ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

October, 2018

"Uncertainty is actually the friend of the buyer of long-term values"
Warren Buffett

IN FOCUS:

In retrospect, investor optimism for U.S. stocks endured in the third quarter, despite emerging market dislocations and an expanding array of tariffs on U.S. imports and exports. The Standard and Poor's 500, the broad market index, posted a 7.7% return, its largest quarterly gain in nearly five years, pushing the index's year-to-date total return to 10.6%. Sound U.S. economic fundamentals, accelerating year-over-year corporate earnings growth, and consumer confidence at an 18-year high, overwhelmed negative headwinds and pushed equity prices to new highs. Looking at the broad style indices, growth stocks pulled ahead of value stocks and shares of larger-capitalization companies were ahead of smaller-cap shares.

In the end of the third quarter, there was a fair amount of drama with the Supreme Court nomination as well as Brent crude oil rising above $80 a barrel to its highest level since late 2014. In a widely anticipated move, the Federal Open Market Committee (FOMC) implemented its third quarter-point rate increase of the year, the eighth since late 2015, raising the federal funds rate target range to between 2.00% and 2.25%. The Federal Reserve's median growth forecasts for real gross domestic product (GDP) for 2018 and 2019 were revised higher, to 3.1% and 2.5% respectively. The Trump administration imposed 10% tariffs on $200 billion of Chinese goods, bringing the total to about $250 billion, and ultimately prompting Beijing to sidestep trade negotiations. Additionally, the 10-year Treasury note yields rose above 3.00%, closing the quarter at 3.05%; and the average interest rate for a 30-year fixed mortgage climbed to 4.72%, its highest level in more than seven years according to Morgan Stanley Research.

In its third estimate of real GDP growth for the second quarter of 2018, the U.S. Commerce Department reported an increase of 4.2% at a seasonally adjusted annual rate. That followed growth of 2.2% in the first quarter. Nonresidential fixed investment (capital expenditures) was a bright spot, rising at an 8.7% annual rate. Employment trends remained relatively strong. Monthly nonfarm payroll growth averaged 190,000 during the quarter and the unemployment rate clocked in at 3.7% by the end of September. The latest Job Openings and Labor Turnover Survey data from the U.S. Labor Department showed that job openings increased to 6.9 million in July, the highest level since December 2000 when the survey first began. Average hourly earnings rose 2.8% from a year earlier. However, with the latest U.S. Consumer Price Index (CPI) inflation reading coming in at 2.7% year over year, the trend in real wage growth remains relatively flat. Overall, the U.S. economy remains relatively healthy growing an estimated 3.0% annually. This was most likely bolstered by the Trump Administration reducing regulations and lowering taxes.

CLOSE-UP: The Economic Landscape as the 4th Quarter Unfolds

One of the most significant macroeconomic developments of 2018 was the sell-off in U.S. Treasuries, that contributed to the increasing volatility not only in equity markets but other asset classes as well. Issues that didn't affect markets when U.S. rates were low or falling have moved to the foreground now that U.S. rates are rising. Yet when you look at the 'reason' U.S. yields have been going up, the news isn't all bad. Nobody focuses on 'secular stagnation' anymore, and most investors think the economy will be able to live with higher real interest rates than seemed possible just a few years ago.

However, based on the price volatility in most segments of the markets we have seen over the past month, this isn't providing much comfort especially for the most interest-rate sensitive parts of global markets, particularly auto and housing stocks. Fortunately, the automatic stabilizer tends to kick in: Yields rise, equities eventually sell off, yields reverse and we end up where we started. However, we recognize that we can't be complacent assuming this response mechanism will always be there as a safety net.

In an effort to simplify the interest rate outlook, economists like to think about long-term yields in three parts: expectations of short-term real interest rates, inflation expectations and the rate of return (term premium) on an asset that provides an incentive for investing. Keep in mind that real rates have increased significantly since 2017, inflation expectations are up slightly and the term premium continues to lag historical averages. It is the behavior of the term premium that has been the most surprising element of the sell-off so far. Remember, this is the additional compensation investors demand to hold longer dated paper rather than rolling over short-term securities. From a historical perspective, the term premium remains alarmingly low, which is what had unsettled investors in 2017. The former Fed Chairman, Ben Bernanke, always insisted QE operated through the term premium, so if central banks were keeping rates 'artificially low', which was a popular notion at the time, the end of global QE would surely trigger a powerful rebound in rates – potentially leading to a very negative market reaction which we got a glimpse of since September 30th.

Is A Trade War Priced In?

