered your exposure to high yield debt in the fixed income part of the portfolio – as we suspect that yield spreads are quite narrow and unlikely to narrow further going forward.

In summary, while the equity markets appear to be suffering from an ***ongoing correction***, we feel that this episode presents an opportunity to ***re-jig portfolios*** to position for moves we are likely to see over the next twelve to eighteen months. After all, the market does tend to climb the proverbial ***"wall of worry"*** from rising interest rates, the Chinese trade spat, slowing global growth and elevated earnings expectations among a plethora of worries.

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