ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

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"All of man's misfortune comes from one thing, which is not knowing how to sit quietly in a room"
Blaise Pascal

IN FOCUS:

Given the current preoccupation with Fed policy on interest rates, we have taken the thoughtful stance of "sitting quietly in a room" full of investors who fear the Fed will act politically rather than pragmatically in their approach to economic data.

The Federal Open Market Committee (FOMC) voted to lower the federal funds rate target range to 2.00%-2.25% at the last meeting. This was the first rate cut since 2008. In addition, the committee decided to terminate quantitative tightening (QT) ahead of schedule. The Federal Reserve Chairman Jerome Powell claimed that the Fed is independent and won't bow to political pressure. Yet, in his congressional testimony on monetary policy, Powell mentioned the trade issue a number of times in his prepared remarks and attributed this decision to "the implications of global developments for the economic outlook as well as muted inflation pressures." Also, the word "uncertainties" was used regarding the economic outlook - the first time this word has appeared in an FOMC meeting statement since 2003. Back then, you may recall the concern was about "geopolitical uncertainties," specifically the imminent war with Iraq. Today's uncertainties are similarly geopolitical, centering around escalating trade wars.

The Fed has left open the possibility for future rate cuts dependent upon upcoming data releases, noting they will act as appropriate to sustain the expansion, with a strong labor market and inflation near its 2 percent objective. This development by the Fed, opening the door to additional rate cuts, should provide some support to stock prices amid escalating trade tensions with China. In the interim, the Fed will be awaiting updated information regarding jobs, ISM non-manufacturing, and consumer confidence. Any significant downturn in this data could signal future rate cuts.

This idea of an "insurance" rate cut by the Fed is preemptive in nature, as opposed to reactive. Compared to two prior insurance rate cuts in the mid/late 1990s, real interest rates are currently lower relative to GDP growth and create a more ideal situation for equities. Although equity markets do not generally perform well after the initial rate cut, investors are expecting that additional cuts may be necessary to offset any coincident economic softness and reinforce a more positive stock market response. The timing of any additional cuts along with the pace of GDP growth are significant factors to watch in the upcoming months. But history tells us that over the past 50 years, no U.S. recessions have occurred with interest rates this low.

The strong equity markets so far this year have been driven in part by corporate earnings growth and lower interest rates. In the years subsequent to the financial crisis, the Federal Reserve managed to maintain an overall accommodative approach while keeping interest rates in positive territory. Fed action helped lower borrowing costs in an effort to stimulate economic growth. Keep in mind that even after 9 interest rate hikes by the Federal Reserve since 2015, overnight interest rates remain relatively low at 2.50% with inflation in check.

CLOSE-UP: The Economic Landscape as the Third Quarter Unfolds

The U.S. economy has expanded by 3.2% in terms of real GDP over the past twelve months ending the first quarter. Other countries are growing significantly slower, with the European Union growing at 1.2%, the UK at 1.8%, and Canada growing 1.3%. While Japan continues to muddle through growing only 0.9%, China officially recorded a rate of 6.2%, its lowest rate in 25 years.

Unemployment in the U.S. is at 3.7%, the lowest rate in 50 years - and current employment trends remain strong averaging 225,000 in line with 2018. The strength in employment is broad-based with notable gains in professional and business services, health care, transportation and warehousing. We would expect employment growth to begin slowing, since the U.S. is approaching full employment.

Hourly wages have improved with growth at a 3.1% rate over the past twelve months through June. At present, economists conclude there are about 6 million more jobs available than there are workers. While growth in the first quarter of 2019 was 3.1% in terms of real GDP, some temporary factors such as an increase in inventories and strong exports helped support the economy. Adjusted for these two factors, growth may have more accurately been closer to 2.5%. Looking forward over the balance of the year, we could expect growth to moderate because of current weakness in housing, manufacturing and trade-related issues. Obviously, a resolution of the trade dispute with China would improve the economic outlook of both countries as well as the rest of the world.

In the end of July, the Bureau of Economic Analysis announced its first estimate of second quarter growth at 2.1% in terms of real GDP. Personal consumption continues to forge ahead at 4.3% with spending strong in durable goods, nondurable goods and services. Investment spending was surprisingly weak, however, declining versus a healthy single digit gain in the first quarter. This was no doubt caused by business uncertainty related to tariffs and the trade war with China. Supply chains are being disrupted. Exports were down while imports grew. This reversed a trend we observed in the first quarter where exports grew against declining imports. Government expenditures continued to improve with non-defense spending particularly strong at close to 16%. Lastly, inflation measured by the PCE index increased to 2.2% compared to only 0.8% in the first quarter. It came as no surprise that in terms of the contribution to growth, consumption and government spending added while private domestic investment and trade subtracted from growth.

