Investment Perspective

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THE "EVERYTHING RALLY" COLLIDES WITH GLOBAL TRADE CONFLICTS

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As the First Quarter of 2019 ended and company earnings reports, and economic reports as well, began to cross the wires during the month of April, an existing ebullient mood in the financial markets grew stronger. Surprisingly strong earnings performance and robust economic growth had investors feeling like nothing could stop the rebound from Fourth Quarter 2018 woes. In April, stocks continued what has been called "The Everything Rally." Indeed, nearly all broad categories of domestic and international equity markets posted strong returns for the month. May, however, has been a different story. This month has been a turbulent reminder that many different crosscurrents can affect markets, equity markets in particular, no matter the underlying fundamentals. The proximate cause of the May disruption has been the escalating trade conflict between the United States and China. Rising tariffs on both sides have investors worried about the impact of higher costs on economic activity and profits. But perhaps there are other crosscurrents as well that investors should take note of.

Recapping the Year So Far

As the First Quarter of 2019 progressed, asset prices rebounded nicely from the Fourth Quarter 2018 sell-off despite negative attitudes dominating expectations for both economic activity and profit growth. By the time the "earnings season" got going in earnest in mid-April, aggregate analysts' expectations called for companies to post a profit decline of nearly 5 percent for the quarter (compared to the first quarter of last year). This was accompanied by economists' estimates calling for domestic economic growth to be below 2.5%. As it came to pass, however, both results were much better. Real GDP growth during the quarter was 3.2% (in the first estimate released at the end of April). Corporate profit growth, as represented by the S&P 500, displayed a huge positive surprise as well, with the final results showing a decline of only one-half of one percent.

While negative, the fact that actual earnings results were so much better than expected assuaged investor worries about a sharp slowdown from tax-cut boosted results in 2018. Perhaps more importantly, top line performance was strong during the quarter. S&P 500 sales grew by 5.4% in the first quarter, which was also better than expected.

With the strength of the Everything Rally, stock prices likely anticipated these good results as they rose steadily throughout the first quarter. Nevertheless, the confirmation of that anticipation surely contributed to positive market psychology about the current state of affairs and helped to drive the rally through the end of April.

The S&P 500 posted a total return of over 4% in April; most other broad segments of the U.S. domestic market did equally well. The MSCI Euro Index (member countries of the European Monetary Union) was up over 5%.

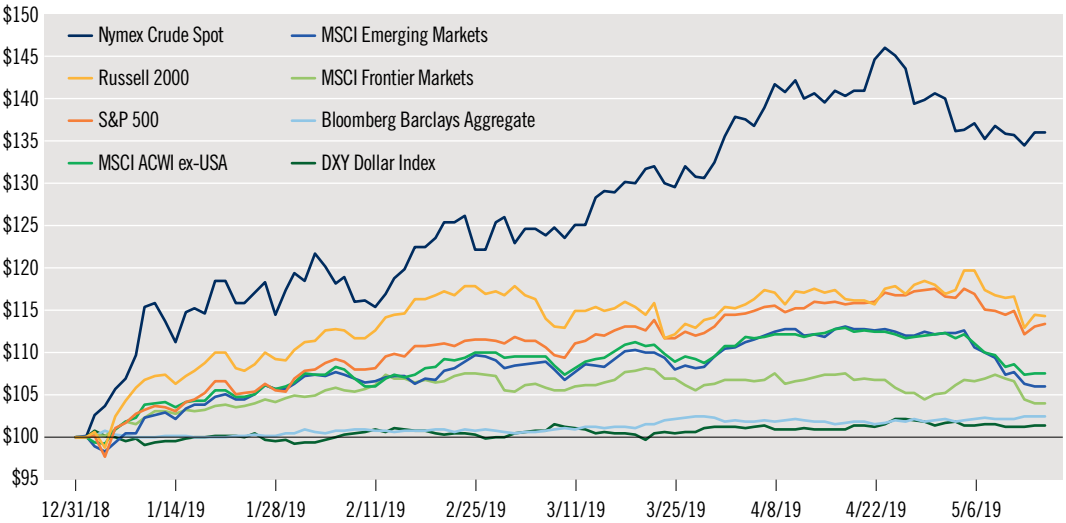
The Everything Rally

Growth Percentage

	April 2019	Dec. 31, 2018 – Apr. 30, 2019
Bloomberg Barclays Aggregate Bond Index	0.0%	3.0%
S&P 500	4.0%	18.2%
Russell 2000	3.4%	18.5%
MSCI ACWI ex-USA	2.6%	13.2%
MSCI Emerging Markets	2.1%	12.2%
MSCI Frontier Markets	0.2%	7.1%
NYMEX Crude Spot	6.3%	40.7%
DXY Dollar Index	0.0%	1.4%

