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The Recently Hot Market Seems Likely to Cool

As February winds down, U.S. markets continue to soar, generally up over 11% on the year through the 27th. The strong rise potentially sets up the strongest first quarter return performance for U.S. equity markets in history. At the beginning of the year, we voiced confidence and optimism for U.S. markets based on many fundamental measures, and yet the pace of gains still remains a bit surprising. The angst of December that drove markets down into near bear market territory seems a distant memory.

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While many economic and financial indicators have receded from levels reached a few months ago, most remain solidly positive. GDP growth expectations are still above 2% which is hardly exceptional and lower than last year's numbers, but still solid. Similarly, business outlook, consumer sentiment, disposable personal income, corporate profit growth, the jobs market, and various additional leading indicators have mostly declined but remain positive. Financial indicators such as interest rates, credit availability and the yield curve follow the same pattern – solid but off their highs.

Other issues, however, are less inspiring. Domestically, small businesses are growing increasingly cautious about investing and hiring as economic confidence wanes, reaching its lowest level since President Trump's election. Notably, only 14% of firms expect the economy to improve this year versus 36% that expect the economy to worsen according to a monthly survey of 765 small firms from the Wall Street Journal by Vistage Worldwide Inc. (Vistage polls firms with between $1 million and $20 million of revenue).

A Federal Reserve report showed U.S. industrial production dropped sharply in January although the manufacturing sector remains strong. During the holiday season, retail sales fell a surprising 1.2%, the biggest drop in nine years. More notably, the retail sales control group, a proxy for categories that translate more directly in GDP, fell 1.7%, the largest decline since a similar 1.7% decline in September 2001. Housing also continues to slow and both commercial and residential real estate appear to have peaked. Monetary policy, while more neutral, hardly provides the tailwind that is has for most of the past decade.

Financial research service Refinitiv expects 14.9% earnings growth for the final quarter of 2018, but just 5.1% for all of 2019 according to Reuters. The earnings decline seems consistent with many expectations for continuous slowing, and lower profitability leaves less margin for error if either or both consumer and business fear translate into lower spending and investment.

Some fear that we could be at a turning point since many recessions result from not a single event or company decision, but instead many firms cutting back marginally. While evidence of a full-blown contraction appears scant, many believe we are much closer to this possibility than a year ago.

Probably most significantly, the international economic outlook continues to decline. Weakness within local economies, a poisonous global political environment and heightened geopolitical risk are all rattling confidence. Potential trade wars continue to unsettle domestic and international markets, even if eventual agreements may potentially improve future relations.

In a frequently repeated pattern, the broader eurozone economy once again underperformed expectations and appears likely to cool further in 2019. Italy is slogging through its second consecutive quarter of recession while Britain's

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planned and very messy exit from the European Union drags down U.K. growth. Trade wars and a slowing Chinese economy hurt many European countries with strong export focuses, particularly Europe's economic engine, Germany. Survey data from the European Union's statistics agency released late February indicated that France's output declined, while in December retail sales across the eurozone had their steepest monthly fall since mid-2011.

Against this backdrop, the International Monetary Fund (IMF) lowered their predictions for global GDP expansion to 3.5%, down 0.2% from last October's forecasts which had held steady at 3.7% since 2017. The IMF also projected lower U.S. growth at 2.5% this year and then a further decline in 2020 to 1.8%. While projections for global growth in 2023 are steady at 3.5%, it is one third lower than the 5.6% rate of 2008/2009, the year before the Developed Markets' Financial Crisis.

The declining numbers result primarily from developed markets slowing dramatically while emerging markets contribute a larger share of growth. The IMF projects developed economy growth to decline from 2.4% in 2017 to just 1.4% by 2023. By contrast, the IMF expects emerging market economies to grow slightly faster, rising from a 4.7% rate in 2017 to 4.8% by 2023. The projected top 20 fastest growing and greatest contributing countries to global growth in 2019 and 2020 are all emerging markets. Using purchasing power parity, a method that adjusts for currency value differences, emerging markets contributed 74% of total global growth in 2018, and their contribution is predicted to rise to 84% by 2023 according to the Ashmore Group, a firm focused on emerging market asset management.

As the emerging market economies grow increasingly faster than their developed market counterparts, they are becoming a larger percentage of the global economy and their growth rates are increasingly impacting global growth. Even the U.S., which will likely continue to outpace most or even all other global developed markets, will likely grow much slower than the average emerging market.

As the growth of developed and emerging markets progressively diverge, it seems likely that investors will increasingly seek out growth and likely assign a premium to faster growing economies while penalizing laggards. If this occurs, the present discount assigned to many emerging markets because of perceived higher risks could not only disappear but transform into a premium in a growth hungry world, potentially leading to significant outperformance of emerging market equity markets.

Focusing exclusively on the U.S. again, equity markets appear fairly stable, but our return expectations have become more muted. Valuations have risen sharply along with rising stock prices presenting greater challenges to future market gains. At the same time, sources of future growth appear to be limited while possible growth hurdles are rising. While little evidence suggests an impending disaster, we believe it's wise to temper expectations.

https://www.reuters.com/article/us-usa-stocks-weekahead/fed-pause-validates-market-fears-about-u-s-growth-idUSKCN1PQ4MW
https://www.imf.org/en/Publications/WEO/Issues/2019/01/11/weo-update-january-2019
THE EMERGING VIEW February 2019, Ashmorem EM versus DM growth (2019-2023): How global is 'global' growth really? By Jan Dehn

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