What changed in Oct 2018 and what is the short term outlook for 2019.

In order to understand what will drive markets in 2019, we need to understand what changed in October 2018 that caused the market to decline.

The Fed miscommunicated policy. In early October, Fed Chairman Powell signalled to the market that Fed policy would be tight, saying that rates were far from neutral. This was change in the consistent message that the Fed had been sending the market for over a year. The original message was that the Fed would be dovish to neutral and tightening gradually. The Fed had been sending a dovish signal to the market while resolutely raising rates. This was the narrative that provided the market confidence that the economy was healthy and could tolerate rate hikes and comfort that the Fed would maintain a very gradual path of rate hikes to keep financial conditions accommodative. The reaction to Powell’s hawkish October comments was declining markets and widening credit spreads. At the same time, the President was increasingly critical of Fed policy and calling for an end to rate hikes. The Fed’s second error which compounded the first, was to backtrack on its hawkish statement by saying that rates were just below neutral, signalling a dovish stance going forward. While the first signal took away the dovish tone of the Fed, the second signal took away the confidence in the economy. It made the Fed look reactive, weak, and open to influence from the White House. This exacerbated the weak sentiment in the market.

In December, Secretary of Treasury Mnuchin did something odd. The market was not looking at the solvency or liquidity of the banking system, yet Mnuchin conferred with the CEOs of the nations largest banks seeking reassurance of their liquidity.

Mnuchin then Tweeted that his discussions reassured him of ample system liquidity and solvency. This was a mistake in communications. Where markets are concerned and when confidence is fragile, nothing confirms suspicions more than denials.

Trade war: It is difficult to ascribe blame for the market volatility on the trade war because there hasn’t been a major change in the substance or signalling around trade negotiations in the period in question. At the G20 summit in late November, Presidents Trump and Xi met, and agreed a ceasefire in the trade war, and an effort find agreement by the end of March 2019. Since that meeting, China has offered a number of concessions to the US which should de-escalate if not defuse the trade tensions. Given that no material deterioration or improvement in the situation has taken place since then, it is hard to pin the blame for weak markets on the trade war.

Economic growth. It is also hard to blame the market volatility on economic growth. Growth had been slowing in Europe and China all year. And their markets have been weak. US growth, however, has remained buoyant, and the latest weakness in global markets has been led by the US. Were growth concerns responsible for market weakness, the last quarter should have seen the US outperform China and Europe. It has not.

Therefore, it appears that the weakness in the last quarter of 2018 in global markets was driven by US markets, due to a change in sentiment and not fundamentals, triggered by a miscommunication of policy, and exacerbated by the relative richness of US assets compared with the rest of the world.

The longer term implications for markets in 2019 involve other factors, such as economic growth, earnings, policy and politics. However, the short term implications are that assets have become over sold on technical and sentiment driven factors and are likely to rebound.