INVESTMENT PERSPECTIVES

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The Gales of December Remembered

Our apologies to Gordon Lightfoot for mangling his "Wreck of the Edmund Fitzgerald" lyric in our title. Much like the doomed iron ore carrier, equity investors went on a wild ride during last year's fourth quarter, which while scary did not prove fatal. There had been some turbulence in equity markets earlier in 2018 (an 11% drop in January and February and a nearly 9% drop in March and April), but the S&P 500 entered 4Q18 up more than 10% for the year. Not as good as the more than 14% gain over the first three quarters of 2017, but still not shabby. Last year's third quarter was in fact the best 3Q for equities in five years. Then, over the course of the fourth quarter, the S&P 500 fell 13.5%.

December was the worst month of 4Q18 by far with the S&P 500 down nearly 15% from the start of the quarter by December 24. The small-cap Russell 2000 hit bear-market territory with a drop of over 20%. Last December ended up being the worst December for U.S. equities since the depths of the Great Depression.

What caused the storm that roiled financial markets in 4Q18? There were a couple of major factors. We entered 2018 on a wave of euphoria due to the Trump tax cuts and the belief that we were on the cusp of the biggest wave of synchronous global economic growth in more than a decade. That belief faded over the course of 2018 as it became apparent that most of the world outside of the U.S. was slowing.

Adding to this gloom was President Trump's acrimonious trade rhetoric turning into action with the implementation of tariffs on China. Trade concerns and slowing international economic growth combined to provide the first inkling to equity investors that the 10% plus 2019 earnings growth estimates in place at the time for the S&P 500 might be wildly optimistic. Remember that 2018 earnings rose more than 20% from the prior year, so comparisons were already going to be tough.

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On top of everything else, the Fed on December 18 pushed through 2018's fourth increase in the Fed Funds Target Rate while Chairman Powell declared more such increases were on the way (rates were still below the neutral rate) and that the reduction in the Fed's balance sheet would remain on autopilot. The culmination of all of these factors was a liquidity crunch among fears that Fed actions were about to engineer a recession.

So will this year's fourth quarter be a repeat of 4Q18 for equity investors? We believe there's a good chance that we will see above average stock market volatility over the course of the fourth quarter. A few things are missing from last year's fourth quarter setup, though. Expected S&P 500 earnings growth for 2020 is around 10% again, but that's coming off 2019 where earnings growth will end up in the very low single-digits at best. The typical 3% to 5% dip between earnings estimates entering a year and where results finally end up is unlikely to take investors by surprise.

Also different this year – the Fed is the market's friend rather than its enemy. The Powell Pivot away from tightening and toward easing early this year sparked the sharp recovery in equity prices we've seen since last December. The Fed delivered its third cut in the Fed Funds Target Rate of the year on October 30 and will be prepared to do more if economic growth appears to waver. Trade and tariffs remain a wildcard, but matters on that front are unlikely to worsen in the fourth quarter in our opinion.

The two most likely culprits in a potential equity swoon, in our view, are political discord in D.C. and potential turmoil in short-term funding markets.

Despite the momentous outcomes we could see issued from inside the Beltway over the balance of this year, politics are a more minor concern in our view. It's clear the Democrats want to impeach Trump and sow turmoil among Republicans heading into 2020. It's equally clear that Trump and the GOP are prepared for a fight. We don't think impeachment of Trump by the House, should it come, will have a major impact on markets. Conviction in the Senate is what would result in Trump's removal from office. This remains unlikely as Democrats would need to turn 19 Republican Senators to yes votes to reach the required 2/3 majority for conviction even if all 47 Democrats vote in favor. Such a swing among the GOP ranks would likely come only with an increase in the portion of the public that supports impeachment from about 50% now to well above 60%.

The bigger risk to equities more likely lies in the short-term funding markets – often referred to as the repo markets. Essentially, the short-term funding markets are the plumbing that keeps things flowing smoothly in fixed income. Banks, bond dealers and hedge funds finance their safe bond positions by borrowing excess cash reserves from other financial institutions.

This little known or appreciated area of the fixed income markets burst into the headlines in mid-September. The rate that governs this short-term liquidity market, the Secured Overnight Financing Rate (SOFR), soared from its usual 10 to 15 basis point spread below the Fed Funds Target Rate to more than twice the target rate. This move reflected an extreme shortage of liquidity in the market. The causes of this liquidity shortage were many, but quarterly tax payments, the unprecedented amount of U.S. Treasury borrowing and stringent liquidity and trading rules placed on banks after the Global Financial Crisis all played a role.

