WESTLAKE
PRIVATE WEALTH MANAGEMENT

Quarterly Missive
Fourth Quarter 2018

My how quickly things change.

The last two quarters were generally smooth sailing, characterized by consistent stock market returns and little volatility. In fact, the last ten years have largely been the same. Absent a handful of intermittently-spaced volatility spikes, the market has had a remarkably smooth run since the end of the financial crisis in 2009. Economic data has been supportive, with GDP and earnings growth consistently positive and inflation consistently absent. It's no surprise so many analysts regularly referred to this as the *Goldilocks economy*.

However we cautioned in our last missive that volatility would likely return to "play a greater role in our investing psyche and might challenge some of us to rethink our tolerances", and the last several weeks have certainly borne this out. Volatility has spiked, with roughly one-third of October's trading days seeing one-percent or greater moves. At the same time sentiment has soured and stocks have found themselves unwinding their year-to-date gains in a few weeks' of unpleasant trading. At its worst the S&P 500 was off nearly 10% from its highs - with about half of the stocks in the S&P 500 down 20% - and smallcaps were off nearly 12%. At this point our clients are naturally asking two questions: *what's happening?* and *where do we go from here?*

There are a handful of catalysts behind the market's recent pullback but investors are largely focused on three familiar themes – first, that by raising interest rates the Federal Reserve may risk stalling the economy into another recession; second, that the upcoming midterm elections may tip the political balance to the left and provide support for higher tax rates; and third, that the ongoing trade conflict with China may continue disrupting supply chains and increasing raw materials costs, thus impacting future earnings. To some, these issues are so substantial they believe they're a threat to the economic cycle and bull market. We're not buying it.

Let's take these issues one by one.

The Federal Reserve has been on a tightening cycle for the last 18 months. With the backdrop of solid economic growth the Fed has had little choice but to do so; in fact rising rates in a robust economy is actually quite normal and healthy. Lucky for us, the Fed has moved in such a slow and steady fashion it has barely been felt in the markets, until now. However the question that's beginning to surface: how much tightening is too much…and at what point do higher rates actually risk stalling the economy back into recession? We've always believed that Fed policy is considered neutral when interest rates are in the neighborhood of *nominal GDP* (real GDP growth + inflation). With real GDP growth around 3% and inflation around 2%, the Fed Funds rate would be neutral around 5%, however today rates are well below that - at 2.25%. Assuming the Fed tightens at its December meeting and again four times in 2019, we'd be at 3.5% - still a very long way from restrictive. If anything, the Fed would be "less loose". So with interest rates still reasonably accommodative, we believe there's little chance the Fed will stall us into recession in 2019, and perhaps even in 2020.

The midterm elections have also surfaced as a concern and largely for one reason: there has been talk on Capitol Hill of unwinding last year's tax cuts which have been quite unpopular amongst Democrats and have become a central theme in many campaigns. According to our friend Greg Valliere with Horizon Investments, Democrats look poised to pick up around 30 seats in the House of Representatives, more than the 23 needed to gain House control, but Republicans will likely retain control of the Senate. The only way Democrats can roll back the tax cuts is by winning a veto-proof majority, which we believe they'll be nowhere near. However unfortunately, with one party controlling each house, gridlock and partisanship will not change one bit, and we're all losers in that scenario.

The one theme that does cause us some concern is the ongoing trade spat with China. By now it has become well-known that in-place tariffs are beginning to wreak havoc on raw materials costs and on the supply chains of many US businesses, and we're seeing a handful of companies deferring capital spending projects because of international trade uncertainties. In a macro sense, many economists have argued the impact would – at worst – shave a couple tenths off GDP growth and add a couple tenths to inflation. However there is a very real human element at play here too, and if the issue drags on deep into 2019 the pain and apprehension could escalate. But there are some positives to be found as well. The Trump Administration has maintained that tariffs would gradually weaken China's manufacturing sector and disrupt its economy, causing China's leaders to face their very real fear of social unrest and bring them to the negotiating table. In fact, we're now seeing tangible signs that China's economy is slowing indeed. We also believe that China is an intensely proud country, and privately it is hard at work lowering its own tariffs on thousands of imported goods in an attempt to reduce tensions. Overall China has reduced its tariff level from 9.8% in 2017 to 7.5% today[1], an encouraging sign. And there is great hope that Presidents Trump and Xi will take constructive steps toward a resolution when they meet at the end of November. This is a fluid and ongoing situation that will take time to sort out, and one that certainly bears watching.

While we doubt that any of these issues troubling investors today will in-and-of-themselves throw the economy off its rails, there are nevertheless a few cracks that do cause us concern and which the market has not yet fully addressed. In our last piece we borrowed Liz Ann Sonders' quote that "better or worse tends to matter more than good or bad" and we're beginning to wonder whether 4% GDP growth, 20% earnings growth and impressive jobs numbers are as good as it will ever get. We're also looking a bit deeper into indicators such as household debt levels, new housing starts, existing home sales and product shipping metrics – all secondary measures of economic activity yet all showing signs of topping or softening and suggestive that we keep both hands on the wheel here.
More than anything we remain mindful that the volatility we experienced in October will likely stick around for a while. Deep in the economic cycle, with the bull market run in its late innings, volatility and substantial swings in the market - not only in stocks but also in bonds - are typically the norm, not the exception. It is exactly for this reason that we remain broadly diversified in our client portfolios and highly disciplined in our approach. It is also why we design our client portfolios around quality holdings and stick to our investment disciplines, resisting the fatal flaw of market timing.

In conclusion – our glass remains half-full…for now. Earnings and GDP growth, the underpinnings of equity prices, may be slowing from *spectacular* to just *very good*, yet we believe they remain supportive of continued gains. Volatility at this phase of the cycle should be expected. And while we remain vigilant for any signs of a shifting tide, we do not see recession anywhere on the near-term horizon.

As always we remain grateful for the trust and confidence you continue to place in us, and we wish you the best of everything the Holidays ahead have to offer.

James H. Dryden
Director

[1] Reuters 9/30/2018