Global Economic Review

Eagle Eye

MARKET & ECONOMIC OUTLOOK

JAN 2019

BARILOTTI WEALTH STRATEGIES, LLC IS PLEASED TO PRESENT ECONOMIC AND MARKET INSIGHTS FROM THE PORTFOLIO MANAGERS IN THE STRATEGIC ASSET ALLOCATION AND SOLUTIONS DIVISION.

"Economic cycles and market cycles, like rock 'n roll drummers, do not die of old age – they die of excesses."
– unattributed

"It's like déjà vu all over again." - Yogi Berra. The pace and scale of global equity market declines strike us as unusual. Very few examples of global financial market turmoil have occurred alongside a robust real economy. Today, the global economy is growing. The U.S. looks particularly strong. Retail sales are on a tear; business surveys are within spitting distance of record highs; banks are relaxing lending standards; real interest rates are hovering near zero; companies continue to add to their payrolls at a healthy clip, and, most importantly, profits are booming. These are not the conditions under which recessions take hold nor that precipitate bear markets. Absent is the mania that typically marks the death of an economic expansion.

While this divergence between financial markets and economics is a bit of an abnormality, it's not entirely without precedent. Looking back a generation, we see the year 1994 as being a relevant analog. Then, as now, growth was strong. The unemployment rate was dropping towards, and possibly through, what was believed at the time to be the natural rate. Despite tightening labor markets, inflation remained quiescent. Nevertheless, the Fed was engaged in an extensive rate hiking campaign, lifting overnight rates steadily throughout the year. The housing market was predictably responsive to rising interest rates with the National Association of Home Builders sentiment survey plunging precipitously. The yield curve was likewise reacting to tightening monetary policy by flattening. The widely watched 2s-10s segment of the curve fell from 1.56% to 0.12% over the course of the year, portending a possible recession on the horizon. Stock prices swooned twice, once in the late winter and then again in the fall, finishing the year in negative territory.

In varying degree of exactness, these conditions are present today, although more exaggerated in the case of the market decline. The world is very different now than it was two-plus decades ago, but the parallels resonate with us. Let us hope they persist. Why? Because equity returns in 1995 topped 30%!

ON THE RADAR SCREEN

1. Activity in the real economy remains healthy, but financial markets are unsettled. Should this persist into 2019, damage to confidence could precipitate an actual slowdown or recession as households refrain from spending and businesses curtail investment plans.
2. Brexit is approaching its end game. A neutral (deal approval) or positive (second referendum and vote for Bremain) resolution would likely be supportive of equity pricing while a no-deal outcome could inject still more volatility.
3. Trade negotiations remain a source of anxiety for investors. Progress toward a US-China agreement would help settle markets.
4. The Chinese economy, which has been slowing gradually, is of considerable significance to global growth. We look for the government to take further stimulative action and arrest the slide.
5. Both France and Italy have relaxed fiscal policy in recent months. Expect similar action from other European governments ahead.

Insights from the Strategic Asset Allocation and Solutions Division

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"I've never made a buy at a low that I didn't just feel terrible and scared to death making it" – Stan Druckenmiller. Holding risk assets through a tumultuous market decline with no way of knowing just where the bottom may lie is an agonizing, stomach-churning experience. Adding to those positions is more excruciating still. This is especially true when it is not just your personal investments at stake but your clients' savings and your career reputation that is on the line. Yet that is exactly what we have done.

There is a range of factors from which we draw comfort when taking that stance. Chief among them is the collapse in sentiment: as Warren Buffett famously noted, the time to be interested in stocks is when nobody else is. Right now, buyers are scarce. Valuations are also on our side, having suffered a deep bear market as stock prices fell sharply even as corporate earnings surged. And the barrage of worries bombarding investors over the past year shows every sign of subsiding (the Fed is beating a slow retreat from persistent rate hikes, US-China trade negotiations are actively underway, headline inflation is rolling over, and Italy has come to a budget agreement with the EU). By our lights, this market looks primed for a significant bounce. Our job is not merely to pontificate on market events, but to deploy our clients' capital. Amidst December's tumult, we swallowed hard and added to equity positions.

Whistling past the graveyard. While we remain bullish on the economy and markets, we believe the greatest threat to the U.S. economy and financial markets is a stubborn Federal Reserve. Monetary tightening, including both rate hikes and balance sheet reduction, drained considerable liquidity from the market over the past few years, and today, some rate sensitive sectors like housing, autos, and big-ticket durable goods that are typically financed already show strain. That strain will likely grow.

We believe that the Fed recognizes this risk. Chairmen Powell does not want to be "fool in the shower", who turns the faucet all the way to hot waiting for warm water. Not wanting to be burned, we believe the Fed may turn the faucet (slow the pace of hikes) to accommodate lower for longer growth. If the Fed does pause, we believe equities will see a new high before the cycle is over.

About Risk

All investments are subject to market risk, including possible loss of principal. Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline. A bond's prices are inversely affected by interest rates. The price will go up when interest rates fall and go down as interest rates rise.

MLPs and other natural resources sector companies are subject to certain risks, including, but not limited to fluctuations in the prices of commodities; the highly cyclical nature of the natural resources sector may adversely affect the earnings or operating cash flows of the issuers in which a strategy will invest; a significant decrease in the production of energy commodities would reduce the revenue, operating income, and operating cash flows of MLPs and other natural resources sector companies and, therefore, their ability to make distributions or pay dividends.

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