Market Commentary

Market Overview

In contrast to 2017’s ultra-low volatility market environment, the pendulum swung in the other direction entering 2018 from a steady freight train of returns into a roller coaster. Only a few weeks into 2018, escalating concerns over rising inflation expectations disrupted the tranquility investors enjoyed throughout the prior year. Leading up to the first equity market correction in late January 2018, the S&P 500 Index had not experienced a drop of more than 1% for a record 112 trading days.

Worries about inflation faded through the second and third quarters as domestic business and consumer optimism soared. The domestic equity market rallied over the summer on a fragile foundation of sanguine expectations that government policy (both trade and monetary) would not interfere with the economic mojo set in motion by a massive corporate and personal tax cut.

Source: Bloomberg
Early in the fourth quarter, major cracks started to appear in this foundation as investor confidence was shaken by recently appointed Federal Reserve ("Fed") Chairman Jay Powell when he declared during an interview that interest rates were “a long way from neutral.” The hawkish tone did not sit well with investors and the equity market slide began.

Fearing the world’s largest central bank no longer had the stock market’s back, the S&P 500 Index would mark an all-time high close of 2930 on September 20 and, over the course of the quarter, fall to within a hair of an official bear market (a decline of 20% from a peak) before rallying after Christmas. The ups and downs throughout the year netted a -4.4% annual return for the index including dividends—the benchmark’s first calendar year loss since 2008. In a traditional flight to safety trade, Treasury bonds rallied and credit spreads widened.

Chairman Powell, perhaps recognizing the gravity of his comments and the potential for financial market volatility to spill over into the real economy, attempted to backtrack in a speech to the Economic Club of New York, saying that “[interest rates] remain just below the broad range of estimates of the level that would be neutral for the economy.”

Increasing monetary policy uncertainty was only one punch in the combination that investors endured in the final quarter of the year. The cloud of a trade war also weighed heavily on sentiment with daily headlines creating large market swings in both directions. Of course, one of the very last statements market participants wanted to see following what appeared to be a productive G20 summit in early December was a provocative President Trump tweet “... I am a Tariff Man.” Yet that is exactly what occurred, keeping the equity market on its heels leading up to the Federal Open Market Committee’s (FOMC) final meeting of the year.

Confronted with an equity market approaching bear market territory, the Fed pressed on with its fourth Fed Funds rate increase of the year and its ninth since moving off the zero bound in December 2015. Further compounding investor concerns, the Fed continued to forecast the need for future hikes—a policy path the market clearly felt was missing signs that the global economy was softening. Despite Chairman Powell’s attempts to qualify that these projections were subject to “data dependence” and “highly uncertain,” it did not stop market anxiety from deepening. In an unusual move, the President broke with protocol and openly criticized the Fed Chairman by declaring that monetary policy was the “only problem” with the economy.

Amid swirling policy uncertainty, global financial markets enter 2019 with a growing wall of worry that has the potential to keep volatility elevated for the foreseeable future.

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Economic Highlights

**GDP Growth:** The domestic economy expanded at an annual rate of 3.4% during the third quarter. Consumer spending remained robust as wage growth accelerated and workers benefited from lower tax rates. Inventory build ahead of announced tariffs also helped support above-trend growth. But higher interest rates do appear to be having a restraining impact on residential investment activity, which contracted for the third consecutive quarter. *Source: Bureau of Labor Statistics*

**Employment:** December’s non-farm payroll increase of 312,000 far exceeded expectations and capped off another solid quarter of domestic job growth. An increase in average hourly earnings of 3.2% for the full year—the best since 2008—was a welcome sign that the labor market remains strong. The U.S. economy averaged 220,000 new jobs per month in 2018 compared to 182,000 per month in 2017. Higher wages enticed sidelined workers back into the job market and the labor force participation rate grew to its highest level since 2014, leading to an uptick in the headline unemployment rate. *Source: Bureau of Labor Statistics*

**Inflation:** Falling energy prices are keeping consumer prices in check. Headline inflation increased by 2.2% through November on a year-over-year basis. The Fed’s preferred measure of inflation, the core Personal Consumption Expenditure (PCE) deflator, measured 1.9% in November—just shy of its stated 2% target. *Source: Bureau of Labor Statistics*

