

The Stock Market Corrects

In our last commentary on the market in mid-October (“Volatility Returns”), we noted the swift pullback in stock prices that had begun two weeks prior. The downward pressure on prices has continued, and we find ourselves firmly in a stock market correction, defined as the market being off 10% or more from recent highs. As we write, the US market is hovering at break-even levels for 2018. Overseas markets are almost uniformly lower for the year.

The near-term economic outlook of investors has degraded; stocks are telling us that. The trade tiff with China appears nowhere close to getting better, putting both countries under self-inflicted economic stress. The 10% tariffs on Chinese imports is set to increase to 25% after January 1, assuming no breakthroughs. In the short term, that’ll be a profit dampener to affected companies. Longer term, tariffs will get passed through to consumer prices.

Technology stocks, and high-beta stocks generally, are in a sustained selloff mode. Apple has shocked investors with order cuts to its suppliers, suggesting a slowdown in the smartphone market, and the stock has headed steadily lower. There is a new round of regulatory worries hanging over companies like Facebook and possibly Google. In addition, some of the selloff feels like year-end technical action (e.g., investors protecting what are still gains). At present, investors continue to sell technology, but we think shares will find their bottom soon.

Capital spending is a growth driver, and was expected to increase following the corporate tax cuts, but we have yet to see a sustained pickup. Within the consumer economy, despite strong jobs data, housing is in a downturn, with higher rates the main culprit, and the new limits on local and state tax deductibility hitting real estate values. Auto sales are likely plateaued, at best. The ripple effects from housing and autos are decently big, and the uneven action in those sectors represent another headwind for the economy.

Among the world’s major economies, China is slowing, due partly to trade issues, and Japan and Germany both printed negative third-quarter economic growth. US numbers are likely artificially high. In the year’s first half, there was a “buy ahead” from companies hoping to mitigate increased tariff costs. So, business inventories are elevated, and that will need to burn off in future quarters. For purposes of measuring economic growth, inventory builds (now in the past) are positive contributors, and drawdowns are negative contributors.

In sum, what began as a growth scare from higher rates and China trade has developed into a more significant market event, as price drives the narrative. As we have noted previously, this isn’t a systemic event, with markets falling apart on panicked conditions; we don’t expect that to be the case, either. But it’s clear that stocks are trying to find a footing at lower levels.

There are a few bright spots: the Fed (ironically enough), and valuation. The Fed is expected to move in December with a rate hike, but the increased betting is for some dovish language that softens the central bank’s prior hard-rate stance. Valuation overall on the S&P 500 is about 17x current earnings, and roughly 15x forward (i.e., considering 2019 earnings estimates), assuming some profit growth.

It is premature to call the end of the current economic expansion, and we continue to monitor and navigate the investment markets on your behalf.

Scott C. McCartney, CFA
Partner and Chief Investment Officer

Christopher Lai, CFA
Senior Portfolio Manager