Source: FactSet

$100 Cumulative Growth

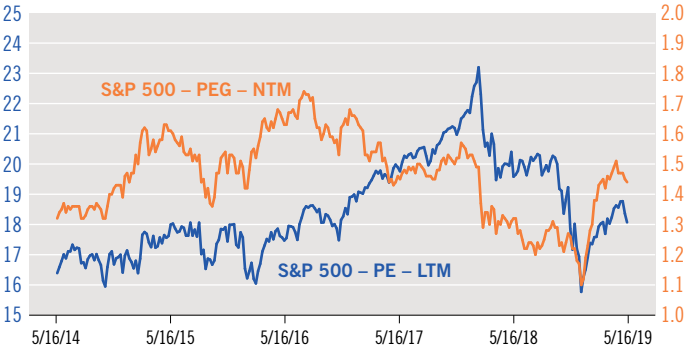


Source: FactSet

Equity Valuation Is Supportive

The turbulence experienced over the past few weeks is a microcosm of the past 18 months, in which intermediate term equity market volatility has been extremely high, with a major correction interrupting record peaks. Yet, in the aggregate, stock prices have not advanced all that much in total. Since the end of 2017, the S&P 500 is up 10.2% (price change only) while S&P 500 EPS have climbed 29.7%. This means that even after the rebound so far in 2019, the P/E ratio on the S&P 500 is quite a bit lower than it was at the beginning of 2018.[1] Other fundamental measures (book values, dividends, sales) and their related price ratios show similar, albeit less pronounced, improvement.

S&P 500 Valuation



Source: FactSet

The end result is that equity valuations do not appear to be distorted at present by the vast amounts of global central bank liquidity sloshing around in markets, nor by overheated investor optimism. While valuation levels are not what one might describe as historically attractive, they are also not a cause for concern on their own. When valuations reach extended levels, any sort of internal or external disturbance to market psychology can cause extreme reactions and can increase downside volatility.

Projecting out into the rest of 2019, expectations of fundamental growth prospects are subdued but are not (yet) negative. In fact, after a growth slowdown in 2019, which can partly be explained by the tax-cut boost to corporate bottom lines in 2018, analysts expect earnings growth to reaccelerate in 2020. And as noted above, the growth slowdown anticipated in the First Quarter of 2019 did not materialize nearly to the extent expected.

Collision With Trade Tensions

The surprising escalation of the tensions between the U.S. and China in recent weeks has led to increases in tariffs on both sides of the border. This has caused an increase in worries among equity investors as evidenced by the extreme volatility over the last few trading sessions. May is off to a rough start. As of 5/14/2019, the total return for the S&P 500 Index was -3.7%. Daily price volatility has increased markedly. In the first four months of the year, the average daily move (up or down) in the S&P 500 was 0.53%. Since 4/30, the average has been 0.80%.

Investors can be excused for worrying about these developments. The U.S. has legitimate beefs with China on a number of fronts (forced intellectual property transfer, corporate cyber espionage, and so on). Despite these legitimate concerns, tariffs raise costs. Those cost increases not only show up in consumer prices, they also show up in corporate profits. They can become a growth impediment.

At the moment, investors seem to be signaling that trade negotiations should be tough, but should also take into consideration the costs that domestic economic participants bear. On the flip side of this worry, however, is the fact that technological advancement is mitigating China's historical production cost advantages. Companies are more able today to move production to other locations, including within the U.S., and still remain competitive. Just this week, Stanley Black & Decker, Inc. announced the location of a new Craftsman Tool manufacturing facility in Texas, due to open late next year. Before being acquired from Sears by Stanley, the Craftsman line had been mostly manufactured in China.

The Road Ahead

So trade tensions are causing investors to take a pause in the midst of the Everything Rally. At issue, of course, is how long it will take for the two countries to negotiate a resolution, and how deep the damage will be from the added burden of tariffs on economic activity. In the meantime, however, surprisingly strong economic growth should eventually find its way into corporate revenues. Markets are discounting mechanisms of future growth expectations, so perhaps the report of 3.2% Real GDP growth[1] in the First Quarter of 2019 should not have been such a surprise, given the strong performance in stock prices leading up to that report. And despite a very mild decline in S&P 500 EPS in the first quarter, top line revenues grew by over 5%[2]. Unlike profits, top line numbers are less subject to manipulation, either in the form of internal actions, or external causes like tax rate reductions. S&P 500 sales growth of 5.4%[3] is a good indication that the present environment is conducive to aggregate growth and maybe expectations should not be so low.

Given moderate valuation levels, and expectations for positive and accelerating growth, and given the possibility of positive surprises to those expectations, domestic equity markets are in a bit of a sweet spot. In the (hoped for) absence of a major external event, the near-term path ahead should be supportive of equity markets.

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Sources:
[1, 2, 3] FactSet