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A KRAMPUS MARKET

As the calendar moves toward the end of the year, stock market investors look forward to the traditional "Santa Claus Rally," to brighten their portfolios along with their Holiday spirits. This year, however, instead of Jolly Old St. Nick, we got a visit from Krampus. In Central European traditions, Krampus is a horned, half-goat/half-demon, that appears at Christmastime to terrorize poorly behaved children with threats of being beaten, eaten, or dragged to Hell. For most stock market investors, that was a pretty good analogy for the trading in December. A few bean counters pointed out that the S&P 500 Index's decline of 19.8% from the September high was just shy of a bear market, but few took much comfort from that.

People seemed baffled by Krampus' sudden arrival, since they were certain that they and the economic trends had been good this year. After all, only a couple of months ago, stocks were on track for solid double-digit gains. The economy advanced at a 3.4% real rate in the third-quarter and, with unemployment so low, there was a buoyant outlook for consumer spending this Holiday Season. Yet, when the downturn arrived, it came by storm.

There were few places to hide with almost 90% of the S&P 500 stocks down in price over the twelve weeks prior to Christmas. Surprisingly, stocks usually considered more defensive were down about the same amount as the overall market. In U.S. dollar terms, international stocks also fared poorly, with the EAFE Index down 13.8% and the Emerging Markets Index fell 14.6%. Declines were not isolated to the stock market. Many important commodities were weak, with oil down over 37% from its September close and copper posting its fourth consecutive down quarter. Rising interest rates pushed many bond prices lower as well, but in many cases the coupon payments were able to offset most or all of the price declines. New-Age speculative investors in Bitcoin, however, saw a drop of 75% for the digital currency during 2018. Krampus indeed!

AN UNUSUALLY SHARP DECLINE

Not only was the magnitude of the stock market's decline unsettling, but one of its most puzzling aspects was its speed. According to figures provided by the ***Hulbert Financial Digest***, since the September high, the major market indexes dropped at twice the velocity of the first three months for an average bear market. No obvious explanation for the severity of this decline has emerged. Most of the litany of reasons trotted out by market strategists have been well known by investors for many months. Once the selling began, it seems to have released a tidal wave of concern over issues that had been previously glossed over, such as rising China-U.S. trade tensions, the possibility of a disorderly Brexit, slowing global growth, and the ongoing turmoil in the White House.

OTHER FACTORS AT WORK

We suspect that the velocity of the decline may have been accentuated by other factors. For example, investors younger than 35 or 40 only have personal experience with one of the worst economic downturns in U.S. history: the Financial Crisis. Once bitten, twice shy, so they may have been more likely to sell first and ask questions later. We understand their concerns, but we see few parallels between the current environment and the conditions leading up to the 2008 recession. Secondly, a Christmas Day article in the ***Wall Street Journal*** noted that the swiftness of the decline could be related to the amount of computer-driven trading. According the Journal's figures, the combined transactions from quantitative hedge funds, high-frequency traders, and passive index-driven funds account for about 85% of the volume on the Exchanges. Many of the algorithms backing this trading use momentum measures in their formulas, so it is possible the machines helped turn what normally would have been a modest correction into a full-fledged bear market. Similarly, ***Yardeni Research*** noted that the U.S. stock markets have reacted more quickly on the downside ever since 2007, when the SEC eliminated the Uptick Rule. This was a Federal restriction that prevented traders from selling short at progressively lower prices. Without the Uptick Rule, they argue, the lighting-fast computer trades created a short-term cascading effect on stock prices. These technical issues may have helped drive the market lower, but we believe that the real test from here will turn on whether the U.S. economy rolls into a recession.

THE RECESSION CALL IS CRITICAL

Looking back at prior post-war bear markets, in half of the cases, the stock market drop was foreshadowing an economic recession and further stock-market losses followed the initial 20% decline. On average, stocks dropped an additional 17% when the market correctly predicted that a recession was on the horizon. In the remaining examples, when there was no recession, the average total decline was only another 4%. Based on history, if the U.S. avoids a recession, then it is quite possible that the worst of the stock market decline is already behind us.

