

Q4 2019 MARKET OUTLOOK: WAITING FOR POWELL

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Not long ago, executives at Houston airport had a problem. Travelers were furious about the wait times at baggage claim. Baggage would arrive, on average, within eight minutes – well within industry norms. So why all the complaints? An onsite study provided the answer: Travelers deplaned next to the baggage claim, so their wait time was fully idle. *Is the belt broken? How long do I have to stand here? Is someone taking care of this?* The uncertainty was maddening. Travelers spent eight minutes staring at an unmoving conveyer belt as their blood simmered.

The solution wasn't more baggage handlers or equipment. The executives simply moved the gate farther from baggage claim. Now travelers spent most of the eight minutes walking instead of idly waiting. The complaints disappeared.

Uncertainty is projected outwards as anger and angry people need someone to blame. It's not the inevitable wait, but the perception of that wait that infuriates people. The Federal Reserve, no doubt, has the market's perception in mind as it looks toward the next recession. The Fed's management of market expectations will be the crucial difference between a mild pullback or a cataclysmic, self-reinforcing contraction. Like waiting for luggage, a recession may be inevitable, but uncertainty is what will make it painful.

Following the Q3 market summary below, we discuss the Fed's policy constraints and what they mean for the market in Q4 and beyond.

2019 Q3 MARKET SUMMARY

The US Economy: The Record Economic Expansion, Now Over a Decade Old, Continues

The US economy is on pace to finish the year still in a record economic expansion. Q3 economic data brought the lowest unemployment rate in 50 years, strong retail sales, and higher monthly wages. GDP growth, now estimated at 2.3% for the year (down from 2.9% in 2018), is steady but not stellar. Personal consumption, which accounts for 70% of GDP, still drives the economy.

Trade disputes with China are an economic wild card, as they have been for nearly 18 months. Recent headlines notwithstanding, expect trade disputes to simmer down and presidential election uncertainty to bubble up over the next year.

US Equity Markets: Equity markets stable in Q3 after large H1 gains. The bloom is off the IPOs.

The specter of the past hovers over the month of October due to the massive declines of 1929, 1987 and 2008. Although the first three quarters have given investors little cause for concern (the S&P is up nearly 19% YTD) investors are watching trade disputes and the Fed closely. Absent a massive Q4 decline, however, the equity market will end the year with stellar performance.

2019 has been a hard row to IPO. 2019's high profile offerings, Peleton (-21%), Uber (-34%), Lyft (-45%), and Smile Direct (-47%), have each seen huge post-IPO declines. But the failed WeWork IPO was the highest profile capital markets stumble this year.

The curious incident of the IPO in the summertime started innocently enough. With great fanfare, the We Company, formerly known as WeWork, released its IPO prospectus in mid-August. Analysts shredded the company for its material conflicts and massive losses. Less than six weeks later, the IPO was withdrawn, the CEO forced out, and We's very survival is now in doubt. The rapid valuation collapse and failure of the offering has cast a pall over the IPO market.

US Credit Markets: Steady returns continue through Q3 and default rates tick up. The yield curve inversion continues.

Credit markets held steady through Q3 after large H1 gains. Year-to-Date returns in Investment Grade (+13.2%), High Yield (+11.4%), and Leveraged Loans (+6.8%) have more

than made up 2018's declines. Defaults in the HY market ticked up to 5% at an annualized rate.

The inversion of the US 3-month/10-year yield curve has nearly reached its 20th week and points to a recession on the horizon.

Central Bank Activity: The Fed and ECB ease into 2020 with normalization nowhere in sight.

What a difference a year makes. This time last year, the Fed was committed to raising rates and the ECB was ending QE. Both policies have since been halted and reversed.

During its September meeting, the Fed's stance on future policy actions was noncommittal. As expected, rates were lowered just a little to between 1.75% and 2.00%. Investors responded with nonchalance, as the reduction was already priced in with 100% certainty by the futures market.

Global Equity Markets: Ex-US markets give back some of H1's gains due to Q3 declines.

In Q3, global equity markets had a minor stumble, with most markets down every month of the quarter. Brexit uncertainty continues. Overall, global markets are still up for the year due to a stellar H1. Even double-digit gains this year won't bring global investors back to even who have held through the declines of 2018. Only equity holders of Brazilian and Russian markets are seeing record highs due to 2019's gains.

Emerging markets (represented by the MSCI TR Emerging Market Index) declined nearly 5% in Q3 and are up just over 4.5% for the year.

The European Central Bank continues its dovish monetary policy and has restarted quantitative easing. Normalization is unlikely anytime soon.

[And now back to the Fed. Why is lowering interest rates with the equity market near its all-time highs considered normal? It goes back to the 2008 crisis, which upended the monetary policy playbook.](#)

THE MONETARY POLICY PLAYBOOK...

Fed policy actions normally run counter-cyclical to the economy. When the animal spirits of the market become too excessive, monetary policy yanks the reins in the other direction. The standard playbook says to raise interest rates to tame inflation and halt frothy economy growth. (This was famously described as "to take away the punch bowl just as the party gets going.") Interest rates are then reduced

during a slowdown to spur lending and investment. This is normally how the Fed acts.

