The long bull market in US stocks powered ahead to new highs in the first nine months of 2018. Although the year started with a stumble in January, all market averages hit records in the fall with the Dow Jones Industrial Average nudging against 27,000, the S&P 500 Index breaking 2,900 and the tech-heavy NASDAQ Composite Index piercing 8,000. In the final three months of the year, however, the S+P fell almost 20% from its peak, and the NASDAQ did even worse. The declines were enough to wipe out the gains for the year, and all major indices ended down for the year. Although sharp corrections are painful
for all investors, it does help to maintain a long-term perspective: the S&P 500 Index was at 675 in March 2009. So even after the sharp decline in late 2018, the S&P, at the end of the year, was still up 270% in less than 10 years.

But what was behind the march to all-time highs and the subsequent sudden selloff? The US economy certainly remained strong all year. Economic growth, as measured by real GDP, actually accelerated in the second half of the year with growth exceeding 4% in the second quarter. (Although the 2018 fourth quarter real GDP growth rate has not yet been calculated, it is estimated to be a still solid 2.8% by the Atlanta Federal Reserve Bank.) This strong growth, in a business expansion which is one of the longest on record, provides strong support for stocks, since corporate profits tend to grow with the economy. In fact, after-tax corporate profit growth has been boosted even faster by large cuts in business taxes. Although final results for the year have not been published, corporate profits in 2018 are likely to have risen an extremely strong 20% over the previous year.

The length and strength of this long economic upswing pushed the US unemployment rate down to 3.7% in November, its lowest level in 50 years. At the same time, monthly job gains, which averaged almost 200,000 in 2018, were strong enough to pull many Americans back
into the labor market and provide higher wages which exceeded inflation. Rising real incomes for American workers help power the economy, since most of this income is spent on consumption, which accounts for almost 70% of GDP. Investment spending by businesses also rose, and this new capital equipment lays the groundwork for more growth in the future. So what was Wall Street suddenly afraid of? In two words: The Fed.

During 2018, the Federal Open Market Committee (FOMC), raised the overnight interest rate (called the Fed Funds rate) by ¼% four times. The current target range for this rate is now 2.25%-2.5%, with the actual rate hovering at 2.4%. All of these increases were telegraphed in advance by the Fed in order to keep the markets calm, and even at 2.4%, the real Fed Funds rate, (after subtracting inflation of 2%) is barely above zero. Monetary policy is indeed less stimulative now than it was during
much of the economic expansion, when the nominal Fed Funds rate was kept close to zero, with the real Fed Funds rate negative. But monetary policy is by no means tight. So what went wrong? Stock traders were unnerved by the Fed’s projections of several more interest rate increases in 2019, and by the White House’s increasingly hostile reaction to the 2018 increases in rates. Wall Street fears that the Fed will increase rates enough to push the economy into a recession, which, if true, would certainly crimp corporate profits and weaken stock prices. Yet, other than the decline in stock prices, there is no solid evidence that the economy is headed for a recession. And as Paul Samuelson famously said, “The stock market has predicted nine of the last five recessions.”

A more serious concern is that the President will try to bully the Fed into abandoning its plans to raise rates. (This would not be the first time a President has tried this.) Economic research shows, however, that central banks like our Fed do a much better job of managing economic growth and inflation when they are “independent” of domestic politics and politicians. Jerome Powell knows this, and the Fed will continue to make policy while ignoring politics. The Fed will probably raise rates in 2019 because the very strength of the US economy could push inflation above the Fed’s target rate of 2%.

The reason for the Fed’s worry is that when the economy is operating near its capacity, rapid growth in demand can lead to price inflation rather than more production. One shorthand way to gauge when the economy is at its productive capacity is by looking at the level of unemployment. When this number is very low, as it is now, it can mean that businesses will have to raise wages and benefits to coax more workers into the labor force. When this happens, these same businesses will often increase prices to maintain their profit margins. Since the Fed is publicly (and correctly) committed to promoting economic growth while maintaining low inflation of 2% a year, the Fed must tap on the monetary brakes to make sure the economy does not “overheat” and push inflation above its target. Since no one knows when inflation will pick up (it is still around 2% or a bit below depending on how inflation is measured), and since any braking action by the Fed will take months before it has a significant effect on the economy and inflation, the FOMC plans to raise rates a bit in 2019, unless the economy shows signs of real weakness.

But these planned increases in rates, as unnerving as they seem to be to jumpy Wall Street traders, cannot alone account for the extent of the late-year selloff. In particular, stock traders developed a morbid fascination with “yield curve inversion.” The yield curve plots short-term and long-term interest rates
on one graph. When short-term rates exceed long-term rates, it is usually a signal of future weakness in the economy. Yet in 2018, the yield curve went flat but never fully inverted: the two-year yield never exceeded the 10-year yield, which is a common measure of inversion. Yet traders, fearing the worst, sold stocks in advance of an inversion which never took place.

