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July 19, 2019
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Todd Asset Management

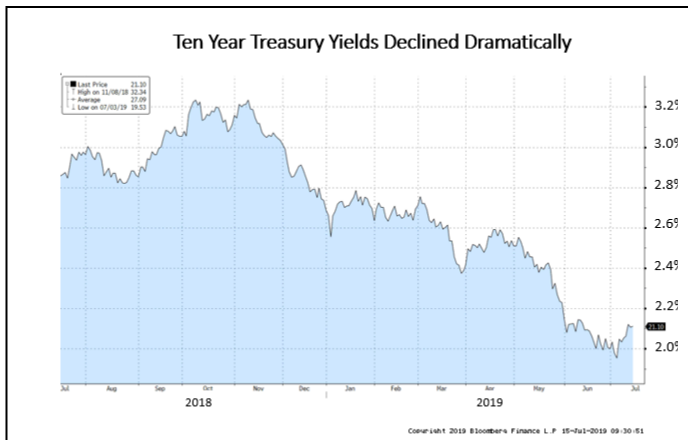
Waiting for the Pivot

Todd Asset Management Q2 2019 US Market Commentary

	2Q 2019	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	4.3%	18.5%	10.4%	14.2%	10.7%	14.0%	14.7%
Russell 1000 Value	3.8%	16.2%	8.5%	10.2%	7.5%	12.1%	13.2%

* *Annualized Total Returns.*

The US market has acted very well this year, despite economic worries spurred by the new tariff concerns and a global manufacturing slowdown. Markets weakened in May after the breakdown of trade negotiations, only to recover in June as anticipation of a resumption of talks was priced in. Economic uncertainty caused the Fed to predict a pivot away from raising rates, and we now expect them to lower short term interest rates as the year progresses. We believe lower long term rates are forcing investors into risk assets. While global economic growth has slowed, markets do not appear to be worried about a recession yet despite the fact that 10 year government bond yields have plunged from 3.2% in November to under 2.0% briefly in July. High yielding bond indexes are not seeing their yield spread to high quality bonds widen and have actually declined recently, indicating fears of an economic slowdown are declining. Tariffs, political uncertainty and tighter monetary policy from last year have pressured business sentiment and capital spending plans putting some deflationary pressure on the economy and reducing inflation expectations. Don Rissmiller, of Strategas, put it well, saying "The Fed tightens until they break something. This time they broke inflation expectations." The decline in energy prices last year, coupled with purchasers looking to avoid Chinese tariffs and moving production to lower cost venues have pressured inflation expectations. Additional deflationary pressures have been driven by retail price competition and the application of technology to enhance productivity.



Major concerns for the quarter included:

- The threat of new trade tariffs between the US and China.
- Bond yields declining, and sentiment that economies would weaken.
- British PM May resigning, leading to worries about a disorderly Brexit.
- Softer global manufacturing and weaker business confidence.
- Deflationary concerns in most developed markets.

Major positives from the quarter were:

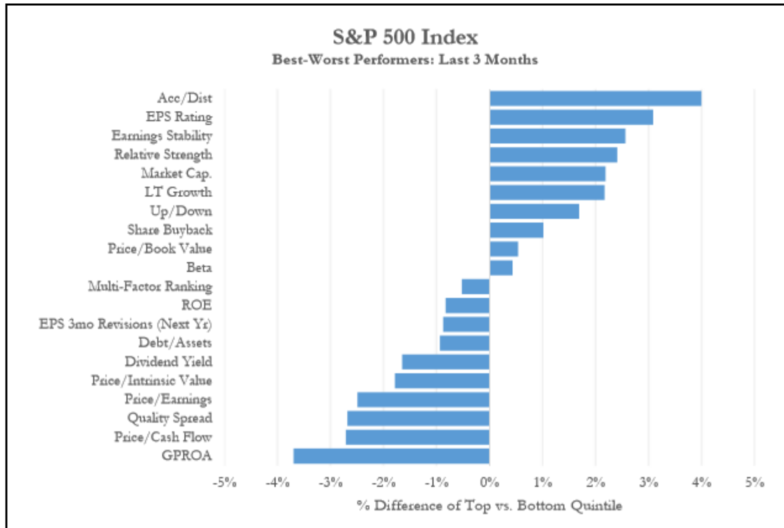
- Most Central Banks (including the Fed) have pivoted to easing policies. As they undertake stimulative policies, we would expect economies to firm up.
- Chinese fiscal stimulus is expected to counter the negative impacts of the trade tariffs. European populism could lead to further fiscal stimulus. Both would be positives for growth.
- Labor markets remain firm, with wage gains evident in the US and other developed economies. Recessions generally do not occur when jobs are plentiful.
- Market action effectively lowered borrowing rates across all maturities. This reduction in borrowing rates has resulted in the 3 month yield exceeding the 10 year yield, something know as an inverted yield curve. If the Fed decides to lower rates, that should repair that inversion.
- The US and China are back to the negotiating table after mutually inflicted trade dispute pain. If President Trump wants to get re-elected, he will need a deal to garner the support of swing states.