**Housing:** Impacted by higher mortgage rates, existing home sales fell 6.7% in November from a year prior. However, home values remained buoyant with the median existing home price advancing 5% to $260,500 over the same period. *Source: National Association of Realtors (NAR)*

**Energy:** Oil’s worst quarter since 2014 more than wiped out gains made during the first three quarters of the year. The global benchmark Brent Crude futures opened the year at nearly $68 per barrel and rallied on OPEC supply cuts to $86 in early October before falling over 32% to finish the year at $54. A continued increase in U.S. output boosted inventories and helped offset production cuts by OPEC members. *Source: Bloomberg*

**Corporate Earnings:** U.S. companies turned in another stellar earnings season for the third quarter. Led by the energy and financials sectors, the S&P 500 Index saw earnings climb 28%. Supported by substantial tax cuts, earnings for the S&P 500 Index are expected to increase by 24% for the full year. Analysts are currently forecasting 8% earnings growth on 5% revenue growth in 2019. *Source: Thomson Reuters*

**Consumer:** Measures of consumer income, spending, and sentiment all displayed very healthy signs for the U.S. economy despite financial market volatility and higher interest rates. A tight labor market and lower taxes led real consumption growth to accelerate from 3.5% in the third quarter to around 4% in the fourth quarter according to Capital Economics. A strong holiday shopping season is expected to boost retail sales for the quarter.
Market Returns as of December 31, 2018

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<tr>
<th>As of 12/31/2018</th>
<th>% Total Return</th>
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<tr>
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<td>Q4 2018</td>
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<td>S&amp;P 500</td>
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<td>MSCI EAFE</td>
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<td>MSCI Emerging Markets</td>
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<td>Bloomberg Barclays U.S. Aggregate Bond</td>
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<td>Bloomberg Barclays Municipal Bond</td>
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<td>ICE BofA ML U.S. Treasury Bills</td>
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<td>Bloomberg Commodity</td>
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Source: Morningstar Direct
Periods greater than one year are annualized

Equity Market Year in Review

Despite an already elongated economic cycle, investors greeted 2018 with a rosy outlook for future corporate earnings on the back of fiscal stimulus in the form of tax cuts. As the year progressed, however, analysts lowered earnings estimates for companies in the S&P 500 Index from 16.7% to 11.4% for the fourth quarter (year-over-year), with all eleven sectors recording a decline in bottom-up Earnings Per Share (EPS)\(^1\) forecasts as 2018 drew to a close.\(^2\) This downward revision represented the largest cut to quarterly EPS estimates since the third quarter of 2017.

2018 was also marked by significant divergences in equity market performance, notably between domestic and international stocks, large cap and small cap stocks, and growth and value styles. The outperformance of U.S. equities versus non-U.S. stocks was attributed to stronger corporate earnings and stock buybacks, with additional support from tax reform. While small cap stocks led large cap stocks for most of 2018 due to the belief that smaller firms are less likely to suffer from trade disputes, this pattern reversed course in the fourth quarter of 2018. Growth continued to outperform value, driven largely by positive performance from the technology sector which represents a quarter of the S&P 500 Index.

In November, investors turned their attention to U.S. midterm elections and what they might signal for the economy and equity markets.

2019 Year End Forecasts

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<th>S&amp;P 500 Year End Price Targets</th>
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<th>US GDP Real</th>
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Source: HighMark Asset Allocation Committee, Bloomberg

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\(^1\) An aggregation of the median EPS estimates of all the companies in the index.
Midterm Elections and Equity Market Opportunities

The midterm elections delivered results consistent with our expectations: Democrats regained control of the House of Representatives and Republicans retained control of the Senate. While a polarizing figure, President Trump galvanized voter turnout. Though turnout in 2018 (which reached nearly 20 percent of eligible voters) was low compared with general midterm and presidential elections, it was higher than in past years, comparing quite favorably to the midterm elections in 2014 when 14.3% turned out, and 2010 when 18.3% voted.3

What, if anything, should equity investors expect from the U.S. midterm elections? In the way of public policy, little will likely change. Due to the partisan divide, it is doubtful that sweeping legislation will materialize over the next two years, though narrow bipartisan measures are possible based on areas where the two parties can find common ground.

