MarketOutlook

Mid-Year 2019

Market Commentary by K. Sean Clark, CFA® Chief Investment Officer

June 2019

Charting the Course: Navigating a Maturing Economic Cycle

HIGHLIGHTS

- We believe we will see continued economic growth (although at a slower pace) for the remainder of this year and well into 2020
- We are adjusting our year-end S&P 500 target outlook from 2900 to 3100
- The Fed has pivoted to a more dovish and data dependent stance and the number of rate cuts will depend on economic strength and geopolitical activity
- Conditions are in place for emerging markets to outperform, but it will depend on ongoing trade resolutions
- While economic indicators remain positive, we believe the range of outcomes is wider than usual given current geopolitical risks and market headwinds

Revisiting Our January Market Outlook

We entered the year with a ton of uncertainty hanging over the markets after coming off a volatile affair in 2018 and on the heels of a nearly 20% decline in December. While we didn't see an elevated risk of recession, there were a lot of headwinds and other risks that were bubbling up to the surface.

Risks we saw heading into 2019 included slowing earnings growth, Brexit, the China trade war, and a growing budget deficit here in the U.S. However, the primary risk we saw at the beginning of the year was that the Federal Reserve was on the cusp of making a major policy mistake.

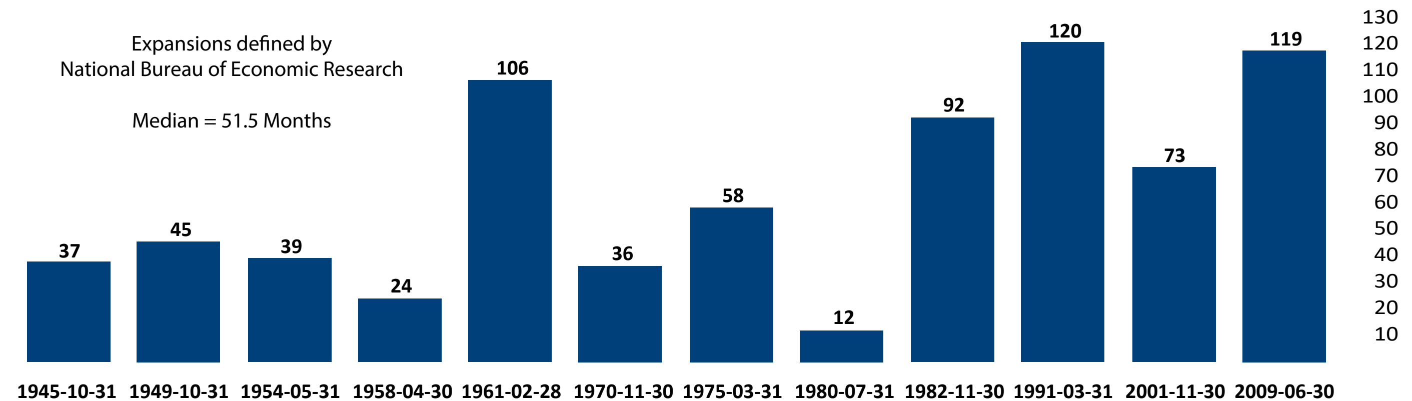
We expected only one rate hike coming into the year, which was well below consensus, and noted that the market was beginning to price in the chance of a rate cut late in 2019 or early 2020. That chance of a rate cut has increased since Fed Chairman Powell pivoted in January and the Fed has been messaging a more dovish tone.

