Ongoing Economic Strength and Receding Recession Fears Propel Markets Forward.

After the U.S. stock market suffered a dismal December, the worst since 1931, the market has roared back in January. Through January 30th, the S&P 500 is up just over 14% since the Christmas Eve low, and even after a couple sharp pullbacks in early January, the S&P 500 is up just over 7% on the year. In our last newsletter, we voiced optimism regarding the markets, yet the very sharp and almost immediate reversal is still a bit surprising.

At the end of last year, investors appeared to price in a near-term recession regardless of generally good news from all quarters. When the Federal Reserve raised rates, investors seemed to read both the rate increase and the Fed's comments that future rate increases were likely as yet another sign that a recession was imminent.

Since that time, investor focus appears to have shifted back to facts rather than possible problems. The market got a further boost when the Fed kept rates constant on January 29th and also removed all language from their policy statement that had previously signaled future rate increases.

In addition, central banks around the world are almost uniformly indicating that they are rethinking plans to gradually reduce financial stimulus because of the slowing global economy and ongoing low inflation. The belief that the economies are only slowing rather than heading for recessions is causing central bankers to focus only on slowing tightening rather

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than launching new stimulus. The measured policy reversal showing both restraint and confidence is expected to support economies in the months ahead while also calming markets.

Much of the market's bounce back likely results from a reassessment of the many current indicators that remain positive such as the general economic outlook, low interest rates, consumer sentiment, energy costs, credit availability, corporate profit growth, inflation, business spending, labor markets, consumer spending, yield curve (which steepened after the recent Fed non-action), disposable personal income, fiscal policy, GDP growth projections of 2.6% for 2019, and nearly all leading indexes. Just a few indicators are trending more neutral include slowing housing market, mortgage rates, monetary policy and international outlook particularly in developed Europe. Negative areas primarily focus around political issues such as the toxic political environment, ongoing geopolitical risk and, of course, potential trade wars.

A generally positive economic outlook appears to be shared by many industries. Railroad executives note that shipments of oil, plastics, steel, grain, e-commerce deliveries and various other goods more than offset trade policy concerns. Demand is strong and issues that could indicate weakness are notably absent.

The CEOs of the major U.S. railroads CSX and Union Pacific both reported optimistic conversations with shippers across a broad swath of the economy ranging from agriculture to chemicals. Not only are customers shipping more goods, they are forging ahead with long-term capital projects too, including expanding facilities. Historically, railroads offer a particularly insightful view of the domestic economy because they ship everything from raw materials to finished goods. Notably, the railroads have also reported that U.S. focused companies are performing much better than companies with oversees exposure.

In other industries, executives at United Technologies, makers of Pratt & Whitney jet engines and Otis elevators, reported strong demand

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for its industrial products resulting from ongoing strength in U.S. and, from their perspective, Chinese economies. Not surprisingly, a notable exception to all the good news came from Caterpillar. The maker of heavy machinery lowered 2019 projections citing slowing exports to China because of trade issues and also increasing material and transportation costs.

China's challenges resulting from trade issues are also shared by other export-oriented economies. Germany's business confidence measure fell to from 101.0 to 99.1, a near-three-year low in December. Trade uncertainties and weak Chinese demand for German exports were cited as the chief concerns. The German economy's rapid decline provides a clear example of challenges facing export-oriented economies in the face of a trade war. Companies listed in Germany's DAX index, the German equivalent of the U.S. S&P 500, derive around 80% of sales outside of Germany. This compares to only 37% for companies in the S&P 500, according to FactSet.

Yet, while trade concerns impacting international economies and markets are a newer problem, underperformance of international equity markets driven by a flight to perceived safety of U.S. markets and the strengthening U.S. dollar has been an ongoing story since the 2008 recession. Now, the past underperformance of international markets, recently exacerbated by trade fears, may be offering investors an attractive opportunity. In mid-January, the forward earnings multiple on the MCSI China Index had fallen to 10.3, less than 60 percent of its 10-year average, according to Morgan Stanley. That compares to a forward multiple of around 17 for the S&P 500. Morgan Stanley strategists also noted that equities outside the U.S. are "exceptionally cheap." In particular, emerging market valuations appear particularly appealing. Furthermore, if currency values revert back to more normal levels as expected, foreign shares will benefit as their currencies strengthen.

Back in the U.S. our biggest concern to future equity market returns revolve around earnings. As earnings jumped over the past couple years, further helped by last year's tax cuts, the price for a dollar of earnings dropped, making valuations more attractive. As noted in an earlier newsletter, earnings growth predictions reached record highs during the fourth quarter, and it seems nearly impossible for corporations to actually hit these projections. Already in 2019, analysts are ratcheting back predictions, and earnings warnings are growing more commonplace. As a result, a market that currently appears slightly inexpensive is likely to look less inviting as the year progresses and earnings growth slows.

Looking forward, the primary driver of U.S. equities appears to be either the occurrence of a U.S. recession or expectations for one. Still, we do not believe a recession is coming in the near-term, and therefore, positive ongoing economic growth appears likely to propel markets forward. The recent strong equity market recovery likely signals broad agreement with this sentiment. Yet, while a recession seems unlikely, downward adjustments to earnings growth, which we expect, could cause volatility throughout the year. In addition, with equity markets already up over 7% on the year, it may be wise to temper expectations for the year.

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