TEXAS CAPITOL GROUP
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Tightening, Tally's and Trade

Portfolio Commentary: December 17, 2018

The three T's are the subject of what I believe to be some of the headwinds we are seeing in the market. The Federal Reserve is tightening in mid-December and based on economic growth and inflation potentially another 3-4 times in 2019. If the Fed overshoots their mandate to slow down inflation this could put the brakes on growth or if they undershoot by not raising rates enough to curb inflation that could be another cause for concern for the markets. In Medieval days a tally stick was used to record debt. A reckoning of tally's may be forthcoming with corporate, government and consumer debt rising from 40% of GDP in 2011 to 46% as of June 30, 2018.[1] Higher rates could be a drag on corporate earnings, consumer spending and GDP going forward. In 1971 we had another Republican president (Richard Nixon) trying to talk the Federal Reserve into a loose monetary policy and they did not get in front of the inflation curve. There was 10 years of inflation that followed averaging 8.6% annually and GDP grew at 10.7% annually.[2] The tension in trade talks with China and Europe are adding another drag on the economy and could easily escalate to a level higher than what we are seeing today. The combination of these factors along with a modest headwind in corporate earnings growth slowdown expected to be 5-6% in 2019 compared to 20% in 2018 all add to the market volatility we have seen over the last three months. Modest returns of 8-10% including dividends on US equities are expected in 2019 with a lot more volatility.

There are some areas of worth attention during these times of volatility. Value stocks have underperformed growth stocks since 2010 significantly. Quality dividends, strong balance sheets and earnings growth tend to hold up historically in times of economic uncertainty. Companies that will continue to grow earnings in fast growth areas like cloud software and security software will still be in demand during an economic slowdown. I believe we will have plenty of opportunities to bottom fish these areas over the next few months. Cash still looks more attractive than bonds right now. We have had volatility in the fixed income markets and I expect more to come as money tightens.

The economic outlook for Europe, Asia and emerging markets are all effected by the same factors as is the US except to a greater degree. Brexit is still an unknown factor and the uncertainty does not add calm to the UK markets at this time. Over the next couple of months Tightening and Trade should become clearer, but in my opinion the deleveraging of debt will take some time. Stocks have still outperformed every other asset class (cash, bonds, stocks) over time.

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you may incur a profit or loss. No investment strategy can guarantee success. It is not possible to invest directly in an index. The S&P 500 is an unmanaged Index of 500 widely held stocks. The Russell 2000 index is an unmanaged index of small cap securities which generally involve greater risks. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. Statistics cited by Focus Economics, energy prices cited by Y Charts, PPI cited by the Bureau of Labor Statistics.

[1]Source: Bloomberg.

[2]Source: Brian S. Wesbury, Chief Economist First Trust