INVESTMENT PERSPECTIVE 4Q 2018

THE USUAL SUSPECTS

Major Strasser: *"By the way, the murder of the couriers, what has been done?"*

Prefect Renault: *"Realizing the importance of the case, my men are rounding up twice the usual number of suspects.[1]"*

That classic exchange from *Casablanca* firmly establishes the morally ambiguous character of the setting. Only a culture of duplicity and cynicism could tolerate such a lame attempt at justice. The conceit is that the Vichy regime, their German overlords and, of course, Rick Blaine are all in on the farce. No one really cares about finding the murderer of the couriers. They are just going through the motions for appearances' sake. 'Rounding up the usual suspects' thus entered the lexicon to describe a purely hypocritical gesture with no real intent.

Having now listened to or read a dozen year-end commentaries, I cannot escape the impression of witnessing a sort of Wall Street round-up of usual suspects. Fed policy tightening, the U.S./China trade dispute, decelerating growth in Europe and China and rising corporate leverage have all been 'perp walked' into the courthouse. Viewed as a collective, it's not hard to imagine that these lurking concerns created enough uncertainty to cause investors to shun risk assets. The only problem with this hypothesis is the timing. Each of these issues had been well aired before the sudden swoon of 4Q. Instead, I would argue that they were a smoldering fire and, the accelerant that ignited the sell-off of December was an unfolding view of the economic cycle.

Markets reprice securities continuously based on new fundamental facts and the evolving stories that we use to frame the news. Professor Robert Shiller has described that framing as Narrative Economics.[2] It involves something more than a forecast or description of sentiment. It is the prevailing story that we use to describe our economic circumstances and these stories can create a feedback loop through our actions back into the markets. And that's what I think changed in an important way over the course of 2018. Going into 2018, the received narrative was that the world economy was experiencing a synchronized recovery that was reinforcing growth everywhere through a kind of multiplier effect.

In fact, U.S. economic performance in terms of employment, wages, business investment and retail spending remained true to the narrative. The much-feared late cycle inflationary pressure (remember last February's bond sell-off?) failed to manifest. U.S. corporate earnings accelerated until late in the fourth quarter when they moderated only slightly. However, growth in Europe and China began to decelerate in the spring, and the narrative shifted to one where U.S. existed on an island of tranquility amid a sea of troubles. The aura of invincibility around the U.S. broke decisively in October when domestic corporations began to point out the unhappy reality that we do not live on an island after all. The story quickly metamorphosed into 'the U.S. is late in an economic cycle that was artificially extended by the fiscal stimulus.' The chart on the following page from Google Trends suggests how rapidly the narrative can shift. The resulting sell-off lowered the U.S. forward earnings multiple briefly to 14x (down from the January 2018 high of 18x).

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