Market Bulletin

December 28, 2018

5 questions on market moves

Dr. David P. Kelly, CFA
Chief Global Strategist

Meera Pandit
Market Analyst

Throughout December, major equity indices have sold off considerably, intensifying in the week leading up to Christmas. Mounting losses may result in this being one of the worst Decembers on record, and one of the worst years for equity performance in a decade. Yet, we still do not believe the fundamental picture for the U.S. economy has deteriorated significantly. Amid this market volatility, we consider five questions to address this sell-off:

1) How have markets moved in recent weeks?

While the third quarter ended with the S&P 500 near a record high, this quarter has been challenging, with the index now down nearly 15% **(Exhibit 1)**. International stocks shared a similar drop, while emerging markets fared only slightly better. Interest rates and the U.S. dollar have come down, although not as significantly given the magnitude of the market move. Oil prices are also well off their peak, down nearly 40% this quarter.

2) Have fundamentals moved markets?

Concerns that have been percolating throughout 2018 have come to a head as the year draws to a close. Last week, the Federal Reserve raised rates for the fourth time in 2018, and released its economic projections, lowering expectations for real GDP growth and inflation. These dovish projections were followed by hawkish comments by Fed Chair Jay Powell, fomenting anxiety that the Fed will exacerbate already slowing U.S. growth by tightening monetary policy too much in 2019. This was swiftly followed by the third U.S. government shutdown this year. Turnover in the Administration's cabinet has made headlines, along with the President's sharp criticism of Jay Powell's rate hike decision. And, of course, uncertainty about tariffs between the U.S. and China remains.

Yet, economic data have been positive in the U.S. Strong auto sales, heavy truck sales and non-defense capital goods shipments reflect steady activity; retail sales this holiday season were the best in years and should support consumption. In fact, MasterCard reported that sales since November 1 have been up 5.1%, including a 19.1% increase online sales, making this the best holiday season we have seen in the last six years. Payrolls were up an average of 170,000 in the last three months, wages were up 3.2% y/y and unemployment may fall to 3.6% in the December 2018 report.

It is not all rosy, of course. Housing starts have been flat, although not down, around 1.2 million units in the third and fourth quarter. Exports have been weak. Globally, the Eurozone flash PMI for December fell sharply to 51.3. Still, mixed data, monetary policy tightening, trade uncertainty and political turmoil have been issues all year and should not warrant the magnitude of movement we have seen in markets in recent weeks.

3) If not, what has moved markets?

Evolving market structure has likely played a role in recent market movements. Broadly speaking, there are three primary types of investors in U.S. equity markets: active investors, passive investors and short-term traders who often use computer algorithms and momentum strategies to try to generate short-term profits. Over time, passive investors have grown and active investors have shrunk, and the importance of algorithmic trading has increased. Once momentum algorithms are triggered, there are not enough active investors, who trade on fundamentals, to stand in their way. This dynamic is amplified during periods of less liquidity and lighter volumes, such as the holidays. However, unless these pullbacks are validated by legitimate deterioration in economic conditions, they are unlikely to endure.

4) Have markets moved fundamentals?

Markets have moved fundamentals, notably household wealth and consumer confidence. If the S&P 500 closes at 2,500 on December 31, then household net worth may fall by an estimated USD 2.4 trillion in the fourth quarter. Consumer confidence has already dropped from 136.4 in November to 128.1 in December, and is likely to decline further. However, the areas of the economy that are most vulnerable to a fall in confidence—cyclical sectors such as housing, autos and business investment spending—are all relatively subdued, suggesting that they should not fall significantly in reaction to a decline in confidence.

Some fundamentals may shift positively. For example, lower oil prices lead to lower gas prices which support consumer spending. Additionally, we may see less monetary policy tightening if market volatility holds. Already the Fed has tempered its rate hike expectations for 2019 from three in September to two after the December meeting, and the market is currently pricing in no hikes next year. We have seen these changing expectations play out in mortgage rates, as the 30-year fixed mortgage rate has fallen from 4.9% earlier this quarter to 4.55% in the last week.

5) How should investors respond?

Investors put great care into formulating investment plans, and market environments like these can put composure and discipline to the test. Now is the time to ensure your goals and risk tolerance are still in line with your plan. A first important step is to make sure that your overall asset allocation is in line with your return goals, time horizon and risk tolerance. A second is to recognize that valuation is more important in determining long-term returns than short-term gains and losses. Consequently, to the extent that recent market declines have left certain assets at relatively cheap valuations relative to history, investors may want to consider re-establishing small over-weights to risk assets including U.S. and international equities.

EXHIBIT 1: FOURTH QUARTER MARKET PERFORMANCE

	2017	2018						
	Dec 31	Sep 28	Oct 5	Oct 31	Nov 30	Dec 24	Dec 27	QTR to Date
S&P 500 Price Index	2,673.61	2,913.98	2,885.57	2,711.74	2,760.17	2,351.10	2,488.83	-15%
U.S. 10-year Treasury	2.40	3.05	3.23	3.15	3.01	2.74	2.73	-10%
U.S. 2-year Treasury	1.89	2.81	2.88	2.87	2.80	2.55	2.53	-10%
Spread	*0.51*	*0.24*	*0.35*	*0.28*	*0.21*	*0.19*	*0.20*	*-17%*
10-year TIPS	0.44	0.91	1.07	1.1	1.04	0.99	1.03	13%
Implied CPI	*1.96*	*2.14*	*2.16*	*2.05*	*1.97*	*1.75*	*1.70*	*-21%*
Oil, WTI	60.46	73.16	74.26	65.31	50.78	42.68	44.69	-39%
Federal funds futures, Jun '19	1.995	2.610	2.665	2.640	2.575	2.430	2.415	-7%
Federal funds futures, Dec '19	2.065	2.810	2.925	2.845	2.700	2.440	2.405	-14%
MSCI EM Price Index (USD)	1,158.45	1,047.91	1,000.76	955.92	994.72	952.84	952.33	-9%
MSCI EAFE Price Index (USD)	2,050.79	1,973.60	1,927.14	1,815.17	1,809.56	1,703.42	1,687.56	-14%
U.S. Dollar Index (DXY)	92.12	95.13	95.62	97.13	97.27	96.55	96.48	1%

Source: Bloomberg, FactSet, J.P. Morgan Asset Management. Data as of December 27, 2018.

MI-MB_5 questions_12.28.18

0903c02a8248d136