BRIEF MARKET INSIGHTS

JULY , 2019

A Note on the Second Quarter:

A Brief Look Back:

The S&P 500 recorded solid gains in the second quarter of 2019, largely driven by a shift in the Federal Reserve's outlook for interest rate cuts, extending a rally that began in the equity and bond markets in mid-February. The S&P 500 has risen 18.5% on a total return basis since the start of the year and one of the best first halves since 1997. The majority of bond returns came from principal appreciation as rates declined. The recent bond market rally has been bolstered by global monetary accommodation. The FOMC also continued the narrative into the second quarter by altering their expectations for interest rate hikes from several to none in 2019 and perhaps only one hike next year.

The dovish tone continued into June as the European Central Bank indicated that the possibility of a rate cut would occur if inflation and growth were to slow further. Chairman Powell confirmed the dovish response keeping the target range for the federal funds rate at 2.25-2.5 percent, but dropped the promise to be "patient" in adjusting rates and signaled possible rate cuts of as much as half a percentage point later this year. The policymakers left economic projections for growth and unemployment mostly unchanged, but lowered headline inflation forecast down to 1.5% for the year.

The resultant inversion between the one and the five-year interest rates - although narrow - does suggest that Fed policy still has room to ease. Trade tensions and tariffs remain at the forefront of Fed concerns and are potentially contributing to slower domestic GDP growth. Given the flat dollar and lack of clarity around long term solutions to trade, inflation indicators remain benign. Domestic and global crude posted significant price gains in the first quarter but appears to have moderated in recent months. The escalating tensions between the U.S. and Iran in the Persian Gulf appeared to push yields lower at the same time compressing the spread between the 5 and 30-year Treasury yields, reducing the likelihood of an imminent recession. In summary, the first half of the year saw stocks rally against a back drop of lower rates, cushioned by the impact of a potential trade war.

Our Outlook for the Financial Markets:

We continue to believe that the U.S. economy will grow at a similar pace of 3.0% in 2019 as in 2018. In June, the economic expansion reached its 10th anniversary, the longest on record. There are many economists who now forecast that a recession is more imminent, due to global slowing as well as many sectors of the U.S. economy that are moderating (such as capital spending and employment). In addition, there is little doubt that the trade war with China, and the use of sanctions and tariffs against other countries by the U.S. government, is resulting in a headwind to global growth.

At present, U.S. fiscal and monetary policy is extremely expansionary suggesting that a recession to materialize is highly unlikely except under extraordinary circumstances. One has to ask the question: why have interest rates not risen in the face of the large supply of Treasury bonds to finance our growing deficit? Usually fiscal deficits occur during recessions as the government attempts through spending increases to offset high unemployment. The current economic situation of high deficits during a record expansion is different from prior U.S. business cycles. Perhaps one might conclude that not enough time has elapsed to bring about higher inflation.

Money supply continues to grow at a 6.0% annualized rate, supported by the purchasing managers index and the ISM manufacturing index coupled with the business activity index remaining expansionary. It is also important to keep an eye on wages that are now growing at a rate of 3.0% in the face of a labor shortage and mark a new high since the expansion began. Overall, we feel confident that the U.S. economy is still expanding - and perhaps some sort of trade concession can be achieved with China.

Market Valuation:

The strength in forward earnings suggests that industry analysts believe that their companies can continue to grow earnings, despite the headline news about weaker global economic activity. Forward earnings tend to be an excellent year-ahead leading indicator of actual earnings with one important exception: industry analysts *never* see recessions coming. If you agree with us that a recession is unlikely over the next 12 months, then forward earnings are bullish for actual earnings and for stock prices. Meanwhile, the stock market continues to perform well. That's despite the fact that earnings growth was weak during Q1 and will likely remain weak during this reported season.

Given weak earnings reports in the first half of the year, keep in mind that the stock market discounts the future, not the past or the present. It is widely known that the historical average price-to-earnings ratio (P/E) of the stock market tends to be around 15. It is our belief that the P/E should be above average in an economic environment like the current one, where inflation and interest rates are well below average. Granted, economic growth is also below average, but the majority of the indicators at moderate levels simply increases the likelihood that the economic expansion is sustainable.

At this juncture, the GDP continues to grow around 2 to 2.5% on a y/y basis. Inflation is around 2%, and the 10-year U.S. Treasury bond yield holds at around 2%. The combination of low inflation and interest rates with slow growth may result in a longer-than-usual economic expansion. The current one became the longest one on record just this month. All considered, we draw the reasonable conclusion that the market can trade at a higher-than-average P/E. This is a very supportive combination for the U.S. stock market.

ALTMAN INVESTMENT MANAGEMENT, LLC
33 Witherspoon Street, 2nd Floor – Princeton, NJ 08540 – (609) 252-0048 – www.AltmanInvest.com