Overall, the new political landscape may be good for markets. In the short term, global stocks and other risk assets got a positive boost while U.S. Treasury yields fell modestly. The U.S. dollar also declined, credit spreads narrowed, and inflation expectations dropped. Collectively, these effects suggest that traders and investors were pleased with a dose of predictability after several years of unsettling political developments and elections around the globe.

Longer term, markets have historically performed well regardless of specific election outcomes. Historically, gridlock has been good for stocks as divided governments can represent a restoration of checks and balances and the greater policy certainty that markets crave. But a potential downside to gridlock is that funding is required to support the government and service the deficit. The late December U.S. government shutdown and equity market selloff demonstrate this downside.

Within equities, the health care sector may benefit from a divided government, which would be unlikely to make major changes to the Affordable Care Act or drug pricing. The split Congress may also provide a tailwind for the banking sector—despite the Democratic majority in the House, Trump’s bank regulators are in place and are expected to continue their goal of implementing bank-friendly deregulation.

Equity Market Outlook

Our equity market outlook remains unchanged. In our view, recent market turbulence reflects more of a market event than an economic event; in other words, a correction without a recession. We have been more conservative than consensus views regarding domestic economic growth, earnings power, and potential market returns largely because equity markets were underappreciating these growing uncertainties. Positive returns are possible going forward but headwinds from higher rates and risks to growth will dampen the upside potential.

3 Bipartisan Policy Center

Overall, the new political landscape may be good for markets.
Global equity markets had been vulnerable because they anticipated clear skies ahead, manifesting in peak investor optimism, high growth/profit expectations, and rich valuation levels going into 2018. One of the main causes of recent equity market turbulence was the “curse of high expectations” and markets are now reconciling excessive optimism against new and unexpected realities. Investors are adjusting to these “new normal” conditions and recalibrating the appropriate price to pay when considering previously underappreciated risks.

**Fixed Income Review**

**Finding Neutral Gear**

The role of the Fed involves a long-standing paradox: how to keep the economy from overheating without becoming the catalyst for the next recession.

According to monetary theory, central banks should lower short-term rates (thereby increasing money supply) when economic activity appears to be weakening in hopes of stimulating investment by increasing liquidity. One of the primary objectives of increasing liquidity is to create what’s known as the “wealth effect”—an increase in consumer spending based on the appreciation of one’s investment assets.

The wealth effect, in turn, should start a virtuous and self-reinforcing cycle of economic activity that will truncate the downside of an economic cycle. Central banks took this theory to an extreme during the Global Financial Crisis by introducing zero interest-rate policy (ZIRP) and quantitative easing (QE). Arguably, both previously untested policies served the U.S. economy well in a time of desperate need, but it was not without a price. The term “Financial Repression” was coined to articulate the penalty savers endured to revive the economy from depths not seen since the Great Depression.

Another unwanted but potential side effect of what is known as ‘accommodative’ monetary policy is excessive inflation. Runaway inflation is the other side of the coin that central banks address by raising short-term rates as the economy picks up steam. Ideally, the economy will hum along at an equilibrium or “neutral” interest rate that neither stimulates nor restricts economic growth beyond its potential. As central bankers see economic activity firming and inflation in check, they will remove accommodation by raising rates in hopes of arriving at the neutral rate.

The neutral rate sounds simple enough on paper, and has been mentioned by the Fed for many years, but this is where things get tricky. The neutral rate of interest is unobservable; it’s a target that cannot be known with certainty. Economists at the Fed use models to estimate what the neutral rate might be, but, in reality, it’s an educated guess at best.

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4 Zero interest-rate policy (ZIRP) is a macroeconomic concept describing conditions with a very low nominal interest rate, such as those in contemporary Japan and December 2008 through December 2015 in the United States.

5 Quantitative easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity. When short-term interest rates are at or approaching zero, and when the printing of new banknotes isn’t an option, quantitative easing can be considered.
The difficulty inherent in forecasting inflation, and thus setting the neutral rate, was highlighted at the most recent Fed meeting where expected core PCE inflation was downgraded from 2% to 1.9% over the next three years due, in part, to continuing oil price softening.

