Notes From the North: Market Outlook

November, 2018

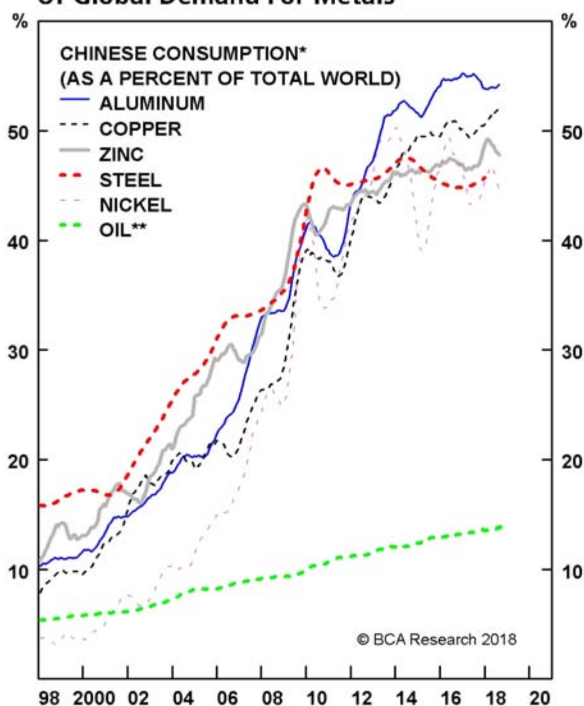
The mid-November price of the S&P 500 is little changed from its price in mid-October. However, after a long stretch of unusually orderly markets, volatility has returned and on balance investors have become more defensive. The best evidence for this statement is the fact that recently, defensive stocks (i.e. those that should be relatively insulated from a recession) have significantly out-performed more cyclical groups. For example, over the last three months the exchange-traded funds for consumer staples (XLP) and utilities (XLU) stocks are up +4.6% and +1.6% respectively. In contrast, more cyclically-exposed sectors like the home builders or the oil and gas producers lost -12.8% and -10.9%. Tech stocks have given back some of their earlier gains, shedding -5.4%, and small company stocks fell -8.5%. In the same 3 months, stocks of large-cap companies lost a more modest -2.7%. (Ticker symbols for these last are, in order, XHB, XOP, XLK, IWM, and SPY).

The change in sentiment cannot be attributed to third quarter earnings reports. These have been robust. With more than 90% of the S&P 500 companies having reported third quarter earnings, FactSet notes that 78% have exceeded earnings expectations and 61% have surpassed revenue expectations. In fact, for the S&P 500 overall, third quarter earnings are on pace to deliver earnings growth of 25%. If this trend holds as the remaining companies report, the third quarter of 2018 will mark the highest year-over-year earnings growth since the third quarter of 2010.

So, why, if earnings were so strong, did many companies report healthy results only to see their stocks decline? One part of the market's concern is that *the rate of growth* has peaked. This possibility was highlighted by somewhat guarded tones and conservative 2019 forecasts shared by various management teams on recent third quarter updates. Today, the S&P 500 is expected to post 2019 earnings growth of 8.8% on the back of 5.3% revenue growth. This is certainly healthy, but nevertheless it represents a substantial deceleration from 2018's (tax reform boosted) 20% earnings and 9% revenue growth. This thought has surely spurred some investors to take some chips off the table.

Others may be giving more scrutiny to what is happening overseas and wondering if the U.S. can remain insulated from slowing global growth. In the third quarter, both Germany and Japan saw real GDP shrink. With worldwide GDP growth estimates falling, JP Morgan reports that just 20% of global asset classes have generated a positive return this year. Even more astonishing is the fact that the broad European, Japanese and Emerging Market ETF's are selling for less than they did in 2007. That is a sharp contrast to the S&P 500's +94% gain in the since the end of 2007.

Amid slowing overseas growth, China may present the biggest potential problem. Many countries are dependent on exports to China. As shown in the nearby chart (right), China now accounts for close to half of the world's demand for aluminum, copper, nickel, zinc and steel. Raw materials and capital goods comprise 80% of Chinese imports. There has been hope that the Chinese government would stimulate the economy, as they are wont to do. However, China's



current preference would be to drive domestic consumption rather than encourage continued investment in productive capacity. Thus BCA, for instance, thinks any stimulus would not be materially supportive of Chinese imports.

China is of course concerned with Trump's threatened tariffs of 25% on exports to the U.S. but one longer-term problem may be its housing market. The Chinese people save a large percentage of their earnings but their choices for investing their savings are few. In the U.S., where virtually everyone has access to robust capital markets (savings account, certificates of deposit, bonds, and stocks), 28% of household assets are held in real estate. In China, 75% of household assets are invested in homes and apartments. China has been over-building homes and apartments for a very long time. According to a national study led by Professor Li Gan of Texas A&M, roughly *22% of China's urban housing stock is unoccupied*. That amounts to more than 50 million empty homes. Prof. Li worries what would happen should cracks emerge in the property market, especially since mortgage loans have grown eight-fold in the past decade.

Regarding exports, one of the reasons the Trump administration has been so bold with tariffs and trade policy is that only ~12% of US GDP is attributable to exports. A "trade war" should hurt our economy far less than the economy of a typical country, which gets 29% of GDP from exports. Nevertheless, our largest 500 companies generate nearly 40% of their revenues from overseas operations so a slowdown overseas would likely have a negative impact on corporate earnings in the U.S.

The possibility that growth has peaked may also be affecting bond prices. The yield on the 10-year Treasury bond has fallen to 3.06% from a recent high of 3.24%, a big move in the world of bonds. There has been some talk that the Federal Reserve may take a more measured pace in raising short term interest rates, but BCA continues to think that the Fed will raise rates *more* than investors expect. If that is the case, short and intermediate term bonds will continue to make more sense than long term bonds.

Given the shifting landscape outlined above, some strategists are becoming less bullish. However, not everyone agrees. JP Morgan thinks that current fears are overdone and that stocks can rally from current levels. BCA would wait for an 8% price correction before doing more buying, but they, too, do not believe that the bull market is over. We would not argue with that view, but note that in coming months investors may favor different groups than those that have led the market over the last 12 months.

We will continue to pursue a measured approach, seeking stocks and bonds of well-managed, fairly valued companies whose balance sheets and cash flows may seem pedestrian when skies are clear and seas are calm, but whose buoyancy is comforting when the weather is less benign.

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