Daniel Wildermuth's
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Volatility Continues as Investors Focus on Oil, Interest Rates, and China

The world economy and equity markets look more fragile than they did at the beginning of the year. After US equity markets roared up around 7% in January to set new highs, the market has bounced up and down considerably since then, both setting new highs and also at one time giving back all of the year's gains.

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While no single factor explains the market's general turn, sentiment appears to be mounting that we have seen the best of this economic cycle. Big stock market corrections like September/October's, have historically been fairly reliable indicators of slower future growth. In addition, when equity markets turn, the rate of change is often more important than any specific data meaning that "better or worse" likely matters more than "good or bad".

Signs of slowing are multiplying across the U.S. and global economy. The U.S. housing market, which comprises about a sixth of the U.S. economy, continues to weaken with sales declining on an annual basis for the past eight months. The slowdown represents the longest slump in four years, and much of the decline has been driven by areas that had previously enjoyed the strongest price growth such as Denver, New York City, Seattle, Boston and the Bay Area.

Another fast-growing city, Dallas, offers clues to the problem. Even though the economy in the sprawling metro area continues to boom, home prices have grown much faster than wages. Affordability challenges were less problematic when interest rates were ultra-low, but the rise in mortgage rates by about a percentage point since 2011 is increasingly impacting housing markets.

Oil and several industrial metals are also struggling, and multiple commodities are down more than 20% from their peaks. The losses could continue as analysts expect weaker global growth to lower demand for commodities and of course various products too.

At first glance, retail sales look good, after a strong recovery in October following declines in August and September. However, when downward revisions and October gasoline prices are factored in, the sales were considerably weaker than expected. The disappointing numbers add to a list of others including industrial production, housing and other household data that suggest the economy is very late in its expansion cycle.

Internationally, Citigroup's Economic Surprise Index for developed markets has fallen to its lowest level in almost six months. The measure tracks economic reports against projections, and the gauge is now signaling data are broadly below economists' expectations. Unfortunately, a similar emerging market index has been in mostly negative territory since June, further reinforcing fears of a coming broader global slowdown. HIS Markit reported in mid-November that its Eurozone Purchasing Managers Index—a measure of activity in the manufacturing and services sectors—fell to its lowest level in almost four years. Early November data also revealed that economic output in Japan and Germany contracted in the third quarter. In China, consumer spending in October hit its slowest pace in five months and bank lending fell.

Potential trade wars, especially the escalating U.S.-China tariff fight, are also adding to investor angst. On Friday, November 30th, the Group of 20 summit kicks off in Buenos Aires, and President Trump and Chinese President Xi Jinping meet on Saturday to discuss U.S.-China trade relations (the Group of 20

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consists of 19 individual countries plus the European Union). Both sides say they want a new trade deal, but progress has been very difficult.

Problems with economic relations between the two nations long precede President Trump. Even former President Obama, not known for international confrontation, was steadily intensifying trade pressure on China.

While many reasons exist behind the trade spat, they largely simplify to China's unwillingness to "play fair", largely meaning open their markets to us and honor intellectual property rights. Previous administrations have largely ignored the problem while Trump is choosing to confront it. Under the current President Xi, Beijing has further increased its role in the economy including supporting state-owned firms with loans from government-run banks. China also continues to pressure U.S. firms to hand over their technology, and frequently simply steals it. A CEO friend of mine runs a large international infrastructure company with products protected by multiple patents. While their patents generally protect them effectively worldwide, in China, they are the fifth leading producer of their own goods.

The challenge with China is what to do. The U.S. benefits enormously from trade with them, but also misses out on countless areas of their economy while suffering from blatant technology theft. Trump's approach could yield significant benefits, but if progress stalls or ends, increased tariffs will damage the U.S. economy while also slowing global trade.

The U.S.-China fight offers a wild card for the economy and markets. Resolution to the trade dispute would brighten the outlook for the global economy, while failure to reach a compromise would add more downward pressure to equity and commodity markets.

Against a backdrop of much less positive news, Fed Chairman Powell's recent comments may offer some encouragement. He stated that rates are "just below the broad range of estimates" of the neutral rate. Very simply, Powell offered up the possibility of a pause in rate increases and possible even an end to them. Since rate increases have been a major factor in nearly all recessions, a signal that the Fed might pause or even stop increases in the near-term suggests that the U.S. may be able to avoid a hard landing.

Much other news also remains positive. While 2019 growth is unlikely to match recent history, the expansion appears unlikely to reverse. Few recession indicators are flashing warning signs, at least within the U.S. Small business and consumer confidence levels are at or near record highs, and even homebuilder confidence is robust.

Regardless, we expect markets to become more volatile as equity markets return to more fundamentally based valuations, which by our measures, have been largely ignored throughout the last year or so. Assuming this occurs, many of the equity positions that have been driven up by sentiment will likely suffer. The terrible performance of U.S. mega-cap tech stocks over the last month has provided an illustration. Looking forward, markets appear likely to remain volatile as investors discern the impact of trade wars and slackening growth on corporate profits and equity markets. Yet, the expansion should continue, even if the speed is slower, meaning equity markets could go anywhere.

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