HB RETIREMENT®

# FINANCIAL MARKET SNAPSHOT

## *Equity Whiplash*

April 2, 2019

***The contrast between the feel-good first quarter market sentiment and the fourth quarter doldrums has been stark.***

***Our position: It wasn't as bad as Q4 indicated and likely not as good as Q1 has shown.***

***To us, the material percentage whipsaw in equity prices we have witnessed, due to market sentiment, does not engender high confidence toward taking substantial risk in this market.***

We have seen a rare event in U.S. equity markets over the last six months. The Q4 to Q1 reversal we have witnessed in stock prices is one of the most dramatic we can recall. To put some perspective around that: The S&P 500 Index loss in Q4 2018 was the worst quarter for the market since 2011. However, that quarter was followed by the just-closed first quarter which was the best such period for stocks since 1998. In all, the S&P 500 Index lost 13.5% in Q4 and gained 13.7% in Q1. The latter was consummated by a 1.9% gain in March. The case of equity whiplash investors may be experiencing has been courtesy of the 180-degree change in perception around the potential direction of Federal Reserve policy.

Meanwhile, long-term market interest rates have tumbled as economic indications have gotten a bit more subdued, and the Fed has pirouetted on monetary policy. The 10-year Treasury yield reached a closing high of 3.24% in early November and closed this latest quarter at 2.41%. We have long maintained that interest rates were unlikely to move higher in a sustainable fashion as inflation was prone to remain in check. Indeed, the Consumer Price Index, ex Food and Energy, has downshifted to 2.1% year-over-year in February from a high of 2.3% last year. Given the easing of economic strength in the U.S. and also globally, that CPI number could see more downside pressure.

**Table 1: Global Equity Market Returns - First Quarter 2019**
Source: Bloomberg

| | Jan '19 | Feb '19 | Mar '19 | Q1 '19 |
|---|---|---|---|---|
| S&P 500 Index | 8.01% | 3.21% | 1.94% | 13.65% |
| MSCI EAFE Index | 6.61% | 2.58% | 0.72% | 10.15% |
| MSCI Emerging Markets Index | 8.76% | 0.22% | 0.83% | 9.90% |

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As a long-time capital market strategist, we can say the about-face in Federal Reserve policy and the change in market expectations around Fed thinking has been something to behold. Late in 2018, Fed policymakers were busy indicating tighter policy to come in 2019. Whether bullied by the market's late-December whitewash of stocks, or simply intent on following global economic conditions, the Fed's policy reversal, since December, has been stark. Clearly, the market in Q4 was indicating the Fed had been tightening too much and since then the Fed's policy direction has been

markedly more dovish. Moreover, the Fed has decided to end, a bit later this year, its policy of shrinking its balance sheet, which should also serve to keep market interest rates low. In aggregate, we believe the policy adjustment is in some reaction to the global economic easing we have previously pointed to in our research. Meanwhile, the equity market jubilation, evident in Q1, indicates participants are glad to have the Fed back in their corner. Market expectations for the Fed funds rate has similarly turned on a dime. Now, market implied probabilities are indicating the possibility of a Fed rate cut late this year. Previously similar probabilities in December pointed to the material chance of a rate hikes

***Table 2 highlights the shift in Fed policy probabilities according to the Fed funds futures market.***

***The "dovish" lean toward Fed policy is pinpointed in Table 2.***

***In December, market's were pricing in further interest rate hikes. As of April 2, markets are now pricing in the probability of a late-year rate cut.***

***Note: December 24 marked the S&P 500 Index market trough.***

**Table 2: Market Implied Probabilities for Fed Funds Rate Changes - By Date**
Source: Bloomberg

| Date: Dec 24, 2018 | Probability of: | | Date: Apr 2, 2019 | Probability of: | |
|---|---|---|---|---|---|
| **Fed Meeting Date** | **Hike** | **Cut** | **Fed Meeting Date** | **Hike** | **Cut** |
| 5/1/2019 | 18.0% | 5.8% | 5/1/2019 | 0.0% | 5.7% |
| 6/19/2019 | 17.5% | 7.9% | 6/19/2019 | 0.0% | 17.1% |
| 7/31/2019 | 24.6% | 7.1% | 7/31/2019 | 0.0% | 25.2% |
| 9/18/2019 | 23.8% | 9.6% | 9/18/2019 | 0.0% | 45.2% |
| 10/30/2019 | 25.5% | 9.4% | 10/30/2019 | 0.0% | 51.4% |
| 12/11/2019 | 22.0% | 19.5% | 12/11/2019 | 0.0% | 63.6% |
| 1/29/2020 | 20.5% | 23.8% | 1/29/2020 | 0.0% | 69.0% |

From a portfolio management perspective, we have been cautiously adding back equity exposure as the Fed policy shift has provided a somewhat better investment foundation. We remain highly cognizant of three primary issues, however, that point to our still-guarded money management approach. The first is the fact that weaker economic data has indeed been coming in, and it is providing us with some concern. To us, this partially offset's the Fed's work to stabilize the environment from a policy perspective. Secondly, we are anticipating a material tapering of corporate earnings growth in 2019. This could diminish the fundamental tailwind behind risky asset prices and reduce the risk premium in equity markets. And finally, the equity market rally we have seen in Q1 is putting the market in a near-term overbought condition, in our view. Thus, we would expect some Q1 returns to be "given back" upon an eventual shift in sentiment. The bottom line is our policy to help clients build wealth while endeavoring to preserve wealth elicits a constructive, but more cautious, approach to markets versus what may be visible in the typically manic financial media. We believe our reasoned strategy is well-placed in today's market; a market that we believe will be more volatile than in recent years past.

**Risks**

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

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