CONWAY • JARVIS LLC

Investment Outlook

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The Fed Successfully Fine Tunes the Economy

As we approached the close to 2018, we witnessed something not seen often, if ever, in this modern era of monetary policy. The Do-Over, or Mulligan for you golfers out there. Typically, when the Fed speaks and the markets react, the FOMC committee Chair goes about his or her business of making the rounds of congressional committees and issuing cryptic statements subject to any number of interpretations by the financial media. The September 2018 policy statement was met by an outcry from many "experts" that the bull market had ended and recession was imminent. The stock market overreacted accordingly, taking several indices into bear market territory and leaving the S&P 500 teetering on the precipice. The Do-Over was comprised of a series of carefully parsed statements from Chairman Powell that left little room for interpretation. The short version: The Fed remains data-dependent and patient. As we've seen in the first few months of 2019, that's music to investors' ears.

What Just Happened?

That's what investors were asking themselves following a raucous fourth quarter that triggered an about-face for the stock market that culminated in the worst Christmas Eve for investors, ever. Granted, a certain degree of uncertainty would be raised by competing interpretations of the Fed's September policy statement. The investor community, professionals and individuals alike, took a nuanced and balanced view. However, the financial media, in their quest to sell advertising, dramatized the narrative in the negative. While long-term investors were standing pat, the trading community hit the sell button with the power of their algo-driven technology and transformed what should have been a run of the mill correction into what some say was a bear market.

In a matter of weeks, what should have been a respectable return for investors in 2018 was transformed into a loss as the market priced in a recession that wasn't. Then came the Do-Over. As new information came to light in the form of economic data, the Fed added further clarity to their earlier statement. The upshot was that the GDP growth was slowing from its Q2 peak of 4.2% to somewhere around 2.6% for Q4. That's a level that was described several years back as the "sweet spot" for the economy: sustainable growth with only minimal inflation. Does anyone remember the days of the Goldilocks economy? All indications are that, while a recession is somewhere in our future, it hasn't appeared on the horizon…yet. The economy is still expanding with benign inflation and the stock market should follow. For us, that's Mission Accomplished for the Fed. You won't hear that news on CNBC, since it doesn't sell advertising.

2019 and Beyond

While we currently see no indication of impending recession for the US economy, the same can't be said of the other theaters of the Global Economy, the Emerging Markets/China and Europe. Together, they hold the potential for triggering a global recession but that would almost certainly require a major fiscal policy misstep from the US. As we approach next year's election, the potential for that will gain prominence in the headlines. For that reason, we've added the Elections Cycle to the list of risk factors that we monitor.

The Fed:
Chairman Powell not only confirmed the FOMC's intention to tread softly in response to data, but also affirmed that an adjustment to the Fed's balance sheet runoff had been added to their toolbox. When it comes to policy statements, less is more. We're seeing clarity and simplicity leave fewer options for interpretation by politicians, journalists, and professionals with something to sell. **We've reduced our risk level from Moderate to Minimal.**

Trade War:
It's been difficult to assess the tangible effect of the continuing trade conflict with China. With deferrals, suspensions, and exemptions from both sides, we're wondering if it's truly trade friction or just fiction? Both parties appear to want resolution on their own terms. What's non-negotiable for the US is the end of the appropriation of intellectual property by China. The glare of investor opinion will focus on that for evidence of a truly meaningful trade agreement. Success will hinge on the result of the upcoming meeting in Florida. If neither party blinks we'll raise our risk rating. **We maintain our risk level at Moderate.**

Europe and the Global Economy:
Brexit appears to be stumbling toward a dead-end or hard exit. Germany barely avoided recession by ONE basis point in Q4 and the ECB was forced to keep the monetary spigot flowing until next year. Throw in economic upheaval in France and Greece's flat-lining economy and you have a recipe for a broad-based contraction in Europe. The dream of the Union is being slowly disassembled under the weight of market forces. A contraction in Europe would be felt in China and the Emerging Markets. **We maintain our risk level at Significant.**

Elections Cycle:
While the elections are in the distant future, the flow of headlines begins now. We suspect that it will be months before media-driven drama begins to shade the stock market. The prospect for a major shift in fiscal policy comes into focus next year after the field of candidates is winnowed down to the serious contender(s). Since we're focused on the economy and its markets, we're hopeful those left standing on both sides demonstrate a higher level of financial and historical literacy than we're seeing today. From our perspective, the prospect for an activist-driven shift in fiscal policy would weigh heavily on the markets and presents the most proximate risk for recession. **Our initial risk level stands at Moderate.**

The Outlook

Is there a recession or bear market in our future? Most certainly. The bigger and tougher question is *when*. We think the US economy can sustain GDP growth of 2.5% well into the future, absent an *event* related to the risk factors we're monitoring. However, there have been instances where the current underpinnings of the economy point to continued expansion only to have a spooked stock market erode confidence in a very short period of time. We'd point to 2015 and Q4 of last year as examples of that. Fortunately, neither of those markets derailed consumer confidence and business investment to the point of pushing GDP growth into negative territory. Our point here is that a protracted stock market *overreaction* to an event can be the trigger for a self-inflicted recession when investors abandon analysis and engage in algo-driven groupthink.

Given the current state of our risk factors, we believe that our current rate of US GDP growth is sustainable well beyond 2020. If you're among those who see 2020 as a watershed year for the markets, we'd suggest estimating your liquidity requirements for the next 18-24 months and revisiting your current asset allocation. If you believe that the end of the current expansion is nigh, it's time to reallocate a portion of equities into fixed income. That will provide you with a source of liquidity in the event you're right. Once again, the next recession isn't a question of if, but when.

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