While the price of oil continues to fall, dampening inflation forecasts, inflationary pressure from credit has trended up with consumer credit, according to Fed data, rising by a seasonally adjusted annual rate of nearly 8% in late 2018 with a significant portion of the increase coming in the form of increasing levels of student loan debt.

Student loan debt, when accompanied by rising mortgage rates as the Fed continues to tighten, may further the trend of declining homeownership in the U.S. as shown in the chart below.

Homeownership is a key component of the U.S. economy, driving hiring and expansion (and inflation) in multiple sectors including construction, lending, and consumer durables. Onerous levels of student loan debt, however, may be discouraging young, prospective home buyers from diving in. The recent uptick in ownership is encouraging, but homeownership is still below historical averages. A Congress with greater Democratic party representation following the midterm elections, should it weigh in on student debt, may in the end be a tailwind to industries reliant on homeownership. The Fed has confronted stubbornly low levels of inflation that justify a tightening program and an upsurge in homeownership could help move the needle—if only by a modest amount.

As the Fed confronts a slowing economy, global trade tensions, volatile markets and increasing pressure from President Trump to refrain from further rate hikes, we expect Powell and his FOMC colleagues to rely even more on sources of data which can help set a rate course that avoids pushing the U.S. economy into a mild recession after a decade of economic expansion.
Don’t Tread on the Fed!

Since assuming the presidency, Trump has not hesitated to weigh in on the Fed, its Chair, and its rate strategies. His comments directed toward the Fed and recorded in the press dwarf those of prior POTUS/Fed Chair combinations dating back to The Monetary Accord of 1951.

Historically, Presidential/Fed interventions typically occur during periods of high inflation and economic stagnation, particularly in President Carter’s administration, but Trump’s tweets directed at both Fed Chairs Yellen and Powell have occurred during a cycle of unusually low inflation and unemployment. Until late last year, the U.S. economy and stock market were firing on all cylinders and markets appeared to pay little attention to Trump’s instructions to hold off on raising rates. But the tone and frequency of Trump’s tweets may increase if budget deficits, further dollar strengthening, market volatility, rising debt levels or a spike in inflation were to occur.

Pressure from the Executive branch could spur the Fed to take two courses: either weakening the FOMC’s resolve to raise rates as economic strength breeds inflation or, to prove its independence, the Fed may turn more hawkish than economic data warrants. Each scenario makes the already complicated role of the Fed as shepherd of the economy even more difficult and undermines its independence.

While not a frequent occurrence in recent history, many presidents have pressured the Fed when interventions served their political interests, including Harry Truman and Lyndon Johnson—the latter famous for trying to pressure Fed chair William McChesney Martin into reversing a recent rate rise. Other presidents, including Clinton and Obama, elected to keep their “hands off the Fed” by trusting it will make policy decisions that enhance the long-term health of the economy.

The Fed has always been a political institution subject to pressure from lawmakers, presidents, market participants and populist groups with the voices of complaint rising loudest when the economy hits a speedbump and politicians seek to avoid blame for a faltering economy.

Like members of Congress, Trump’s presidential interventions enable him to claim credit for good economic outcomes and deflect blame for bad ones. But Trump’s Fed-bullying in good times could turn explosive if an economic downturn impacts his reelection prospects.

History shows that difficult monetary choices require strong political support. Trump’s willingness to lead the charge against his hand-selected Fed chair suggests that an old and recurring cycle of crisis, blame, and reform may be just around the corner.

As The World Turns

It is easy, yet somewhat myopic, to blame the Fed alone for the sudden reversal of market momentum, even given some of the major communication missteps of a ‘rookie’ Fed Chair. Investor psychology can be particularly vulnerable to the perceived risk of a policy error when the economic tide appears to be turning. While coincident indicators of economic health remain strong, it’s the softening of leading indicators that have many believing the Fed’s work is done.

Ironically though, the President blaming the Fed’s monetary policy decisions for economic and market woes may be a perfect example of ‘the pot calling the kettle black.’ The administration’s intense trade standoff with China, the world’s second largest economy, is by no one’s estimate helping to sustain the positive global economic momentum that existed entering 2018. In fact, the prolonged uncertainty surrounding trade policy is taking its toll on both sides.

