SANITAS
WEALTH MANAGEMENT

Q1 2019 Quarterly Market Review

April 2019

Equity markets waive off concerns that surfaced in the fourth quarter of 2018 to stage a comeback in Q1.

NEGATIVE PRESSURES ABATE

During the fourth quarter, negative pressures caused global equity markets to fall. Concerns centered on slowing economic growth, slowing earnings growth, and the potential that the Federal Reserve would raise interest rates too far and too fast. US Markets bottomed on Christmas Eve after the Fed did raise rates again at their mid-December policy meeting.

However, as the year started, economic releases were relatively benign, if not positive. The first economic releases of 2019 showed economic growth continued to look relatively strong, inflation remained well under control, and while earnings growth estimates were falling for the early part of 2019, expectations are that earnings would pick up later in the year and that the decline would thus be temporary. At the end of January, the Fed, perhaps under some public pressure but hopefully guided more by market indicators, determined to leave interest rates where they are and not raise again. At the same time, President Trump finally relented and allowed the government to reopen after non-essential government offices were closed for 35 days.

So, are we skirting a recession or are fears of a recession overblown?

WHAT ARE ECONOMIC INDICATORS TELLING US?

Unfortunately, there are no failsafe economic indicators that can forecast a recession. Many recessionary indicators provide temporary false positives which then revert. However, it is worth examining some indicators and trends in those indicators to see why markets may experience volatility.

Industrial production, retail sales and the national unemployment rate have all been reasonably reliable as indicators of recession. Specifically, if industrial production declines year over year, if retail sales declines year over year, and if the unemployment rate rises above its 12-month average, those are considered to be recessionary indicators.

Examining industrial production, we remain above year ago levels. However, the trend has flattened since November. So, the indicator is not signaling a recession, but a decline in industrial production likely would bring it closer to the year ago level and if it continues, it likely will signal that we may be on the cusp of a recession. Retail sales have been volatile, potentially influenced by the government shutdown and/or slightly higher interest rates which impact major purchases like vehicles. Similar to industrial production, it is not currently signaling that a recession is imminent. The unemployment rate did rise above the 12-month average in December and January, then fell back below the average in February. As we are arguably near the theoretical full-employment number, it's likely that small movements in the rate may cross through the 12-month average.

In short, both individually and as a group, none of these indicators currently suggest a recession is likely. In addition, while the numbers have been coming down, the Institute for Supply Management's Service Economy index remains at a relatively strong level at 56.1 for March, while the most recent Manufacturing index for February came in at 55.3 (the March number will be released shortly). Numbers above 50 signal expansion, and numbers above 55 are generally considered to be signals of relatively strong expansion. Furthermore, the Conference Board's Index of Leading Economic Indicators also continues to signal growth.

Of course, not everything is rosy. On average, economists polled in the latest Wall Street Journal Economic Forecasting Survey have increased the probability of a recession to 25%, with 75% of those polled believing a recession will arrive in either 2020 or 2021. Right now, the signals don't support that view as slower growth is still growth. The question is whether slowing growth turns into negative growth.

The stock market itself can also be a leading indicator of recession, but with the first quarter equity recovery, we are once again within striking distance of new all-time highs, surpassing levels reached last October. Clearly, the stock market has shaken off the thought of a recession – at least for now.

WHAT ABOUT EARNINGS?

At year-end, expectations were for positive growth in earnings in Q1. With revised earnings expectations, we now know that expectations have flipped to an earnings decline in Q1. Specifically, according to FactSet research, earnings expectations have declined 7.2% to an expectation of negative 3.9% earnings growth. However, the negative period is expected to be short lived, with Q2 expectations relatively flat, then increasing to 8.3% earnings growth by Q4 of this year before returning to double digit growth in 2020.

Getting back to 10% earnings growth in 2020 would actually be relatively strong growth in a historical context. However, realize when 2018 growth is finalized it probably will be around 20% growth, so by comparison even a 10% growth estimate looks weaker. Of course, a recession would impact the current analyst outlook.

Valuations across the market vary widely. Consumer Discretionary stocks generally are the most expensive on a trailing basis, currently trading around 21x trailing earnings. Financials are the cheapest at roughly 11x trailing earnings. The disparity is interesting because the earnings growth outlook for the two sectors are similar, yet investors are willing to pay twice as much for a dollar of earnings as long as it's a consumer discretionary company (note that this is simply a market comment, not a trade recommendation to take action on either of these sectors).

WHAT DOES THIS ALL MEAN?

In December, markets showed that they are susceptible to shock and the herd effect (where investors indiscriminately stampede for the exits). While we've seen a tenuous recovery, I suspect markets remain susceptible to whatever the next shock is. I still don't think you can time through that. In fact, DALBAR is an organization which studies the returns investors generate vs. the returns markets generate, with the difference in returns attributed to timing decision made by investors. In 2018, there were two periods where investors thought a more protracted downturn may be taking hold – towards the end of January and into February 2018, and in the selloff in the fourth quarter. As a result of poor timing decisions around that market volatility, the average US equity investor lost 9.42% in 2018, while the S&P 500 drew down only 4.38%.[1] Even tactical strategies which purport to take emotion out of the equation generally traded on a false positive, exiting markets after a decline only to buy back in at a higher level. As I've written before, in the context of a portfolio which is appropriate for your risk tolerance, age, time horizon, etc., in general you must be present to win. That means taking the good with the bad.

As always, if you have any questions about the market or financial plan, please give me a call at (303) 325-7945 or e-mail me at jaco@sanitaswealth.com.

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1 DALBAR Press Release, March 25, 2019, "Average Investor Blown Away by Market Turmoil in 2019."