More worrisome for investors, however, were the change in control of the House of Representatives in November, and the potential for a real trade war to break out in 2019. The midterm election results mean that it is now unlikely that more pro-business laws will be enacted in 2019-2020, and that the White House will have to deal with a steady stream of subpoenas and hearings. In addition, the government shutdown will increase uncertainty and actually delay the publication of crucial economic data which the Fed needs to evaluate the economy.

Most economists agree that 1) a real trade war with the Chinese would be even worse for the economy; and 2) though the tariffs in place so far may have done minimal damage to the US economy, any escalation would be costly for us and would not actually reduce our trade deficit. Investors must hope that a deal will be made, and then this worry will recede.

One more feature of the late-year decline must be noted: it was led by many of the large
technology firms on the NASDAQ like Facebook, Apple, Amazon, Netflix, and Google, the so-called FAANG stocks, which had rocketed ahead earlier in the year. These firms are large enough to have a significant direct effect on the US stock market, and especially in the case of Apple, an indirect effect: an apparent slowdown in demand for Apple products feeds directly into a slowdown for all of Apple’s suppliers. In addition, many tech (and non-tech) companies, especially Facebook, will face increasing scrutiny and probably increasing (bipartisan) regulation as a result of their cavalier approach to the data they collect from their users.

Wall Street’s late-year woes took a major toll on international stocks. Europe also had to contend with the approaching March 2019 arrival of Brexit, when the British are committed to withdraw from the EU. There may be no agreement on departure terms when March 29, 2019 arrives, which could create a period of economic chaos in all EU countries. No one, including the British, knows how this will play out. In addition, Macron of France faced increasingly strident and violent demonstrations against
his economic policies in late 2018. Germany is contending with the departure of Chancellor Merkel, and the Italian left-right populist coalition may be unable to agree on any policies which will stimulate a weak and heavily-indebted Italian economy, while not antagonizing the EU fiscal watchdogs. A glance at the EUROSTOXX 50 chart shows the damage done in 2018. This broad blue-chip Index fell for most of the year, and ended at 3,000, which wiped out all the gains from 2017 and 2018, and left it down over 20% from its all-time high set in 2015. Italian stocks led the way down, falling 26% in the latter part of the year.

The news was not much better in Asia. The Japanese market, as measured by the NIKKEI average, had been strong in 2017. It followed the US higher in 2018, too, but then suffered a decline of 20% in the October-December 2018 period. Japan’s policymakers are still fighting deflation and economic stagnation, and in the third quarter of 2018, the Japanese economy once again contracted, as world growth showed signs of slowing. Japanese consumers also cut back spending, which further weakened the economy. Chinese stocks fell all year and lost 25% of their value in 2018. Chinese growth is clearly slowing as the effects of US tariffs begin to bite. Hong Kong and South Korea stocks also fell.

Was there anywhere to hide in 2018? India’s stock market actually had an impressive gain for 2018. India was once the sleeping giant of Asia, but now India’s economic growth rate is one of the highest in the world, exceeding even China, and Indian stocks have remained in a bull market for five years. (This breakneck growth is not costless, of course: India now has nine of the world’s ten most polluted cities.) Russian stocks also rose, even though the price of oil fell sharply late in the year. But small stock markets like India and Russia are neither liquid nor well-policed, so American investors looking to diversify abroad should approach them with an abundance of caution.

THE 2019 OUTLOOK

Overall, the US bull market should be able to recover from its late-2018 wounds. A strong economy and still-rising corporate profits should be able to offset a gradual increase in short-term interest rates and an increase in political and economic uncertainty. (Case in point: short-term interest rates rose in 2017, while the stock market had a banner year.) But long-term investors have seen yet again how quickly sentiment can change on Wall Street. This year’s short-term selloffs, which could easily pop up again in 2019, are the price long-term investors must pay for the superb returns which can be earned over the long haul.
About Dan Seiver:

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Daniel is a member of the Economics faculty at Cal Poly-San Luis Obispo, where he has taught Introductory Economics, Money and Banking, and Intermediate Macroeconomic Theory, and published his research in the Journal of Wealth Management. He was on the Finance faculty at San Diego State University from 2005-2013, where he taught International Business Finance, Investments, Personal Finance, and Managerial Economics. While at SDSU, he received the Finance teaching award in 2007, and the International Business teaching award in 2011. From 1978 to 2005, he was a Professor of Economics at Miami University (Ohio), where he taught ten different courses in economics, and had over 20 refereed publications in professional journals. He also coauthored an MIT Press book on regional economic policy, and a Probus/McGraw-Hill book on investment strategy. Daniel was a consultant to the Center for Naval Analyses, and the investment adviser to the Population Association of America for many years.

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