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Pence Perspectives, Q1 2019

February 1, 2019

"Aimless switching gathers no profits."
Humphrey Neill

Executive Summary:

- We think 2019 will be a **positive year for stocks** but expect **continued market volatility**
- We expect **one rate hike** from the Federal Reserve in 2019
- We do not expect **a recession** in the United States in 2019 or 2020
- We expect a short-term resolution on **trade tensions**

Bottom Line Up Front

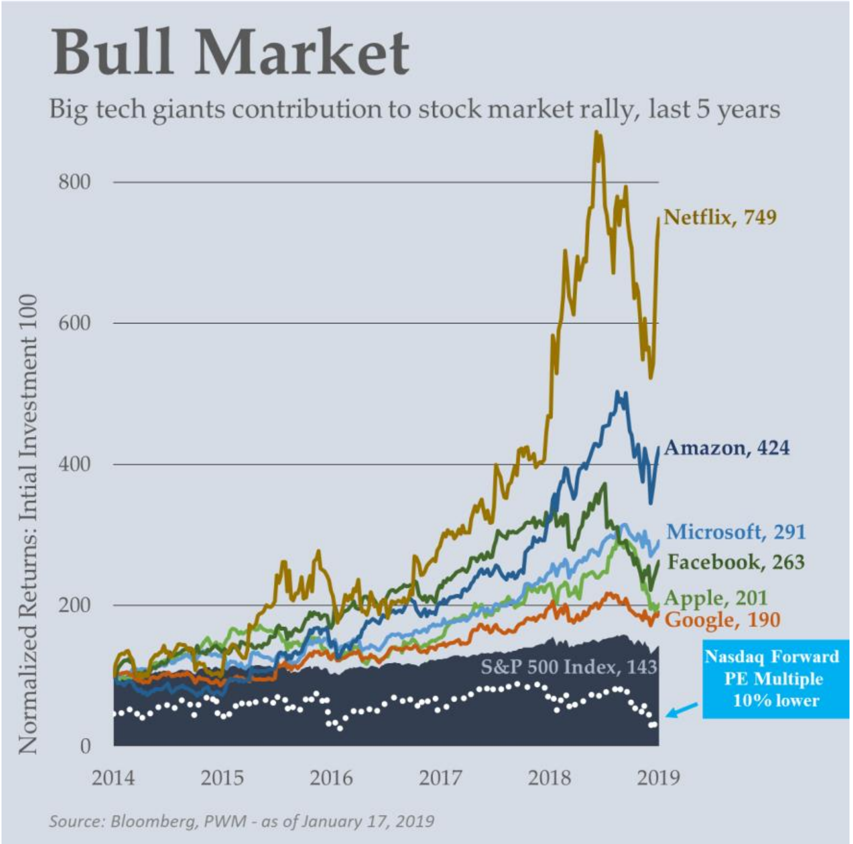
A good economy and a bad market don't coexist for long. However, share prices can fall for many reasons other than economic developments. Good economic news and robust corporate earnings reports powered the S&P 500 to its all-time high on September 20, where it proceeded to plunge 19.8% by December 24. December is usually a very solid month for the market. Historically, stocks are up 73% of the time in December.[1] This year was different. Due to concerns over *regulating the big tech giants*, the *pace of Fed tightening*, ongoing *trade tensions* with China, and *slowing global growth*, the S&P 500 fell 9.2% in December, the worst December since 1931, and ended 2018 down 4.4% in total return.[2]

The impact of **algorithmic trading** and its effect on stock prices and market volatility can be significant, and should not be ignored. According to an *article in the Wall Street Journal*, on a typical trading day, quantitative trading accounts for 50% to 60% of market trades. But when the markets are extremely volatile, like the one we just had in the fourth quarter, about 85% percent of all trading could be controlled by computers that can monitor trading activity, market data—even political rhetoric—and then make instantaneous decisions on what to buy or sell. Unlike humans, they are programmed to act the instant the market changes. When the computers start buying, everyone buys; when they sell, everyone sells. We advise long-term investors to avoid being caught up in momentum buying and selling.

[1] S&P Dow Jones Indices. Data as of Dec. 31, 2018. This is partly because of a phenomenon known as **window dressing** where fund managers buy top-performing stocks to make their portfolios look good and set for the next year.
[2] S&P Dow Jones Indices. Data as of Dec. 31, 2018.

