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John C. Robinson
Chief Executive Officer
Tel: 404-883-2577
john@consequentcm.com

Market Volatility and Outlook

By: Cyril M. Theccanat, Chief Investment Officer

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While equity markets rebounded in the final week of 2018 following steep losses for the month of December and the fourth quarter, the results for the full year were negative across risk markets. A confluence of events ranging from the trade issues with China and tightening monetary policy to concerns about slowing economic growth and the partial government shutdown have weighed on investor sentiment and caused market volatility to spike. The resultant flight to quality has pushed U.S. Treasury 10-year yields below 3%.

Despite the -5.2% return in 2018 for the broad U.S. equity market, the annualized return for the past 2, 3 and 5-year time periods has been between 7.1% and 9.0%, and the longer-term annualized return (10 years), which includes the Great Financial Crisis, is 13.2%. Also, although credit spreads have widened during this period of market volatility, it is important to note that the 183 bp spread widening in 2018 of the high-yield sector to 526 bp is still well below the 800+ bp spread levels reached during the Eurozone crisis in 2011 and the oil price collapse/China slowdown crisis in 2016. There appears to be much angst in the financial markets that the recent declines in the risk markets are a harbinger of an impending recession. Over the past 35 years, there have been 7 equity market corrections, averaging declines of -21%, without an accompanying recession. These equity market corrections took place during continued economic expansions. While economic growth is likely to be slower this year after the growth spurt in 2018 that was fueled by the $1.5 trillion tax cut, Inflation is also declining. As a result, the Fed is likely near the end of its monetary policy tightening path. Low interest rates will provide a positive backdrop for risk markets.

As we have stated in our past commentaries, the U.S. administration's rhetoric on trade appears to be a political posturing position. A trade war is not a zero-sum game; it is, in fact, a negative-sum game whereby both sides on the trade issue lose. Therefore, it is in neither the United States nor China's best interest for the current conflict to turn into an all-out trade war. It is instructive to keep in mind how the initial conflict last year with Mexico and Canada over Nafta was resolved. The same reasoning can be applied to the current partial government shutdown. We have seen full government shutdowns in the past over strong disagreements about budgets between the White House and Congress. These past full shutdowns have not had a material impact on the U.S. economy.

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