STRATEGY TEAM

EDGE RESEARCH INSIGHTS | December 2018

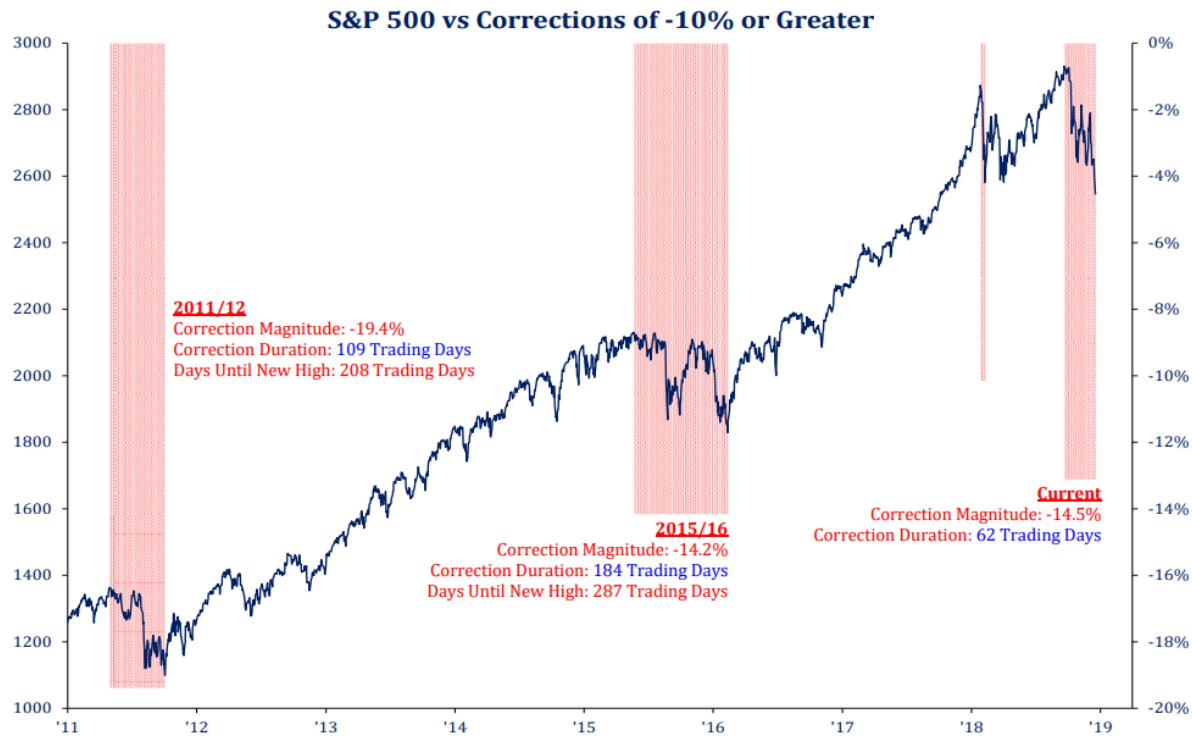
Fed Disappoints but Shows Flexibility

Yesterday at its Fed Policy Meeting, Fed Chairman Jerome Powell announced a 0.25% increase in the Fed Funds rate (range is now 2.25%-2.50%) and set an expectation for two additional hikes in 2019, a reduction from the previously communicated expectation of three hikes. The communication could be considered "dovish", but obviously investors were expecting more, sending equities into the red in the afternoon session after a nice advance earlier in the day. The declines extended a trend that has been in place since the end of the third quarter. Yields on Treasuries followed a similar path, moving higher until the Fed's 2pm comments reversed the momentum. Already there is chatter about whether there is enough acknowledgment of growth risks and deflationary pressures, but our back-of-the-envelope read is that you have a monetary policy maker who is less concerned over recent market volatility and would rather convey that there is not a "Fed put" in the market to reduce moral hazard risk over the long-term.

The Fed is not the market's friend right now, but the silver lining is that they reduced forward expectations for additional rate hikes, and as always, will remain data-dependent. Not too long ago, expectations were for four hikes in 2019. As we have said before, economic cycles do not die of old age. They end through the popping of an asset bubble or government policy changes (monetary, fiscal, and regulatory) that run too far. In this case, we have two government policy changes in action, Fed tightening and trade tariffs that will require a delicate balance to extend the economic cycle beyond 2019.

US large cap stocks have now corrected 15%, small caps are in a bear market (down over 20%), and more than 50% of the S&P 500 stocks are down over 20%. So clearly some of this risk has been priced in. From a technical standpoint, the market is oversold but it is not yet in extreme oversold condition (5% more downside would lead to a major oversold condition). Adding to the downward pressure this month is tax loss harvesting occurring at a time when market liquidity is typically thinner than normal. Should this remain a "normal" correction in the course of an extending growth cycle, we would expect the market to remain choppy into 2019, rebuild a base, and resume its historical correlation to corporate earnings growth. Earnings season will begin in late January and will provide color on 2019 earnings expectations. Current consensus calls for mid-to-high single digit earnings growth in 2019. A surprise tariff agreement would likely lead to a major bounce for global equity markets, particularly emerging markets, and could go a long way in mending investor sentiment.

During periods of heightened market volatility, we believe it important to remind investors that while 10% market corrections are generally an annual occurrence, deeper market corrections also occur without signifying the end of the cycle. The S&P 500 declined nearly 20% in 2011 during a period of deep economic concern and declined 14% during the energy crisis of 2015 and 2016. Clearly the Federal Reserve is in a different position today and a major reason why we remain cautious of a policy misstep creating a deeper drawdown than in prior periods. Liquidity is an investor's friend during times of stress and can be used to take advantage of market opportunities to position portfolios for long-term capital appreciation. As always, please let us know if there are any questions.



Source: Strategas

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