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S&P 500 off to its best start since 1998

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The last quarter of 2018 was a big disappointment to investors. Beginning in the autumn of the year, the market dropped 18.9%, reaching a bottom on Dec. 24. While not panicking, investors were certainly shaken.

The world economy, including the U.S., appeared to be slowing. To make matters worse, the Federal Reserve, sticking to its script, raised interest rates by a quarter point, extending worries about the economy. The market drop was sharp.

But, as often happens, the market surprises. The first quarter of 2019 was the best since 1998. The S&P index was up 13.1%, the Dow up 11.2% and the Nasdaq up 16.5%. Well, how do you explain such machinations?

In the fall of 2018 it became clear that the global economy was slowing. At the same time, the Federal Reserve believed it was time to raise interest rates. A bit of a back story: after a long time of historically low interest rates, some believed it was time to raise rates; the Fed subscribed to this idea. We have often written here of policy accidents. We have been worried about policy accidents. The Fed, looking at its tea leaves (and its point chart), decided that we needed to go on a rate-raising program. And raise it they did — nine times since December 2016, including three times in 2017 and four times in 2018.

But with the economy slowing, was December really a good time for another increase? President Trump, who considers himself an excellent forecaster, told the Fed not to raise rates. The Fed, which considers itself independent of political pressure, felt cornered, and to show its independence, resolved to raise rates.

They had two good reasons, in their minds, to raise rates. It was probably a policy mistake, and the market certainly thought so, and tumbled down. This had the effect of frightening the Fed, and they immediately backtracked on their intent for future raises, but did not take away the one they had done. This allowed the Fed to have its cake and eat it, too.

The markets liked the soothing sounds of the no-rate raise through 2019, and returned to focusing on fundamentals. It should be noted that Larry Kudlow, Trump's economic advisor, recently called for a 50 basis point rate reduction. The market reacted negatively to this suggestion, as it might mean the economy was worse than believed. Kudlow walked his comments back, and the market recovered its balance.

In the meantime, the economy — both global and domestic — is slowing. Gross Domestic Product has never reached the predictions of the Trump administration and now is slowing even more. Tariff wars (easy to win, according to the president) are having a negative effect on the global economy; the U.S. cannot escape the effect. The Fed is expecting growth of only 2.1% for all of 2019. The trade fight between the U.S. and China has made imports more expensive to U.S. buyers, while hurting exports, especially for farmers.

At this point a trade deal, almost any trade deal, would be better than the status quo (in this regard we are like England and Brexit.) If we get an agreement, the market could pop up. Year to date, through this writing, the Shanghai stock index is up 27.38% while the S&P is up 14.38%, so the Chinese appear to be winning on that score. President Trump, focused on his reelection now that the Mueller report has been released, needs an agreement.

Brexit is also a dark cloud over the European and especially British economies. In the meantime, perhaps because of interest rate uncertainty, the yield curve inverted. (When this happens, short-term rates are higher than long-term rates, which shouldn't happen unless we are headed to a recession.) Market analysts looked at this inversion and decided that it was time to call for a recession. But right on cue, because the market likes to trick investors, the yield curve went negative by 2 basis points on one day, only to reverse to positive the day following. If this activity wasn't neck wrenching, you are not paying attention.

As of this writing, order seems to be restored, until the next saga. Remember the market climbs a wall of worry. Stocks, and I mean U.S. equities, are the only game in town. With U.S. treasury bonds yielding a mere 2.48%, stocks are still the most promising investment. As Warren Buffet has said, "Why would I pay 40 times earnings for an investment that never grows? And I might add, loses about 3% a year to inflation."

Corporate earnings growth is slowing. Profit growth in the first quarter of this year is expected to drop to close to 4% over the same period last year. But that is largely because profits last year were inflated by the Federal tax cut. For all of 2019, corporate earnings are declining and are expected to grow by only 4%, which is down from the 10% forecast three months ago. Still, 4% annual growth is close to historical average.

The 2018 market drop likely cleansed the markets of short-term investors and allowed long-term investors to focus on fundamentals, a positive for the markets.

Looking ahead, we are still facing a battle over increasing the debt ceiling. The earlier standoff led to a 35-day government shutdown. President Trump appears poised to have another shutdown in order to get his border wall.

While the U.S. talks about building walls, the Chinese are opening doors to other countries, the latest being their maritime initiative to invest in and build seaports around the world. A very significant event, since it affects the U.S.'s largest trading partner, Western Europe, in their recent agreement with Italy to open China's Belt and Road initiative through the historic port of Trieste, near Venice. For Italy, the deal would open the country to greater Chinese infrastructure investment. Officials say they expect Beijing-backed conglomerates, such as the China Communications Construction Co., to bid hundreds of millions of euros for infrastructure concessions.

The Chinese have already invested in the Port of Vado Ligure, 87 miles from Italy's industrial powerhouse, Turin, as well as in the ports of Haifa, Ashdod, Ambarli, Piraeus, Rotterdam, Antwerp, Bilbao and Valencia. These ports enjoy ideal geographical location, with access to all of Europe and much of Africa. These investments bring favorable customs conditions, faster trade routes and direct access to railroads for moving its goods into the European Union. Not only do these ports provide commercial advantages, but political and military leverage in many countries as well.

The Chinese appear to be positioning themselves for ever-increasing global influence.

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