Notes From the North: Market Outlook

November, 2019

At a glance, the uptrend in stock prices that began early in October appears to be an extension of the strength seen earlier in the year. However, there are subtle, but significant, differences. In particular, this fall, institutional investors have been buying the more volatile and cyclical stocks while selling the defensive and low volatility stocks that led earlier in the year. They are making, in Wall Street jargon, "risk on" trades.

Nancy Lazar of Cornerstone Macro believes the trigger for this change was the reduction in headwinds from trade tiffs and the sense that the risks of a recession in 2020 have diminished. JP Morgan agrees, saying that manufacturing indices demonstrate rising output, rising new orders, and falling inventories. All of these suggest an upturn in the industrial cycle at a time when U.S. employment reports are strong, global consumer spending is rising, and there has been a tentative rebound in capital spending.

Optimism on the macro environment gained some reinforcement from third quarter corporate earnings reports. With 88% of S&P 500 companies having reported, 69% beat earnings estimates and 54% beat revenue expectations. Overall, revenues grew 3.7% over last year's third quarter while earnings fell -2.1% (rather than the -4.7% that had been expected). Corporate revenues in Europe rose 1.05% and earnings fell only 0.09%. To the extent that future earnings guidance was changed, it generally increased. According to leading earnings data provider, I/B/E/S, growth is expected to accelerate to better than 9% next year. The table below (with I/B/E/S data quoted by JP Morgan) provides greater detail on these shifts in expectations:

2019e and 2020e consensus EPS growth expectations

	2019e EPS Growth, %		2020e EPS Growth, %	
	Current	Jan '19	Current	Jan '19
MSCI World	0.5%	7.2%	9.1%	9.6%
S&P 500	1.2%	7.6%	9.5%	10.8%
Stoxx 600	0.2%	8.3%	9.2%	8.5%
Euro Stoxx	0.1%	9.4%	10.7%	9.1%
FTSE 100	-3.3%	5.8%	7.2%	7.0%
Topix	2.4%	7.2%	6.5%	5.5%
EM	0.6%	8.9%	14.5%	11.3%

Investors who are looking to buy stocks at this stage in the market may wish to consider some of the groups that have lagged the most. For instance, Bank America contends that value stocks have rarely been as cheap versus momentum stocks as they are today. David Koskin, chief U.S. equity strategist at Goldman Sachs, highlights the extreme discount at which high dividend yield stocks are trading compared to growth stocks. He thinks there is too much pessimism about the ability of U.S. firms to increase dividends. In contrast to the consensus, which expects dividend growth of only 2.7% through 2023, Koskin expects the S&P 500 Index's per share dividend to grow by 7% in 2019, 6% in 2020 and ultimately at an average rate of 5% through 2023. Both Leuthold Group and JP Morgan suggest taking advantage of another valuation anomaly by moving funds into foreign stocks, which are cheaper than most U.S. issues.

Not surprisingly, greater optimism on the economy has caused long term interest rates to rebound a bit from historically low levels. Of note, this rebound in long-term rates occurred despite a third reduction in the targets for the short-term Federal Funds rate. As of today, the Federal Reserve is signaling that it will pause at current levels.

The Federal Reserve has now reduced short term interest rates sufficiently to undo the inverse yield curve that had worried investors earlier in the year. If long term rates continue to rise, the steepening yield curve would signal good news for the economy. Bond prices, however, would give back some of the gains of recent years.

Both bonds and stocks have benefited from 10 years of loose monetary policy by virtually all of the world's central banks. Although the near-term economic outlook appears to have improved, there is an undercurrent of concern that should economic activity weaken, central banks have little ammunition. Any further monetary easing will be like pushing on a string. Ray Dalio of Bridgewater Associates, for instance, thinks that if the economy were to weaken, fiscal policy (government spending) would need to step up to the plate. However, budget deficits are high today, and looser fiscal policy would necessitate even larger budget deficits. Given the existing huge debts and promises made for pensions and healthcare in the U.S., Dalio thinks we could reach a point where it could be difficult to meet our obligations. If that happens, Dalio expects the government would monetize the debt and inflate out of the problem. The result of this would be a dramatic increase in inflation and a decline in the value of the dollar.

If inflation were to flare up, "nominal assets" such as bonds and cash would quickly lose favor. Should this scenario play out, Dalio suggests that investors would want to own "real assets," including gold. Peter Berezin, chief global strategist at BCA, agrees with this thought, and thinks it is not too early to start favoring these real assets, a category that for him includes stocks, real estate and all commodities.

Even today's low level of inflation (about 2%) would reduce the spending power of $1000 to just over $800 over the course of 10 years. Inflation has averaged about 3% since the government began tracking it in the 1919, but two decades (the 1940's and the 1980's) saw inflation run over 5% annually, and during the 1970's it came in at over 7%. This latter level of inflation would halve the spending capacity of a fixed income in ten years. While it's tempting in these uncertain times to want to lock in profits and go to cash, this is a good reminder of why most long-term portfolios should include an allocation to stocks for their inflation-fighting properties.

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