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"Krampus Comes to Town"

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While holiday songs suggest that there's a naughty and nice list imploring us to be good for goodness sake, we mostly take for granted a Christmas visit from Santa Claus. Stock traders too are hopeful this time of year for the gift of early December performance to help boost their annual returns. They hope that good earnings, a strong economy, low interest rates, and modest inflation will be rewarded. Recent history suggests that this optimism is warranted, for in most years, just over 70 % of the time, they have been rewarded. Only 30% of the time do their profits from stocks turn into a lump of coal. All in all, we have been spoiled with our expectations of being rewarded this time of year.

Holiday folklore, however, suggests a more balanced outlook. The pagan societies which invented most of the traditions incorporated into our modern Christmas were more mindful of both good and evil. The tradition of St. Nicholas, aka Santa Claus, began in Germany around the eleventh century to represent the good, the charitable, and the giving, rewarding children for good behavior. Often forgotten are the figures associated with evil such as Krampus who, according to folklore, punished children who misbehaved.

Krampus is celebrated in Eastern Europe on December 5 in what has become known as *Krampusnacht* (Krampus Night) when men dressed in horned goat costumes run through the streets scaring children as a vivid reminder of good and evil, naughty and nice. It's perhaps no accident that *Krampusnacht* is making a comeback of late. It would seem that Krampus paid a visit to investors this year, scaring those who mostly reside on Wall and Broad Streets.

The year began with a great deal of optimism. There was hope of a synchronized global recovery encouraged by tax cuts, deregulation, and a business-friendly political environment. Central banks continued to be supportive of investors, underwriting prosperity through accommodative policies. The United States proved to be the engine of the global economy pulling the rest of the world's economies out of stagnation. As a result, the dollar was stronger; equity, energy and commodity prices rose, with interest rates modestly higher.

The narrative was challenged in February as speculative bets on low volatility set off a largely technical rout in global equities from which the European and Asian markets have yet to recover. Suddenly rising interest rates, the threat of a global trade war and the reduction of the Fed's balance sheet became significant headwinds. A divergence in growth between U.S. and non-U.S. economies began to emerge. Fiscal stimulus pushed the U.S. economy beyond its potential. There were concerns that the Fed was behind the curve. Meanwhile, investors feared that strong labor markets would likely lead to inflation. The markets began to discount higher rates in the U.S., an inversion of the yield curve and a stronger dollar.

The rising dollar became a threat to debtors and creditors alike. Credit spreads began to anticipate a deterioration in credit quality given the rapid build-up in debt that had been occurring since the financial crisis. Companies used the tax breaks to accelerate stock buybacks, mergers and acquisitions activity, and dividend payouts rather than pay down debt. The anticipated capital spending and investment boom did not materialize. Furthermore, an unanticipated trade war was developing between the U.S. and the rest of its trading partners. Uncertainty regarding tariffs, subsidies, and access to markets began to disrupt supply chains and postpone investment plans leading to a reassessment of global growth forecasts.

By the late summer, it became apparent that the game had changed. Fears of overheating, shortages and inflation were replaced by concerns for liquidity, valuation, and abundance. The deflation genie was once again out of the bottle. While the global economy grew moderately over the last decade very few imbalances were created. The notable exception being the rapid growth rate of non-financial corporate debt. Corporations across the globe took the opportunity to leverage their balance sheets. In the U.S. alone, the growth in corporate debt rated BBB grew to 50% of the investment grade sector from 12% prior to 2010. The growth of debt outside the U.S. is also a concern. The global debt burden is roughly twice as great relative to GDP than it was prior to the financial crisis. The rapid growth of debt in China and specifically in Chinese companies is a concern given the recent slowdown in Chinese growth. There is a significant quantity of debt denominated in U.S. dollars and subject to changes in U.S. interest rates.

By autumn it became clear that the central banks were not going to alter their course despite changes in underlying growth and inflation assessments. They would monitor trade developments but not react to the perceived risks. As a result, investors were forced to significantly downgrade their optimism and adopt a more balanced approach. Stock prices fell modestly while energy and commodity prices fell. Interest rates, currencies, and gold were stable.

Winter proved to be one of discontent. The mid-term elections in the U.S. foretell of gridlock. The new Congress is more likely to investigate than legislate. The trade talks with China appear stalled at best and hostile at worst. With the Fed perceived as more hawkish, markets responded quickly as credit spreads, equities, and commodity prices collapsed. Furthermore, there was evidence of panic as interest rates and the dollar fell and gold rallied.

Nevertheless, despite the more pessimistic tone of year's end, there is reason for hope. The threat of recession in the next year is still moderate with growth likely slowing, but only to trend. Employment will likely be strong, inflation will continue to be moderate, and wages should grow, albeit slowly. The Fed will probably pause or become more dovish as 2019 unfolds. China and the U.S. are more motivated given economic and market performance to reach a trade deal.

As some of the concerns for the economy, the Fed, and trade are resolved positively, the outlook for the markets should improve. We came into 2018 with high expectations and optimism. We begin 2019 with much lower expectations and pessimism. Consequently, the first half of 2019 is likely to surprise on the upside. Consumers will benefit from lower oil prices, interest rates, and tax refunds. Businesses will continue to benefit from tax cuts, lower interest rates, and some productivity gains. The back half of 2019 still warrants some caution. The economic cycle is long in the tooth, and growing horns to more resemble Krampus than St. Nick. The probability of recession, while still low, is increasing, exacerbated by a global economy saddled with excessive debt.

Will we be naughty or nice? Will we be prosperous or not? And, will 2019 bring a visit from Krampus or St. Nick? Only time will tell.

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