Dear Investor,

It was the best of times, it was the worst of times is an appropriate description of the last ten weeks in global markets. The month of December gave us some historically bad red ink across all asset classes, including the worst S&P 500 returns since 1931. Tax selling, program trading, and illiquidity exacerbated the moves and set the market up for a significant snapback in January. Powerful waves of buying started early in the New Year, and multiple accelerants including an accommodative Fed, reasonable earnings and optimism of a trade deal with China pushed most indexes back up to November and October levels. This volatility can be unnerving and also a signal of an inflection point in the markets. Global growth is slowing and the markets are trying to handicap the timing of the next recession. With this uncertainty and increased volatility, we thought it would be a good time to check in with our partners at Strategas Research and recap what they see on the horizon:

With govt bond yields falling across the board last week, what remains key – in our opinion – is a "Shanghai accord II" similar to 2016, where we see fiscal stimulus in China, a U.S./China trade deal, a Fed pause, and oil price stability with some help from OPEC+. We are making some progress (notably on the Fed pause), though this is not a linear process. Recent trade negotiations have been two steps forward and one step back. We are becoming more concerned with possible EU auto tariffs.

Given that global growth is slowing, and U.S. growth is slowing as interest-rate-sensitive sectors top out, a typical bottoming process in the stock market may still need to play out. A retest of recent weakness is still a possible scenario…looking at market bottoms over the last 75+ years true V-bottoms are rare & a basing process typically follows that takes some time. A successful retest today may not need to go all the way back down to the Dec lows on the S&P 500, however. Even if corporate earnings are flat at ~$163 in 2019 a 16x multiple would put us at 163x16 = 2608. So, the 2550/2615 area would likely count as a successful retest here.

Put another way, we lack the reassurance of accelerating growth today. In 2018, the acceleration in the U.S. economy to ~4% real GDP in 2Q/3Q provided that reassurance for investors. Capex turned up in the first half of the year, and productivity hooked higher, restraining unit labor costs. Profits rose. We estimate U.S. real GDP at 2.2% this year.

The Fed's Senior Loan Officer Survey (SLOS) noted that banks began tightening lending standards in 1Q. This data-point is consistent with slowing growth, though it still looks expansionary.

U.S. nondefense cap goods orders ex aircraft (a capex proxy) fell -0.6% m/m. The pathway to a sustained business cycle in the U.S. involves capex boosting productivity. This U.S. data is somewhat old, given the lag from the govt shutdown. Still, it suggests capex took a pause in recent quarters. A reboot is key for 2019.

Recession is still not the right call here, in our view. The interest rate the U.S. economy can take is higher than the rate financial markets are comfortable with. So financial market volatility now doesn't automatically translate into recession. As we've noted previously, there has never been a global recession (using IMF data back to the 1970s) without the U.S. being in recession, and the U.S. economy has led. That leading characteristic is important. It's reassuring now, against a more mixed global backdrop.

The U.S. economy still needs to make the transition from being consumer-led in 2018 to being capex-led in 2019 for this (already long) business cycle to prove sustainable. That is where our attention remains.[1]

As most market forecasters tend to do, Strategas has outlined the delicate balance or razor's edge where we currently sit regarding the future direction of the global expansion. The US must continue to lead until stimulus can lift other economies, and volatility will remain as markets handicap the process. Please call or email me with any questions or comments.

Jesse T. Ellington III
Chief Investment Officer
Union Bank & Trust
4355 Innslake Drive
Richmond, VA 23060
T 804.774.2087
C 843.412.1420
jesse.ellington@bankatunion.com

(1) Source: Strategas Securities, LLC