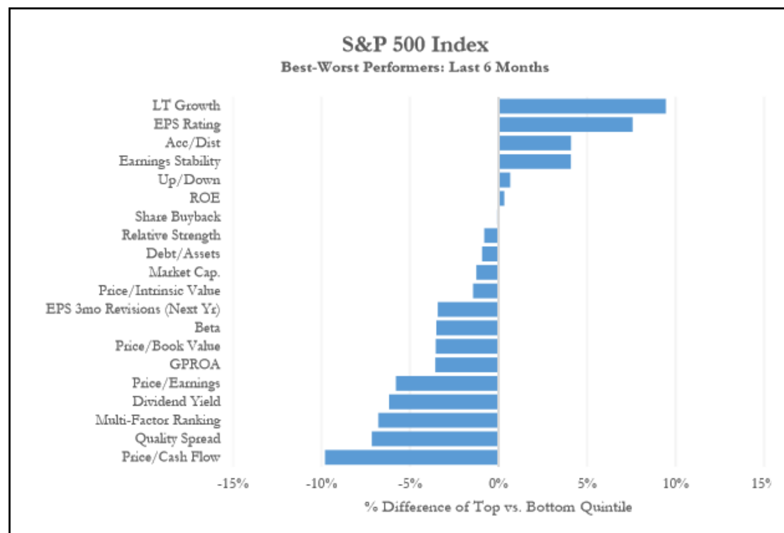
Several issues still need to be resolved. Brexit appears to be becoming more disorderly as time goes on and a new British PM is selected. The current front runner is Boris Johnson, an avowed Brexiteer who believes the UK should leave the EU without a deal if an advantageous deal is not on the table. These fears could negatively impact the economic outlook. Additionally, the US still needs to get through a Debt Ceiling debate, and the run up to a presidential election. There are also concerns that an earnings recession could be imminent in the US.

Our base case is that the US economy will continue expanding, and while 2019 could see earnings stagnate after a large tax induced spike in 2018, we do not think an earnings recession is likely. The trade truce with China, coupled with the stabilization of oil prices coming from the OPEC+ meeting should make for a constructive backdrop for the economy and business confidence. Markets are at a new high, but most participants act pessimistically. Lower rates and more growth visibility could change that for the better for markets. If the Fed moves to lower rates, and capital spending picks up in response to tighter labor markets, then a larger reacceleration of the economy could be in the works than the market currently anticipates.

Factor Watch- GAAP now means "Growth at Any Price"

Our customary review of the factors that have helped and hurt performance over the past quarter (top chart) and year to date (bottom chart) periods ending 6-30-19 are presented below. As a reminder, these charts measure the difference between the highest ranking 20 percent of the S&P 500 index (equal weighted) based on each of these factors versus the lowest ranking 20%.





