October… Earning Its Bad Reputation

Todd Asset Management US Market Commentary

	3Q 2018	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	7.7%	10.6%	17.9%	17.3%	14.0%	16.9%	12.0%
Russell 1000 Value	5.7%	3.9%	9.5%	13.6%	10.7%	15.0%	9.8%

* *Annualized Total Returns.*

October has a bad reputation, and we are seeing why this year, as a market rout is wiping out most of the gains from an excellent third quarter for the S&P. Until the past two weeks, investor sentiment could be summed up as "So far, so good." Since the imposition of tariffs on a raft of Chinese imports, markets have declined almost 7% peak to trough in a little less than two weeks. We believe investor tensions are likely to ease up as we move through the US mid-term elections and a re-examination of some of the fundamental positives occurs. Some of these would include:

- **Earnings and GDP growth**- have remained strong as lower taxes and fiscal stimulus arrive. These impacts are expected to last for the next couple of years. Second quarter GDP growth was over 4% with S&P 500 quarterly EPS advancing over 23% year over year. Sales per share for the S&P gained almost 9% year over year. That's a very healthy gain and expected to continue into the fourth quarter.
- **Employment gains**- remain robust in the US, with the unemployment rate remaining below 4%, and initial jobless claims running at levels lower than at any time since the late 1960's.
- **Inflation** – Is rising but remains at benign levels in most developed markets. US CPI inflation is running at 2.3%, and Average Hourly Earnings (AHEs) are rising at a 2.9% rate. Most economists suggest inflation only becomes an issue for the Fed when AHE's hit 4%.

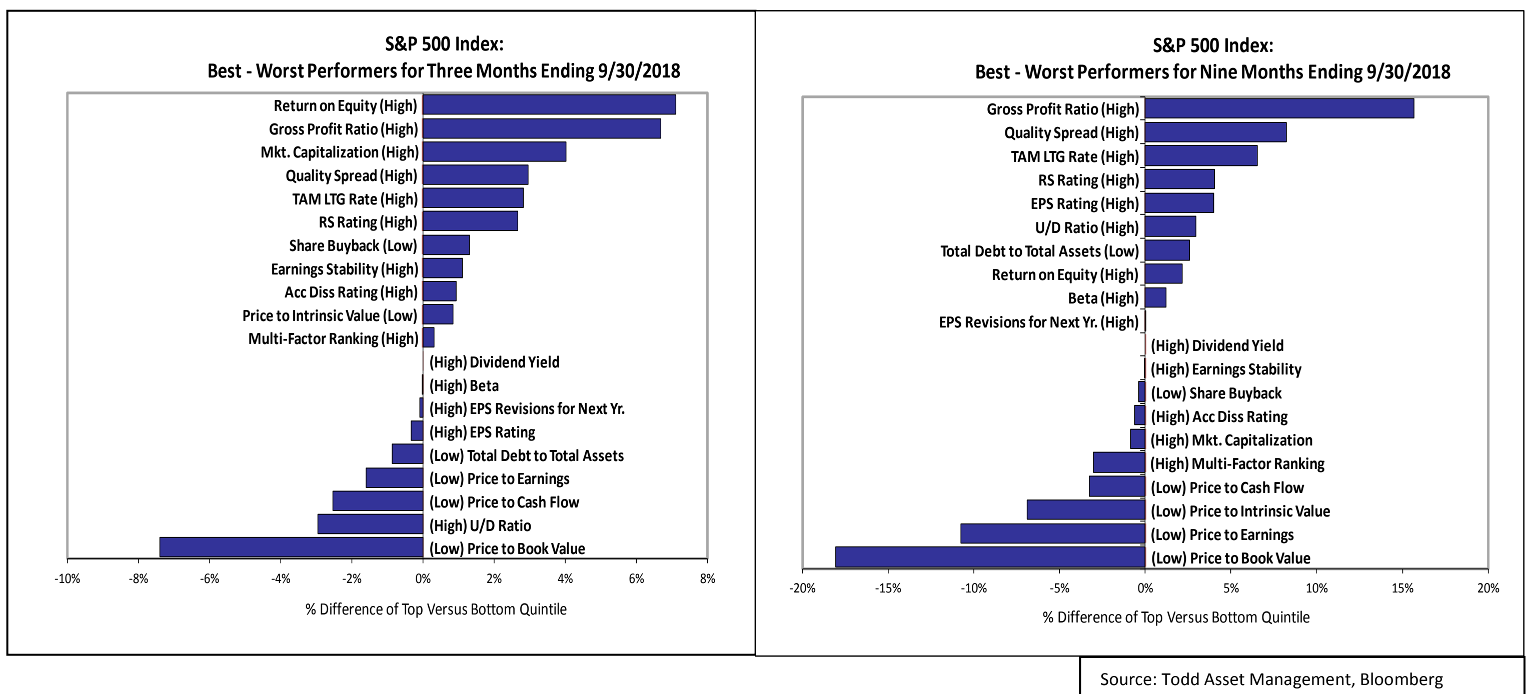
There are several concerns that have taken the forefront recently, including:

