As Good as it Gets?

After the sharp correction through October much is being written about the impending end of the long bull market since the depths of the GFC in early 2009. The market rally since Trump won the presidency and enacted a large tax cutting and deregulation program has been impressive and left many commentators bewildered with repeated calls the past 2-3 years that almost all assets are overvalued. The Federal Reserve has now hiked interest rates 8 times from zero to a 2.00-2.25% range with a few more hikes expected over the next 12-18 months as they seek to "normalise" short term interest rates somewhere in the 3.00-3.50% range. In the last newsletter I included the following quote from famed US investor Peter Lynch who once said:

> "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves"

Selling equities every time the weather looks cloudy rather than sunny is a sure-fire way to under-perform longer term. To borrow from George Bush, it is important to stay the course. However, it is always worthwhile to reassess the economic and market outlook keeping in mind both the good things and bad things that could eventuate. There has been plenty written about the bad things – high global debt, trade wars, Brexit, Italy, a Fed that might over-react, you name it…so let's consider what is still good out there and might remain good for some time yet.

The US economy is clearing doing very well with numerous indicators showing it to still be in rude health. US GDP is growing strongly, driven by consumer spending, at 3.0-3.5% about the average pace since WW2 while unemployment is at multi-generational lows of 3.7% (a 49-year low). Initial and continued jobless claims are still trending sideways to lower and heavy truck sales are trending higher and are at levels only seen three other times since 1970. These indicators (initial claims, continued claims, truck sales) have historically deteriorated before a bear market in US equities sets in and the US economy subsequently enters recession. Financial markets do usually deteriorate before the real economy as the markets discount the future. However, right now the economic indicators still look strong and the recent market weakness is more likely to be a short-term correction than the start of a larger decline in equity markets at this stage. That's not to say that everything is rosy out there. The Philadelphia Fed's Leading Index is slowly retreating which is a possible sign the US economic expansion is getting long in the tooth despite the current strong numbers.

The equity market environment is changing to more of a stock picking environment than a trend following one. Leadership in the equity market is changing as investors fret about the length of the bull market and what lies ahead. The high-flying tech leaders are falling with some sliding into their own bear markets from 2018 highs (**Amazon** -22%, **Apple** -20%, **Facebook** -34%, **Netflix** -32%). At the same time, more defensive areas of the market such as consumer staples are performing better as many anticipate a slowing US economy in 2019 (not evident yet) leading to an accompanying slide in equity markets. **Procter & Gamble** is up 27% to multi-year highs around US$93, similarly **Mondelez** and **Pepsi** have surged in recent weeks – all these stocks offer solid and growing dividends.

The outlook for 2019 appears more challenging than the past few years as the slow drip of the US Fed normalising interest rates continues to pressure investors to reassess where is best to invest. Forgetting all the noise of Brexit, China, and trade wars the major risk is that the Fed continues on a predetermined course with higher interest rates becoming a threat to asset price levels in 2019-2020. There are still good investment opportunities in equity markets', but it is not time to be a lazy trend follower. It is time to make sure each individual asset you own makes sense in a higher interest rate world – strong cash flows, low balance sheet debt and profitable operations. That is why defensive stocks like **Procter & Gamble** have come to life recently.

The companies mentioned above are named to further the discussion. This should not be construed to be personalised advice nor a recommendation to invest in these companies. Please contact Kinnell & Co. regarding how best to take advantage of the trends discussed above.

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