Source: TAM and Bloomberg

The most prominent theme we see this year is growth and we would note that investors continue to avoid most value stocks. Investors appear to be willing to pay any price for high assured growth stocks as High Growth has outperformed Low Growth by 10% YTD and Low Price to Cash Flow stocks have underperformed expensive ones by 10% as well. Investors seem to be suspicious of value, and consider most inexpensive names to be value traps. This mindset began during the early part of 2018, as investor confidence suffered when the Fed was aggressively raising interest rates and most value oriented names were shunned in favor of assured growth. We'll infer that investors do not believe the economic expansion can continue, so they are not willing to venture into cheaply valued stocks like the Financial or Energy stocks as they have no confidence that their economic underpinnings will last. Our sense is that as the Fed starts lowering rates, the value sectors could see some interest when investors believe that the Fed is not trying to end the economic expansion.

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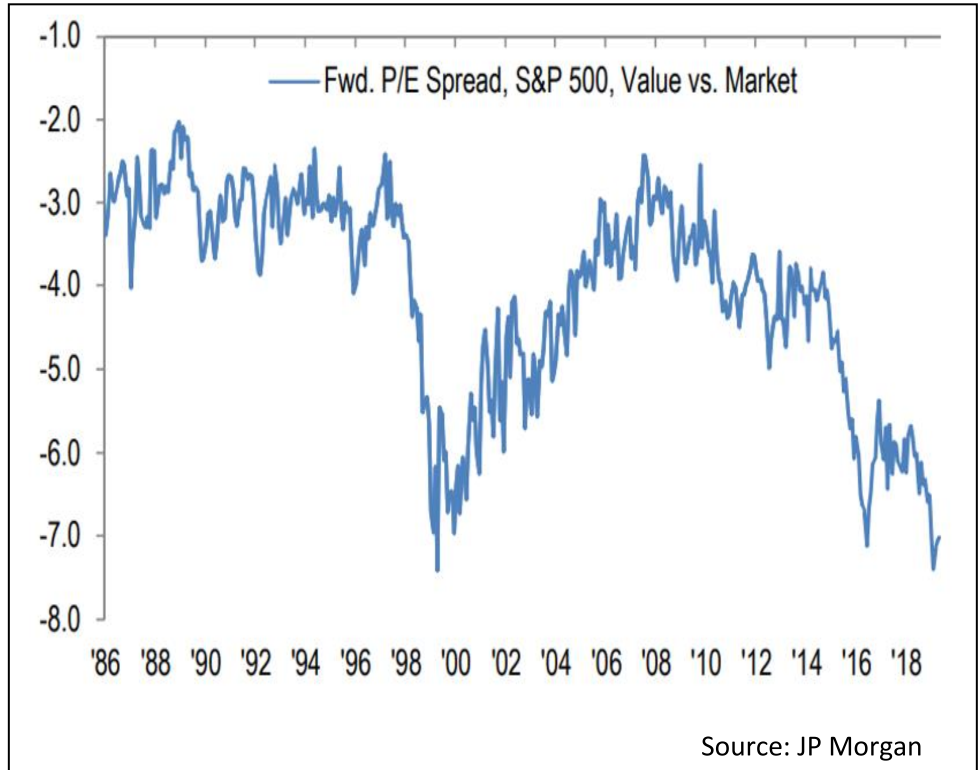
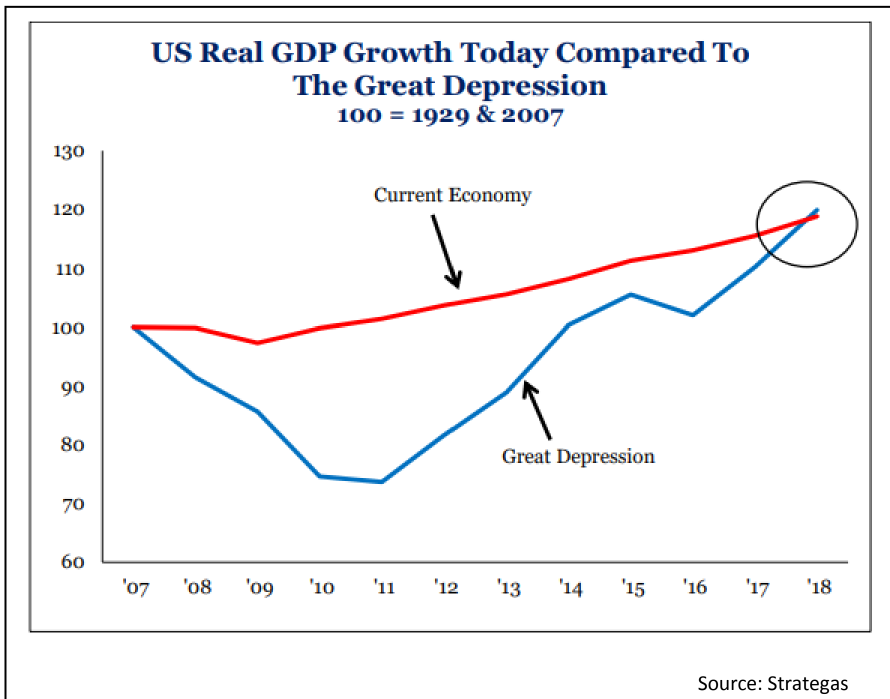
Interesting Charts we saw this Quarter