We also believe the roller-coaster nature of the fourth quarter was elevated by year-end **tax-loss harvesting** where asset managers take advantage of losses on various stocks to offset gains and reduce tax loads for clients. We think selling losses and raising cash exacerbated the selloff, pushing prices further down.

Volatility, which is the norm of investing in stock markets, was absent in 2017 but has returned to a more normal pattern and can be expected to stay. Looking forward, we believe that the S&P 500 index will gradually appreciate, finishing 2019 in a positive territory. The good news is that the economy is still growing and the likelihood of a recession in the next two years is very unlikely. On a technical note, stock markets haven't fallen two consecutive years since 2001. To compound this, because we have a low base for the S&P 500 index to start 2019, there is a higher probability that the index will go higher from where it was on December 24. Both the top line (sales) and bottom line (Earnings Per Share, EPS) forecasts support our theses. According to FactSet, as of January 18, analysts are projecting **earnings** growth of 6.5% and revenue growth of 5.3% in 2019.



Addressing the issues that caused the extreme volatility, we believe that investors focused too much on any sign that the extraordinary profits generated by tech giants are under threat; namely government **regulation of the tech sector**. However, as reported in *a New York Times article*, regulating the tech sector will be very difficult, if not unlikely, primarily due to its scale, complexity, and relatively new entrance into being a fixture of daily life. First and foremost is the question of free speech and whether their platforms can or should be regulated the way other industries have in the past without stepping on user rights and the rights of these companies to operate their own private ecosystems. When the large tech names sold off, the rest of the market went with it. In the fourth quarter, Alphabet, Amazon, Apple, Facebook, and Microsoft (**the Big Five**) accounted for nearly a *quarter* (or $1.1 trillion) of the total losses in the S&P 500 index. This is partly because of their large size in an index weighted by the market values of companies. Looking back, the rally of the large tech companies over the bull market has been crucial to the stock market's gains. 37% of the total appreciation of the S&P 500 index since 2013 is explained by just six of its members: Alphabet, Amazon, Apple, Facebook, Microsoft and Netflix (see chart).[3] Recent data suggests that the tech sector is about 10% cheaper compared to its 5-year historical average, represented by the dotted line in the chart. Going forward, we believe the sector has a lot to offer as they generate nearly 20% of

[3] Source: The Economist and **the Big Five** refers to Alphabet, Amazon, Apple, Facebook, and Microsoft

S&P 500 earnings.[4] Today, tech companies have become a layer that sits across the entire consumer economy, comprising 68% of US total output.[5]

On December 19, the US Federal Reserve (**Fed**) delivered what was an *expected* fourth interest rate hike in 2018. Later that day, the Fed chairman Jerome Powell said he didn't see the Fed altering its policy on the balance sheet runoff, saying that it would remain on "autopilot". By December 24, stocks were down nearly 9%. On January 4, we saw the **Powell Pivot**, when the Fed chairman walked back his autopilot statement and said that the Fed "will be patient" as they watch to see how the economy evolves with a more data dependent model. Since his comments, markets are up almost 4.4%, as of January 24. Going forward, we think Fed policy will be friendlier and more cognizant of the stock market. Current market expectations point to one or maybe two rate hikes in 2019, with the first-rate hike taking place in the second half of the year. This approach could be supportive of a stock rally.

On **trade** tensions, as we stated in *our August Newsletter*, China indisputably needs us more than we need them. *The latest data* showed that China's economy is slowing further, which puts more pressure on the Chinese government to cut a deal rather than walking away without one. In recent weeks, we have seen several signs of modest progress in trade talks which we expect to last until the end of the 90-day trade truce on March 2. In the end, while many issues could be left to discuss and agree upon later, we think China will offer concessions—allowing President Trump's administration to declare victory (or at least progress) and move on. This would be a happy ending for both sides.

