



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – DECEMBER

US Markets and Economy:

In December 2018, Santa delivered a large lump of coal to investors. Stocks fell sharply right through Christmas Eve, and the spirited rally after Christmas still left the market down sharply for the month, and down for the year. Until late September, US stocks were on course for another good year in one of the longest and strongest bull markets ever. What went wrong in the last months of 2018?

Let's round up the usual suspects: interest rates, international trade, domestic policy uncertainty, and future corporate profit growth.

Interest rates: Short-term interest rates, although still low in real (inflation-adjusted) terms, are going up. The FOMC increased the Fed Funds rate by ¼% in September, and did so again in December. Even though *long-term* rates actually fell in November and December, with the US Treasury 10-year yield dropping to 2.7%, Wall Street traders were not happy. One fear was “yield-curve inversion,” which occurs when short-term rates exceed long-term rates. This relatively rare phenomenon often signals that the US economy is headed for recession. Although the yield curve did not actually “invert,” traders’ fears of the prospect of inversion led to panicked selling, even though economic data clearly showed that the US economy was still growing strongly: real GDP growth for the third quarter was a solid 3.4%, unemployment in November remained at a 50-year low, November net job gains were a respectable 155,000, and workers’ wages rose faster than inflation.

Wall Street traders had also convinced themselves that even though the 2018 Fed Funds bumps were anticipated, the FOMC would not continue to increase rates in 2019. But the Fed made it clear (unanimously) that they were still planning a few more bumps in 2019. The FOMC also made it clear that tweets from the President would not influence their decisions in 2019, which would instead be based on incoming economic data. (Some Wall Streeters may have vainly hoped that the White House could cow the Fed into submission, but good long-term monetary policy *requires* an independent central bank free from short-term political concerns.) In fact, the

US economy shows every sign of being strong enough to continue growing even with modest rises in interest rates, which are designed to keep inflation low while the economy grows.

International trade concerns also weighed on the market, and here Wall Street is on firmer ground: if the US escalates trade skirmishes with the Chinese into a trade war with substantially higher tariffs on imports, all countries, including the US, will lose out. Prices would rise faster in the US, jobs would be lost on net, and world economic growth would slow. And the US trade deficit would *not* disappear. While almost all the world's economists agree with this prognosis, and there is still a good chance that cooler heads will prevail (as with NAFTA), the level of policy uncertainty in the White House is high, and every high-level firing stokes the fears of the bears.

The story of corporate profit growth also suggests an overreaction by Wall Street. Over the next two years, corporate profit growth will no doubt decelerate from the torrid pace of 2018. But profits will still be rising, spurred on by economic growth and further deregulation.

In sum, the bulls can still make the case that US stocks can get back to their winning ways in 2019. Long-term investors, sorely tested in late 2018, have been once again reminded that the course of true love (and bull markets) never did run smooth.

World Markets and Economy:

European stocks also tumbled sharply in December. Before a post-Christmas rally, the blue-chip Eurostoxx 50 Index was down almost 20% from its January high. In addition to the drag created by a weak US market, European equities face even greater policy uncertainty over the impending EU Brexit at the end of March 2019. No one really knows, including the Brits themselves, how this will play out. British blue-chip stocks led the way down, dropping to their lowest levels in two years. German stocks (who will replace Merkel?) and French stocks (when will the demonstrations stop?) followed the Brits down in perfect lockstep. The Italians did even worse, with their market pulled down by the shaky "left-right" coalition's battle with European fiscal authorities.

Japanese stocks did not provide a haven for investors either: the Japanese Nikkei Index had a weak December, falling almost 20% from its late-September peak. The Japanese economy shifted into reverse in the third quarter, in part because of a growth slowdown in China. Chinese stocks declined at a much slower pace, but the slowdown in Chinese growth has pushed Chinese equities to their lowest levels in almost three years.

OUTLOOK: US stocks remain in a bull market, and long-term investors must look beyond any short-term gyrations and have the courage to stay the course. (Europe, though, will be dicey at least through March.) But stocks still provide the best long-term returns.