The Market Swoon

By Peter Scholtz
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Several weeks ago, I wrote regarding the recent weakness in the market. I tried to make it clear that although my two year confidence has been deteriorating, we were quite bullish short term, looking for a sharp rebound from a deep oversold condition. Until yesterday, the rebound seemed elusive, but still my longer-term confidence continues to deteriorate.

The primary concern of the stock market is monetary policy. The Fed has been raising interest rates gradually and also divesting themselves of the massive amount of bonds bought which flooded the markets with liquidity. Currently, they are divesting $50 billion a month. How well the market absorbs this bond supply is difficult to gauge. The policy of the Fed buying over $3 trillion dollars in bonds and now trying to unload them has never been a policy in the past. We can only watch for the tipping point as to when it affects the markets and we seem to have arrived at that point. Howard Marks, Stan Druckenmiller and other well-known investors have voiced their concerns about the Fed run-off of its balance sheet as it is tightening credit conditions more than simply the rise in the Fed Funds rate. Both these men made their fortune in the bond market. They understand credit. Druckenmiller last week had an op-ed piece in the Wall Street Journal urging the Fed to stop tightening, put things on hold and watch.

Last Wednesday, the 19th, all five of our investment people watched the Fed announcement and subsequent press conference live regarding the decision on changing their interest rates. They increased the Fed Funds another quarter point. That was expected, but the market wanted to hear about future policy. The Fed stated that their consensus guess for next year was for two hikes rather than the three that had been previously broadcast. Chairman Powell further went on to say that their behavior is flexible and data dependent, and these rate increases are not etched in stone. The market floated slightly into the green. During the Q and A, the Washington Post reporter asked about the stated policy of divesting $50 billion a month in bonds. Chairman Powell quickly stated that they feel putting it on auto-pilot would give the market clarity and visibility. I was watching a daily chart of the S&P to gauge its reaction to his comments. With that comment, the market dropped almost two percent in the next few minutes.

It is quite clear what the market is concerned about. Before the end of the week, John Williams, President of the New York Fed, had an interview which seemed to be an attempt to soften the apparent intransience of the Fed Chairman. Williams said things like, “We will be data dependent….. We are listening to the market and business leaders…..Financial conditions have important implications for the economy.” He went on to say that changing the Fed Funds rate is the primary instrument in adjusting monetary policy, and “we are not at the point to change balance sheet normalization.”

There has been an increase in stress in the credit markets as bond spreads between low and high credits have started to widen and the junk bond market last week has really started to fall. This is reminiscent of August of 2007 when markets seized up badly and the Fed seemed to have no reaction. It is when Jim Cramer had his infamous rant on TV regarding the Fed and the credit seizures were so severe, the Fed ended up acting within days, providing liquidity in the system. By the end of 2007, the economy had entered a recession. The problem is not that the Fed won't eventually change course, but rather that the Fed will change too slowly.

Monetary policy around the world has generally been less accommodative in various forms. Europe has been on a course to end its quantitative easing program, removing some monetary support. The IMF estimates that Europe will grow at 1.9% in 2019. Mohamed El Erian (former CEO of PIMCO) last week said he would make a strong bet that their growth would be around 1%. Europe seldom has dramatic changes in GDP, but this is obviously in the wrong direction. China's growth has decelerated due to tightening last year, but now they are stimulating the economy with tax cuts and monetary stimulus. It has yet to take hold. Over the past year, we have witnessed economic indicators pointing to slower growth. We have closely monitored this and as growth has continued to slow, it has become a source of concern. The trade tariffs are another negative regarding global growth, but this can be mitigated if the United States comes to agreements with Europe and enacts the agreement with Mexico and Canada. We export little to China, however, the effect on the Chinese economy is very important to global growth. As for the United States, we may catch the cold last, but the trend is not good. Williams in his interview said that the Fed's base case is for U.S. GDP to grow at 2 to 2.5%. Ed Hyman, Wall Street's favorite economist, has lowered his forecast three times in recent months from 2.5% to 1.75% for 2019. A Duke poll recently asked a large group of CFO's when they saw a recession and 48% saw a recession by the end of 2019 and 78% said by the end of 2020. These are the people at large corporations that drive investment and hiring. They need to believe and apparently they don't.

Due to the massive spending increase at the Federal level, we will see a record amount of bonds issued by the Federal Government next year. This is in addition to the Fed running off their balance sheet $50 billion a month. This will have a "crowding out" effect in the bond market. The U.S. government won't have trouble selling bonds, but the lower credits will and that is what we are beginning to see.

Markets are reflecting interest rates and growth concerns as housing stocks and auto stocks are down over thirty percent. All cyclical stocks are down much more than the market indices. Companies with lots of debt have also suffered. Adding to these problems are the government shutdown, cabinet resignations and the general attitude in Washington that neither side wants to give the other "a win," obstructing any positive policy initiatives.

Everything is going the wrong way. In theory, that is the time to buy, but not unless things are on the verge on changing for the better. China may re-accelerate, trade talks may take a step forward, and the Fed might abruptly change course. Unfortunately, except for Chinese re-acceleration, I find these problems unlikely to go away soon. This market is ripe for a rapid violent recovery (much of which we saw yesterday), but I sense professionals will use this rally to sell. My opinion this year has gone from a chance of a recession out at least two years to thinking it is almost a coin toss at this point.

All year, we have been slowly moving more towards a more defensive posture, but as things have been deteriorating this fall, the process has accelerated. Although we put some cash to work for this possible rebound, I now still sit on quite elevated cash levels. The relief rally from yesterday may continue higher temporarily, but until the fundamentals start to tick back up, the market is probably not out of the woods. As always, we will be watching carefully, maintaining flexibility along the way.