FEBRUARY 2019 MARKET OUTLOOK: SHUTDOWN IMPACT IS JUST ONE OF SEVERAL ECONOMIC CHALLENGES

February 1, 2019 | Mark Simenstad, CFA, Chief Investment Strategist

The 35-day government shutdown created a great deal of economic angst for the short-term, but there are a handful of other key economic issues that could have a far greater impact on the long-term picture and the direction of the markets.

We believe the shutdown will have only a minimal impact on the economy – probably shaving less than 0.5% from the annualized first quarter GDP growth rate. However, if the shutdown resumes in mid-February, that estimate would likely rise.

There are some other issues on the horizon, however, that we believe could have a much greater impact on the economy over the long term.

Trade policy. Trade issues have created economic friction around the world, particularly involving U.S.-China trade relations and the ongoing Brexit saga in Europe.

Change in the House of Representatives. It is hard to predict what agenda lies ahead with the new Democratic majority in the U.S. House of Representatives. But, it appears likely that the contentious relationship between the House, the Senate and the president will make legislative effectiveness more difficult.

Federal Reserve (Fed) policy. The Fed board has indicated that interest rates have reached a level high enough to enable them to significantly decelerate their rate hike policy. After nine incremental rate hikes since December 2015 to raise the rate from about 0.0% to a range of 2.25 -2.50%, the Fed has indicated that it may have only two rate hikes in 2019 (depending on economic conditions). Our view is that Fed policy has been appropriately prudent to this point in the economic cycle. We believe the Fed is likely to pursue a very measured approach in its policy action going forward. It will keep a close eye on the potential for softening economic momentum and financial market turbulence.

Earnings season. Corporate earnings have been strong in recent quarters, but that has been due, in part, to new tax cuts in 2018. Without the benefit of any further cuts this year, corporations may find it difficult to maintain their revenue and earnings growth momentum. Although we expect the new round of earnings reports to be solid, certain industries may be more challenged by trade-related issues. The government shutdown should have little effect on this round of earnings – which are basically through year-end 2018. But repercussions from the shutdown would likely be reflected in the next round of earnings for the first quarter of 2019. We believe that corporate revenue will continue to grow and that earnings will remain healthy by historical standards if operating margins prove resilient.

Uncertainty. There is uncertainty in the market on how companies have been coping with recent economic concerns and repercussions from the shutdown. Have they pulled back on capital spending? Have they slowed production and reduced inventory? If companies are beginning to trim costs, that could affect economic growth. On the bright side, employment growth has continued unabated. In fact, jobless claims in January dropped to the lowest level since 1969, according to the U.S. Department of Labor. The economy has added jobs for 99 consecutive months.

Growing debt levels. The growing level of debt and other liabilities by governments, corporations and individuals, including pension and health benefit obligations, are beginning to weigh on longer term investor perceptions. Our view is that high debt levels are indeed an issue of concern, particularly if interest rates were to rise further. Partially offsetting this concern is the fact that consumer debt has not increased to excessive levels since the last recession, and thus should not be a contributing catalyst for potential problems.

How to React

Although the markets face a number of potential challenges, the economy continues to show strength in many areas. That includes a booming job market, solid GDP growth, manufacturing expansion, relatively low interest rates, and more moderate equity valuations. Although the stock market experienced one of its worst quarters in years in the fourth quarter of 2018, it stabilized in January and posted a positive return for the month.

In short, this is not a time to consider making sweeping changes to your investment portfolio. For long-term investors, it's important that their overall portfolios remain properly balanced and diversified across asset classes. Changes in your current portfolio make-up should be made only after you have assessed your risk temperament, your investment time frame, and your long-term objectives.

See January 2019 Market Recap: Stock Market Rebounds Even Amidst Historic Shutdown

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All information and representations herein are as of February 1, 2019, unless otherwise noted.

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