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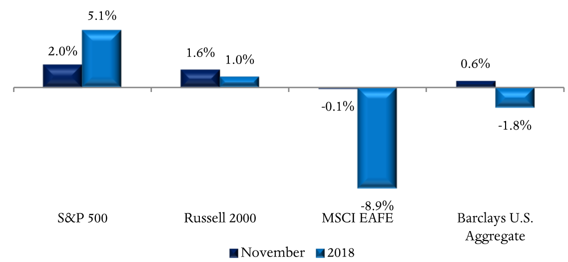
Markets

Geopolitical events continued to sway financial markets in November. The S&P 500 index exhibited meaningful swings during the period, including a notable decline post the US midterm elections which split Congress. Investors focused on the reduced prospects for extended US fiscal stimulus in the run up to the 2020 Presidential elections, central bank policies, global trade, and decelerating economic growth expectations for 2019. Nevertheless benchmark US indexes ended the month in positive territory thanks to a late month buying spree. The S&P 500 rallied +2.0% in November (+5.1% ytd), while the smaller capitalization Russell 2000 index bounced +1.6%, back into positive territory (+1.0%) for 2018. Conversely, overseas equity markets generally experienced ongoing woes last month, as seen by the MSCI EAFE index's decline of -0.1% (-8.9% ytd). European stocks remained under pressure, retreating -1.0% in November (-5.1% ytd). Asian markets were mixed, with Shanghai equities hovering near bear market territory (-0.6% in November; -19.8% ytd), while Japan's Nikkei 225 index showed resilience (+2.0% last month and flat for 2018). Emerging market equities, which have experienced sharp, currency-driven, selling in 2018, bounced +4.1% in November (-12.0% ytd).

The US 10-year Treasury yield retreated by 15 basis points, to close November at 2.99%, as markets became concerned about the outlook for global growth and the prospect of lower inflation. In addition, corporate credit continued to struggle as investors worried about the generally high level of leverage and the potential for margin compression. The Barclays US Aggregate index rebounded +0.6% in November (-1.8% ytd), while the US High Yield benchmark declined -0.9%, breaking into negative territory, -0.1% thus far in 2018).



In energy markets, WTI crude oil, which had peaked at $76.41 per barrel in early October, ended November at $50.93, a one-third decline, reversing all the progress of the past year. Presiding over the decline was a large increase in US and Saudi production, which led to a 400,000 barrel increase in inventories. Other factors include the introduction of exemptions on Iranian crude oil sales, as well as large speculative long futures positioning by the market, while demand remains firm.

Geopolitics

The meeting between China's President Xi and American President Trump at the G20 gathering in Argentina produced a positive inclination, from both sides, to de-escalate trade tensions. The worry over the US plan to raise tariffs on $200 billion of Chinese goods to 25% from 10% was deferred. Negotiations are planned over the next 90 days.

In France, "Yellow Vest" protests have escalated in size and force. Motivated by rising fuel prices, the high cost of living and claims that a disproportionate burden of the government's tax reforms were falling on the working and middle classes. Protesters have called for reductions in fuel taxes, the reintroduction of the wealth tax, the raising of the minimum wage, and the resignation of President Emmanuel Macron.

November also featured a naval skirmish between Russia and Ukraine. To assert its sovereignty Russia is blockading Ukraine by restricting its access to the Black Sea and geographically surrounding it to hinder trade. US President Trump has signaled he is not interested in getting involved militarily, leaving a solution to the Europeans. Ukraine has relied on the December 1994 Budapest Memorandum which calls on the US and Russia to respect its borders in exchange for surrendering its nuclear weapons.

Progress with Brexit continues and a withdrawal agreement between the UK and the European Union has been reached. In order to proceed, it must be ratified by the UK parliament, potentially later this month. The deal presented avoids a hard Irish border, but the need for the United Kingdom to align to EU rules is not palatable to all within the Conservative Party. This has led to considerable angst amongst investors about the ability of the Prime Minister Theresa May to pass the deal through the House of Commons. Failure may lead to a new referendum or general election, both of which, ironically, entail the potential of no Brexit at all.

Tensions between Brussels and Italy also persist. The European Commission rejected the Italian budget law after no significant changes were made to the first spending proposal under the new government. It is unclear whether the Italian government will alter its proposal or face an "excessive deficit procedure." More recently, discussions seem to have become more constructive between the Italian government and the EU, which suggest the possibility of a compromise.

United States

US economic data remains rosy, with GDP growing above trend (3.5% in Q3), a healthy labor market (featuring 3.7% unemployment coupled with an increased participation rate), and tepid inflation. Of course, at this late stage of the economic cycle, there are a few signs of softness. For example, in the homebuilding sector, higher mortgage rates (albeit still historically low) have hindered demand, while consumers adjust to the new norm. Importantly, consumer confidence remains at a high level.

While headline inflation increased to 2.5% year-over-year, this rear-view-facing data point reflects the much higher oil prices of October. Adjusted for volatile food and energy prices, core inflation decelerated to 2.1%, highlighting that there are still few signs of a meaningful acceleration in the underlying pace of inflation. Taking into account the expected economic deceleration to 2.4% in Q4, as per the Atlanta Fed's GDPNow, the central bank has telegraphed that the probability of further interest rate increases has diminished and that future decisions will be increasingly data dependent. The market attaches a high probability of a rate hike later this month, but the expectation for further increases receded after a recent speech by Fed Chair Powell in which he indicated that rates are "just below" the neutral range.

