
Putting the sell-off in perspective

Despite the recent bad news, I am more positive today than I was earlier in the year

Dec 10, 2018 | Kristina Hooper, Chief Global Market Strategist

Last week saw major swoons in the stock market and US Treasuries. As of this writing, the sell-off has been continuing. However, I still hold out hope that we could see stocks finish higher than where they are now by year end. Yes, Virginia, there still is the possibility of a **"Santa Pause."**

Examining the causes of the sell-off

Investors seem to largely be **reacting to concerns** about the possible escalation of trade wars between the US and China. First came the realization that the Donald Trump-Xi Jinping trade talks at the G-20 meeting did not achieve the results that had initially been reported. Then, later in the week, the arrest of Huawei's chief financial officer by Canadian authorities at the behest of the US caused a significant amplification of concerns that the US-China trade relationship would deteriorate. And now, with China summoning the US and Canadian ambassadors over the Huawei arrest and threatening formidable action, I am not surprised to see risk assets are still down and Treasury prices are up.

In the background, there are also concerns about a global economic slowdown, which is causing a lot of nervousness and apprehension - and is clearly contributing to the fragility of the stock market. Last week it was reported that Bank of Japan Governor Haruhiko Kuroda was questioning the strength of the global economy, pushing Asian stocks lower. And we have been seeing signs of a modest global slowdown - but not a recession - in various places around the world. For example, third-quarter gross domestic product (GDP) for Japan fell 0.6% quarter over quarter in the final estimate, which was below consensus and well below the preliminary reading.¹ And eurozone GDP growth for the third quarter rose just 0.2% quarter over quarter, compared with an average of 0.7% quarter over quarter last year.²

I also believe the November US employment situation report has added to downward pressure on stocks and upward pressure on Treasuries. Not only did job growth fall below expectations - striking a nerve, given sensitivity to any signs of a global slowdown - but more importantly wage growth remained relatively high, which could constrain the US Federal Reserve's (Fed) ability to ease up on its plans for interest rate normalization in 2019.

Three things investors need to keep in mind

- The relationship between the US and China is likely to deteriorate, in my view - that was always my base case and should not come as a surprise. But, at least for the time being, tariff increases are on hold - and I believe that is all we could have hoped for coming out of the G-20 meeting.
- The recent increase in US wage growth is not, on its own, enough to stop the Fed from dialing down its monetary policy normalization. In other words, I believe the Fed will not tighten as much as expected next year - and we are likely to see that in the "dot plot" released after next week's Federal Open Market Committee meeting. While I expect the Fed will still hike rates next week, I believe the Fed's policy prescription for 2019 is likely to be just two rate hikes - and that should be good news for markets, in my view.

(And, depending on the data, that policy prescription may get adjusted down in future dot plots.)

- While I expect higher volatility, that doesn't mean that long-term investors should abandon risk assets. We have long warned that volatility could increase as the Fed normalized. In addition, market turbulence has been exaggerated by program trading by computer algorithms as well as the use of derivatives - but that has nothing to do with fundamentals.

In conclusion, I was a lot more worried in August and September than I am now. Back then, valuations were stretched and I was concerned that investors had become less confident in stocks since the February sell-off, suggesting they would flee the market and turn "risk off" at the first sign of trouble. I felt that markets had overpriced the positives and was overlooking the negatives, such as the potential for the trade situation to deteriorate, at its peril. Many of my concerns have now been realized and, in the process, much of the froth has been shaken out of the market.

While stocks could certainly move lower from here, this is not a time for investors with long time horizons to abandon risk assets, in my view. (In fact, I don't believe there is ever a time for that, as investors need growth potential to meet their investment goals and are notoriously bad at market timing.) Rather, I see this sell-off is an opportunity for investors to begin writing a "wish list" of investments they would like to add to their portfolios if they have cash available. One such area is technology; after all, some investors couldn't stomach buying tech at levels earlier this year because of the significant runup tech stocks experienced. Now tech is much more reasonably priced, in my view. In addition, I believe emerging markets - especially Asian emerging markets - are looking more attractive given the potential for the Fed to take its foot off the accelerator next year. And the MSCI Emerging Markets Index is actually up about 5% from its lows this fall.³

It feels like investors are walking on eggshells and have become overly sensitive to bad news. However, I do expect the next few weeks to bring some good news in the form of a kinder, gentler "dot plot" - even if we don't get a pause in trade tensions. Hence, I hold out hope that we could at least see a modest "Santa Pause" rally by year end. But whether or not we get a rally, I believe it's critical that investors with longer-term time horizons and investing goals put this market turbulence in perspective - and stay the course.

What to watch this week?

Looking ahead, we will want to watch the following:

- **Brexit vote.** Parliament was supposed to be voting on UK Prime Minister Theresa May's Brexit plan on Tuesday - and it looked like it was doomed to fail. However, as of this writing, May has announced she is calling off the vote and will attempt to negotiate a better deal with the European Union with months to go before the March 2019 Brexit date. Interestingly, a European Union (EU) court just announced its ruling that the United Kingdom can unilaterally reverse its decision to leave the EU - perhaps paving the way for a second Brexit referendum in the UK. That may be the simplest option at this point ...
- **Indian elections.** Five states in India will hold elections this week, which are being viewed as a litmus test of how successful Prime Minister Narendra Modi will be in next year's national elections. Thus far, the exit polls suggest low popularity for Modi and his party, which does not bode well for next year's elections.

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- **European Central Bank (ECB) meeting.** The ECB is expected to announce an end to its large-scale asset purchase program. I continue to hold out hope that the ECB will at least offer strong language suggesting it would re-start quantitative easing at the first signs of greater deterioration in the eurozone economy.
 - **Macron speech.** France has been rocked by weeks of protests that French President Emmanuel Macron has failed to mollify despite revoking the much-despised fuel tax. Today Macron will be delivering a speech to address the protests. Some are suggesting the only way rioting will stop is if Macron steps down, but I believe that would be an extremely negative development for France, which should ultimately benefit from his reform plans, in my view.

Source

¹Cabinet Office, as of Dec. 10, 2018

²Eurostat, as of Dec. 7, 2018

³Bloomberg, L.P., as of Dec. 10, 2018

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Investments focused in a particular sector, such as technology, are subject to greater risk, and are more greatly impacted by market volatility, than more diversified investments.

In a "no-deal" Brexit, the UK would leave the EU in March 2019 with no formal agreement outlining the terms of their relationship.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

Risk off refers to price behavior driven by changes in investor risk tolerance; investors tend toward lower-risk when they perceive risk as high.

The MSCI Emerging Markets Index is an unmanaged index considered representative of stocks of developing countries.

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