



## Volatile year ahead likely to end well

12-13-2018

As 2018 bounces up and down to a disappointing outcome relative to our expectations, it seems a particularly good time to consider what went right and wrong and where we might be heading in 2019.

### Looking back

What is most disappointing to us about 2018 is that most fundamentals improved even while the market was roughly a wash. Tax reform passed late in 2017, offering the promise of a supply-side investment pickup that has been delayed but likely awaits more stable times. Earnings should end the year above \$160, up 19% from 2017. Economic growth, fueled in the short term by the demand stimulus in the tax reform bill, was better than expected, close to 4%. Bond yields, after attempting to break higher in January, look now to end the year only modestly higher than their year-ago levels.

**Why, then is the market flat and down almost 10% from intra-year highs and more importantly, why are the more economically sensitive areas of the market down 20% or more?** Frankly, as we've expressed in several of our recent pieces, there is no perfect explanation despite all the narratives out there seeking one. As an old industry veteran once told me many years ago, "Steve, sometimes there are simply more sellers than buyers." Indeed, with the increasingly high share of market activity dominated by players with relatively short horizons (think ETF investors, hedge funds, risk parity funds, etc.), combined with concerns that we are "late cycle" (whatever that means), short-term news flow has driven markets more than ever.

Of late, headlines on the Fed, trade and oil have been key. And though all three seem to be moving in a market-positive direction (see "The bulls hit the trifecta"), the market continues to fret with every early morning tweet on Xi, Huawei, Jay Powell and Saudi Arabia. Piling on top are economists insisting that the cycle must end soon simply because it is old in age, despite it's being young in cumulative growth with few signs of typical late-cycle optimism and over investment/consumption. Behind the scenes, the Ouija board operators whom confused investors turn to when all else fails—the so-called technicians—are all issuing foreboding warnings about market death crosses, double tops and other scary "explanations."

### Looking ahead

Given all the worries out there, and investors' insistence on "proof" that the good news that some (including us) foresee is real, 2019's first half looks to be what I call a "Missouri Market"—unlikely to advance until all the facts are in. Compiling the difficulties we are likely to experience in next year's first half: all the fourth-quarter 2018 worries that suggest corporate decision-makers across the economy may be simultaneously tapping the breaks awaiting longer-term developments. To us, this translates as an economic soft patch ahead, with growth "slowing" to maybe 2.5% in Q1 2019 before reaccelerating later in the year as the Fed actually pauses, Trump and Xi actually sign a trade deal and OPEC+ actually cut production and stabilize oil prices. Although soft patches can and sometimes do extend to something worse—even a full-blown recession—we see this as unlikely given the solidity of the banking system, reasonably tight corporate inventories and a healthy U.S. consumer.

**Although the markets could start the year where they've left off**, and perhaps even temporarily plumb new depths before stabilizing, we see several good reasons we should eventually head higher, perhaps not until the second half of the year. First and foremost, by then the uncertainty around the Fed, trade, and oil should be resolved, freeing up economic players everywhere to move forward more confidently with their investment and spending plans. With this, earnings growth is likely to reaccelerate toward our 2019 target of \$170 to \$175. As the much touted "second derivative" turns up, investor concerns about being late cycle should ebb. As confidence rises, the gradual expansion of the market multiple, which began in the depths of 2010 but stalled out this year, should resume, re-achieving a relatively undemanding 18 P/E on trailing earnings, compared to today's Christmas bargain of 16. This should eventually get us to our longstanding 3,100 target on the S&P 500, if not by midyear as we've been expecting, then by year-end at least. This gives the market upside on a 12-month view of roughly 15%.

At Federated, we are remaining at 70% of max overweight positions in stocks in our PRISM® stock-bond portfolio model, with a view to add further to equities on another break lower if we are fortunate enough to get one. And if our friends from Missouri are all doubting us here, all the better. Bull markets need the balance of Investors cautious and

ready to sell on all breaks higher. "More for me", said the bull.



**Stephen Auth, CFA**

Chief Investment Officer, Equities, overseeing all of Federated's equity and asset allocation products globally

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