ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

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"The Only Thing We Have to Fear is Fear Itself."
Franklin Delano Roosevelt

IN FOCUS:

As the 2018 year closed, we were reminded of the well-known quote above from FDR, when recognizing that the possibility of an imminent recession could very well *cause* a recession. We do not expect this to happen, despite the evidence that what can be referred to as the "fear phenomenon" depressed the U.S. economy during December and January.

The synchronized global economic expansion expected by many investors in 2018, and reflected in the IMF's forecast of 3.9% global growth at the beginning of the year, is now recognized as overly optimistic. The contraction in many global equity markets earlier in the year and now happening in the U.S. reinforces the view that economic growth around the world is slowing and has spilled onto our domestic shores. In Europe, for instance, during the third quarter Germany's GDP growth fell to a negative 0.8% with Italy growing by only 0.1%. Overall the Euro area's growth was recorded at an annualized rate of only 0.7%. Japan also experienced weakness, declining at an annualized rate of 1.2% during its third quarter as it continues to fight deflation, despite the low yields below ¼ of a point on its 10-year bonds due to extreme monetary expansion.

In contrast, China grew at 6.6% in the third quarter, but economists have highlighted the fact that this growth rate marked the lowest rate in a decade. China's outlook is now further clouded by a growing trade war with the U.S., against record levels of debt that the government is attempting to address without further damaging the economy. Despite these global headwinds, the U.S. GDP actually started to accelerate to the 3.0% growth rate in the most recent quarter through September, after experiencing many years of below trendline growth of 2.0%.

Focusing on the U.S. economy, there is now little doubt that a slowdown appears inevitable for 2019. While the third quarter growth rate of 3.5% looked great at first glance, economists estimate that 2.1% of that growth came from an inventory increases potentially anticipating the start of a tariff war. If one were to adjust for inventory increases, the growth rate would have been less spectacular despite strong government spending. The expectation of a capital spending cycle emerging from the tax cuts boosted corporate profit growth, and stock buybacks only reduced corporate assets by using excess cash. Economists estimate that in the first half of 2018, some $367 billion was spent on buy backs against approximately $300 billion on capital spending. The stock buybacks are estimated to reach $1 trillion by year end, a new record.

In addition to slowing capital expenditures, residential spending was under pressure in the back half of the year - as rising costs of homes from increased labor and material costs, as well as higher mortgage rates, have finally taken a toll on home buyers. Existing home sales had been down for the last six months and home prices have started to fall. Other leading indicators have softened, despite robust consumption and employment statistics showing a very different picture.

While corporate tax cuts have doubled corporate profit growth in 2018, investors are mainly concerned with trade, particularly with China and the effect these headwinds will have on business confidence. There is no doubt that the tax cuts have materially impacted the government's budgetary outlook, increasing an estimated 18% from prior forecasts. If this current trend continues, the fiscal deficit will approach $1 trillion in 2019, or close to 5% of GDP. In an effort to address this, the U.S. Treasury has already announced that debt issuance will double in 2019. Because of these debt levels, investors are hypersensitive that any signs of rising interest rates will have a significant impact on slowing the economy. This had the effect of a reversal in the Federal Reserve language of putting rate normalization policy on autopilot instead of a more cautious tightening policy in 2019.

Earnings Overview

The enthusiasm for the 2019 earnings outlook has been doused, as fourth quarter results have concluded and industry analysts have introduced the possibility of an earnings recession (defined as two consecutive down quarters).

We are carrying an S&P 500 earnings growth outlook for 2019 of high single-digit percentages coming off of an outstanding year, thanks to the corporate tax cut and better-than-expected revenues growth. Additionally, the S&P 500 profit margins exploded last year marking a new record high during the third quarter. We expect that margins will be under some pressure this year against a backdrop of slowing revenue growth, as the global economy continues facing headwinds. Although earnings may be under some pressure in 2019, we remain optimistic that a slowdown will be viewed as a "growth recession" in earnings and not materialize into a significant economic contraction.

So why are stock prices continuing to rebound from December lows in the face of a forecast for an earnings disappointment? Our positive read on a rising market in 2019 is predicated on the fact that despite the 24% rise in earnings in 2018, the S&P 500 index fell -4.4%. That leaves us with a catch-up market this year, as earnings flatten and fears of an economic recession have dissipated. Markets trade on forward earnings and so our 2020 estimate of high single digit gain over 2019 expectations leaves plenty of room for expanding stock prices.

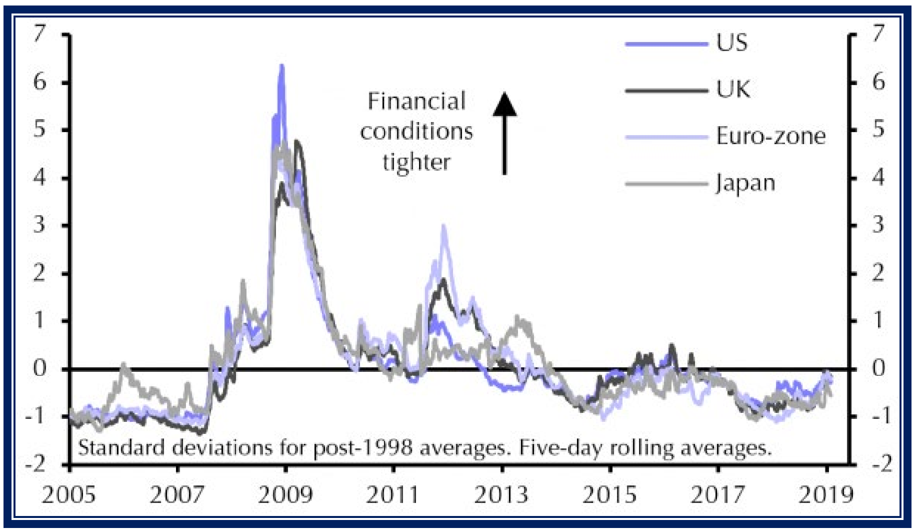
CLOSE-UP: The Economic Landscape as 2019 Unfolds

