ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

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"The investor's chief problem—and his worst enemy—is likely to be himself. In the end, how your investments behave is much less important than how you behave."

Benjamin Graham

IN FOCUS:

US stock prices rebounded in the first quarter of 2019, reversing most of the 20% decline intraday peak-to trough drawdown through year end. This recent decline resulted in the first negative S&P 500 annual return since the financial crisis over ten years ago. The selloff in retrospect was a result of the long anticipated slowing economic growth, coupled with a tightening Fed and worries about both a yield curve inversion and liquidity concerns. The political uncertainty did not help matters either.

The significant gains in January and February marked the strongest calendar-year start for the market since 1987, according to the Wall Street Journal. However, late in the first quarter, the momentum began to fade as investors appeared to discount the potential effects of a slowing global economy, the uncertain outlook for US-China trade negotiations, and the United Kingdom's pending exit from the European Union.

In January, the Federal Open Market Committee (FOMC) signaled a more accommodative policy stance. The pivot left interest rates unchanged and indicated a greater willingness to maintain a large balance sheet at the quarter's end of $3.975 trillion. The FOMC's message appeared to surprise investors and, gauging from the market reaction, was viewed positively. As recently as December 2018, following four 0.25 percentage-point rate increases earlier that year, the FOMC was projecting two more rate hikes in 2019.

There were similarly accommodative moves by other major central banks. Just a few months after ending its €2.6 trillion bond-buying program, the European Central Bank (ECB) announced it would hold a key rate, the deposit rate, at its current level of -0.4% for a longer period, at least through the end of 2019. The ECB also announced that it will be expanding its long-term loan program for banks. These loans are priced at the deposit rate. The Bank of Japan (BOJ) announced in March that it will keep rates at their current levels (-0.1% for the short-term rate and a 0.0% target for the 10-year bond). In its policy decision, the BOJ noted that "exports and output have been affected by slowing overseas growth." Meanwhile, China's response to weaker economic conditions has been a mix of fiscal and monetary programs that include tax cuts in the manufacturing sector, increased funding for infrastructure projects, and measures to prompt bank lending to smaller companies.

In the fourth quarter, the US economy expanded 2.2% at a seasonally adjusted annual rate, according to Department of Commerce data on real gross domestic product (GDP). On an average annual basis, real GDP rose 2.9% in 2018, the highest rate since 2015. Payroll growth averaged 180,000 per month during the first quarter of 2019, a modest slowdown from the pace in recent years. At the end of March, the unemployment rate remained at 3.8% while year-over-year average hourly earnings were up 3.2%. (Source: Bureau of Labor Statistics.)

On the energy front, crude oil prices rose as Saudi Arabia, Russia, and other Organization of the Petroleum Exporting Countries (OPEC)-plus producers made progress toward their goal of cutting output by 1.2 million barrels a day. Domestically, crude inventories trended lower, helping to support higher prices. Brent crude, the international benchmark, finished the quarter above $68 a barrel, up 27%.

In addition, the US Dollar declined against most major currencies as a yield curve inversion and dovish Fed-speak weighed on the currency. Commodities recovered from their 4Q18 decline driven largely by the recovery in oil prices. Brent and WTI prices rose on the back of OPEC production cuts, lower US inventories and improved global risk sentiment. Disruptions in Iran, Venezuela and Libya also contributed to bringing supply/demand to more balanced levels.

The yield on the 10-year Treasury fell to 2.42%, driven by concern around the global economic outlook, elevated global policy uncertainty and a more dovish Fed policy outlook. The yield curve flattened and has become slightly inverted at various points along the curve. While inversion has raised questions regarding the likelihood of a recession from investors, we continue to assign low, 15-20% odds of a recession this year. As a result, the 1Q19 rally in bonds boosted returns for the Barclays US Aggregate Bond Index, which advanced 2.9% during the quarter.

Of course, the inversion of the yield curve (i.e. shorter-term rates above long-term rates) has fueled recession fears. The current inversion implies market expectations of rate cuts in both 2019 and 2020. Further, it is often costly to reduce risk on this signal as there is also a long lag between inversions and market peaks. We expect the Fed to be on hold in 2019.

CLOSE-UP: The Economic Landscape as 2019 Unfolds

Investors are still grappling with a divergence between U.S. and global economic data. U.S. data is expected to slow in the first and second quarter, and recent economic numbers such as the February jobs report and retail sales have been disappointing. However, a trough could be near, with housing appearing to have bottomed and consumer confidence rebounding from late 2018 lows. By contrast, the trough for the global economy remains uncertain, despite steps taken by global central banks and governments (specifically China) to stimulate their economies.