The lack of corporate investment and the overindulgence in government nondefense spending is still of major concern, as well as signs of rising inflation. It is now more evident that the trade war with China is slowing business growth in both countries. Chinese foreign direct investment in the U.S. fell to one tenth the peak established in 2016 at $46.5 billion. Although delayed until the end of the year, we expect that U.S. trade negotiators will restart the talks that had broken down in the end of May. With financial markets starting to show some vulnerability, investors now appear more concerned that a favorable resolution of the trade dispute will occur. One of the major issues that stalled the trade resolution had been the U.S. recent treatment of Huawei Technologies Company, the leading Chinese telecommunications and consumer electronics company. Another factor that gave rise to the concern was the resultant collapse of Chinese purchases of U.S. agricultural products that has severely hurt U.S. farmers. There is no doubt that U.S. tariffs and counter tariffs by the Chinese added to the trade dispute given the conventional view that China has abused World Trade Organization rules.

The Federal Reserve:

The Federal Reserve Chairman, Jerome Powell, has clearly signaled that the rate cut of 25 basis points in July was appropriate at that time. This cut, however, may not be enough to offset the current weakness we experienced in the second quarter. The rate cut brought the federal funds rate to 2.00-2.25%. This cut represents a major reversal of monetary policy since the prior policy of the normalization of rates. We can surmise that perhaps what caused the significant change was the substantial drop in equities in the fourth quarter of 2018, as the Fed raised rates, coupled with the reaction to President Trump's demand to lower interest rates as 2019 unfolded.

Was this the lead indicator that the Fed needed to head off a possible recession? What we *do* know, however, is that the shift in Federal Reserve policy on rates places them in line with all the other central banks' lowering interest rates over time.

It is estimated that about $13 trillion of bonds worldwide have negative real interest rates (rates lower than their current inflation rate). This development has no historical precedence and such a policy has led to record debt levels around the world and may have potentially enabled excess borrowing. Valuations of bonds and equities have become distorted by these low rates that represent the price of money. At present, the money supply, as measured by M-1, is growing at an annual rate of 12.3%, versus 4.8% a year ago over a three-month period - while M-2 is growing at an annual rate of 8.7% compared to 4.8% a year ago over the same period.

With a 10-year economic expansion in place, and record highs reached in equity prices at the end of the second quarter, investors have shifted from complacency to worrying about monetary policies that historically have caused credit and stock market declines. This phenomenon is coincident with a U.S. fiscal deficit of $1 trillion in 2019, because tax revenues are growing at one quarter of the pace of government spending. The recent government debt agreement that allows another $320 billion of borrowing over the next two years may serve to only aggravate the problem. This will be the reason why gold recently hit a six year high at $1524 per ounce as investors surmise that these debt levels increase the possibility of a return of higher-than-expected inflation. One might add that tariffs and protectionism are inflationary as competition is reduced, particularly if money supply growth is excessive.

By the end of the second quarter, interest rates had stabilized, the dollar index remained strong along with equities, and commodities were mixed. The 3-month Treasury bill yields closed the month at 2.04%, the 10-year Treasury bonds yielded 2.06% and long-term high-quality corporate bonds are at 3.4%. As August unfolded however, all these rates declined abruptly, with the 30-year Treasury bond dropping intraday below 2.0% level, the lowest level in the post war cycle. This interim correction has certainly improved equity valuations and recharged the bull market cycle – with the caveat that a recession does not materialize.

The Record:

The Thomson Reuters Commodity Index (170) is down from 181 with oil at $54 down from $57 per barrel and copper down 3.80% in the month of August. The copper price reflects economic weakness in China. The dollar index has responded accordingly, rising from only a month ago. Gold rallied 7.4% in the risk off trade. Coincident with the rise in gold, the Baltic Dry Index, a measure of shipping rates of bulk commodities shot up to 1950 from 1280 at year end, a gain of 52%. This index has been used as an early indicator of global inflationary tendencies. In our opinion, the surge in oil prices is primarily a response to Iran's seizure of a British tanker in the Gulf of Hormuz, which accounts for 35% of the shipments of seaborne oil and 20% of oil in general.

At its current price of 2,840, the S&P 500 Stock Index now sells at 16.9 times our $168 per share earnings estimate. This drop in market prices is coincident with a decline in reported S&P 500 corporate earnings for the first half of this year. We are currently estimating quarterly earnings will decline about 2.6% in the second quarter year-over-year, with 75% of companies having already reported. The market's strong returns so far in 2019 are a result of a major change in monetary policy resulting in lower bond yields and therefore higher P/E ratios. The S&P had climbed 18.5% including dividends for the six months ending in June. Consensus S&P 500 forward revenues and earnings have declined from their record highs, as analysts begin to adjust forward revenues growth estimated at 5.3% and forward earnings growth estimated at 8.0%.

