Graybill, Bartz & Associates, Ltd.

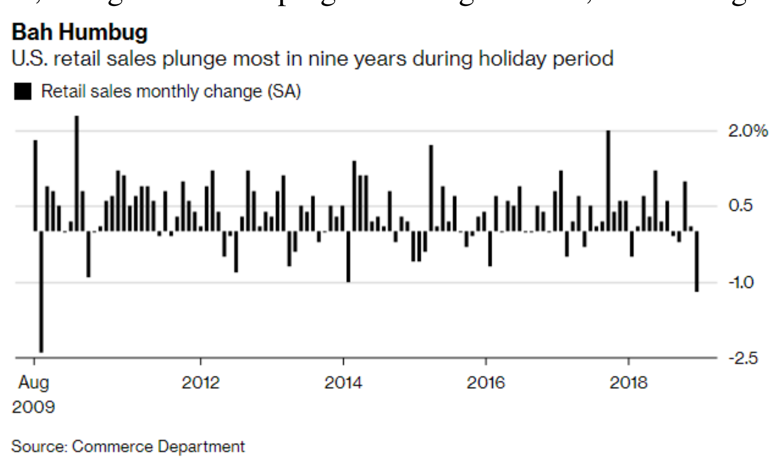
COMMENTARY

March 2019

What a difference a new year makes. As we exited 2018 only two short months ago, a pervading sense of doom and gloom hovered over global asset markets. The Federal Reserve was committed to raising interest rates and running off its balance sheet, our trade dispute with China was putting a damper on business investment, and the possibility of a government shutdown was damaging consumer confidence. The combination of these factors was raising the prospect of a recession arriving sooner rather than later. Against this dreary backdrop, equities have started 2019 in a non-stop rally mode, with the S&P 500 posting gains in 9 of the last 10 weeks. The index has had its best performance to start a year since 1991, returning ~11%, leaving it only 4% away from reaching its all-time high set in September. What has changed to reverse sentiment so quickly over the last 2 months?

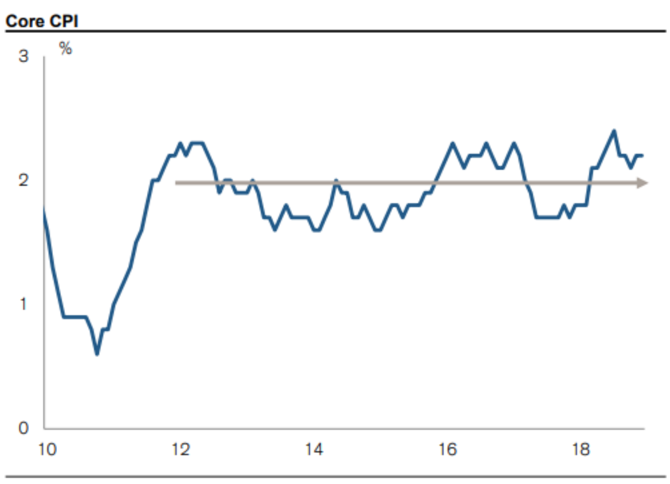
The biggest change has been the public stance of the Federal Reserve. Gone are the days of policy interest rates being "a long way from neutral" and balance sheet reductions being on "autopilot", with "patient" becoming the new buzzword coming out of the Fed in recent months. To illustrate, on January 4 sharing the stage with his predecessors at an economic conference, Fed Chairman Jerome Powell stated that "we will be *patient* as we watch to see how the economy evolves." Later in January during the press conference following the Fed's open market committee meeting, Powell noted "Today, the FOMC decided that the cumulative effect of these developments…warrant a *patient* wait-and-see approach regarding future policy changes." And as if to belabor the point, in late February, Powell told the Senate banking committee "this is a good time to be *patient* and watch and wait to see how the economy evolves." The expectation for 2-3 interest rate hikes in 2019 has since fallen to 0 hikes, making clear how the market has interpreted "patient."

Progress towards a trade deal with China has been the second positive catalyst for the markets in 2019. Mostly recently, President Trump announced a delay in Chinese tariff hikes past his March 1 deadline, citing substantial progress in negotiations, and hinting at a late March summit at Mar-a-Lago to sign a deal. As we have written before, cumulative corporate America would breathe a huge sigh of relief at a deal between the two nations, regardless of the actual fine print in the agreement.



Not all is rosy however. Global growth looks in peril, with economic indicators in Europe and Asia increasingly showing contraction. The driver of the US economy, the consumer, has flashed mixed signals of late. U.S. retail sales in December fell 1.1% month over month, the largest decline in nine years, leading some to conclude that the negative headlines of the trade war and government shutdown began to worry consumers. However, subsequent reports of consumer confidence have remained near 10-year highs. Expectations for corporate earnings in Q1 have also changed since the beginning of the year. Since December 31, consensus analyst predictions for earnings in the first quarter have declined about 6%, from a gain of 3% to a fall of 3%. While a decline in earnings in Q1 is now priced into the market, the key debate becomes whether this will be a one-time blip or the start of a sustained downturn.

With forecasts of falling earnings to start the year and as rising equity markets approach the levels of last fall, the question becomes what needs to happen to push markets to new highs and beyond. The first near term catalyst could be a trade agreement with China. Increasing momentum towards a trade deal has undoubtably been a large factor in the rise in the valuation multiple assigned to the markets over the past few months, leaving a risk that putting pen to paper becomes a "buy the rumor, sell the news" event. However, a trade deal could lead to a flood of companies raising their earnings guidance in the quarters ahead, with many having baked in tariffs and other negative impacts of extended trade tensions to their 2019 forecasts. Second, the U.S. consumer needs to continue showing strength. Some cracks have appeared recently, including the aforementioned retail sales report, as well as pockets of weakness in housing, but by and large the consumer remains healthy. Finally, the Fed needs to maintain its "patient" approach. The 4 Fed rate hikes in 2018 seemed to be in part an effort to tame future inflation before it starts, given the unemployment rate had reached lows not seen in decades. While we did see an uptick in inflation in 2018, year-over-year growth in the Core Consumer Price Index (CPI) remains around 2%, the level that it has hovered around for the last 6 years. The new policy approach appears to be more of a "show me" story, with the Fed only raising rates in 2019 if they see a sharp and sustained increase in inflation. Given strong consumer and small business confidence and a potential trade détente with China, a reversal in the Federal Reserve's newfound patience could be the biggest risk to further equity market gains in 2019.



Graybill, Bartz & Associates Ltd., makes no representation as to the completeness or accuracy of data received from outside sources, and no duty is hereby assumed to update or in any other way to make current and/or complete and/or accurate any of the said information. Securities are identified for illustrative purpose only. This should not be construed as a recommendation to purchase or sell any securities.