Value stocks recently reached a discount to the growth stocks only seen during the internet bubble. Watching hot IPOs for companies that are not likely to have any earnings or cash flow for some time to come is reminiscent of that time as well. We do not believe this valuation gap persists for much longer as Fed action to extend the economic cycle should help value stocks.



Source: JP Morgan



Source: Strategas

The US recovery just became the longest in postwar history, crossing the 10 year mark. The strength of the recovery has always been a question mark though, as this chart points out. When comparing this recovery to the one from the Great Depression, The Great Depression recovery is now exceeding the Post Financial Crisis recovery. We still think there are few excesses in the economy, and that this expansion should have a long time to go. It may even have room to accelerate from here.

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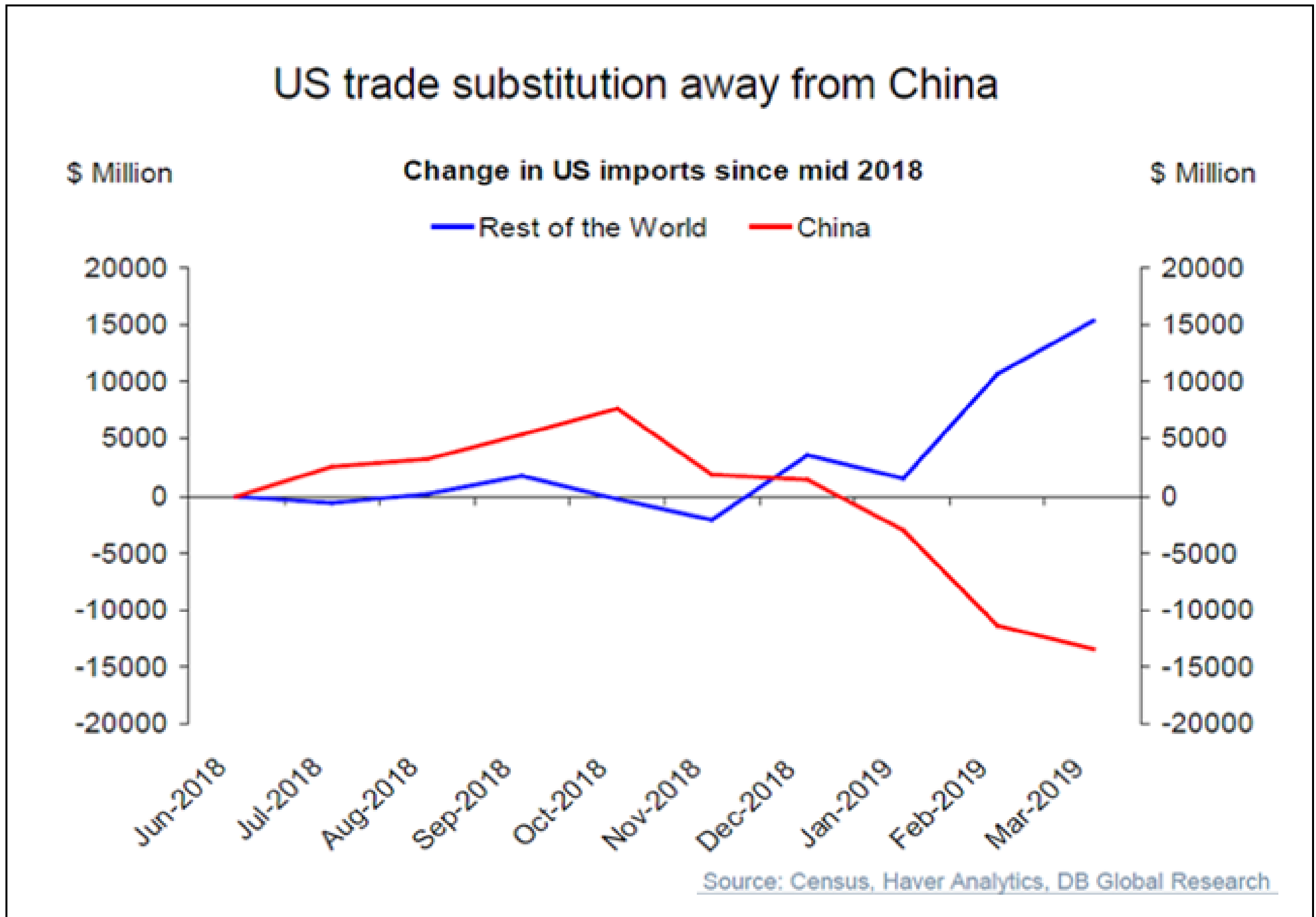
Most investors have been surprised that inflation isn't a more prominent feature of this economic expansion. We spoke in the introduction about the deflationary forces at work in the economy, and why they are exerting downside pressure on inflation rates. Still, when we see covers like this one from *Bloomberg Business Week*, it does give us pause and makes us question whether higher inflation could be nearer than we think.

