Weekly Capital Market Comments

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Weekly Review

Equities ended the week (Thursday-Thursday) in the green as markets continue to grind higher due to a myriad of factors we discuss below. While at the same time, fixed-income indices finished the week flat, taking a back-seat to risk-on trading. Still, High Yield continues to find a bid. What we found interesting this week was that TIPs (inflation protection) was the second best performing fixed-income style. For equities, Growth (in general) was the top performing equity style this week, while Value lagged. Technology, Healthcare and Real Estate lead from a sector perspective, while Materials and Industrials, while positive, still lagged.

"The Sky Is Falling"…Said Nobody This Week

For dedicated readers of our weekly, we must be sounding like a broken record…or Chicken Little for that matter, as we continue to suggest limited upside in equity markets as: (1) valuation multiples will have a difficult time expanding (currently ~16.5x) given we are so late in the cycle, and (2) while positive, operating earnings continue to contract in 2019, and are now expected to grow less than 4% year-over year. Yet we remain only 4% below the S&P's all-time high set back in September 2018 and have bounced almost 20% from Christmas Eve lows. So what gives? This is the question many clients have been asking us over the week. Well for one, if we truly knew the answer, we wouldn't be drafting a weekly note late on a Thursday evening, but rather sipping tropical drinks on some island or more likely – taking in the next round of the UEFA Champions League in Barcelona. However, we are not….and therefore providing a few theories supporting the recent market "melt-up" in equity markets. First and most notably, inflation remains elusive, not only here, but across the globe. This has a positive impact on risk assets (aka equites/stocks). Not only does this allow for operating margins to remain in check along with budgeted input costs, but it also staves off the Federal Reserve from preemptively raising interest rates. This in turn allows for lower borrowing costs, and potentially greater revenue (as companies borrow to expand) and net income; yet estimates for 2019 continue to come in. Accommodative interest rates also reduce the rate at which future cash flows of financial assets are discounted back, hence resulting in higher warranted values. Another big reason why markets are shrugging off the recent correction, is that employment data – overall – remains positive. Despite the recent headline miss in Non-Farm Payrolls, the trailing 3-month average monthly change remains a healthy +186k, and the recent upward break-out in Initial Claims have reversed (for now). Together, lower inflation (rates/growth) and relatively solid employment growth (here and globally), has lulled many market pundits to accepting that a lower growth trajectory will help elongate the cycle and perpetuate the bull market (we have seen this movie before, and it always ends the same way). And in other cases, "experts" are suggesting that equity values are looking through the current economic soft patch outside of the US, or any potential earnings recession here in the US. But let us remember, sell-side analysts get paid to "sell" equity ideas and most buy-side portfolio managers need to believe that financial assets grow to the sky, else they are out of a job (trust me; I've been both). Next, there is volatility, or lack thereof. In this case, the lower the volatility, the more complacent investors become – i.e. not appropriately pricing in risk (aka higher discount rates). Another consideration as to why equities continue to grind higher is a technical argument. Today is a "triple witching" session, whereby stock index futures, stock index options, and options on individual stocks all expire simultaneously. So, the technical argument is that given many market participants may have all "speculated" in one direction leading up to and following the Christmas Eve low, these same investors may now be caught short and might need to reverse these trades. Therefore, as expiration approaches, they might need to reverse their trades, resulting in a bid for equities and higher prices. Next, corporate buy-backs are increasing once again; spanning across several industries including financials, energy, technology and discretionary/retailing. And while some may argue that buybacks are just another form of repatriation of net income back to shareholders, the impact to stocks like JP Morgan Chase and Home Depot cannot be overlooked. Here, we remain concerned that buy-backs are funded with debt, and at some point, valuations (multiples) will reflect more risk, or higher borrowing costs will negatively impact earnings. Additionally, we have seen a general loosening in overall financial conditions over the past several months, which also has positive implications for stocks. For example, while credit spreads on junk bonds have tightened by over 100bps since January 1st. And finally, there is China. Not only are market participants expecting a resumption of domestic growth (just look at the recent Chinese stock market performance), but we believe the US equity markets have also priced in a "win-win" trade outcome – which we continue to believe will disappoint and fall short of expectations. So this is our take on why we have seen such a sharp recoil in markets, and why the slow grind higher may continue in the near-term. In almost every case we have a rebuttal, but make no mistake, as quoted by Keynes, "The market can remain irrational longer than you can remain solvent." Still, we remain convicted in our fundamental view that markets will soon take a breather and continue to recommend a more pragmatic investment allocation in the near-term. **We'd love to hear your thoughts.**