Whether by coincidence or effect, economic data in China indicates a slowdown in growth is happening faster than most anticipated. China’s fourth quarter GDP growth is expected to decelerate to 6.4%, and by 2020 growth is forecast to slow further to 6%—the slowest rate since 1990 following the Tiananmen Square protests. While a six percent-plus growth rate seems very healthy compared to developed economies that are expected to expand by about two percent over the next couple of years, one must consider how critical sustaining a high growth rate is for a developing country with a rapidly expanding debt burden.

Although slowing growth is a secular headwind China would be expected to face as its economy matures, the tough trade dispute has accelerated both its timing and pace, adding to the challenge of managing through it. Feeling the pressure to prevent further slippage in growth, China announced a number of stimulative fiscal and monetary policy measures, including tax cuts and a mandate for banks to lend to small businesses.

As the world’s second largest economy and a major source of global demand, China’s slowdown is by no means isolated to its economy. Ripple effects are being felt throughout the global economy. During a European Central Bank (ECB) press conference announcing the end of QE in Europe, ECB President Mario Draghi warned, “…the balance of risks is moving to the downside owing to the persistence of uncertainties related to geopolitical factors, the threat of protectionism, vulnerabilities in emerging markets and financial market volatility remain prominent.” (In case you missed it, he basically said “trade war” four separate ways.)

Currently, the U.S. is applying tariffs on $253 billion of Chinese-made goods, or roughly half of total imports from China.
Meanwhile, the U.S. is feeling its own pain. Although not as leveraged to global trade as many other countries, domestic economic data has begun to soften as tensions have escalated. Despite fiscal stimulus pumping though the economy, uncertainty on the trade policy outlook, along with the rising cost of tariffs, has delayed decisions by businesses to make significant capital investments.

Such hesitation was evident in December’s manufacturing Purchasing Managers Index, which came in below expectations at 53.8—a 15-month low. A recent profit warning from Apple stating that Chinese economic softness and trade tensions were weakening demand provided another piece of anecdotal evidence of the pressures faced by U.S. based multi-nationals in this environment.

A dinner attended by Presidents Trump and Xi at the G20 summit in December yielded a cease-fire that allowed for additional time for negotiation. The tariffs the administration planned to raise and apply to an additional $257 billion of Chinese imports were delayed by 60 days. Trump boasted that the dinner “was an amazing and productive meeting with unlimited possibilities for both the United States and China.” Currently, the U.S. is applying tariffs on $253 billion of Chinese-made goods, or roughly half of total imports from China. The truce will end March 1 when the final round of tariffs will go into effect if a deal is not reached.

As we anticipated, the ongoing trade dispute between the world’s two largest economies has remained the focal point of global financial markets. A quick settlement was an unlikely outcome in our view given the significance of the demands and the disposition of the parties involved. However, the upside of the global economic slowdown is the incentive it creates for both sides to negotiate a resolution. The data demonstrates the true cost of this standoff and it’s only likely to get worse the longer it drags on. Therefore, our optimism for a deal has increased meaningfully. However, we must remind ourselves that the protectionist instincts of a “Tariff Man” are strong. A protracted battle cannot be ruled out just yet.
Conclusion

2017’s global synchronized growth narrative has morphed into a global synchronized slowdown scare driven predominately by self-inflicted setbacks in 2018. The euphoric investor sentiment supported by the global growth narrative rolled over accordingly when it became unclear if the security blanket that markets had come to depend on, namely a dovish Fed, would exist under new leadership.

In our view, Jay Powell’s Fed is not the enemy of financial markets. Communication mistakes have been made, but there is no uber-hawk at the helm as some might fear. For now, inflation does not appear to be forcing the Fed’s hand and we expect that it is unlikely to change any time soon. Therefore, the Fed can afford to cautiously calibrate its monetary policy path to reflect potential inflection points in the domestic growth trajectory.

Trade policy is another story. It remains one of the most significant, yet difficult to forecast, variables in both the economy and financial markets. Or, as Donald Rumsfeld would put it: a known unknown. Combine this wild card with a softer global economy and a mountain of debt piling up on the balance sheets of governments and corporations—and it becomes clear that the roller coaster ride could very well continue into 2019.

We expect first quarter earnings reports and management commentary to give us a better look at the full impact of trade policy. As mentioned earlier, our outlook for a resolution on the trade war front has improved, but there is little to be certain of at this stage.

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