Trend Dynamics

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Investment Review

1st Quarter 2019

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A lot can happen in three months and a lot has in the stock market, which is off to its best start since 1987. That start is a far cry from how 2018 finished, yet it's a byproduct of why the stock market climbed more than 300% from its 2009 low and set a new record high in September 2018. Major indexes have now recouped almost all of the losses they suffered in the final months of 2018, when fears about an economic downturn sent markets around the world sliding.

The S&P 500 added 13.7% for the quarter, its best showing since 2009, the Dow Jones Industrial Average finished the quarter up 11.8% and the Nasdaq Composite added 16.8% for the quarter.

On December 21, 2018, the S&P 500 was in a tailspin, as markets were spinning on an axis of concern that the Federal Reserve ("Fed") was being too aggressive with its monetary policy and placing the U.S. economy on a crash course to recession. The next trading day -- Christmas Eve -- was a washout. The S&P 500 dropped 65 points, or 2.7%, to 2351.10, leaving it down 14.8% for the month of December alone.

And that was it. Since Christmas Eve, the S&P 500 has risen 21.4%.

What changed?

The rebound started with a belief that the market had gotten oversold and was due for a bounce.

There was a sense that the stock market fallout in the fourth quarter would compel President Trump to strike a trade deal relatively soon with China.

The biggest change agent, though, has been the Fed.

The Fed changed its message on January 4 with an acknowledgment from Fed Chair Powell that the Fed is going to be patient before changing monetary policy. That was music to the ears of the stock market, which heard "we won't be raising the fed funds rate anytime soon." Mr. Powell also asserted that the Fed would be open to making changes to the balance sheet runoff plan, which he said only weeks before was on auto pilot.

Flash forward to the March FOMC meeting, which culminated with a decision to leave the target range for the fed funds rate unchanged at 2.25% to 2.50%, which produced an updated dot plot that showed a median estimate for no rate hikes in 2019 (down from two rate hikes at the time of the December 2018 meeting), and a clarification that the balance sheet runoff will be completed at the end of September 2019.

That dovish-minded message came just two weeks after the European Central Bank told the world its key interest rates are expected to remain unchanged at least through the end of 2019 (versus prior guidance for at least through the end of summer), which was joined with pledges out of China to use fiscal and monetary policy to support the economy, and no inclination on the part of the Bank of Japan or the Bank of England to raise their key rates anytime soon.

The world's major central banks, then, have all said "easy does it" with their monetary policy, which in turn has made for some easy money so far in 2019 for equity investors.

TREND DYNAMICS

2nd Quarter 2019 Outlook

For now, the stock market is riding a wave of price momentum and trading with a predictable reflex to buy stocks when the Fed, and other central banks, are ringing the bell of easy monetary policy. It has been further supported by performance chasing and efforts to re-risk after the widespread de-risking in last year's fourth quarter.

Stock market action is all on the up-and-up right now, because nothing has happened yet to upset the view that a second half recovery is going to happen. Accordingly, investors are settling back into old ways, riding the "central bank put" to strong returns that were there for the taking with the discounted valuation entering the year.

Much of this year's rally has been fueled by relief that central banks are willing to back off their rate-increase campaigns after growth cooled from the eurozone to China and stocks collapsed. Others attributed part of the rebound to investors stepping back into stocks after a selloff that many considered overdone.

The U.S. economy continues to be a relative bright spot around the world. Indications that inflation remains muted have helped push the Federal Reserve to pause its rate-increase campaign. Some have called for the Fed to go even further: National Economic Council Director Larry Kudlow has said the Fed should lower its benchmark federal-funds rate by 50 basis points to help protect the U.S. economy.

Central banks' softer approach to monetary policy this year has reassured markets that borrowing costs, which can feed into corporate profits and consumer spending, are unlikely to race out of control. There is a lot of optimism embedded in stock prices -- or perhaps what we should say is that there is a lot of relief embedded in stock prices.

There has been tremendous relief in the understanding that the Fed isn't going to be raising interest rates; there has been relief in the idea that the U.S. and China seem to want to get a trade deal done; and there has been relief in the awareness that the U.S. economy is still holding up better than feared.

From an earnings standpoint, there is real hope that the trade deal gets done and paves the way for a reversal in the earnings estimate revision trend, as a trade deal that lifts tariffs is considered a pathway to improved confidence that translates into stronger levels of business and consumer spending.

The trend in the first quarter EPS estimate has been decidedly negative, but ironically, one can argue that there is a lot of hope wrapped up in those downward revisions.

The hope is predicated on the view that the first quarter is the worst of things and that EPS growth estimates soon go the way stock prices are suggesting they will, nearly in a straight line.

The stock market essentially fears no evil at the moment, because it is confident that it has the "central bank put" at its side.

Cautious

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