Bull markets don’t die of old age; they are killed by bad policy decisions. At the close of trading Christmas Eve, the S&P 500 was down 19.8% from its September closing high, just shy of the 20% marker that typically defines a bear market. Will this bull survive?

The matadors in Washington are – probably unintentionally – using every dagger in their arsenal to stab this aging bull. At the White House, President Trump’s tirades against Fed Chairman Jerome Powell undermine investor confidence; Treasury Secretary Steve Mnuchin’s weekend phone calls seeking reassurance from bank CEOs raised more questions than they answered; the accelerating exit of Cabinet advisors – Defense Secretary James Mattis and Chief of Staff John Kelly being the latest high-profile departures – leaves Mr. Trump seeming more isolated; and the President’s flip-flop on a border wall has shut down parts of the federal government.

The Federal Reserve and Congress have been using a few daggers of their own. At the Fed, Mr. Powell’s formal statement and press conference last week were deeply disappointing to investors seeking a more dovish tone. The rate hike itself was widely anticipated, but the “dot plot” of expected future hikes was more hawkish than current economic conditions merit. In Congress, incoming Speaker Nancy Pelosi and Senate Minority Leader Chuck Schumer sparred publicly with the President on live television, an embarrassing spat that gave viewers a dispiriting preview of the next two years. And no one knows how the Mueller investigation may upend the calculus when its findings are made public.

The stock market's price has plunged (green line) but earnings estimates (red line) remain strong. The P/E ratio has consequently plunged from 19 to 14 in just a few months. This chart is designed so that the price and earnings lines overlap at the historical average P/E of 16; when the green price line is below the red earnings line, the market is cheaper than average, and vice versa.

Source: FactSet
Small wonder the stock market has cratered in the past two weeks, plunging almost 10% in just the past six trading sessions. This has been the market’s worst December since 1931; it’s also the first time in a century that December was the worst calendar month of the year. Yet earnings estimates have barely budged, and the resulting compression of the market’s P/E ratio has been unusually severe (See Chart 1, previous page). Heading into year-end, investors are left to wonder, *Is the nightmare really black, or are the windows painted? ... Can my mind really take it?*¹ Just what is the market telling us?

The U.S. economy is still robust, and talk of a recession seems premature. The data mostly tell an upbeat story: Holiday retail sales were up over 5% this year, one of the strongest Christmas seasons in recent years. Despite exceptionally low unemployment, wages are rising only 3%. Durable goods orders and business investment are healthy. The Institute of Supply Management indexes of economic activity are solidly positive: On a scale in which a reading above 50 indicates expansion, the latest readings were 62.1 for the manufacturing sector and 60.7 for services. Likewise, the index of leading indicators remains supportive, as shown in Chart 2.

Yet there are some important weak spots in the economy. The energy sector is under some strain, as the supply-and-demand dynamic has been distorted by rapid U.S. output increases that have overwhelmed the country’s distribution capacity. While OPEC has cut its production targets, slowing demand overseas has kept a lid on our exports as well. As the price of the benchmark West Texas Intermediate has fallen from nearly $77 to $43 in just three months, some domestic drillers have begun to cut their production, which may ripple through the economy.

The housing market has also been stumbling through a rocky year, hampered by rising mortgage interest rates and by the punitive effects of last year’s Tax Cuts and Jobs Act. By limiting homeowners’ ability to deduct state and local property taxes, the tax law effectively raised the cost of high-end homes, dampening demand. Further, by limiting interest expense deductions on new mortgages but not on existing ones, the tax law created a huge deterrent to homeowners trading up to new houses. The effects of these factors are evident in Chart 3; new home construction has dropped about 12% from last May’s peak level (seasonally adjusted).

Taken together, the data suggest that the economy remains healthy, but with a few important yellow flags. This remains consistent with the status of the “bear market index” we shared in our commentary two weeks ago. It is the change in the political landscape, not the economy, that has given the bears their opportunity to run rampant in the intervening fortnight. This is as evident in the bond market as in the stock market; Chart 4 shows that the yield curve has flattened and slightly inverted, and Chart 5 highlights the sudden increase in credit spreads as investors have started demanding higher interest rates for “risk assets” like corporate bonds.

![Chart 4: Treasury Yield Curve](image)

The yield curve has nearly flattened in recent weeks (green line), as short-term rates have risen while long term rates have fallen slightly. The slight kink in the 2-to 5-year maturity range could be the beginnings of a more substantial inversion (negative slope), a precursor of recessions.

![Chart 5: Credit Spreads Over Treasury Yields (bps)](image)

This graph compares the interest rate for high-yield or investment-grade corporate debt in comparison to Treasury debt of comparable maturity, measured in basis points (1 bp = 0.01%). Higher spreads indicate greater concern about default risk.

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2 “Don’t Feed the Bears,” published December 12, 2018.
The apparent disconnection between generally upbeat economic prospects and sharply “risk-off” market behavior in recent weeks is startling. At earlier points in the past decade, the healthy bull eventually shook off the passing worries (taper tantrum, profits recession, spiking dollar, etc.) and kept going; today, bloodied by a steady barrage of political daggers and controversial policy decisions, it’s quite possible that the bull has met its demise. We also recognize that market behavior can cause consumers and businesses to change their behavior; in that sense, it’s possible that the market’s current swoon may actually cause a recession sooner than we might otherwise have expected.

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We are currently working through our annual strategic review of our clients’ investment portfolios. We will publish our 2019 outlook, along with a review of 2018, in mid-January. In the meantime, we continue to emphasize patience and discipline. If you have properly aligned your asset allocation objective to fit your personal circumstances, you will be in good position to withstand the current market turmoil.

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