The latest forecasts from the International Monetary Fund (IMF) and the World Bank showed that the **global economy** in 2018 and 2019 is on track to grow at the same or slightly slower rate than it grew in 2017. This suggests the headlines highlighting slowing global growth have been overstated.[6] Yes, trade disputes between the US and China are concerns for the entire world because they have comprised of half of all global growth in the last decade. Further rate hikes from the Federal Reserve, which have pushed the US dollar higher, could make it difficult for emerging economies serving their dollar-denominated debt. The IMF also warned that Great Britain leaving the European Union (**Brexit**) without a deal could spark a further deterioration in sentiment and hit global growth in the second half of the year. Given the Fed's recent dovish tone and the progress in trade talks, there is hope that some or most of global growth concerns will evaporate by the end of the year as we get more data.

The **US economy**, propelled by the tax cut stimulus, is projected to have grown at a 3% rate in 2018, the highest since 2005. This growth will likely slow to a 2.5% rate in 2019 as the effects of the tax cut boosts fade. However, another government stimulus package such as a bipartisan infrastructure spending bill could boost growth back to a 3% level. Meanwhile, the US unemployment rate is currently at 3.9%, nearly its lowest since 1969 and economists at Goldman Sachs expect a steady 3.6% unemployment rate until 2022. In and of itself, this invalidates the possibility of a recession on the near-term horizon. Corporate earnings are expected to have grown 23% in 2018, which is the highest since 1994, excluding the rebound in 2010.[7] Ordinary Americans care little about inconsequential partisan politics or a slowing China, but they do care about their paychecks.

[4] Source: S&P Dow Jones Indices. As of January, there are 68 tech companies listed in the index
[5] Source: FRED
[6] In January, the World Bank said that the global growth would be at 2.9% in 2019, down from 3% in 2018 and a reduction of 0.1 percentage point from its forecast in June. The International Monetary Fund (IMF) forecasted that the global economy to grow a 3.7% in 2018, slightly down from 3.8% in 2017. And the latest IMF forecast for 2019 is 3.5%.
[7] FactSet … In the third quarter, earnings growth came in 25.9% from a year ago after averaging 25% growth during the first half of the year.

Wages are growing at a decade-high rate of 3.1%. Moreover, as of January 16, oil prices are down 30% since last October, which could lift consumer spending further.

We believe a long-term investment view is prudent when navigating episodic market volatility. From a global perspective, world GDP is around **$80 trillion** today. *PWC research* projects it will ultimately double its current size in the next 30 years. This is akin to creating another planet, while improving living standards in the process. Corporations, both old and new, will have to produce more in order to satisfy rising demand, which in turn means more profits and higher returns to their shareholders. In essence, this is the fundamental rationale of investing in stock markets. In other words, God and nature are long, and so are we.

Market Outlook

Stocks have risen steadily for nearly a decade, but history tells us that stock market volatility is an inevitable part of investing. Corrections (defined as a 10% decline or more), bear markets (an extended 20% decline or more) and other challenging patches have always been short-lived. Despite two bear markets in the last 30 years, the annualized total return (including dividends) of the S&P 500 index was **9.96%**.[8] In the end, long-term investors have historically been rewarded. We understand market corrections can be challenging, and a 10% drop may be significant for many investors but they are sometimes considered healthy for both the market and for investors.

Where we stand today, valuations look attractive. As of January 23, one-year forward price-to-earnings multiple (PE ratio) of the S&P 500 index is at **15.6**, down from 20.0 a year earlier and down from the 16.9 thirty-year historical average. Given the market expectation of earnings per share (EPS) at $173 and a multiple between 16 and 18, we could see the index to finish the year between 2,768 and 3,114. That is significantly higher than where we are today as of January 24. We believe this is achievable given all-time high profit margins and an estimated 5% sales growth in 2019. The rule of thumb is that, without market frictions or unexpected shocks, **sales** tend to grow twice as much as **GDP**, and **earnings** tend to grow twice as much as sales.

Volatility is here to stay. In an average year for the past 50 years, investors typically experienced more than **60 days of 1% S&P 500 price moves** in either direction. In 2017, volatility was mostly absent, only **eight** such days occurred.[9] Last year, it returned to a more normal pattern finishing 2018 with 64 days of 1% price moves. In the first 15 trading days in 2019, we have already witnessed 6 days of 1% moves. Going forward, investors should get used to such market conditions with more frequent price moves of greater than 1%, both up and down. During these times, we continue to urge our clients to stay calm, have a long-term view and be more opportunistic in building their portfolios.