S&P 500 Topline Growth:

The S&P 500 actual revenues this year, and estimates for next year, have been rising to record highs. After a short pause at the end of last year, this U.S. corporate bounce-back is impressive given the very slow growth pace of the global economy.

Consensus estimates show that the Standard and Poor's 500 revenues in the second quarter rose 5.0% y/y to a new record high, and no recession is evident in the quarterly revenues data. In hindsight, there was a brief earnings recession from Q1-2015 through Q1-2016, when plunging commodity prices caused a global growth recession. But it has been solid growth since then. This suggests to us that as long as U.S. real GDP continues to grow around the 2.5% trend line, and global growth remains subpar but positive, U.S. corporations should continue to achieve positive low-single-digits revenues growth. If they can maintain their historically high profit margins, we would expect earnings growth to equal or exceed revenue growth. Of course, if a recession unfolds, revenues growth will turn negative and impact share performance.

China

The debate hinges on the concern that China "grows old before it grows rich". In looking back several decades, China has no doubt gotten much richer. Standards of living have certainly improved for most people in China. China's infrastructural achievements - the highways, railways, ports and cities - are unmistakably impressive. Yet many investors still are concerned that the underlying reality is a fundamentally indebted, extremely unequal and vastly over-built society that is going to be knocked sideways by its own demographic earthquake - as decades of the one child policy come home to roost and China's population growth starts to falter.

Our view is that China runs the risk of having lots of state-of-the-art "ghost" infrastructure that stay vacant. Undoubtedly, you've seen the videos of China's ghost cities most of which have failed to live up to their original promise despite their population growth. Nevertheless, China's rapidly aging demographic profile does increase the risk that China has built too much infrastructure that will be plagued by excess capacity and burdensome debt for some time to come.

The Chinese government has provided lots of fiscal and monetary stimulus to manage their economic slowdown. These efforts could buffer the downturn, as we have pointed out in prior commentaries. This slowing is partly because that's what emerging economies do as they mature into developed economies. But the slowdown we believe has been greatly exacerbated by the one-child policy. China's fiscal policy has focused on building infrastructure, which has been creating the excess capacity. Monetary policy has enabled too much debt expansion, which is weighing on China's economy rather than stimulating it. And all this has been pushing China's CPI up rising at a 2.8% rate y/y, boosted by food prices - particularly pork. Of course, higher food prices reduce the purchasing power of Chinese consumers. The PPI is also falling in China, suggesting that its manufacturing sector is weakening, with industrial profits under pressure. This is likely to put financial stress on China's manufacturers who already face challenges from Trump's escalating trade war. And despite an easy credit policy, the stimulating effect on the economy is not as effective as in the past.

Markets are obviously concerned about all this, since China is the second largest economy of the world. This is coupled with Hong Kong coming to a boiling point. The use of lethal force to end pro-democracy protests in Hong Kong creates further uncertainty as well, and a potential U.S. response through additional tariffs is quite possible.

***The Underlying Issue*:**

Xi's assertion of global dominance, particularly over and above the U.S., remains at the center of their geopolitical strategy - and that domination focus is on the high-tech industry. The U.S. has identified this strategy as a major threat to U.S. intellectual property, as China continues to "steal" U.S. technologies, an injustice that sits at the core of the U.S.-China trade dispute. The bottom line is that the undercurrent of China's actions makes it hard to trust Xi as a friendly globalist but more as an authoritarian dictator. This has fueled the risk off trade we witnessed in August.

The Currency Response:

It appears Beijing is now willing to tolerate further currency weakness, in the face of the renewed escalation of trade tensions with the U.S. We are now expecting that the yuan will devalue another 3% this month and could break 7.5 in 2020 if all tariffs on Chinese imports increase to 25%.

The Risk Outlined:

A resolution of the trade dispute with China would improve the economic outlook of both countries as well as the rest of the world. As we've said before, we believe that the U.S-China trade dispute is more about rival powers fighting each other over global hegemony. It is quite possible that another global cold war could break out with China. Global economic growth could suffer and financial markets would respond accordingly if a new global split occurs between the U.S. and China. However, we remain optimistic that a pragmatic solution to trade problems will occur by yearend.

The U.S. Fed is visibly aware of the risks and we're predisposed to be more bullish, as long as the Fed is on our side. U.S. stocks ended the second quarter on a strong note as the broad market S&P 500® Index hit a new, all-time high in late June. For the quarter, the index gained 4.3%, bringing its year-to-date total return to 18.5%, the strongest start in the first half of a year since 1997 (source: Dow Jones). Equity investors seemed to take their cues from policy makers. Talk of interest rate cuts and other forms of central bank stimulus generally elicited positive stock market responses, despite the underlying perception that these measures are needed to combat slowing global economic growth and mounting dislocations from the U.S.-China trade war.