- **Many believe the US economy is late cycle**. Most of these judgements are based on how long the cycle has run. Many indicators we look at suggest no recession for at least 3 years or longer.
- **The Fed is raising rates**. Real rates (after inflation) are still near zero. Long-term rates spiked in October after the Fed chairman indicated the bank intends to continue raising short term rates to a more normal rate. Interest rates on longer-term bonds have risen to a point where concerns about a yield curve inversion, where short rates exceed long rates, have dissipated. Normally, curve inversions end badly for equities and signal the economy is within a year of recession. Avoiding this indicates to us the market thinks the economy can handle higher short-term rates and avoid recession.
- **Tariffs and geopolitical turmoil have raised concerns**. The negative impact of tariffs has likely been dwarfed by the size of the US stimulus and repatriation. Over time, they may lead to higher prices, but for the next year there are many factors offsetting any economic pressures that arise from this.

We thought the mid-term elections would dampen enthusiasm for stocks, though we do not hear many pessimists pointing to the election as the markets problem. More concerns center on trade, especially with China. These same concerns were voiced about Mexico, Canada, and the EU earlier this year. The agreement on a new US, Mexico and Canada trade agreement as well as a very positive meeting and agreement with the EU president have assuaged some of those fears. We still anticipate more trade agreements to be struck through 2019. The European Union indicated in August that they were open to a deal, and the US has engaged in further dialogue with the Chinese delegation as well. We believe a deal with the EU is likely to be worked on next, while coming to an agreement with China is a longer-term goal and not necessarily guaranteed.

We think the S&P remains in a bull market. Further gains are likely, especially when you consider that 12 months post midterms, (since 1950) the average S&P return is over 15%, and it has not posted a loss in any of those years. As far as we can see, so far, so good. Stay tuned.

Market Action



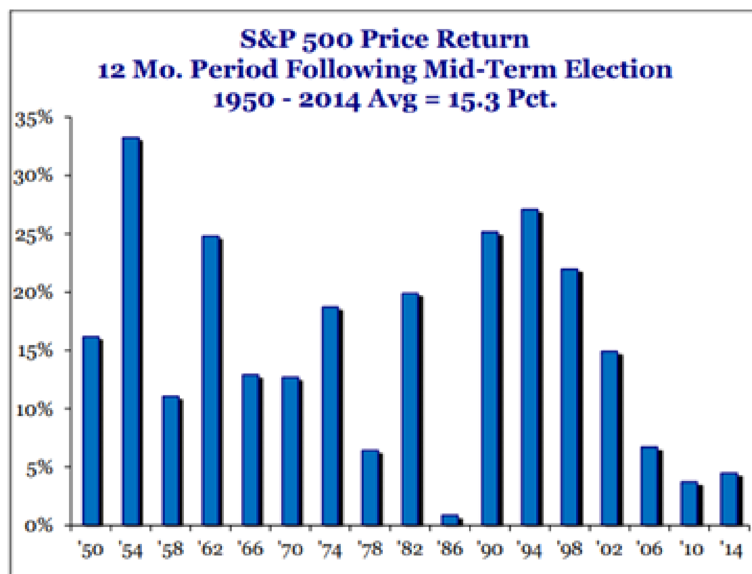
Source: Todd Asset Management, Bloomberg

We present our customary factor analysis for the third quarter (chart left) and year to date (chart right) above. In general, the market has favored factors indicating higher quality on the year to date and quarterly basis. Our proprietary quality rating as well as the Gross Profit Return on Assets were each among the top four factors over both periods. In addition, measures indicating higher growth rates and better market action (Relative Strength rating) performed well. Almost uniformly, valuation measures remained in the tank. Growth investing has dominated value investing while the Fed has kept rates extraordinarily low. This may change as the Fed raises rates especially if investors begin to believe the economic growth we are seeing is sustainable.