[8] Source: Bloomberg
[9] Goldman Sachs Asset Management

Economic Outlook

In its tenth year today, the current US economic expansion is expected to become the longest on record. This is partly due to the fact that it has had one of the slowest rates of recovery, growing at a 2.06% rate since 2009.[10] We believe this slow yet steady recovery will carry on for multiple years ahead. In fact, a close examination of business cycle history and a dive into the specific characteristics of the current expansion tells us that recessions do not operate on a set schedule and economic **expansions** have lengthened with **longer cycles** in recent decades. More importantly, limiting the scope as such, ignores so many of the intricacies that define economic cycles.

According to a recent *Goldman Sachs report*, a look back at 100 years of US recessions suggests that several of the most important historical causes are, in fact, less threating today. The paper highlights **five major causes**:

i. industrial shocks and inventory imbalances
ii. oil shocks
iii. inflationary overheating that leads to aggressive Fed rate hikes
iv. financial imbalances and asset price crashes and
v. fiscal tightening

Goldman argues that the *first three causes* of recessions have become structurally *less threating* due to improved technology and better supply-chain inventory management. Thanks to US oil shale production, today the US economy is less dependent on the impact of oil price shocks. To add to this, the firmly anchored inflation expectation of the Fed's 2% target policy has reduced the risk of inflationary overheating. Although there is no specification as to timing, the report suggests that the next recession could be the result of a *financial crisis* or *political dysfunction* both of which have some merits. Current data indicates that the private sector remains in very good shape with less leverage and looks much less vulnerable to a decline in asset prices or a tightening in lending standards than in the last two recessions. The report highlights the fact that political polarization has reached new highs and events such as *government shutdowns* and *debt ceiling* debates can have substantial effects on economic growth, but there is no evidence or data measuring such dysfunctionality on economic output so far. The authors conclude that the US economy will more likely experience a *soft landing* than a severe recession in the next few years, which is consistent with our view.

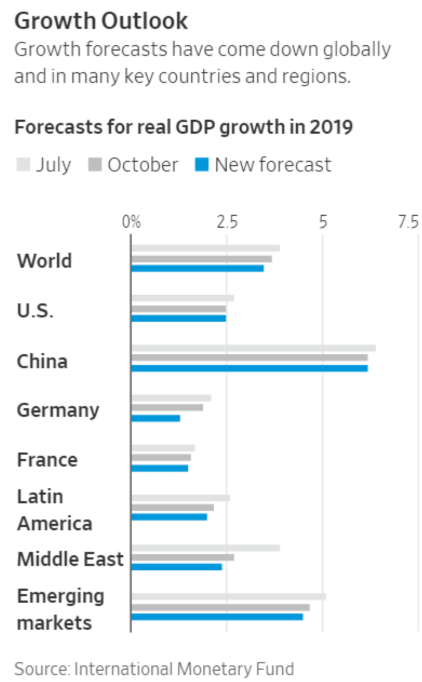
Some may argue that there is a one-to-one relationship between a recession and a bear market, hence predicting the next recession could mean identifying the next downturn in stock markets. We argue that predicting the next recession and consequent bear market is a very hard thing to do. Since World War II, 10 out of 12 recessions saw the S&P 500 index go into a bear market in plus or minus 12 months around an economic slowdown. There is an old joke, *the stock market has predicted nine out of the past five recessions*. The important point to remember is that each economic and stock market environment is unique. There are no playbooks for how *exactly* the stock market will react when there is an economic downturn or vice versa. As the final data continues to come in, the US economy is expected to have grown 3% in 2018, the highest annual rate going back to 2005. Yet, stock markets were down last year for the first time since 2008. We believe the severity of the next bear market or the next recession will have a lot to do with how well investors, the Fed and the government handle it when it finally arrives.

[10] Source: FRED

Global Growth Outlook

Headlines highlighting "*substantial*" slowing global growth have been an overstatement (see chart). According to its latest report, the IMF forecasts that the global economy will grow at a 3.5% rate in 2019, slightly lower than the 3.7% rate forecasted for 2018. The report also suggested growth should tick up to 3.6% in 2020.