November 2018 Economic Statistics

	Nov-18	Dec-17	Dec-16
Federal Funds Target Rate	*2.00 - 2.25%*	*1.25-1.50%*	0.50 - 0.75%
Consumer Confidence Index	*135.7*	*122.1*	113.7
Manufacturing PMI Index	*59.3%*	*59.7%*	54.7%
Unemployment Rate	*3.7%*	*4.1%*	4.7%
JPY/USD	*113.46*	*112.67*	116.87
USD/EUR	*1.1315*	*1.1996*	1.0513
Gold/oz.	*$1,221.88*	*$1,302.45*	$1,151.46
Oil (WTI)/bbl	*$50.93*	*$60.42*	$53.72

Europe

Europe continues to generate lackluster economic growth, as seen by the most recent GDP reading of 1.7%. Importantly, Germany surprised to the downside (-0.2% quarter on quarter) due to a sharp decline in industrial production, partly attributed to a decline in vehicle production as companies addressed new emissions standards. In Italy, third-quarter GDP also declined by -0.1% from the previous quarter, affected by the recent political uncertainty surrounding their budget impasse with the EU. Concerns are focused on the impact of a 2.4% budget deficit target for next year on Italy's debt, the biggest in the euro area in absolute terms. Nevertheless, European companies produced a respectable 10% earnings growth in Q3, with over half the companies beating expectations.

The eurozone composite purchasing managers' index (PMI) registered a more than two year low at 52.7%. In tune with economic output, Germany showed the weakest expansion in nearly four years, while Italy was the weakest performing member. In contrast, Ireland, France and Spain were firmer. Of the composite components, future output and employment fell the most. In turn, inflation which stands at 2.0% on the headline rate and 1.0% for the core rate (which excludes volatile prices of energy, food, alcohol & tobacco), remains stubbornly low. This poses a significant challenge for the European Central Bank (ECB) which is still expected to end its quantitative easing program at year-end. Looking ahead, the market is increasingly skeptical that the ECB will be able to raise interest rates in the second half of 2019, as per its current guidance.

In the UK, economic data and monetary policy expectations appear conditional on the approval of the Brexit-related EU withdrawal agreement by parliament. On the labor front, unemployment rose modestly to 4.1%, and wage growth remains anemic (still 5% below 2008 levels). Constructively, headline consumer price index inflation stabilized at 2.4% while core inflation held at 1.9%.

Asia

While tensions between the US and China will likely linger for at least the next quarter, during which negotiations will be ongoing, our research indicates that further escalation would be economically detrimental to both sides. Ultimately, the two sides should be able to reach a compromise. Preemptively, China has launched a new round of fiscal stimulus expected to take effect in early 2019. Additional monetary stimulus is also anticipated, featuring a further cut of the reserve requirement ratio (from the current 14.5%) to support regional banks and small enterprises. Economists at the International Monetary Fund forecast that Chinese economic growth will naturally decelerate over the coming years, from an estimated 6.5% in 2018, to 6.2% in 2019, following a slight gradual downtrend thereafter. The stability of China is important given that its economy has nearly tripled in size over the past ten years, and any slowdown will have a larger ripple effect globally.

In Japan, real third-quarter GDP growth contracted by 0.3% quarter-over-quarter, although this decline was expected given the recent natural disasters (including typhoons and an earthquake). The government's reconstruction programs, which are likely to start in 2019, are aimed at reinforcing growth dynamics.

Outlook

Over the past several months, investors have been struggling to reconcile the positives of solid economic fundamentals with the geopolitical risks that indirectly threaten corporate earnings. On the one hand, the Organization for Economic Co-operation and Development (OECD) is calling for 3.5% global growth for 2019 (recently downwardly revised by 0.2%), which we consider to be healthy. On the other hand, investors have to contend with China-US tensions, Brexit and the transition from central bank easing to tightening. Further, while third quarter US earnings per share grew in excess of 25%, thanks in part to reduced corporate taxation, there were hints of a coming slowdown as seen by a higher incidence of softer forward guidance. Notably, select corporations noted margin pressure associated with higher energy and labor related costs. All said, from a valuation perspective the S&P 500 index is trading at a reasonable 14.6x 2019 expected earnings, at a time when sentiment has turned negative, a solid contrarian indicator signaling a buying opportunity.

Fixed income markets have also become increasingly volatile, and yields have retraced a fair amount of their recent increases. 2-year US treasury yields remain an interesting risk-reward where investors can safely participate. However, we continue to recommend avoiding bonds with long duration, and caution against taking much credit risk.

While 2018 has been a challenging year for stocks, bonds and non-US Dollar denominated assets, prospects for 2019 appear favorable. Still, we envision that volatility will remain elevated and recommend an overall conservative stance. In such an environment, select alternative assets should prove useful in reducing overall portfolio market correlation while dampening volatility.

History and experience tells us that investing is different from trading (especially the algorithmic strategies that have been dominating the markets of late) and recommend that long-term oriented investors stay the course, maintaining an iron hand on the tiller.

Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal

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