	Domestic Indices	1Week
1	NASDAQ Composite PR	2.8%
2	S&P 500 TR	2.2%
3	Russell 2000 TR	1.8%
4	NYSE Composite PR	1.7%
5	S&P MidCap 400	1.5%
6	DJ Industrial Average TR	1.1%
7	ICE BofAML US High Yield TR	0.5%
8	BBgBarc US MBS TR	0.2%
9	BBgBarc Municipal TR USD	0.1%
10	US Inter Gov Bd TR Bond	0.1%
11	BBgBarc US Agg Bond TR	0.1%
12	BBgBarc US Government TR	0.03%

	Style Stratificiation	1Week
1	US Mid Growth	2.7%
2	US Growth	2.6%
3	US Large Core	2.4%
4	US Large Growth	2.4%
5	US Large Cap	2.3%
6	US Market	2.2%
7	US Core	2.1%
8	US Mid Cap	2.0%
9	US Large Val	1.9%
10	US Mid Val	1.7%
11	US Mid Core	1.4%

	Sector Stratificiation	1Week
1	US Technology	3.3%
2	US Healthcare	2.7%
3	US Real Estate	2.5%
4	US Financial Services	2.5%
5	US Commun Svc Capped	2.4%
6	US Snstve Sup Sec	2.4%
7	US Dfnsve Sup Sec	2.3%
8	US Cycld Sup Sec	1.9%
9	US Utilities	1.8%
10	US Consumr Dfnsve	1.6%
11	US Energy Capped	1.6%
12	US Consumr Cycld	1.3%
13	US Basic Materials	1.1%
14	US Industrials	0.7%

	Bond Indices	1Week
1	ICE BofAML US High Yield TR	0.5%
2	US TIPS TR	0.4%
3	US Inter Corp Bd TR Bond	0.2%
4	Mortgage TR Bond	0.2%
5	US Inter Core Bd TR Bond	0.2%
6	US Corp Bd TR Bond	0.2%
7	US Lng Corp Bd TR Bond	0.2%
8	BBgBarc Municipal TR USD	0.1%
9	US Core Bd TR Bond	0.1%
10	US Inter Gov Bd TR Bond	0.1%
11	US Lng Core Bd TR Bond	0.1%
12	US Shrt Gov Bd TR Bond	0.1%
13	US Gov Bd TR Bond	0.1%
14	US Lng Gov Bd TR Bond	0.0%

	International Markets	1Week
1	MSCI EM Latin America PR USD	3.9%
2	Nikkei 225 Average PR JPY	2.0%
3	MSCI Europe NR USD	1.9%
4	SSE Composite PR CNY	1.8%
5	Euronext Paris CAC 40 NR EUR	1.6%
6	MSCI Europe PR LCL	1.0%
7	MSCI World ex USA NR USD	1.0%
8	FSE DAX TR EUR	0.6%
9	MSCI EM PR USD	0.4%
10	FTSE 100 TR GBP	0.4%
11	MSCI World Ex USA PR LCL	0.4%
12	MSCI EM PR LCL	0.3%
13	MSCI Japan PR LCL	-0.6%
14	MSCI Pacific NR USD	-0.7%

Source: Morningstar.com