Fall Economic and Investment Outlook

Finishing 2019 and looking ahead to 2020: Risks are piling on, but opportunities remain.

Back in January we wrote: *"... We would like to put ourselves in the forward-looking camp and believe that the market reactions of 2018 were the forward reaction to 2019, and therefore 2019 is already priced in. What matters to us ... is what the picture for growth and earnings will be for 2020."*[1]

From the looks of the market year to date (S&P 500 up 20.5% through 09/30), earnings forecasts for 2020 should be very strong. However, our concern remains that we are going through another case of deja vu all over again.

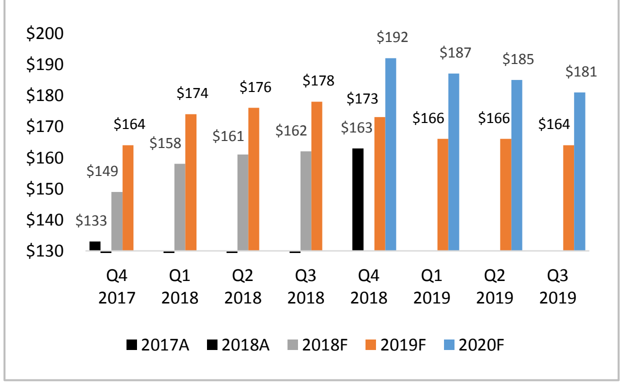

Exhibit 1 - S&P 500 EPS (Actuals & Forecasts)

As seen in Exhibit 1, actual year on year growth of S&P 500 earnings per share for 2018 was 22.6% (up from an expected 12% at the beginning of 2018). Despite this, the index closed the year down 4.4% on a total return basis. Perhaps the double digit rise in the market during 2017 had priced in all of the good news for those earnings?

Expectations for 2019 remained healthy at the end of 2018, even with a near 15% drop in prices during Q4. Growth in earnings was expected to be slightly above 6% (though below the 9.2% expectations of three months earlier).

Since then, a global economic slowdown, trade wars (yes wars, not tensions), and uncertainty around Brexit have caused business confidence throughout the developed economies to drop significantly (see Exhibit 2).

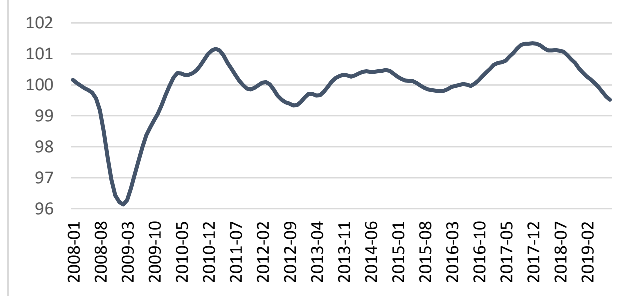

Exhibit 2 - OECD Business Confidence Index

So given this backdrop, are we surprised that the latest consensus earnings expectations for the S&P 500 for 2019 are for only a $1 increase – merely 0.6% more than last year? No, but given our weaker second half outlook for the economy, we anticipate a more reasonable $161-$162 per share, or a drop of 0.6% in year over year growth.

What puzzles us more are consensus expectations for 2020. Despite the lowering of expectations for 2020 from $192 per share back in Q4 2018 to $181 per share today (see Exhibit 1), this still implies a double digit increase in earnings for next year. In our opinion this will require a substantial pickup in GDP growth to 2.9% in 2020 (vs. consensus expectations of 1.8% and our expectations of 1.2%), a highly unlikely event given where the trends for global growth, trade wars, an aged business cycle in the U.S., corporate leverage, and economic confidence are headed. A case of déjà vu all over again?

Central banks and fixed income markets have certainly taken notice of increased global uncertainty. Not only have interest rates dropped meaningfully since the beginning of 2019, but long-term rates have fallen faster than short-term rates, causing the yield curves to flatten considerably, and even become inverted along much of the term structure.

Here in the U.S., our once out of consensus call for 75 bps of rate cuts for 2019 is now about average; however, our mid-year 2020 forecast of 1.0% on the Federal Funds Rate remains well out of consensus (see Exhibit 3).