There are a few international events worth paying attention to this year. On March 29 2017, the United Kingdom (UK) triggered **Article 50** of the Treaty on European Union. As set out under the treaty, the UK has had two years to negotiate a withdrawal agreement and framework for a *future relationship* with the European Union (EU). The deadline is two months away, on March 29 2019 when the UK is scheduled to leave the Union after 46 years. The worst outcome would be a "no deal" or "hard" **Brexit**, meaning the UK leaves the bloc without any trade, immigration, or treaty agreements. In other words, the UK would become a third economic-zone. As stated on *NHS European Office website*, the UK would no longer be eligible for participation in EU organizations, networks and collaborative programs. Many argue while it is a possibility, in reality neither the UK nor the EU would favor a no deal because it signals a poor political relationship.



To compound Brexit, the European parliament will hold elections in May 2019. In Germany, Angela Merkel is stepping down from her leadership in Germany in 2021. Annegret Kramp-Karrenbauer, a staunchly Catholic conservative career politician, has been elected as the successor to Merkel as leader of Germany's Christian Democrats.

The Economist

From a global perspective, the bigger worry seems to be China, which contributed around 35% to total global growth in 2017, according to the IMF. However, headlines about China's weak growth are somewhat misleading. As it has developed, China's economic growth has notably cooled over the years. The country is expected to have grown 6.6% in 2018, lowest in three decades. As depicted in *the Economist*, this is simply due to the sheer size of its economy. In 2018, China's Nominal GDP increased by 8 trillion yuan ($1.2 trillion), well above the 5.1 trillion yuan added in 2007, when it notched up 14.2%. In other words, China is now growing from a much larger base. Morgan Stanley projects an average real GDP growth rate of 6.1% from 2016-20, falling to 4.6% (2021-25) and 3.1% over the 2026-30 timeframe. By 2030, China may become the largest economy in the world. Managed correctly, however, that is precisely the trajectory China wants. China has already pivoted towards more supportive economic policies. Consumption accounted for three-quarters of the growth rate last year (see chart). Its private consumer market is expected to reach $9.6 trillion and account for 47% of its GDP, up 39% of GDP today. A stable, growing China is economically positive for the rest of the world.

Conclusion

The economic cycle has entered its 10th year, soon to be the longest in US history, but it doesn't mean a recession is imminent. Australia, Canada and the Netherlands have all enjoyed sustained growth lasting more than 20 years in recent memory, and late-cycle characteristics such as significant wage pressures, high inflation or a restrictive level of interest rates have not yet materialized. In fact, current economic data suggests that consumer spending, which accounts for two-thirds of the US economy, has been growing at a 3.9% rate since 2009 and has contributed 76% of US GDP growth.[11] Meanwhile, contributions in other domestic drivers such as business investment and government spending seem to be improving as well.

All in all, we believe 2019 will be positive for asset valuations. Despite the bumpy road for stocks in 2018, the United States economy displayed profound growth and appears positioned for further expansion. Growth will likely slow compared to 2018's tax-cut fueled earnings expansion, but it is important to note that slower growth *is* still growth. The biggest overhangs of last year were the Federal Reserve's path on interest rates, and the possibility of a permanent disruption in US-China trade relations. Both of these issues have significantly more clarity than they did even just 4 months ago.

Today, more Americans are working, and making more money than ever before. It's harder to find someone who will take a job than it is for an applicant to find a job. Wages are rising at a steady and sustainable rate, which is a boon for an economy propelled by the activity of its consumers. Technology will continue its path to becoming an even more omnipresent fixture in every day life, improving the efficiency and productivity of both humans and companies. Going into the 10th year of the recovery, think about just how much the world has changed over this timeframe – the release of the original iPhone was only 12 years ago this year. The world is vastly different today. Long-term investing is a form of art, which requires patience and steady hands. Getting swept up in headline-driven hysteria is one of the greatest risks to a portfolio. There is an old saying – that "Both God and Nature are long" – one we whole-heartedly repeat.

We appreciate your trust and the opportunity to be of service.

All the best, ❖

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[11] Source: FRED

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If you are not yet a client and are interested in learning more about our services, please contact Milo Reyes at (949) 660-8777 extension 129 or Ramilo.Reyes@lpl.com to schedule an appointment.

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