...is not currently in effect.

But these are not normal times. Today the Fed has little room to move rates either up or down. This constraint is the legacy of the financial crisis of 2008. At the time, the risk of market collapse was judged to be existential, and the Fed took extraordinary measures in response. Interest rates were cut to zero and the Fed used its limitless balance sheet to flood the market with liquidity. Both measures, it was believed, were required to stabilize the market. The Fed's plan was to survive the crisis and then normalize¹ later.

Despite over a decade of economic growth since, the normalize later part never came. The Fed has been unable to raise rates and shrink its balance sheet. Now, approaching a turn in the credit cycle, it's too late. If the Fed even hints at raising rates, the equity markets will plummet.

THE FED'S CONSTRAINTS GOING FORWARD

Credit is easily available and cheap, and has been for some time. Given that, what role does the Fed's rate setting play? The Fed funds rate has transformed from a market clearing price of money to a symbolic communication to the market. The message sent by the most recent rate cut was: Dear Equity Market, We still have your back. XOXO, The Fed.

It works, for now, not only because the Fed's credibility is high, but mostly because the economy has cooperated. A long period of low inflation has allowed the Fed to avoid choosing between fighting inflation or increasing economic growth. With interest rates already low, managing perception may be the most powerful tool the Fed has left.

For the remainder of 2019 and through 2020, the Fed will have to navigate between the devil of the zero bound and the deep-blue-sea of low rates. Also, to complicate the job, the rudder will be randomly and frequently yanked in one direction or another by tariff concerns. The Fed has limited room to maneuver should another crisis occur.

Uncertainty causes frustration. Clear communication with established timelines and frequent updates can dispel much of that unease. What investors won't stand for is Fed hesitancy in response to market declines. If investors lose faith in the Fed, the market and economy will suffer.

ONE POSSIBLE SCENARIO: A BLACK SWAN ARRIVES AND EQUITY MARKETS DECLINE

Imagine this possible catastrophe:

It all starts with a CPI release showing inflation increasing more than expected. The market winces as further rates cuts are now off the table. At the time, not a single analyst suspects that this release is the trigger for the disaster that follows.

China, seeing weakness, pounces. Unexpectedly, the trade war escalates in a way that can't be smoothed over with mere words. China's posture shifts from compromise, to inflicting pain on the US and the US reciprocates. During an otherwise slow news period, the trade fight is in the headlines for weeks. China and the US "go to the mattresses" on tariffs and on social media.

Consumers and businesses brace for recession. The Federal Reserve slashes rates back to zero, but it's too little, too late; its credibility is gone. The rate cuts have no economic impact and the Fed is out of bullets.

Here comes recession. The yield curve predictor has proved right again. GDP goes negative. NFP is a disaster. Can it get worse?

Another round of QE is announced, it temporarily buoys the market... as the smart money rushes for the exit. Then the market plummets.

Desperation now. The Fed announces it will buy corporate debt and stocks. "Limitless balance sheet," goes the refrain. It might have worked, but following an emergency FOMC meeting, a clip of the Chairman's voice cracking with dread goes viral and causes market panic. The Chair resigns that weekend "to spend more time with family." The market decline continues.

THE AFTERMATH OF A MARKET DECLINE

Within three months of that first inflation measure, the equity market drops 40%. The statistical probability of a market recovery saving the day is now indistinguishable from zero. A 40% market decline requires the market to go up nearly 70% just to get back to even. A 50% market decline needs a 100% increase. 70 million people just saw their retirement cancelled.

The above is, of course, pure fiction but a reflection of the asymmetric risk of tying US economic fortunes to equity market performance. Further market growth might only be setting the next bear market to fall from even greater heights.

CLOSING THOUGHTS AND WHAT INVESTORS CAN DO

“Remember, July is followed by December,” said the Ant to the hungry Grasshopper – Aesop’s reminder that the merry months of summer should be used to prepare for the bleak season that always follows. The Fed, during the one of the longest economic expansions in history, has not been able to normalize interest rates. During previous recessions the Fed has cut rates, on average, by 5%, which is obviously not possible now. With rates under 2% and expected to decline, the Fed has done the financial equivalent of consuming its seed corn.

What strategies should investors be thinking about? During a market decline, long convexity strategies will, at long last, have their day. Declines and a return of volatility will bring active asset managers back into fashion. A turn in the cycle will turn off the credit spigot, so profitable companies with fortress-like balance sheets will be able to scoop up bargains. Financial products with a low correlation to the broader equity market will get more attention.

Still, investors anticipating a near-term recession might be waiting for Godot. The Fed has so far been able to steer the economy to a record expansion. We don’t know the Fed’s future actions, but we do know its constraints. Uncertainty is what will cause investors to reorder their risk assessments and bring market decline. Right now, uncertainty in policy and in credibility is what the Fed must avoid at all costs.

¹ Normalization needs a rebrand. Normal is the thing we’ve been doing for ten years straight: low rates and a swollen Fed balance sheet. Policy actions from over a decade ago are too long ago to be called “normal.” The Fed funds rate hasn’t been over 6% since 2000, nearly 20 years ago! In other words, no Millennial has worked or invested in a world with so-called normal rates.

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