Daniel Wildermuth's
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U.S. Markets Keep Humming Along, but Don't Ignore Overseas

April of 2019 has continued to treat U.S. equity investors very well, with the S&P 500 up nearly four percent. After a very strong first quarter, which saw the S&P 500 rise more than 13%, various U.S. equity indices recently hit all-time highs. Yet investors have become so accustomed to the strong market that the incredible performance and new highs have largely been met with yawns.

Various economic indicators also suggest equity markets can keep moving forward. A recession is the most likely disruption to the equity bull market, and although the expansion is in its 10th year, it looks solid enough to continue for the foreseeable future.

Economic strength continues to drive corporate profitability, the primary driver of equity markets. Last year's tax reduction boosted corporate profits to 10.7%, the highest level FactSet has recorded in their data going back to 1999. Through the third week in April, nearly 80% of S&P 500 companies that had reported earnings surpassing analyst estimates again according to FactSet.

First quarter's annualized growth rate in gross domestic product (GDP) – the value of all goods and services produced in the U.S., adjusted for inflation – came in at a surprisingly strong 3.2%, well above expectations of 2.3%. The GDP growth announcement helped drive markets to their new highs.

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American factory activity accelerated in March as manufacturing jobs and new orders rose to 55.3 up from 54.2 the previous month according to the Institute for Supply Management. Readings above 50 indicate activity is expanding across the manufacturing sector.

The University of Michigan's Consumer Sentiment Index was revised higher in April, reflecting a more optimistic outlook by consumers. Likely related, household formation, helped by the massive wave of millennials moving through life-stages, remains near multi-year highs. The formation of households is not just a boom for the housing market, but all sorts of associated retailers and service providers.

Against this seemingly overwhelming positive backdrop, it might appear that equities should simply rise indefinitely, possibly with as little disruption as we have seen during the blissful 2019. While this could be the case, there are some areas of concern – as always – and it also seems very possible, if not likely, that the dominance in performance of U.S. markets may be reaching an end.

Looking at recent GDP growth, the numbers are deceiving. Economic growth resulted primarily from inventory build-up and a large net export number – exports minus imports – which resulted from a short-term drop in imports related to the current trade-war. Final sales to domestic buyers, a key part of ongoing GDP health, fell sharply to 1.3%. Consumer spending which makes up two-thirds of U.S. economic activity was also weak at 1.2%, making the GDP numbers look limp. Consumer confidence suggests the same. It has notched up recently, but the overall trend in has been softening since last summer, likely pointing to a future moderation in economic growth.

Other weaknesses or at least headwinds persist. Unemployment continues to stay at historically low levels, making hiring more challenging and expensive for employers. In February, wages grew at their fastest pace in nearly a decade rising 1.3% for the month, and March's numbers came in even stronger at 1.4%. Not surprisingly, strong wage growth occurs late

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in most economic cycles, and annualized wage growth of 4% generally starts raising concerns about inflation.

Increases in other costs could also reduce profits. Energy prices have been ticking up with a barrel of oil trading in the mid $60s. While we are nowhere near the $110 level hit in 2011, costs are obviously higher than in 2016 when oil hit $25.21 per barrel. Energy and wages are usually analyzed closely because they not only impact corporate profitability, they can also trigger inflation and force the Federal Reserve to raise interest rates.

Challenges outside of the U.S. also cause concern. While China's manufacturing sector is rebounding, most of the world, particularly Europe, is struggling. Germany, Europe's powerhouse, narrowly avoided a recession in the first quarter, and their 2019 GDP growth estimate is a dismal 0.6%. Europe's factories continue suffering from weak export demand, partly because of various U.S. initiated trade disputes across the globe affecting their trading partners, and European confidence measures continue to deteriorate. Asian exporters and manufacturers such as Japan and South Korea are also struggling. South Korea's economy actually contracted in the first quarter, surprising nearly everyone.

Economic data is poor enough globally to create high expectations that central banks will continue to loosen monetary policy to combat the slowdown.

Pulling all this together, it appears highly likely that U.S. GDP growth will slow in the next quarter or two. A Fed increase appears unlikely, and a possible rate cut resulting from low inflation despite wage increases would probably have little effect on markets. Corporate profits appear destined to go down after recent record levels, but a recession also seems unlikely. The market is not cheap based on valuations, but it's also not overly expensive and most indicators remain fairly solid. The U.S. market may remain a reasonable place to hold assets, but probably will not be as profitable as the last few years.

International markets are a bit more complex. Persistent past weaknesses, particularly in emerging markets, may offer the best opportunities for investors. Since the beginning of 2008, shortly before the U.S. economic recovery started, earnings per share for U.S. equities have risen by 80%, according to FactSet data. In dollar terms, over the same period, Japanese earnings have risen by half, emerging-market earnings are flat and European profits have yet to recover to their pre-crisis level.

Ex-U.S. global economic growth post-crash has been amazingly weak while the dollar has continually strengthened to further diminish international earnings levels. The divergence could continue, but parts of the outperformance will be exceedingly difficult to repeat. U.S. corporate earnings have surged relative to the size of the economy and now run about 25% higher than their historical averages. To continue the trend, profits would need to rise to unprecedented levels, double those of pre-2008.

Similarly, it appears likely that global economies will not underperform the U.S. so dramatically in the future while the strengthening dollar, a large contributor to the past decade's outperformance, will almost certainly slow significantly or even reverse course.

The combined trends strongly suggest that investors should not expect such dramatic U.S. equity market outperformance in future, and investors might want to look overseas for more than just possible vacations.

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