MID-QUARTER UPDATE – FEBRUARY 2019

2018 was a difficult year for all major asset classes with the exception of Treasuries, which posted modest returns for the year. The fourth quarter was particularly challenging, especially for domestic stocks, which had held up far better than foreign equities through the first three quarters of the year. Last year the "Santa Claus rally" never came, and it was the worst December since the Great Depression for US stocks. The S&P 500 declined over 16% from the beginning of December to the low on Christmas Eve, but then put in a complete reversal and rallied to within just a couple percentage points of that early December level as of this writing. Why did the markets have such a wild December, and why have they rebounded so quickly in 2019? Perhaps more importantly, where do we go from here?

In the long run the markets are focused on economic growth and corporate earnings, and this is manifested in the short run right now by two major factors – Federal Reserve monetary policy and the trade deal with China. What happened with the stock market in December was a very abrupt pricing of an escalating trade war with China and weaker economic numbers in Europe, accompanied by a Fed that was steadfastly maintaining a tightening monetary policy. On December 19 the Fed raised rates by 25 basis points, as expected, and insinuated that more rate hikes were coming in 2019 and that the balance sheet reduction, Quantitative Tightening (QT), was on "auto-pilot". Basically all the negative boxes were checked: bad news on trade, bad news with Europe and a Fed that was going to keep raising rates anyway – the markets decided it was "time to sell".

What happened after that was an immediate about-face from the Fed with statements on January 4, 2019 by Chairman Powell saying that the Fed "could be patient", a sentiment he reiterated the following week and then again in late January, implying there would be no rate hikes in 2019 and that the balance sheet reduction may be slowed or even stop this year. The market went from pricing in two to three rate hikes in 2019 and steady QT to zero rate hikes in 2019 and an end to QT in 2019, and the result was one of the best Januarys on record.

The Fed is supposed to be impartial and market agnostic, unbending to the daily temper tantrums of the markets, but this Fed's complete reversal shows that they were scared by the markets and will cater to the whims of stock prices. This implies that the Fed will be supportive of markets during periods of market duress and thus the old *"Fed put*"* from the days of Greenspan, Bernanke, and Yellen is alive and well. There seems to be progress out of Washington with a trade deal with China that could be coming as soon as the late March/early April time frame, with President Trump seeming willing to extend the "cease fire" until the two leaders meet during that time frame. So now all the positive boxes have been checked: good news on trade (potentially) and great news on the Fed – the markets decided it was "time to buy".

The best cases scenario for the rest of 2019 would be no rate hikes, a trade deal, and no recession in Europe, which is the region closest to turning negative growth. With underlying GDP growth in the 1.5% range, any misstep for Europe means that they are only a couple of bad quarters away from recession and then the focus would be on contagion to other major economies. This best case scenario may be difficult to achieve, because then the Fed could very easily shift policy again should economic numbers remain robust. At that point markets would again have to factor in rate hikes and tighter

**The Fed Put remark is a term that references put options which are purchased to put a floor value for what a trader can sell a position at. The term implies that the Fed is putting a floor under the market.*

monetary policy later this year, which would in turn pressure stock prices, likely leading to another bout of high volatility.

The worse case scenario would be that no trade deal materializes, a recession begins in Europe, and investors begin to worry about recession spreading here in the United States. In this scenario the Fed would probably consider a looser policy of cutting rates and ending QT completely, but even so, the markets could set new lows and have periods of extreme volatility.

The likely scenario - *Where do we go from here?* Economically speaking, not much has changed from last year to now, and the backdrop of consistent growth and reasonable earnings is still intact, at least domestically. As the markets balance the trade offs between economic data, Fed policy, and trade, we can envision a year with periods of calm punctuated with bouts of significant volatility. Our best guess is that stocks trade in a very wide range for some time to come, perhaps accompanied by new highs and potentially including new lows. But with a wide 20% trading range for stocks, a wishy washy Fed, and slow but steady economics, an uncertain future with a bouncy ride seems a reasonable forecast for some time to come. That being said we strive to build portfolios designed to weather the storm and believe that volatility brings opportunity.

Operational Notes

- An important note regarding checks: Please include your account number in the memo section on any checks that are sent to us for deposit. If you do not know your account number, please feel free to call the office for this information. As always, checks should be made payable directly to the custodian (Fidelity, TD Ameritrade or Charles Schwab) and never made payable to Grimes & Company. Unfortunately, we will be required to return any checks that are not filled out properly.

- Note that IRA and defined contribution limits increased slightly for 2019. The IRA contribution limit is now $6,000, and the "catch up" contribution for those age 50 and over remains unchanged at $1,000. The defined contribution (401k, 403b, etc) limit increased to $19,000, with the "catch up" contribution for those age 50 and over unchanged at $6,000.

All the best,

Kevin T. Grimes, CFA, CFP®
President/Chief Investment Officer

110 Turnpike Road, Suite 100 • Westborough MA 01581
Tel. (508) 366-3883 • Fax (508) 366-0999 • E-mail: advisors@grimesco.com

Sources include eSignal.com, Bureau of Economic Analysis, Bureau of Labor Statistics and FactSet
Not a substitute for tax or legal advice.