Growth Continues, but Opportunities Seem Harder to Find

September of 2018 has offered further proof that this stock market cycle is forging a unique path. Since 1926, September is the only month that has delivered negative returns, and yet this September was solidly up despite threats of a trade war, a federal reserve rate increase, recession warnings and various other concerns.

While numerous reasons can be highlighted as key drivers of the market, certainly some or even much of the market's strength appears to be linked to our unconventional president. Regardless of one's opinion of President Trump, he is exceptionally business-friendly. His pace of deregulation has been faster than President Reagan's and January's tax cut has significantly boosted corporate profits. In addition, corporate and consumer confidence has skyrocketed. The University of Michigan's August Consumer Price Index jumped to its second-highest level since 2004 with sentiment improving across all income groups. While the press has largely focused on Trump's latest tweets, corporate America and consumers seem much more absorbed by their improving prospects.

Much of the economic news remains good. The U.S. economy is purring along nicely, with the second quarter's GDP delivering 4.1% annualized growth. Unemployment is at record lows, and third quarter GDP projections are down a bit but still remain strong at around 3.5% annualized. Yet, against this highly positive backdrop, we believe that

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investors likely need to temper expectations, largely because so much good news is already priced into values for various assets ranging from equities to real estate.

High asset prices of all types are not surprising given the unprecedented low interest rates employed by the Federal Reserve to help the economy recover from the 2009 recession. Low rates not only spurred growth, the dramatic injection capital into the financial system inflated asset prices of all types, including equities.[i]

Today, equity valuations are somewhat high, particularly when recognizing that the boost to profit margins resulting from the tax-cut was a one-time event. Earnings growth will likely further moderate over the next year, making stock valuations appear even more expensive. The combination leaves stocks vulnerable to a pullback as margins can be adversely impacted by various factors including higher borrowing costs, rising wages, tariff costs, capacity constraints in a tight labor market, and so on.

A wider look at broader asset values also reveals concerns. Morgan Stanley recently published projections claiming that 17 major asset classes (e.g., stocks, real estate, commodities, oil and gas, etc.) they track will deliver their lowest inflation adjusted returns since 2008.[ii] While equities have performed well so far in 2018, they potentially face future challenges. Global earnings per share growth has dropped to 16% from February's exceedingly strong 22% growth rate, and GDP estimates for third quarter are targeting the mid 3% range – better than during most of the expansion, but not as strong as numbers from earlier in the year.

In a related event, bank stocks are now falling as rates rise, rather than moving in tandem as had been the case earlier in the expansion. When the two no longer move up together, it has historically signaled coming downward pressure on GDP growth and earnings per share estimates.

Some economists are also warning that a recession could be imminent, although warnings should be treated fairly cynically. A study from the International Monetary Fund found

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that economists failed to predict 148 out of 153 recessions that occurred across the globe. While a recession nearly always impacts the market, equity prices could be more vulnerable today because of current high valuations. Still, a repeat of the 2008 stock market meltdown seems unlikely for many reasons including much greater cash holdings by both corporate America and consumers. Less leverage would likely result in a shallower recession and quicker recovery even if equity prices suffered significant volatility.

While U.S. markets have enjoyed a solid year, global markets have struggled, down on the year nearly 10% in aggregate. For investors willing to look outside of the U.S., recent losses could provide opportunity, particularly in emerging markets where several factors have driven emerging markets down making prices more attractive.

The media continues to speculate that economic problems faced by Argentina and Turkey will spread to other countries through some undefined means resulting in a currency crisis. The assumption is that emerging markets are dependent on foreign funding for their economic survival and growth. Currency crises almost always result from countries concurrently suffering through bad macroeconomic policies and inadequate internal domestic funding. In Argentina and Turkey, these conditions created fairly predictable problems and results. Notably, these two issues are not present on a similar scale anywhere else in the world, yet investors appear to be acting as if they are meaningful threats.

The strengthening U.S. dollar also drove down the value of foreign securities in dollar terms, but this trend appears set to reverse as slowing U.S. growth makes future significant dollar appreciation unlikely. Investors also fear Trump's ongoing trade-war threats. While this could impact emerging markets, emerging market trade with the U.S. has diminished steadily over the past decades leaving emerging markets much less vulnerable to U.S. economics and trade policy. Moreover, this seems to be the only real issue of substance, and even this challenge should have little impact. Simply, sentiment for U.S. markets may be too positive, while opportunities in emerging markets may be underappreciated.

U.S. stock investors appear to be unphased by recent interest rate hikes and trade war speculation, even though several trends and indicators appear to be signaling that we are entering that latter part of the bull market cycle. Rising rates are not an automatic negative, but rate hikes this late in the cycle amidst various other rising challenges usually signal an oft repeated pattern. Better growth and capacity constraints lead to increasing interest rates which slow growth. The result is a drag on all risk-oriented asset classes including equities. This does not mean that equities should be jettisoned. Nearly all assets that offer investors some form a return for a taking risk are likely affected to some degree. But, future return expectations should likely be fairly moderate, especially in comparison to returns from recent years. In this environment, a solid approach to equity management can be particularly important.

i. https://www.thinkadvisor.com/2018/09/21/the-great-bull-market-is-dead-merrill/?kw=The%20Great%20Bull%20Market%20Is%20Dead:%20Merrill&et=editorial&bu=TA&cn=20180924&src=EMC-Email&pt=PortfolioBuilder

ii. https://www.fa-mag.com/news/revenge-of-real-rates--2018-poised-for-worst-returns-in-a-decade-41040.html?section=43&utm_source=FA+Subscribers&utm_campaign=b7d0634833-FAN_FA_News_SEI_Weeklong_092618&utm_medium=email&utm_term=0_6bebc79291-b7d0634833-222234433

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