Sector work favored a mix of economically sensitive and defensive areas. The Health Care sector performed best, returning twice that of the S&P 500. The Industrials, Technology, Telecommunication Services, and Discretionary Sectors also outperformed the market. Materials, Energy, Real Estate, Utilities, Financials and Staples lagged.

Thematically, the market was not willing to reward the commodity based sectors, or those that would be impacted by changes in rates. The other notables in the quarter were the poor performance of some of the former tech leadership, especially Facebook and Twitter. There was a broadly positive revaluation in large cap pharma, and the higher profile retailers. Additionally, deal talk surrounding the auction of Fox Networks in the quarter drove up many of the media stocks over the summer.

Interesting Charts We Saw During the Quarter



Source: Strategas

While we don't hear much about midterms, historically, getting them out of the way has led to better performance in the following 12 months. As you can see from the chart above, from Dan Clifton at Strategas, during the twelve months following midterms since 1950, the average gain is over 15% and there has never been a loss during the period.

Maybe this could get upended if the Democrats take control of the house and immediately move to start investigations or impeachment proceedings as some of their members would suggest. While that could provide some drama and volatility, it probably would not result in unseating President Trump.

We believe that if a Democratic majority emerges in the House, there is a higher likelihood of President Trump moving closer to the center. After all, issues like infrastructure have bipartisan appeal.

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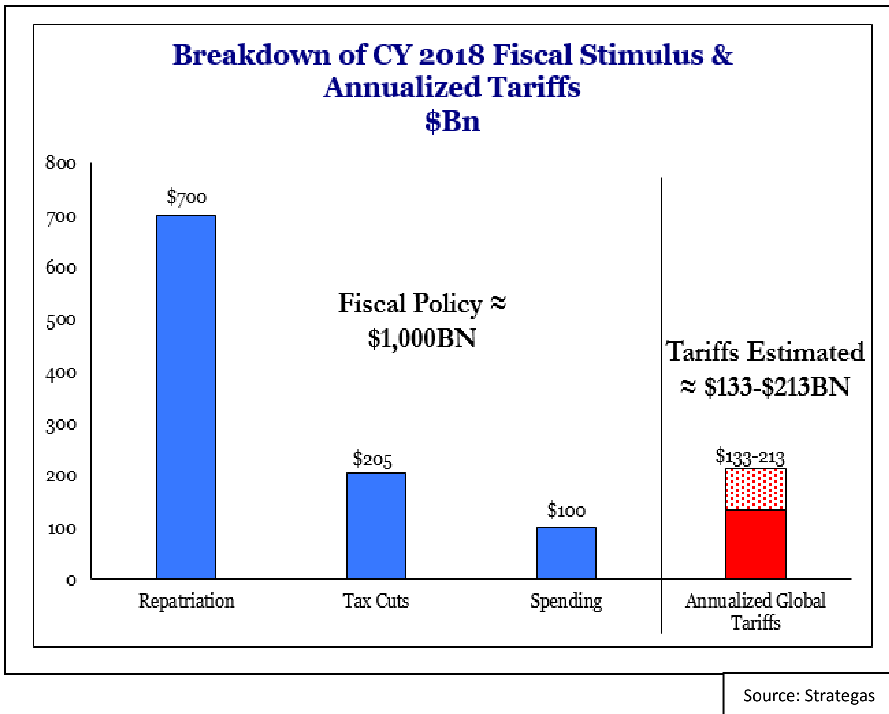
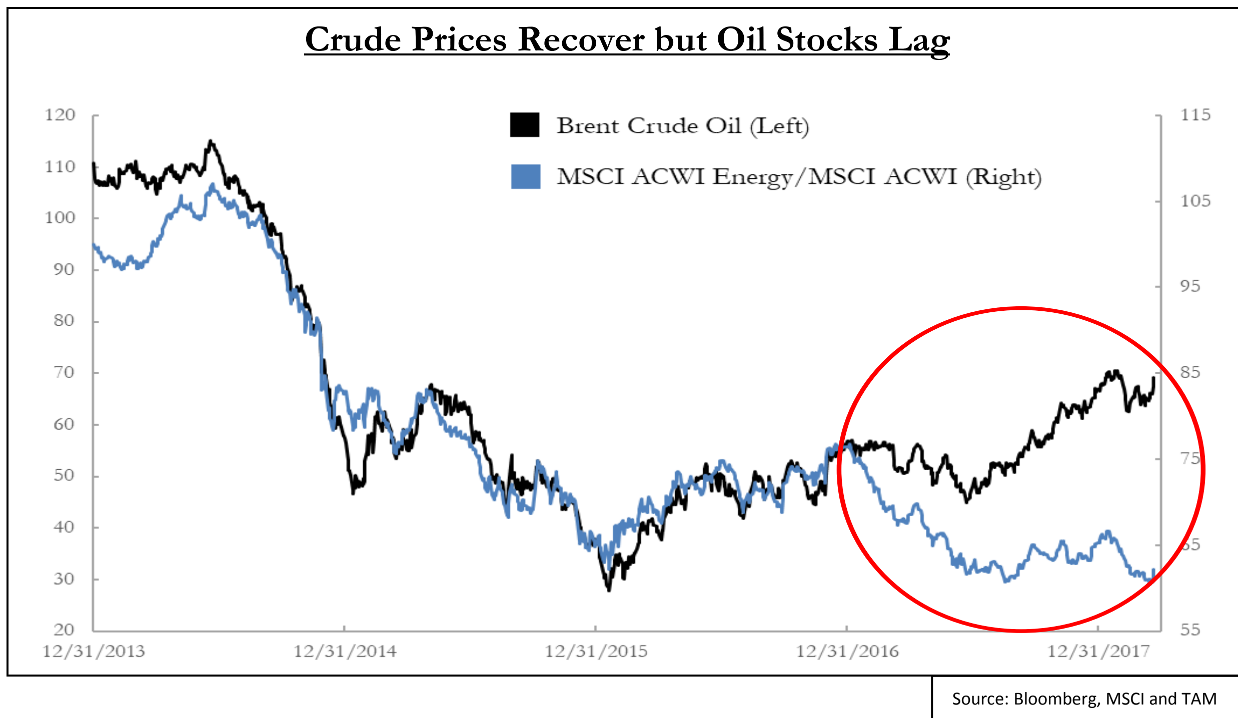