The Fed seemed unprepared for this liquidity crunch and was haphazard in its emergency liquidity operations designed to calm the system. The Federal

Open Market Committee (FOMC) has subsequently stepped up the level of liquidity injections into the repo market and things seem to have calmed down somewhat. Still, many market observers believe that we could see another short-term funding crunch at the end of this year. Should the Fed stumble in dealing with any such crunch, that could affect the broader fixed income market and negatively impact equity prices.

Short-term liquidity matters so much because the global economy has become much more dependent on financial markets and the global balance sheet than it was even at the outset of the Global Financial Crisis. All problems are papered over with increased borrowing. Small problems can compound in this environment, making it likely that when the inevitable economic slowdown does hit, it will be more severe and protracted.

Overall, while there are plenty of risks, we think that global financial markets have a better chance of navigating through the potential "Gales of December" to safe harbor this year than last.

Financial Markets Performance

Equity Markets Performance			
Updated 10/25/19	**QTD**	**YTD**	**1 Yr.**
S&P 500	1.64%	22.54%	14.01%
S&P Equal Weight	1.27%	21.62%	13.95%
NASDAQ Composite	3.08%	25.30%	13.93%
Dow Jones Industrial Average	0.26%	17.81%	10.53%
S&P 400 Mid-Cap	1.29%	19.38%	9.85%
Russell 2000 Small-Cap	2.37%	16.86%	5.39%
MSCI EAFE (International Developed)	2.98%	16.77%	12.97%
MSCI Emerging Markets	3.60%	9.96%	12.38%
MSCI All Country Ex-U.S. Index	2.93%	15.35%	12.84%

Domestic equity markets have maintained their upward bias through the first few weeks of the fourth quarter. The "risk-on" feel to the markets appears based on hopes that global trade tensions have at worst stopped deteriorating and at best could decrease materially. Faith that Fed policy will remain accommodative also appears to be providing support for risk assets.

Fixed Income Performance			
Updated 10/25/19	**QTD**	**YTD**	**1 Yr.**
Bloomberg Barclays U.S. Aggregate Bond	-0.32%	8.17%	10.59%
Bloomberg Barclays U.S. Treasury Bond	-0.67%	6.99%	10.10%
Bloomberg Barclays Municipal Bond	-0.05%	6.70%	9.03%
Bloomberg Barclays High Yield Bond	0.53%	11.99%	8.41%

Fixed income market strength has ebbed a little so far in 4Q19. This is directly inverse to the movement in equity markets over the same period. Yields have risen on the perception that economic growth may have bottomed. Trailing one-year returns on bonds now lag those on equities for the first time in a few months.

Economic Spotlight

Housing	19-Sep	19-Aug	19-Jul	19-Jun	19-May	19-Apr
U.S. 1-Unit Building Permits (yr/yr change)	8.0%	12.5%	0.1%	-5.7%	-1.7%	-6.3%
U.S. 1-Unit Housing Starts (yr/yr change)	4.3%	2.9%	1.3%	1.2%	-13.1%	-3.4%
U.S. 1-Unit Housing Completions (yr/yr change)	1.8%	-0.7%	10.5%	3.2%	1.0%	17.4%
U.S. 1-Unit New Home Sales (yr/yr change)	15.5%	16.9%	9.2%	18.0%	-8.0%	4.3%
Existing Home Sales (yr/yr change)	3.9%	2.8%	0.6%	-1.9%	-0.7%	-4.1%
Existing Homes for Sale Inventory (yr/yr change)	-2.7%	-4.2%	-1.0%	-0.5%	2.1%	1.7%
NAHB Homebuilder Confidence Index	68	67	65	64	66	63
S&P/Case-Shiller Nat'l Home Price Index (yr/yr change)	3.2%	3.3%	3.5%	3.6%	3.7%	3.9%
Purchase Mortgage Originations Index (yr/yr change)	9.6%	5.1%	6.4%	9.8%	-7.5%	0.8%

This month's economic spotlight shines on the U.S. housing market. After nearly hitting stall speed last year as mortgage rates rose more than 100 basis points, new home sales have regained momentum thus far in 2019. Trends in housing starts and permits, ongoing gains in home purchase mortgage originations and improvement in homebuilder confidence suggest this strength will continue into 2020. It is important to note that home price increases continue to wane. This is necessary as home price gains have far outpaced incomes over the last several years. It also helps the millennial generation, who are mainly first-time homebuyers, to more fully participate in the home buying market.

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