Pessimism Warr(e)nted?

Measured by the bellwether S&P 500 and Dow Jones Industrial Average indices, the stock market continued to march higher through the end of the third quarter, notching a respective 1.39% and 1.36% gain for the quarter and respective year-to-date gains of 18.74% and 15.39%. Meanwhile, the tech-heavy NASDAQ Composite suffered a modest 0.10% decline for the quarter and remains higher by 20.56% for the year.

We noted in our last quarterly newsletter that “with the threat of higher interest rates off the table for the foreseeable future, trade talks with China have become the glaring Achilles heel for the stock market”. That the S&P 500 and Dow Jones Industrial Average were able to eke out quarterly gains even as negotiations between the Trump Administration and China seemed to sour speaks to the lack of attractive alternatives in the wake of persistently declining interest rates. Indeed, the yield on ten-year Treasury bonds has plummeted 20% from 2% to 1.6% in the latest quarter.

The uncertainty caused by the ongoing trade dispute with China is finally weighing on the U.S. economy as the Institute of Supply Management (ISM) manufacturing index registered a reading of 47.8 for September after falling below 50 in August for the first time in three years. While any level below 50 indicates a contraction in manufacturing activity, it is important to realize that there have been many past instances where a sub-50 ISM manufacturing level has not coincided with recession. Moreover, consumer spending accounts for 70% of U.S. economic activity and is by far the most important engine for U.S. GDP.

Total U.S. household debt is on pace to rise for the 21st consecutive quarter to approximately $14 trillion with the vast majority (approximately $11 trillion or 80%) of that attributed to mortgage debt. Student loans are the second largest category of household debt at $1.5 trillion followed by $1.3 trillion in car loans and $0.8 trillion in credit card debt. While this level of debt may appear alarming, it is a very reasonable percentage of overall household net worth, now valued at over $109 trillion. In addition, generation low interest rates allow consumers to service this debt burden on very favorable terms. Monthly debt service payments as a percentage of overall disposable income remain at historically low levels.

Perhaps more important than the level of debt to the health of the consumer is the level of unemployment. On that front, the jobless rate fell to 3.5% in September from 3.7% in August, the lowest unemployment rate since 1969. At face level, this low level of unemployment again implies a very healthy consumer. However, lurking beneath the surface, the level of job openings declined 4% in August for the third consecutive month. The last time that job openings declined for three straight months was during the Great Recession of 2009.

To be sure, the supertanker U.S. economy is moderating from its approximate 3% pace of 2018, but still seems poised to deliver GDP growth approximating 2%. In the wake of slowing global growth, trade war and Brexit uncertainty and now over $16 trillion of negative yielding sovereign debt, the Federal Reserve has intervened accordingly and cut interest rates at each of its last two meetings in July and September in 25-basis point increments. The Fed is appropriately concerned that weakness in manufacturing and declining business confidence may spread to other parts of the economy. The Fed cited muted inflation pressures, trade-policy uncertainty and weak global growth to justify its recent interest rate cuts. Fed Fund futures indicate an 80% probability that the Fed will cut rates again at the end of October.

Through quantitative easing and monetary manipulation, global central banks intend for consumers to promote economic activity by spending and investing as opposed to hoarding unproductive cash. It is possible that the overall impact may be the opposite as households and companies save even more for the future since cash returns are so dismally low. Emblematic of this possibility, Sanford Bernstein research reveals that investors allocated $1.1 trillion out of equities into bond and money market funds in the past year, the largest year-over-year net flow between the asset classes in history. In a world of plunging interest rates, declining global manufacturing activity, continued tit-for-tat tariff and trade war posturing and now the advent of a Trump impeachment inquiry, risk aversion has become rampant. The recent AAII Investor Sentiment Survey illustrates bullish sentiment at 20.3% (compared to a historical average of 38%) and bearish sentiment at 44% (compared to a historical average of 30.5%), a multi-year high spread between bullish and bearish sentiment pointing to widespread pessimism.

For equity investors, such widespread risk aversion and pessimism often implies a market that may have already priced in much of the already known “bad news”. With the S&P 500 trading at a PE of 18x 2019 earnings and a PE of 16x forward estimates for 2020, stocks seem reasonably priced, especially with interest rates so low and pessimism so rampant. With an accommodative Fed, even an intermediate truce between the U.S. and China would seem to remove any obstacles for the market as we approach year-end.

While the market trades at a more reasonable PE of 15x 2021 estimates, these estimates seem premature given the looming election year and rising possibility for Elizabeth Warren to win the Democratic nomination. There is little debate that Warren’s agenda is far-less-business friendly than that of most other candidates and her policies, should they be enacted, would have far-reaching consequences for corporate America and the overall U.S. economy. While it is also premature to begin handicapping the odds for a Warren Presidency, the stock market would likely correct to that possibility long before November’s elections. As such, the markets will be watching 2020 primaries with great interest and we would not be surprised to see heightened volatility in the coming year.