World trade growth has slowed further but remains relatively robust. A pickup in the freight costs is encouraging for the trade outlook, but signs of the well-publicized and anticipated shift in the supply chain configuration still remains tenuous. Emerging Markets (EM) equities meanwhile have declined markedly. Much depends on trade war developments next year, but EM equities may now be pricing in a decline in trade that may not necessarily be fully realized. The following observations should be considered:

- **World trade growth continues to slow.** World trade data published last week showed a 0.2% increase in volume for August, while momentum (volume for the last three months vs. the previous three months) surged to 1.5%, its highest level since February. Such good news is of course relative.
- **The increase in the value of trade relative to global GDP** has however stalled over the past three months, while the year-on-year growth continues to trend southwards.
- **Trade may have slowed, but it has not collapsed**. Over the past five years, there has been a broad correlation between the year-on-year growth of trade and the six-month lagged cost of container freight leaving China. The sharp decline in freight cost since the beginning of this year according to Bloomberg data delivered a warning as a precursor of falling trade volumes in the future. Trade volume growth, however, has declined slowly and remains well above the lows of 2016. A recent pickup in the growth of freight cost may be an encouraging sign for the trade outlook, but disappointing exports in some EM economies may provide a warning or lead indicator that a more negative scenario could develop.
- **Trade war disruption has hit EM exports**. Morgan Stanley research recently has shown that export growth in Indonesia in September was less than 2% having averaged more than 10% in the year to date data, while exports in countries like Thailand shrank by more than 5% over the same time period. It has been observed that some of the sharpest declines in the Thai data were in sectors that include auto parts and electronics. It is no coincidence that these are precisely the products that are likely to be ones affected in the global supply chain reconfigurations that will inevitably be disrupted by the U.S.-China trade conflict.

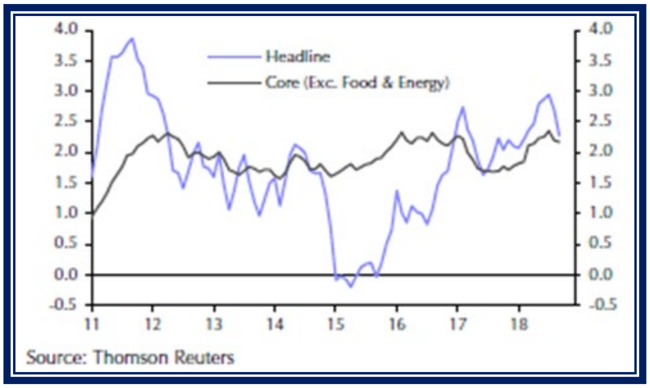
Will Core Inflation Remain at Current Levels?

The collapse in crude oil prices over the past few weeks has materially altered the outlook for headline consumer price inflation over the next 12 months. The stronger dollar will only add to the disinflationary pressure, at a time when the risks of core inflation overshooting the Fed's 2% target appear to be fading. The spike in natural gas prices looks dramatic but so far has had only a modest impact on final consumer prices. The WTI crude oil benchmark has declined by nearly 32%, from its peak of $75 per barrel in early October to close to $50 at the time of this writing. Gasoline futures have fallen by a similar amount from their peak in early October and retail prices should decline by close to the same magnitude over the next few weeks.

While the recent free-fall in the price of oil may be contributing to potential risk in the credit markets, it's unlikely to be signaling a significant drop in global oil demand. The problem appears to have shifted to over supply rather than sudden weakening in the global economy. Nevertheless, the weakness since the year began in the CRB raw industrials spot price index (which doesn't include petroleum or lumber products) has indicated that the dollar, rising interest rates, and the possibility of a trade war are weighing on global growth.

The uptick in headline CPI inflation to 2.5% in October, which was reported in early November, appears to be an aberration from the 2.3% trendline. Slumping retail gasoline prices should subtract an estimated 0.4% points from headline consumer prices according to Morgan Stanley Research, and should drag the annual inflation rate back down to 2.0% by year-end. Next year's inflation forecast remains difficult to predict due to trade and global growth uncertainties. If real economic growth continues to slow in the near term, which it should despite any modest boost from lower energy prices, lower inflation makes us a little more confident that the federal funds rate may peak at 3.00% to 3.25% in mid-2019.

CPI Inflation (%)



Source: Thomson Reuters

Inflation has levelled off, and the same fundamentals that pointed to higher inflation 18 months ago now suggest that core inflation will remain closer to 2%. Labor costs are unlikely to rise fast enough to push inflation meaningfully above the Fed target. Tightening labor market conditions are still putting gradual upward pressure on wages, but with annual productivity growth now running at close to 1.5%, annual wage growth would need to rise above 3.5% to push inflation much beyond the 2.0% level.

With the unemployment rate well below most estimates of its longer-run level, there are concerns that a more marked acceleration in wage and price inflation lies just around the corner. We are beginning to see that labor market conditions are not as tight as the low headline unemployment rate suggests - and with most measures of inflation expectations below their averages of even a few years ago, an upward wage-price spiral no longer appears to be a "fait accompli" at this point.