Source: Strategas

Trade tariffs are getting a lot of attention recently, as President Trump has implemented them (or threatened to use them) on all imports to the US from China. While this may become a problem longer-term as it would eliminate a low cost supplier, it should not derail the current expansion. Tariffs could equate to $133-$213 Billion annualized, while tax cuts, repatriation and increased federal spending could add $1 trillion (chart left). The US economy is unlikely to see a recession with this type of stimulus in place.



Source: Bloomberg, MSCI and TAM

Oil prices have recovered much of the ground they lost a few years ago. Tighter conditions exist with new Iranian Sanctions and supply disruptions from Venezuela and Libya keeping supply in check. Oil demand has continued to grow, driven by the US and Asia. Economic forecasts remain firm, and investment in exploration and production has not yet recovered from a significant curtailment in 2013-14. Despite this visibility for oil demand, the global measure of oil stock performance has barely budged relative to the markets. We think this offers a good opportunity.

Summary

After performing well during the third quarter, US stocks declined and got much cheaper early in October. The concerns driving stocks lower centered on trade tensions, higher rates and the longevity of our economic expansion. We believe stocks are probably also reflecting the potential for the midterm elections to lead to a change in control for the House of Representatives, but probably not in the Senate.

As we look at it, we still believe that there is a potential for better markets after the midterms. Sentiment has deteriorated broadly in October, but fundamentals still look very solid. Concerns are growing that perhaps we are at peak margins, or maybe our trade spat with China spirals out of control. Other concerns center on the midterms and potential for gridlock afterwards. You will hear naysayers wringing their hands over the Brexit, or our breakdown in relations with Iran. To counter that, we remain focused on the economic indicators. Earnings look excellent. Inflation remains well behaved and is not accelerating. GDP estimates look firm. Valuations are not excessive. The Federal Reserve is telling us that the economy is getting back to normal, not dangerously overheating. Until that becomes a risk, we think stocks should make progress from current levels, but will do so with more volatility than we have become accustomed to over the past few years.

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

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10/19/18
S&P 500 – 2,768
Russell 1000 Value – 1,202

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S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

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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