Donaldson CAPITAL MANAGEMENT

This Week in the Market
3-4-19

Consolidation Underway

After slowly losing momentum over the last week and a half, the consolidation we have been anticipating has begun. The market posted a roughly 19% gain from its Christmas Eve low and moved higher for 9 of the last 10 weeks before ultimately running into heavy resistance near October, November, and December highs. Still, selling pressure has been far from intense and an impressive intraday rally ensued today to recover from an enormous miss on the jobs report. While further consolidation is possible, it feels more like the market now has an excuse to pause after a weak cluster of data rather than a significant change in sentiment. With the Fed clearly on hold and optimism for a trade deal likely at its max until we get something concrete, it's not surprising the market is catching its breath. This is especially true considering that positioning had become decidedly bullish over the last several weeks. Investors look to be using the weak economic data as cover to take profits in the interim. Technically, the 2600 to 2650 area should offer significant downside support for the S&P and over the long-term conditions are looking more favorable as a number of leading indicators reaccelerate.

The stumble in markets this week was brought on by the combination of significant weakening in Europe, lack of clarity on trade negotiations, and a US jobs report that dramatically missed expectations. In Europe, the ECB lowered its year-end projections for economic growth and inflation. To provide a remedy, the central bank slowed its projected path for rate hikes and announced discount lending program for banks. In London, parliament has a few weeks to get its act together to avoid a hard Brexit. Still, the probability of leaving without a deal remains low as British lawmakers don't want to be responsible for pushing the country off the ledge. It's also important to note that a lot has been done in anticipation of Brexit and its exit is certainly priced in to a degree. While the slowing pace on the continent is concerning on one hand, its acknowledgment and the resulting stimulus could ultimately be positive steps.

Trade details were scant this week, but one thing was very clear. China is hurting. Exports dropped 20% YoY in the month of February. They need a deal and President Trump needs a deal, particularly with the Korean negotiations falling through. Optimism seems to have peaked and likely won't carry the market any further without something in writing. A signed deal is the catalyst the market is waiting for in this regard.

On the home front, payrolls came in at 20K vs. 180K expected in February. It's clear that the shutdown and volatility in the early part of the year continue to weigh on the data. Markets largely acknowledged the muddiness with today's intraday rally. Below the headlines, unemployment fell back down to 3.8% and underemployment fell all the way to 7.3%. The slack in the labor market is gone and wages are beginning to accelerate. Average hourly earnings came in at 3.4% and while we are moving closer to the 4% level that has historically signaled trouble, Strategas had an important addendum. Recessions typically occur when the Fed is tightening into rising wages. With the Fed signaling a pause and expectations for a cut building towards the back half of the year, the pressure is not as intense. Additionally, a few leading indicators are starting to signal a rebound from the recent weakness. Housing permits and starts are recovering as the dip in long interest rates provides a second wind. Non-manufacturing PMIs jumped in February and consumer sentiment has begun to improve. The likelihood of a recession remains low. In fact, productivity is improving in the background as CapEx remains generally robust. This is certainly an area that could spark a reacceleration towards the back half of the year.

In the equity market, risk-off has taken over for the moment, but trends have not meaningfully deteriorated in the more cyclical sectors. Having some candidates on the bench feels appropriate here. This is particularly true given that strong January and February returns have typically meant outsized full year returns for the market. The S&P 500 has been up by an average 12.1% in years with a positive January and February and only 2 of these 28 years have seen negative returns.

S&P rolling over at resistance. Support between 2600 and 2650.