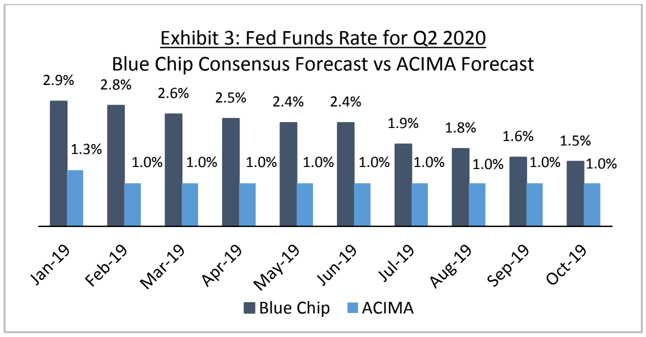

Exhibit 3: Fed Funds Rate for Q2 2020
Blue Chip Consensus Forecast vs ACIMA Forecast

The Treasury market remains unimpressed with central bank actions. Recent 10-year Treasury yields around 1.5% imply a substantially higher probability of a recession than the current consensus view. Our ACIMA Economic Exuberance Index, which has a fantastic track record of predicting recessions (though with substantial lags at times), has been sending warning signals for some time now (see Exhibit 4).

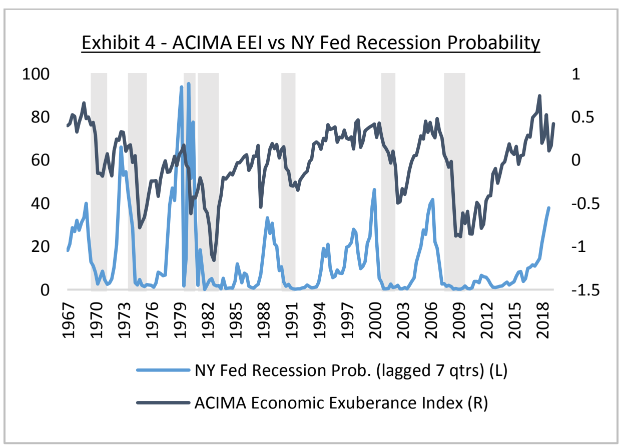

Exhibit 4 - ACIMA EEI vs NY Fed Recession Probability

We believe the trade war is still in its early innings, and economic uncertainty will only continue to grow. Though the U.S. vs. China trade war and Brexit (itself a trade war of sorts) have dominated most of the headlines, rising trade tensions within Asia (Japan vs. Korea, China vs. Vietnam, amongst others) and in the Atlantic (U.S. vs. E.U., Latin America vs. E.U.) will only add to the slowdown we have already felt in global trade.

A recent study by the Center for Strategic & International Studies reiterated our concern that unlike what many believe, the U.S. - China situation cannot and will not resolve itself.[2] As a result, business confidence, especially within the industrial manufacturing sectors, but increasingly within the all-important services sector, will continue to deteriorate into 2020.

Business confidence has rarely weakened to the degree it has recently without negative implications for the labor markets. Within the North Atlantic economies, we expect labor market weakness to commence by the end of 2019 with eventual negative implications for consumer confidence in 2020. In the U.S., Europe, and even China, central banks have been vigilant regarding this component of overall economic confidence measures and will not hesitate to take further action (i.e. rate cuts) if personal consumption begins to weaken. We remain surprised at how the consensus is treating a lagging indicator such as consumer spending as a coincident indicator.

From a business cycle perspective, our primary concerns center on where the increased leverage in the U.S. has come from: nonfinancial corporations and government. According to the Federal Reserve, nonfinancial corporate debt reached a whopping $292.5 Billion just in the first half of 2019, keeping pace with last year's increase of over $588 Billion. And all of this has come after a very friendly, cash flow-enhancing cut in corporate income tax rates.

Our concerns regarding this increased debt would have been somewhat alleviated if the positive cash flow impacts were utilized by the private sector through increased business investment designed to enhance productivity. Unfortunately, this has not been the case. Recent revisions by the Commerce Department instead show that corporate profits between 2012 and 2019 have remained steady at approximately $1.9 Trillion per year despite a cumulative 35% increase in nominal GDP over the same period.

So, with profits remaining steady, where has this increased leverage impacted corporations? According to Goldman Sachs, S&P 500 companies spent $811 Billion (or roughly 30% of total cash spending) during 2018 alone on stock buybacks. And according to our calculations, total cumulative stock buybacks since the end of 2011 (slightly over $3 Trillion) were financed exclusively with increased leverage (Exhibit 5). In fact, the entire 63% increase in S&P 500 earnings per share since the end of 2011 can be explained by the reduction in shares outstanding due to stock buybacks.

