Mixed Signals In Fundamentals Lead To Neutral Position In Equities

As October draws to a close, the S&P 500 hit another new all-time high, boosted partly by a Federal Reserve rate cut. The index is now up over 20% on the year. Yet, while the market has continued up in recent months, investors are changing their behavior, likely because of lingering fears about global and domestic growth. Notably, earnings are becoming more important.

Companies with high gross profitability outpaced their peers during recent weeks even when valuations were poor. Similarly, during the recent earnings period, The Wall Street Journal reported that numerous highly valued growth companies reported better than expected revenue growth but were still punished by investors if their earnings disappointed. As an example, investor darling Alphabet reported earnings below analyst predictions on October 28th, and the stock dropped 1.6% despite better than expected revenue. While the fall was small, investor reaction differed markedly from last year when Alphabet beat earnings expectations yet shares dropped because it missed on revenue. The same trend rewarded Tesla. After declining all year, their price jumped on unexpected profits despite worse-than-expected revenues.

Beyond trading patterns, more fundamental measures of economic growth and health offered mixed signals. Corporate profit margins continue to shrink, extending the longest margin contraction in post-war history.

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Analysts expect earnings of S&P 500 companies to fall about four percent for the year according to FactSet data. The drop would mark the biggest year-over-year decline since 2016. Analysts have also reduced earnings projections for all 11 S&P 500 sectors.

A record number of tech companies are on track to issue negative guidance for third quarter according to FactSet. Since tech has been a key sector driving market gains, negative news could disproportionately impact broader equity markets.

Retail sales also dropped unexpectedly by 0.3% last month. Consensus estimates projected a 0.3% increase. Manufacturing also continues to struggle, falling from 49.1 to 47.8 in September, "missing all estimates," as reported Bloomberg News. The index is now lower than the 2016 low, and domestic factory activity hit a 10-year low in September.

Historically, readings under 46 are consistent with recession, and recent weakness brings us close. Although manufacturing is a small part of the economy, it remains a critical component, producing income and multiplier effects, especially in the Midwest. It also has historically acted as a signal of both broader strength and weakness. Services were brighter, but still expanded at their slowest pace in three years.

International markets also continue to struggle. Business activity in the eurozone was close to stagnation in October, while it declined in Japan.

Around the world, factories have been hit by rising tariffs and declining investment as businesses wait for greater clarity on trade. Surveys of purchasing managers in the eurozone released in late October indicated that the ongoing manufacturing contraction continued into the fourth quarter, while the services sector teetered on the brink of stagnation.

Germany, the engine of Europe, is almost certainly already in a recession. Within the country, the ifo Business Climate Index, compiled by the Munich ifo Institute, probably the most

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widely used gauge for Germany's corporate mood, reports that sentiment has fallen to levels which were last observed in 2012 at the height of the euro crisis. Economists keep downgrading their euro-area 2020 growth forecasts, and GDP growth projects are now barely above 1%.

Similar surveys for Japan also released Thursday pointed to a fresh decline in activity during October, with the manufacturing sector contracting for the sixth straight month.

Bloomberg Economics also warned that early Chinese indicators point to a further slowdown in the economy. They have cut their Chinese GDP forecast to 5.9% year-over-year in third quarter and 5.8% year-over-year in quarter four.

Still, all news is not negative. Banks were just given significant regulatory relief by the Federal Reserve regulatory rollbacks. After the 2008 Financial Crisis, regulators added countless costly rules and regulations in an effort to prevent another crisis. More recently, regulators have sought to rationalize the regulations to better balance safety, costs and liquidity needs. The likely boost to the economy through removing constraints on lending and cash is hard to project but should be noticeable.

Consumer spending and services also generally remains solid. Services comprise about 70% of total economic output versus about 10% for manufacturing. Reports by IHS Markit noted that expansion in consumer services business activity was still strong in September, and the rate of consumer goods production growth surged to a seven-month high as well.

Job growth also continues. Wages are up 3.2% year-over-year and the jobless rate hit 3.5% in September, remaining at its lowest level in 50 years. In a recent survey, 57% of small business owners reported hiring or trying to hire. A majority of these business owners reported finding few, if any, qualified applicants for open positions, indicating a skilled labor shortage in the U.S. While this can be a constraint to growth, the challenge generally leads to slowing growth rather than a severe economic pullback.

Internationally, economists believe that negative trends could be bottoming. The weakness in Germany's ifo business climate index may be reversing, having rebounded off recent lows a bit. Sentiment in France has been improving since the beginning of 2019, and the French CAC 40 equity index is more than 15% ahead of the German DAX equity market on the year.

Even Asia offers some good news. Outside of China and Japan, manufacturing PMIs are stabilizing around 50, suggesting manufacturing activity is relocating from China into other regions.

Finally, on October 30th, the U.S. Federal Reserve lowered rates another quarter point, but signaled that rate reductions will pause indefinitely based on future economic strength. While the statement hardly claims that the U.S. is poised for strong growth, the more tempered outlook suggests Fed confidence rather than growing concerns.

The mixed signals are typical at such a late stage in an economic expansion. While a crash or serious correction could be imminent, there is no obvious reason to believe one is near. In addition, if we enter a recession, most believe that it would be a fairly shallow slowdown.

As a result, we remain unenthusiastically neutral on equity markets domestically and abroad. Still, if you own equities, you need to be prepared for the possibility that a crash could happen any day. It remains the nature of the beast.

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