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"By The Way"

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"I hate down markets during the festive season"

Tis the season to be jolly, but it's not easy to remain merry during these volatile and nerve wracking markets. As an old friend once said to me, "I hate down markets during the festive season". The S&P 500 lost 9.1% between September 30th and US Thanksgiving, that's the third worst performance for that time period in the last 50 years. So much for seasonal strength. Nevertheless, we must play the cards we are dealt, and while there are more and more reasons to worry, (to name a few: interest rates and the FED, trade war with China, oil prices, Brexit, and slowing global growth rates) I have not as yet thrown in the towel on this bull market. We suggested last month that a retest of the lows on the S&P was to be expected, and it happened. We would have preferred to see a spike in bearish sentiment during the retest which would have suggested selling had been flushed out. That decline was followed by a rally that while strong, was not powerful enough to break through zones of resistance or convince us the worst was over. Our concern centers mainly around two factors: an insufficient participation in the rally by a majority of stocks, and a lack of buying in riskier assets, such as small cap stocks, that would have indicated a more convincing belief by investors that higher prices are to come. As an example, despite being up over 1% on December 3rd, only 41% of the S&P 500 traded at a new 20 day high. One would have hoped to see well in excess of 50%. Still, previous levels of price support continue to hold, if only barely, as do upper levels of resistance. Until this range bound market breaks out convincingly one way or the other, the jury will remain out. Having said all that, there is definitely enough uncertainty to take time to examine one's portfolio and make an effort to reduce risk and weed out weaker names. Even if this bull market has another leg higher, correlation among stocks and sectors will be much lower. The days of the market "raising all ships" are likely in the past, and as a consequence selectivity will be much more important.

For example, the policies of Central Banks to rescue world economies from the so-called "great recession" involved large injections of liquidity and interest rates near or even below zero. As a consequence, many companies (and countries as well) were able to stay afloat given the ease of funding debt. Now that credit conditions are tightening, it is worth doing one's due diligence and reduce exposure to companies with too much debt and potentially too little cash flow to service that debt in an atmosphere of higher rates and/or a less robust economy. If this is a market tracing out a market top, it is to be remembered that tops can take a long time to form, but once complete, can go south in a hurry. Don't panic but get prepared.

The FED continues to demand our attention, although trying to ascertain the future direction of monetary policy is challenging to say the least. The latest policy speak from the Fed is the concept of the "'neutral rate". There is no official definition, but my best guess is neutral is the rate that would neither help nor hurt the economy. It is a different number to different people and in addition, it is a moving target. As is the FED, on October 3rd Chairman Powell declared, "We are a long way from

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neutral at this point". Yet just last week, less than 2 months later, he said in his press conference that we are now "just below" the neutral rate. Not surprisingly both statements had an immediate and meaningful impact on markets. Without doubt most statements by board members have recently become more dovish, suggesting fewer rate increases in 2019 if not a pause to get a better sense of the direction of the U.S. economy. How are we and the market to interpret this seeming change in attitude by the FED? On the one hand a pause in the increase in rates could be leading to a soft landing for the economy and would be a positive. On the other hand, is the FED now seeing a decline in economic growth that could be leading to a recession which would be detrimental to the stock market? The recent decline in yields suggest players in the bond market believe the recession story. We have written previously about an "inverted yield curve", where short term interest rates are higher than long term rates. As we near such a condition, it has become front page news. To put things in context, while inverted rates have almost always presaged a recession, the timing is undetermined and can be as long as several years. However, we should keep in mind that the stock market will also react before the start of the actual recession.

As expected the Democratic party took control of the House of Representatives, much to President Trump's chagrin. As also expected the result had no serious impact on financial markets. That is not to say that will remain the case. The debt ceiling will once again be a matter for debate in mid-2019 and in all likelihood the Democrats will try to leverage their new position of strength to repeal some of Trump's recently passed legislation, such as the tax cuts. This has the potential to be negative for markets.

We have long held the view that while geopolitics can have a material effect on markets, at the end of the day economic and earnings growth will have the final say. Globally there is increasing room for concern on that front. The U.S. economy remains strong, but is decelerating. China is slowing from a high rate, although the government is attempting to spur new growth. Japan has experienced a few weak quarters, and there is much uncertainty in Europe given the issues like the budget in Italy and Brexit. Much like the markets, the situation has not become totally negative, but appears to be worsening.

In summary, I try desperately to keep a level head, despite the daily volatility making it more and more difficult, particularly on severely down days. As Thomas Paine wrote during the American Revolution, "These are the times that try men's souls". I could certainly use the proverbial "Santa Claus Rally".

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