In this chart, you can see Investors anticipate that the 5 year forward rate of inflation in 5 years from now should be about 1.5%. That is lower than we have seen over most of the past 18 months and below the Fed target. As we move forward, if the job market remains firm and economic growth does not deteriorate, we believe inflation expectations should increase and bonds may weaken. This would indicate more confidence in the economy.



Since the trade dispute started, US Imports from the rest of the world have skewed away from China and towards other sources. While overall imports are only down 2% y/y, monthly imports from China are running down 10-30% versus prior year periods since November of 2018. Supply chains are shifting to other countries, and this shift is unlikely to end even with a trade agreement. As companies shift their supply chains, we believe they are accessing lower cost sources of product.

Summary

The crosscurrents in the market are maddening at times, as markets advance while investors worry about the economy. Realistically though, how bad can it be when stocks have hit new highs? The problem we see is that investors remain crowded in the one way trades of assured growth and technology, and unwilling to venture out to cheaper areas of the market because they perceive risk to the fundamentals in those areas. A "pessimistic bull" is how I've heard some investors describe it, and that characterization feels correct. Investors are not embracing the market run up and skepticism remains high. While that could keep a lid on the market over the summer as we work our way through the debt ceiling debates, Brexit and whatever developments occur on the trade negotiations, we see a number of forces at work that probably support the market through year end. The Fed is in the process of fixing a rate overshoot from their tightening campaign last year, which should allow investors to take a look as some of the neglected corners of the equity market and shift away from the one-way trades we spoke about above. China and the US should be able to come to some agreement in coming quarters on the trade dispute. China is incented to so they can prevent any further shifting of manufacturing out of their country. If President Trump wants re-election, he'll need to eliminate the uncertainty all this drama has injected into the US outlook. Additionally, markets have lowered long rates already for the Fed, which should promote housing, autos and capital investments if other uncertainties are removed and unemployment remains low. We're not sure what the resolution is for Brexit, but eliminating the uncertainty of whether there a deal or not should prompt some relief for investors. Lastly, the debt ceiling debate is probably going to get messy, but it has a limited shelf life, and there has always been a resolution in the past. Concerns are high right now on a number of issues like they have been in the past. When the concerns eased up in the past, markets have rallied and rotated to out of favor sectors. We expect it to play out this time as well.

As always, if you need any additional information, please feel free to contact any of us.

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07/19/19
S&P 500 – 2,977
Russell 1000 Value – 1,261

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Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.

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