The domestic soft patch in the first quarter was most likely, in retrospect, a function of seasonality. By the end of the quarter, the current business cycle will mark the longest on record and many economists are becoming skeptical about an impending recession. It is our belief that an economically induced recession is not likely, at least in 2020. Historically, recessions are usually preceded by rising inflation and the inevitable Federal Reserve response by pushing rates higher to prevent inflation from running out of control. While the global economy, in particular the European Union (EU) and Japan, is facing a severe slowdown so far this year, the U.S. appears to also be experiencing a moderate slowdown. We estimate that U.S. GDP will grow at a real rate of 3.0% this year in comparison to 2.9% in 2018. In contrast, the EU is expected to grow by under 1.5% and Japan by only 1.0%. Our inflation rate, as measured by the consumer price index (CPI), is currently running under 2.0% year over year.

Throughout the current cycle, first-quarter data has been typically weak, with the Bureau of Economic Analysis recently acknowledging the challenges with regards to adjusting the data for seasonal impacts. The government shutdown in the quarter, delayed tax refunds and consumer apprehension in light of market volatility were all likely factors to negatively impact GDP in the near term. However, we are expecting a rebound in the second half. While many believe the stimulus from the Tax Cuts and Jobs Act of 2017 has run its course, the fiscal stimulus related to the tax refunds was actually larger in 2019 than it was in the previous year.

Looking abroad, global economic data appears to be bottoming. Recognizing that Chinese deleveraging efforts have been the central challenge of forecasting global economic growth, Global Purchasing Manager Indexes (PMIs) have also been under pressure for much of last year. This nearly matches the record of consecutive declines of global PMI data recorded in early 2008.

On the positive side, while Chinese manufacturing data appears weak, Chinese services have held up much better. In keeping with the aim to diversify its economy, China has focused its stimulus on services. Steven Roach, an economist and senior fellow at Yale University and formerly Chairman of Morgan Stanley Asia, stated recently on Bloomberg that China is "in the process of rebalancing their economy from an export-led to a consumption-oriented one, from manufacturing to services, imported to indigenous innovation, and a surplus saving to a savings absorption economy". The codependence of the US and China continues to strain as the US tenaciously holds on to the traditional Chinese model of export led development. Much of the Chinese efforts, including tax cuts and government spending, support the domestic consumer. The government has also taken steps to shore-up the shadow banking system and unwind past manufacturing excesses.

Given the prospect of a sluggish global economy, we believe the coming quarter could see increased volatility compared to the quarter just completed. Unlike the fourth quarter of 2018, positioning and sentiment data do not appear to be at extreme levels, meaning any pullback is likely to be more muted than the volatility experienced late last year. As a reminder, the market has seen 17 pullbacks of 5% or more since March 2009, several of which were linked to global economic slowdowns. However, each of these has proven to be a buying opportunity for the long-term investor. While global economic data is not yet flashing green, it is important to remember that the stock market is a forward-looking mechanism. As a result, equities typically begin to rally well before economic data and even corporate earnings recover. These dynamics played out in the 2016 global slowdown, with the market bottoming 10 months before global earnings revisions turned positive. A similar pattern emerged in 1998, 2003 and 2009.

Other positive and noteworthy economic green shoots emerged in March. The LEI, a composite index of leading indicators, was up 0.4% versus flat in January and February, currently up 2.8% year over year. The Manufacturing Index (55.3) increased from February while the Non-Manufacturing Index (services) remains strong. New orders ran at an expanding rate but slower than February levels. Overall, these indices are still supportive of growth albeit at a slower rate than at the end of 2018. On the assumption that an improved trade deal with China will be reached, we believe that the U.S. economy will grow 3.0% in 2019, as measured by real GDP. We have become more confident on our forecast, based on the strong first quarter earnings report. We think that inflation, as measured by the CPI, will continue at the 2.0 to 2.5%% rate and that corporate profits will sustain a high single digit growth rate on average for the year. Another possible bullish development could be a material rebound in US productivity, given widespread innovations that potentially offset any advances in labor costs.

A China Trade Deal & Brexit Status

- The challenge will be to craft and enforce a deal to resolve structural issues, such as Chinese industrial policies, IP (intellectual property) protection, and FTT (forced technology transfer) as a precondition of obtaining market access. We are also expecting some sort of watered-down US-China trade deal within the next few weeks, as Trump pushes the Chinese to close a deal by threatening more tariffs. If an agreement is accomplished, that should provide a "peace dividend" to the global economy.

- While Brexit will continue to be a source of market volatility as the UK and the EU navigate the final stages of a deal, we believe that a disruptive exit will be avoided. Also, the impact of the UK on the US economy and markets is limited, with the UK economy making up just 3% of global GDP and the UK representing only 1% of S&P 500 revenues. Although the US/China trade talks appear in limbo, there is yet to be a concrete resolution in place and details are still limited. At this juncture, we continue to expect a soft Deal Brexit or none at all.

IN SUMMARY:

The markets have come a long way from the lows of last year and we believe there is more upside for equities in this cycle. However, it would not surprise us to see a pickup in volatility during the coming quarters, given the likelihood of additional weak global economic data coupled with the potential for possible pressure on earnings estimates as the second quarter unfolds. We conclude that the expansion continues and believe any weakness in individual investments should be viewed as a long-term buying opportunity. As the economy enters the later stages of this cycle, risk management and a focus on quality and valuation become increasingly important characteristics for investors.

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