Market Volatility – "The Wall of Worry"

Recent volatility is typical of summer markets, as evidence of the past several years and throughout the current bull market. Our research shows that there have been as many as 60+ panic attacks followed by as many relief rallies in the S&P 500 since early 2009. We expect that the current panic attack will also pass. We are still predicting that the Standard and Poor's 500 will continue to rise into record-high territory this year, and potentially 10-12% higher next year. "No boom, no bust." Or put another way, "no credit crunch, no recession." Booms lead to speculative excesses financed by debt binges; the resulting inflation in consumer and/or asset prices forces the Fed to raise interest rates. In the past, such scenarios have triggered a financial crisis for a few select corporate borrowers and lenders, which rapidly morphed into a widespread credit crunch that caused a recession.

We recognize that the inverted yield curve is somewhat nagging, but remember inverted yield curves don't cause recessions. Instead, they provide a useful market signal that monetary policy is too tight and risks a credit crunch causing a recession. The Fed's recent decision to be patient and pause its rate-hiking may have reduced the chances of a recession.

This roller coaster market may persist through the next several months. However, given all this commotion, it's curious why the S&P 500 is down only 4.5% from its record high (July 23rd). While we are getting the impression that investor fear of an impending recession is mounting, it's hard to see any confirmation of that in the stock market's performance or in sentiment indicators so far.

Some investment strategists explain the ongoing bull market with the notion that "there is no alternative to stocks". One could argue that bonds have been a reasonable alternative given the stock volatility. Of course, both bonds and stocks are beating cash, for sure. Other strategists have attributed the bull market to Fear of Missing Out, or FOMO. At the end of the day, the forward P/E of the market isn't too extended and is significantly below the last tech bubble high of 25.7 times in 1999.

The Inverted Yield Curve:

Although an inverted yield curve has predicted 7 of the last 10 recessions, it isn't as accurate a predictor of economic downturns as widely believed. It can be misleading, having given three false signals of a recession. It is important to highlight that inverted yield curves don't cause recessions. There is certainly no sign of a credit crunch in our estimation given the evidence that the yield spread between high-yield corporate bonds and the 10-year Treasury bond is so narrow.

We conclude that credit remains in ample supply and the Fed appears to be back in easing mode since the end of July, when the federal funds rate was cut by 25bps. Fed officials are likely to respond to any inversion with more rate cuts. We are keeping a close look on bank credit issues specifically, net interest margin, charge-offs and dividends, and business loans. For the time being, these metrics aren't signaling a credit crunch.

At present, U.S. fiscal and monetary policy is extremely expansionary suggesting that a recession is highly unlikely to occur, except under extraordinary circumstances. Recessions normally occur as interest rates increase to offset rising inflation. Prices rise during expansions when industrial capacity declines, and wages rise as unemployment declines.

Inflation, as measured by the CPI, is 1.8% and other measures of inflation are at a similar level. While interest rates have risen with the federal funds rate in a range of 2.25%-2.50%, 10-year Treasury bonds have recently fallen below 2.0% from a recent high of 3.0%. Current interest rates are historically low after this record economic expansion. While the current inversion of interest rates often suggests that a recession is imminent, there are also many instances of this phenomenon when a recession hasn't occurred. No doubt low inflation against a background of low unemployment is highly unusual.

IN SUMMARY:

The combination of low inflation and interest rates with slow growth extends the longer-than-usual economic expansion. The current one became the longest one on record just last month. If the expansion continues, even at a slower pace, we believe it still makes sense to pay relatively high price-to-earnings ratios for stocks.

No doubt, stocks in the rest of the world are cheap compared to those in the U.S. However, keep in mind that this has been so most of the time since the start of the current bull market. As we've often observed, our "stay at home" investment strategy has outperformed the "go global" alternative since the start of the current bull market. The U.S. economy has weathered the Great Financial Crisis better than have the other major economies. The U.S. economy and stock market are also more diversified than elsewhere. The U.S. economy is less dependent on exports than are other countries. The U.S. capital market is the biggest in the world and provides ample financing of economic activity through the banking system as well as through lots of other financial intermediaries. The U.S. has the largest private equity market in the world. In the U.S., distressed asset funds continue to attract lots of money and collectively act as a very good shock absorber in the credit markets.

The lower bond yield in the U.S. at the end of the day is bullish for the stock market, as the low rates have the effect of boosting valuation multiples, provided that they don't foreshadow a recession. Our view remains that the U.S. economy will approach a growth rate of 2.8% in 2019, as measured by real GDP, with CPI inflation of 2.0%, and that corporate profits will increase at a rate of 8.0%.

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