The bright spot rallying markets against the recent gloomy global economic forcast is that the resilient U.S. growth is boosted by consumer spending and lower oil prices. This is coupled with improving German and Chinese business sentiment as trade tensions ease.

The "about face" by the Federal Reserve to a more dovish tone, along with recent positive economic data, suggests that U.S. GDP growth could hold up better than previously forecasted. Althougn we are somewhat skeptical, we recognize the possibility that the Trump tax cuts might start to give a bigger boost to productivity growth, and oil prices at the lower end of our expected range should stimulate consumption. This could result in pushing inflation down and put the Federal Reserve on the sidelines for 2019. Given the recent drop in consumer confidence, especially in the Eurozone, we suspect that households will initially increase savings as a result of lower oil prices. Historically, lower oil prices have boosted real consumer spending growth in advanced economies.

In addition, there remains a good possibility that business sentiment might recover sharply if a trade deal is reached with China and the current ceasefire with the EU becomes more permanent. While tariffs imposed so far apply to only an estimated 2.5% of world trade, according to Capital Economics, the growing threat from protectionism might well explain some of the recent drop in business sentiment. After all, the decline has been relatively sharp in Germany and China (the nations most targeted by Trump). We also believe the laggards of the Eurozone might experience a late resurgence. For example, both France and Italy still have significant spare capacity, political risks have eased and fiscal policy has been loosened. We believe a trade deal may be easier to achieve against the backdrop of a strong U.S. economy. The Eurozone consumers might be more inclined to spend their energy savings, if the EC provides moderate fiscal stimulus at the same time that political tensions ease.

Although the recent economic data does not in itself confirm a new global downturn, the answer lies in what happens to financial conditions and is typically reflected in interest rate futures. Tightening economic conditions in the major advanced economies will show up in the direction of equity markets and credit spreads.



Source : Capital Economics

A Closer Look at the Effect of Tariffs on the Global Slowdown

Our current economic forecast takes into account that tariffs imposed in the past year appear to account for only a part of the slowdown in global trade growth. According to our sources, the threat of future tariffs might also have hit trade through its effect on business confidence and investment. But the key driver has been softer underlying demand, implying that any positive conclusion to ongoing trade talks would not necessarily lead to a sharp recovery in world exports.

It is not surprising that protectionism is often blamed for the slowdown in global trade volumes. World trade indeed started to slow at the start of 2018 just as the first tariffs were imposed. There were few other obvious explanations, with domestic demand growth holding up well in the major economies at the time. But it is actually quite difficult to pin the slowdown on protectionism. While exports from the U.S. and China have softened, the downturn has been more pronounced in the Eurozone, emerging Europe and Japan, none of which have faced significant new tariffs so far. Indeed, changes in U.S. and Chinese export growth account for less than 0.1 percentage points of the 2.5 percentage point decline in world trade growth. Other regions' exports might well have been affected by tariff-related distortions to supply chains which run through China, but tariffs alone cannot explain why they would have suffered more than China itself.

The U.S. has also applied tariffs to steel and aluminum imports from all trading partners and there have been retaliatory tariffs on some other goods. But since the affected products account for only 0.4% of world trade, it is hard to imagine that they have made any real difference to the global aggregate, particularly since U.S. imports of steel (which saw the biggest tariff hike) have continued to rise. Of course, this does not negate the threat of bigger tariffs to come. If firms lose confidence in future demand because of threatened car tariffs for example, this may limit their investment, damaging imports. But the evidence is not yet compelling. Changes in business confidence measures this phenomenon as it relates to reliance on trade with the U.S. Countries for whom trade with the U.S. is relatively important, such as Germany, are most exposed to future tariffs and some have seen confidence fall sharply. But our sources are far from consistent in this conclusion and actually conclude that confidence has been affected by a whole host of other factors.

Recent developments regarding trade tensions seem encouraging, as the Trump administration appears ready to extend the U.S./China talks beyond the March deadline. The talks have been reported as "productive", with China proposing to increase its purchases of U.S. semiconductors, for example. However, the key driver of world trade will continue to be underlying demand. We expect China will likely be under pressure in the short term as the weakness of credit growth continues and the U.S. is impacted by reduced policy stimulus.

IN SUMMARY:

At current levels, the Standard and Poor's 500 sells at 16.5 times our $164 estimate for earnings in 2018 and at 15.6 times our $178 estimate for 2019. These earnings estimates represent gains of over 20% for 2018 and 9% gains for 2019. The modest earnings increase assumes some pressure on profit margins from material and labor cost increases, against the background of a slowing economy. We have no recession forecast for 2019 - only a slowdown**.** At present, we believe that equity prices weakened in 4th quarter because of fears of interest rate increases while the economy is decelerating. A **so**lution to the China-U.S. trade conflict would increase business confidence and increase business investment that has recently weakened.

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