The Weekly

Economic & Market Recap

Peapack-Gladstone Bank, Private Wealth Management

December 21, 2018

As of 12/21/2018		Wk	Wk		YTD	12 Mos
		Net	%	Div	%	%
STOCKS	Close	Change	Change	Yield	Change	Change
DJIA	22,445.37	-1655.14	-6.87	2.52	-9.20	-9.43
S&P 500	2,416.58	-183.37	-7.05	2.22	-9.62	-9.99
NASDAQ 100	6,046.56	-548.41	-8.32	1.25	-5.47	-6.58
S&P MidCap 400	1,611.35	-121.46	-7.01	1.98	-15.22	-15.42
Russell 2000	1,292.09	-118.73	-8.42	1.75	-15.85	-16.48

TREASURIES	Yield	**FOREX**	Price	Wk %Change
2-Year	2.63	Euro/Dollar	1.14	0.42
5-Year	2.64	Dollar/Yen	111.26	-1.89
10-Year	2.79	Sterling/Dollar	1.26	0.37
30-Year	3.03	Dollar/Cad	1.36	1.59

Source: Thomson Reuters & Bloomberg

What Caught Our Eye This Week

Global network providers (Verizon, AT&T, Deutsche Telekom, BT Group, etc.) will soon begin the process of transitioning their networks from 4G wireless to the next generation 5G wireless which could offer speeds of more than 50x our current network speeds. This will enable autonomous driving, virtual reality, a faster "Internet of Things" and many other applications. The world's largest supplier of the equipment that run wireless networks across the globe is a privately-owned Chinese company called Huawei. The 21-year-old company has 22% market share in 4G communications equipment. Huawei is also the second largest smart phone maker behind Samsung Electronics. The research of Huawei's 80,000 scientists has allowed the company to leapfrog western rivals technologically, and the firm has gained market share by selling its 4G equipment well below its rivals' prices. Governments and intelligence agencies globally are now raising red flags as they view Huawei's potential 5G dominance. It is widely believed that the company has close ties to the Chinese government, and at China's behest, Huawei could use "back doors" to control 5G communication networks around the world. It is feared that China could use its influence to spy with impunity and to sabotage networks at will. The U.S. has moved to ban Huawei from selling its equipment in the United States. Some U.S. allies have followed suit, and others are considering restricting the use of the company's equipment.

Economy

The most anticipated report this week was the durable goods report, which was released on Friday. Overall orders for durable goods increased by 0.8%, led by defense orders (↑31.5%) and civilian orders (↑6.7%). Core capital goods orders decreased by 0.6% and core capital goods shipments decreased by 0.1%. Core capital goods orders are one of the best leading indicators for the U.S. economy, and core capital goods shipments are used by the government to calculate business investment for GDP purposes. In other news this week, existing home sales figures for November increased by 1.9% to 5.32 million units at an annual rate. These numbers were better than expectations and existing home sales have now advanced for two consecutive months after declining for six consecutive months. On Friday, the final look at third quarter real GDP showed a small revision with GDP advancing by 3.4% instead of the previously reported 3.5%. Finally, personal income and consumption were reported and displayed moderate gains with personal income increasing by 0.2% and consumption by 0.4% during the month of November. Disposable personal income also advanced posting a gain of 0.2%.

Fixed Income/Credit Market

Next week, the U.S. Treasury (UST) is set to auction off another $113B of short-term Treasury notes. The abundance of new issue UST debt coupled with the Fed's balance sheet runoff has many wondering who will absorb the added supply. Currently, overseas demand remains strong and money managers that are benchmarked against indices with increasing U.S. Treasury weightings should keep downward pressure on yields. While the 10-year Treasury yield has decreased 26.4 basis points (bps) in the 4th quarter, U.S. rates continue to look attractive versus global yields.

Global 10-Year Yields					
Country	**Rate**	**Bps spread vs U.S.**	**Country**	**Rate**	**Bps spread vs U.S.**
U.S.	2.785		Italy	2.823	3.8
U.K.	1.314	-147.1	Spain	1.392	-139.3
France	0.689	-209.6	Switzerland	-0.286	-307.1
Germany	0.243	-254.2	Japan	0.034	-275.1

Our View/Equities

We have been cautioning clients that we would expect to see a period of heightened volatility in the financial markets as we approached the later stages of the bull market. The nine-year equity bull market has been supported by strong corporate profits, generally declining interest rates, low inflation and extremely accommodative central bank policy. Quantitative easing and zero interest rate policies in many international economies (Japan went a step further an instituted a negative interest rate policy) forced investors toward risk assets to generate more suitable levels of income. Valuations expanded to levels well-above historic averages, but were seemingly justified by low discount rates and solid underlying fundamentals.

The environment has gradually shifted during 2018 in large part due to a less accommodative Federal Reserve policy. With short-term interest rates rising and trade tensions escalating, investors have become increasingly concerned regarding the potential impact on the business cycle and the prospect for economic growth next year. The sensitivity of financial markets toward new information regarding trade negotiations or central bank policy has progressively increased. The reaction of the equity markets has been profoundly greater in the fourth quarter to news that market participants perceive as likely to amplify the trade war or increase the Fed's rate path.

There have been six days during the quarter where the S&P 500 has dropped over 2% and the index has corrected slightly over 15% from the start of the quarter. The volatility has been jarring at times especially since the domestic stock market had been so resilient. We need to remind ourselves that corrective phases are common. On average, the equity market corrects every 2.8 years with a median peak-to-trough change of 13.7%. The duration of the typical correction is slightly over four months. The market recovers its losses within 3.8 months from the trough, so the entire peak-to-peak round trip is only 7.8 months.

The economy is solid. Third quarter GDP growth was 3.4% and it appears that consumption spending in the fourth quarter remains strong. Employment continues to grow at a healthy pace and the labor market is tight with modestly higher wages. The U.S. economy will slow as the effects of fiscal stimulus from the federal tax cut fades, but it should return to trendline growth of roughly 2.25%. With reasonable growth in the economy, earnings will continue to grow, but at a more moderate rate next year. These are not the conditions that produce a full-blown bear market.

The equity market volatility in the fourth quarter implies a fundamental change in the characteristic of the equity market. Central banks are no longer going to be placing an implied "put" under equity markets. So, there will be occasions when fear will overwhelm the financial markets and we will experience volatility like we have seen in the fourth quarter. The correction we are experiencing is the equity market's attempt to establish an appropriate valuation level in a world where global economic growth is slowing without the implicit backstop of the Fed.

Although the drawdown in the fourth quarter has been excessive, it has served to reset valuations. The price-to-earnings multiple on the S&P 500 is now 14 times consensus estimates for 2019 earnings. Valuations are more reasonable today than they have been in many years to give some context. The market started the year at over 18 times forward earnings. We expect the Fed to clarify and reconcile interest rate expectations closer toward the market's current view of less than two rate hikes next year. A tempering of trade rhetoric would also go a long way toward turning market sentiment.

COMING UP NEXT WEEK		**Est.**
12/26 Case Shiller 20 YY	(Oct)	5.0%
12/27 Consumer Confidence	(Dec)	134.3
12/27 New Home Sales – Units	(Nov)	0.555M
12/28 Chicago PMI	(Dec)	63.0

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