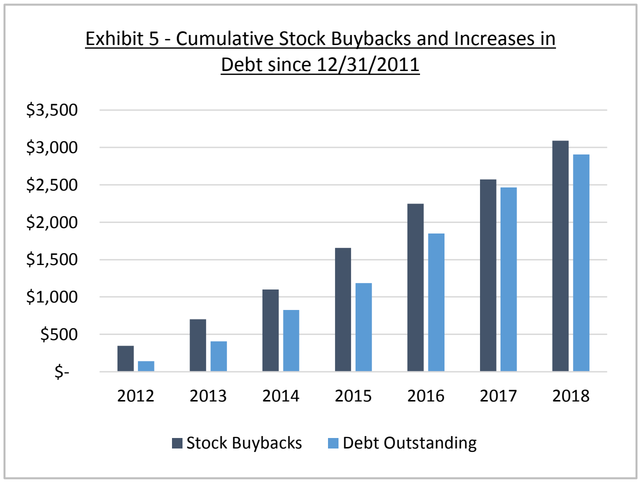

Exhibit 5 - Cumulative Stock Buybacks and Increases in Debt since 12/31/2011

On the government front, we are not so much concerned about the level of debt and the ability of the federal government to pay its bills on time, but rather with how much this debt is contributing to our nominal economic output. As seen in Exhibit 6, almost the entire increase in nominal economic activity since the end of 2012 can be explained by the increase in gross federal debt held by the public. Borrowing to spend by the government is one matter (i.e. rising deficits), but borrowing to spend to support the entire economy is a different matter all onto itself, especially this late in the economic cycle.

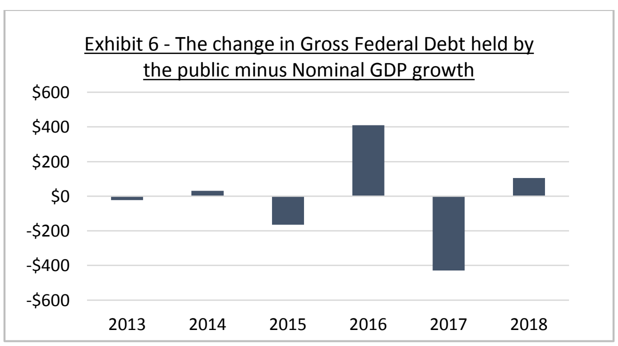

Exhibit 6 - The change in Gross Federal Debt held by the public minus Nominal GDP growth

Outlook

We remain even more cautious towards U.S. equities as we enter the fourth quarter than we were earlier in the year given that all year-to-date gains can be explained by expansion of earnings multiples on what we believe is the false premise that lower policy rates are a positive for corporate earnings going forward, which therefore justifies higher multiples. Ten years into an expansion, relying on the central bank to expand the P/E ratio when the "E" itself is subject to significant downside revisions is a risk to which we would rather have minimum exposure.

With the big year to date drop in interest rates, and with corporate credit spreads remaining tight, we have become cautious on longer-term maturities. Since the beginning of June, we have reduced the duration of our U.S. fixed income portfolios, and believe given the outlook for weaker than expected nominal growth and earnings, the value proposition remains with short term maturities within the Treasury and investment grade corporate sectors.

Outside of the United States, equities remain attractive across the Pacific, both in developed markets (specifically Japan and Australia), as well as emerging markets (greater China), where a combination of early cycle economics and favorable valuations are providing what we believe to be great relative value opportunities. Given the early stages of the economic cycle in many of these countries, we also favor the riskier and higher yielding government and corporate sectors.

Select opportunities within equities remain in Latin America (particularly in Argentina and Brazil, despite political uncertainty), and are emerging in parts of Europe (within the Eurozone financial sector and in the U.K., which we believe has already substantially priced in lingering concerns over Brexit).

As always, stay tuned,

Ardavan Mobasheri
Chief Investment Officer
October 7th, 2019

IMPORTANT CONSIDERATIONS:

IMPORTANT DISCLOSURE INFORMATION

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Sources:

1. ACIMA 2019 Investment Outlook
2. CSIS, Beyond the Brink: Escalation and Conflict in U.S.-China Economic Relations https://www.csis.org/events/beyond-brink-escalation-and-conflict-us-china-economic-relations

Exhibit 1 – Goldman Sachs
Exhibit 2 – OECD
Exhibit 3 – Blue Chip Survey
Exhibit 4 – ACIMA PrivateWealth Research, NY Fed
Exhibit 5 – Federal Reserve
Exhibit 6 – US Treasury