Meanwhile, after boosting inflation for the past 18 months or so, the dollar now looks set to be a modest drag on consumer goods prices. The 10% appreciation of the dollar since April has already been reflected in lower prices for imported goods and should show up, with the usual lag, in consumer goods price inflation over the coming year. We don't think that imposing tariffs will substantially alter the picture, either. Most of the boost to input costs appear to have been easily absorbed in firms' margins so far according to our sources, with final goods prices little changed to date. There appears to be plenty of evidence that businesses are finding ways to reconfigure their supply chains to minimize the impact. Even if trade tensions continue to ratchet up, and we end up in a worst-case scenario where all imported goods from China were subject to a 25% tariff, economists are now estimating that this would only push up the U.S. prices by just a few tenths of a percent.

The bottom line is that we now expect core CPI inflation to average 2.3% over the coming year, and the Fed's preferred Personal Consumption Expenditures (PCE) measure to average just over 2%. That should be high enough to keep the Fed on track with its gradual rate hikes over the coming quarters. But now with little risk of a larger overshoot, we suspect that Fed officials would not hesitate to change direction if the economy began to slow.

Current Season Earnings Picture

At this juncture, the third quarter earnings for the Standard and Poor's 500 are winding down. Reported numbers with respect to revenues and earnings for Q3-2018 are mostly good news across the board, but company guidance released during the season indicated that the third quarter could likely mark the top of the growth cycle during the current economic expansion.

During the quarter, we saw a most extraordinary jump in revenues by the S&P 500 by as much as 8.5% y/y according to Bloomberg, and has been above the long-term growth trend since the 2016 presidential election. Normally this far into an economic expansion, revenues growth tends to be around 4%-6% y/y. However, quarterly revenues were down sequentially. If that decline holds as the Standard and Poor's 500 reports, as well as according to Morgan Stanley, this would mark the first time that Q3 revenues have fallen sequentially since Q3-2008.

S&P 500 index's earnings peaked again in the quarter at an all-time high soaring 27.5% y/y last quarter, its strongest growth since Q4-2010 and up from 25.8% y/y during Q2 according to Bloomberg data. The third quarter results continue to reflect the strength in revenues as well as the cut in the corporate tax rates. Profit margins also hit an all-time high. Despite the increasing fears concerning rising costs, companies again beat expectations in the recent quarter as the S&P 500 corporate profit margin, based on S&P's trailing-four-quarter operating earnings data, rose once again to a record high of 11.4%. Prior to the tax cut enacted in 2018, the recent record was of 10.1% reported during Q4-2017. We expect these profit margins could hold at these levels in 2019, because of the lower corporate tax rate and our expectation of a possible pickup in productivity growth.

IN SUMMARY:

We believe that productivity growth is a key factor - not only for the long-run outlook but also may prove pivotal in extending the economic cycle. In the mid-1990s, then-Fed Chairman Alan Greenspan held off raising interest rates, judging correctly that rising productivity growth would allow economic growth to accelerate without pushing up inflation. That meant monetary policy never became a big drag on activity, with the economy experiencing a soft landing in 1995 before picking up its pace again. Continued accommodative policy extended the economic cycle all the way through the 1990s, until interest rate hikes in 1999 and 2000 helped to relieve the dot.com bubble that ultimately sank the economy.

With productivity growth still subdued, a similar outcome this time around is unlikely. Admittedly, even the small rise in productivity growth seen so far has been enough to offset the gradual acceleration in hourly wage growth, keeping unit labor cost growth down. That in turn suggests that core inflation is unlikely to rise materially from here. But with inflation at the 2% target, the unemployment rate well below its longer-run natural level, and many Fed officials worrying about risks to financial stability, the Fed looks set to continue raising interest rates gradually. That shifting policy mix is why we expect economic growth may fall below its potential rate by the middle of next year. Under those circumstances, we'd expect the Fed to pause its rate hikes, and ultimately begin to unwind some of its tightening in 2020.

Lastly, the recent plunge in oil prices should take some pressure off both the headline and core inflation rates. The 10-year U.S. Treasury bond yield falling back to the 3.0% level coincident with the expected inflation rate falling to 2.02% is now holding around its lowest readings since the start of the year. In our opinion, the plunge in stock prices, especially the ones of cyclical companies, suggests that the economy may not be as strong as the Fed earlier perceived and that inflationary risks remain low. Under these assumptions, we believe that an expanding U.S. economy (albeit at a slower pace than recent quarters) and the improved stock valuations based on lower equity prices have already adjusted for lower growth expectations. Much of the valuation premiums earlier in the year no longer pose additional portfolio risk, and we remain bullish on equity prices into 2019.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.