Should the initial signs of improvement we're seeing here and in China prove out, and with the Fed remaining on the sidelines, 2019 could be very rewarding for investors.

WHIPLASH

What a difference a quarter makes. In the fourth quarter of last year, the S&P 500 suffered a bear market, falling 19.7% peak to trough—close enough for our purposes to the unofficial bear market threshold of 20%. The market made its low on Christmas Eve, promptly turned on a dime, and rocketed up 23% since then. What gives?

Late last year a number of factors weighed on the US stock market. First, growth in China was slowing. As China is the second-largest economy in the world, that meant global growth would slow, including in the US. Exacerbating these worries was President Trump's escalating trade war with China, which further threatened growth in both China and the US.

Separately, Federal Reserve Chairman Jerome Powell made some infelicitous comments about Fed monetary policy being on "autopilot." This was read as a sign that the credit-tightening measures the Fed had pursued for the past two years (e.g., raising interest rates) would continue.

The prospect of the Fed raising interest rates as global and US growth slowed naturally raised fears that the Fed would overdo it and push the US into recession. And, so, investors re-priced the stock market as if a recession loomed on the horizon.

Fortunately, in this case, Trump views the stock market like a Nielsen TV rating for his presidency. So as stocks plummeted, he dialed back his bluster on a trade war with China. At the same time, Chairman Powell corrected his comments on "autopilot" and, instead, suggested the Fed might well be done raising interest rates.

The Fed raising interest rates has been a key cause of every US recession since World War II. So, in saying "we're likely done," the Fed took a major risk off the table for investors. As quickly as they had re-priced stocks for recession in the fourth quarter, investors re-re-priced stocks for continued expansion in the first quarter.

GOLDILOCKS REDUX

Abetting investor optimism were some initial signs of improvement in China's economy, which was finally responding to months of vigorous stimulation by the Chinese government. An improving China spelled better days ahead for the global economy, including the US.

This was confirmed, first, when the ISM Manufacturing Index, one of the best leading indicators of the US economy, surprised to the upside, posting a better reading for March than anyone expected. More confirmation came when almost 200,000 new jobs were created in the US in March, also besting expectations by a healthy margin.

Perhaps even more surprising than all this good news was the absence of what would normally be the expected bad news: rising inflation. Remarkably, readings of inflation in the US remain quite tame. Indeed, inflation may even ease a bit in 2019. Which is odd.

Typically, at this late date in an economic expansion, low unemployment creates a tight labor market, which in turn causes wage inflation to overheat. Overheating wage inflation then spurs more generalized inflation. This prompts the Fed to raise interest rates to slow the economy and inflation with it. Usually, this ends up pushing the economy into recession and the stock market—in anticipation of recession—into a sharp decline, as we saw in the fourth quarter. This is the textbook pattern.

Yet here we are, nearing a record tenth year of uninterrupted US economic growth, with the unemployment rate at 3.8%, its lowest reading in 20 years, and still no worrisome inflation in sight. This is a Goldilocks economy that's *still* not too hot and not too cold.

WHAT'S DIFFERENT THIS TIME

We're not seeing inflation overheat because something's happening we haven't seen since the 1990s. After falling

for most of the past 20 years, the participation rate of prime-age workers (25-54) has been rising steadily since 2016. While the unemployment rate is very low, it considers only those workers actively looking for work. But there is a portion of the potentially employable population that *isn't* looking for work, that isn't "participating." And they're not counted in the official unemployment rate.

The current economic expansion is pulling these non-participants off the sidelines and back into the labor force. Which means that while demand for labor has been rising, so too has the *supply* of labor. As wages are just the price of labor, if supply rises along with demand, those prices don't rise as much. Hence wage inflation is restrained along with its knock-on effect of more general inflation.

As long as inflation remains tame, the Fed has no reason to raise rates to slow the economy. So, the current expansion can continue until inflation becomes a problem. And that's not on the horizon.

A WORD ON INVERSION

As we noted in a recent email to clients, there's been a lot of angst-inducing headlines lately having to do with the "inverted yield curve." Think of bond yields plotted along a timeline from shorter- to longer-term yields. Usually, this "yield curve" slopes up and to the right as longer-term bonds yield more than shorter-term bonds. But not always. Sometimes, as happened recently, the curve "inverts" and longer yields are lower than shorter yields.

The much-ballyhooed fact about such inversions is that a recession always follows. This is true. But you could also say that a recession always follows summer. The question is: When? In the fall? Next spring? Three summers from now?

This is the problem with saying inversions "predict" recession. Recessions always follow them, but sometimes with a lag of almost three years. So, the inversion of the yield curve doesn't tell us anything that we didn't already know, which is that sometime in the next few years we'll probably have a recession.

WHO'S IN THE DRIVER'S SEAT?

Two things drive stock prices: corporate earnings (profits) and the amount investors are willing to pay for them. This latter is referred to as "the P/E" or price-to-earnings multiple: how much investors are willing to pay for $1 of corporate earnings expressed as a multiple. All the movement in stock prices in both the fourth and first quarters was driven by changes in the market P/E. When investors see recession on the horizon, they pay less for corporate earnings and the P/E contracts, as it did in the fourth quarter. When they see no recession on the horizon, they pay more and the P/E expands, as it did in the first quarter.

The P/E expansion that has driven the market up 14% in the first quarter is just investors taking back the P/E contraction that drove the market down in the fourth quarter. That P/E reset is likely done. Going forward, we think earnings growth rather than changes in the market P/E will drive stock prices. And here we must express a note of caution.

The pace of earnings growth in 2019, at least for part of the year, will likely slow from what we saw in 2018 simply because the economy will grow slower this year than it did last year. If earnings are in the driver's seat, stocks' path forward will be driven by the outlook for US and global growth, which were in question late last year. Should the initial signs of improvement we're seeing here and in China prove out, and with the Fed remaining on the sidelines, 2019 could be very rewarding for investors.

That said, the risk of policy errors coming out of the White House remains. We think the market's drubbing in the fourth quarter chastened Trump, resulting in his terms for making peace with China becoming far less demanding. As Treasury Secretary Steven Mnuchin appears to be wrapping up a trade deal with China as I write, it may be that peak policy risk is behind us, for now.

Farnum Brown, Chief Strategist

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