Some economic warning lights have been blinking yellow. First, the pace of U.S. economic growth has been in the process of slowing, with real GDP up 4.2% in the second quarter, down to 3.4% in the third and with most forecasts anticipating a further deceleration to between 2.7% to 2.5% last quarter. Credit spreads in the junk bond market have risen to the widest levels in two years. Housing activity has slowed in response to higher mortgage rates. The Purchasing Manager's Index for manufacturers posted its largest one-month decline since 2008, with new orders dropping the most in five years. Given that two-thirds of manufacturers reported tariff-related issues, the trade frictions may be spilling into the overall economy. The Conference Board's Index of Leading Economic Indicators has shown a deterioration in many of the underlying components. The partial shutdown of the Federal Government will soon start to affect the reported employment statistics.

Despite this, labor markets seem to be booming, as reflected in a very strong December jobs report from the Labor Department. Unemployment is holding around half-century lows and wage gains are finally showing some significant improvement. Thanks to the job growth, most measures of consumer sentiment remain high and auto sales have held steady at about 17 million units. Retail sales in December were very strong, up about 5%. The rate of inflation, as measured by the Consumer Price Index, continues near the Fed's 2% target and lower oil prices should help dampen the headline inflation number for a while. Corporate insiders have been buying their own company's stock at a rate not seen since 2011, indicating their positive outlook for the future.

THE FED BACKS AWAY FROM THE BRINK

The trigger for the worst of the stock markets' drop appears to have been Fed Chairman Powell's comments on October 3rd that interest rates were "a long way" from neutral. It was no secret that the Fed Governors had a strong desire to normalize interest rates, but investors now feared that short-term rates would be pushed far above expectations. There also were indications that the Governors were willing to march rates steadily higher, with three increases planned for 2019, regardless of the obvious global economic slowdown. Investors remember that the Fed, either by design or mistake, has caused most of the recessions in the past fifty years. If monetary policy was being put on autopilot, then the chances of a miscue were almost inevitable.

In the intervening weeks, many Fed officials, including Chairman Powell, have tried to walk back their prior comments and put a more dovish spin on current policy. While it is not the Fed's job to keep the stock market rising, they do rely on financial markets for both information and as a feedback loop for their decisions. The plunge in intermediate and long-term Treasury bond yields, along with rising credit spreads, was a strong indication that monetary conditions were tighter than they presumed. At the same time, falling stock markets could take some steam out the economy, allowing them to postpone their planned interest rate increases. After spending years nursing the economy back to health from the Financial Crisis, our sense has always been that the Federal Reserve would be exceedingly cautious in normalizing rates, which was confirmed by the most recent Federal Open Market Committee minutes.

Chairman Powell also lessened another major fear of investors concerning the Fed's balance sheet. Over the past decade, the world has been living through an unprecedented experiment in monetary policy … the massive Quantitative Easing programs both here and abroad. Not so long ago, the combined purchases of the U.S., European and Japanese central banks were an astounding $100 billion per month. While the Fed has been reducing its balance sheet by $50 billion each month since 2017, purchases globally by other central banks managed to offset the decline here. This will no longer be the case. The European Union is now moving toward a balance sheet reduction and, as a result, the world is on the cusp of losing liquidity. Many view these balance sheet adjustments as a more significant tightening of monetary policy than raising interest rates. Chairman Powell's comments on December 19 and the FOMC minutes showed that, although the Fed Governors believed their actions were small relative to the issuance by the Treasury, they would consider being flexible on their balance sheet policies. This was a relief to many investors.

THE DANGER OF SELF-FULFILLING PROPHECIES

The stock market is traditionally thought of as a leading economic indicator because investors base their decisions on forward-looking information. Financial markets were supposed to anticipate recessions, not cause them. Given how important the financial markets have become in recent years, we have some concerns that businessmen and consumers may react to the bear market in ways that may trigger an economic falloff. If the plunge in stocks cause businessmen to hold up capital investments and households increase their savings rate, then overall demand will drop and force economic growth to a grinding halt. The severe drop in the Manufacturing Purchasing Managers Index could be reflective of such a move, so we were relieved when the Non-Manufacturing Index remained more consistent with prior trends. With the financial markets showing some stability over the past few weeks, it doesn't appear as if the psychological damage from the financial market turmoil has significantly altered economic behavior up to now, but this will be worth watching.