POSSIBLY A TRAIN, PROBABLY A LIGHT

So is it a light at the end of the tunnel or a train? Is that yield curve signaling a looming recession or tame inflation? To help recover your bearings amid gyrating and disorienting markets, see which of these narratives looks more convincing to you. I'm still pretty optimistic, but there are a couple of things that could change my mind.

IF YOU THINK MARKETS WERE RIGHT DURING THEIR PRE-CHRISTMAS SWOON, YOU ARE LIKELY FOCUSED ON:

Cycle: This late in the cycle, we are naturally seeing S&P 500 earnings weakness, with growth rates apparently falling from the high teens last year to the high single digits this year. It could get worse.

Rates: Higher borrowing costs create stress on consumers that comes through in the form of weaker U.S. housing data. Some businesses may already be feeling the pain.

Shadow Banking: Excessive issuance and lending outside the banking system may have made the whole economy more vulnerable to a potential downturn.

The Fed: Chair Jerome Powell is tone deaf to market sentiment, never got a degree in economics and may be leading the Fed straight into making a major policy error.

China: The Chinese PMI manufacturing index dipped to 49.4 in December 2018 as the government has reined in excess lending[1]. Trade friction with the U.S. has dampened consumer sentiment.

Europe: Growth has slowed, even in powerhouse Germany, hurt by falling exports and political uncertainty around Brexit and the standoff over the Italian budget. Weekend demonstrations in Paris don't help.

Emerging Markets: They all tend to suffer when the world economy slows. Commodity exporters look especially vulnerable if Chinese demand tapers off.

Oil: Last year's price collapse may stem partly from looser restrictions on Iranian exports, but such a sharp fall must also be telling us something about global demand.

Source: National Bureau of Statistics of China. As of December 31, 2018.

Washington: The U.S. government shutdown may not yet be affecting the economy directly, but it embodies the type of political gridlock and dysfunction that unsettles investors.

Markets: Investors have only started to adjust to all of this bad news, and this is only the beginning of the end. Valuations are cheaper, but not nearly cheap enough.

IT'S A STRONG CASE, ESPECIALLY ON THOSE DAYS WHEN THE MARKET DROPS. BUT LISTEN TO THIS ALTERNATIVE STORY:

Cycle: U.S. earnings are lower mostly because there are no tax cuts slated for this year, but U.S. labor markets are strong, wages are rising and consumers delivered a knockout Christmas buying season.

Rates: The yield curve may not be signaling robust long-term demand, but its shape has been distorted by unprecedented central bank purchases over the past decade. Meanwhile, inflationary forces remain very much under control.

Shadow Banking: Most lenders outside the banking system are themselves unlevered, making them more tolerant of a potential economic downturn.

The Fed: There are actually plenty of Fed economists, and there is nothing in their textbooks to suggest that policy rates are too tight at roughly 25 bps in real terms. Nor is there anything in monetary policy theory that would recommend more accommodation with unemployment at only 3.5%.

China: The world's second largest economy is, indeed, slowing from 6.6% growth last year to 6.2% this year, according to the IMF, but the government seems to be managing well. Looser monetary policy, lending targeted to healthy private firms and a temporary trade truce with the U.S. should go a long way toward alleviating investor fears.

Europe: The region's deceleration is hardly dramatic, with 2019's IMF forecast dropping just below 2% at a time when unemployment has finally reached pre-crisis lows. Moreover, Italy has proposed a reasonable budget for now, and whatever the outcome of Brexit, any damage will largely be contained to Britain.

Emerging Markets: Unless the world economy is really collapsing, markets like Brazil, Mexico and even Russia appear to deserve a closer look.

Oil: Russia and Saudi Arabia have now agreed to supply cuts, and we will likely see a bounce in prices from here as signs of continuing global demand materialize.

Politics: Get used to it. This is the new normal. Companies will need to build in higher costs globally if tariff levels start to rise; investors will need to factor higher levels of risk into their expected returns.

Markets: You don't hear any complaints about excessive valuations any more. If the U.S. growth story persists and the slowing elsewhere remains as expected, then many markets look eminently reasonable, in my view.

Of course, a responsible optimist cannot just brush aside a sharp drop in bond yields from 3.2% to 2.5% over the last two months of the year without keeping a sharp eye on the incoming data. If market turbulence begins to seriously undermine U.S. consumer confidence, if U.S. firms don't turn their tax windfalls into capital expenditure or if the Chinese government loses control of its decelerating economy, the first narrative may begin to look a lot more appealing.

Until I hear a more distinct train whistle, however, I see light.

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