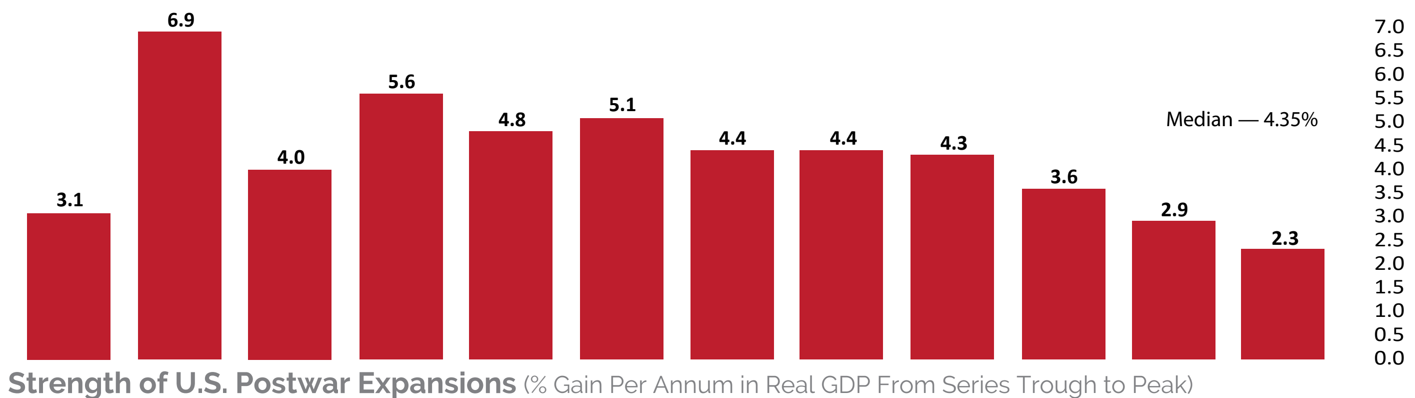
In January, we said that once the 4th quarter correction ran its course, secular winds would take hold and a new cyclical bull market would begin, taking the market to new highs. In fact, the S&P 500 did indeed make a new high. In January, our expected 2019 year-end target for the S&P 500 was 2900; however, we saw the potential for a wide range of outcomes given the many risks and uncertainties.

On the economic front, we expected growth in both the U.S. and abroad to slow. In the U.S., we expected economic growth to moderate to 2.3% and for the expansion to become the longest on record. We expected global growth to slow to 3.5%, which would be on par with its long-term trend. In fact, the global economy has been slowing for over a year, as Europe and Japan have stagnated and emerging market growth has slowed, particularly in China.

Where Are We Now?

Figure 1. **Slowest Post-War Expansion on Record**





Source: Ned Davis Research. For illustrative purposes only.

The current economic expansion has been very resilient. The median economic expansion dating back to 1945 lasted 51 months. At 119 months, this expansion has more than doubled the median length of past expansions, and at the end of June, it will become the longest economic expansion on record, tying the expansion from 1991–2000.

One of the reasons the expansion has lasted so long is that it has had few overinvestment bubbles, like the internet or housing bubbles that ended the previous two expansions. Due to lack of investment, increased regulations, debt overhang, low productivity, and demographics, real GDP has grown at only a 2.3% annualized rate (as shown in **Figure 1** above), which is the slowest pace of any post-war expansion.

Our Take on Key Economic Indicators

We look at a variety of data and indicators to gauge the overall health of the economy. When assessing our economic outlook, we take a close look at the Conference Board's Index of Leading Economic Indicators (LEI), the health of the labor market, and the shape of the yield curve. We've highlighted all three of these in the past several Market Outlooks and up until this point, these indicators have signaled continued economic growth.

LEI has hit all-time high after all-time high over the past couple of years. After a brief period of flat readings in late 2018, it has once again reached a new all-time high.

This new high in Leading Indicators is important because over the past 60 years, early weakness in the LEI has preceded every recession in the U.S. As the table in **Figure 2** shows, the typical lead time between the peak in LEI and the start of recessions has ranged between 4 and 21 months. Since 1960, the average lead time has exceeded 11 months, and prior to the last three recessions, leading indicators were declining for an average of 16 months. The fact that LEI are at a new high suggests that the U.S. economy should continue its expansion, and we believe calls for a recession in the near future are premature.

Figure 2: **LEI Recession Lead Times**

LEI Peak	Recession Start	Months from Peak to Start
12/31/1959	4/30/1960	4
4/30/1969	12/31/1969	8
2/28/1973	11/30/1973	9
10/31/1978	1/31/1980	15
10/31/1980	7/31/1981	9
1/31/1989	7/31/1990	18
4/30/2000	3/31/2001	11
3/31/2006	12/31/2007	21

Source: Ned Davis Research. For illustrative purposes only.

Another indicator that is signaling continued expansion is the number of new claims for unemployment benefits. Typically, unemployment claims start rising about 6 to 12 months prior to the start of a recession (shown in the red lines in **Figure 3** below). Jobless claims recently hit their lowest level since October 1969, a 49-year low, which is consistent with continued growth in the economy.

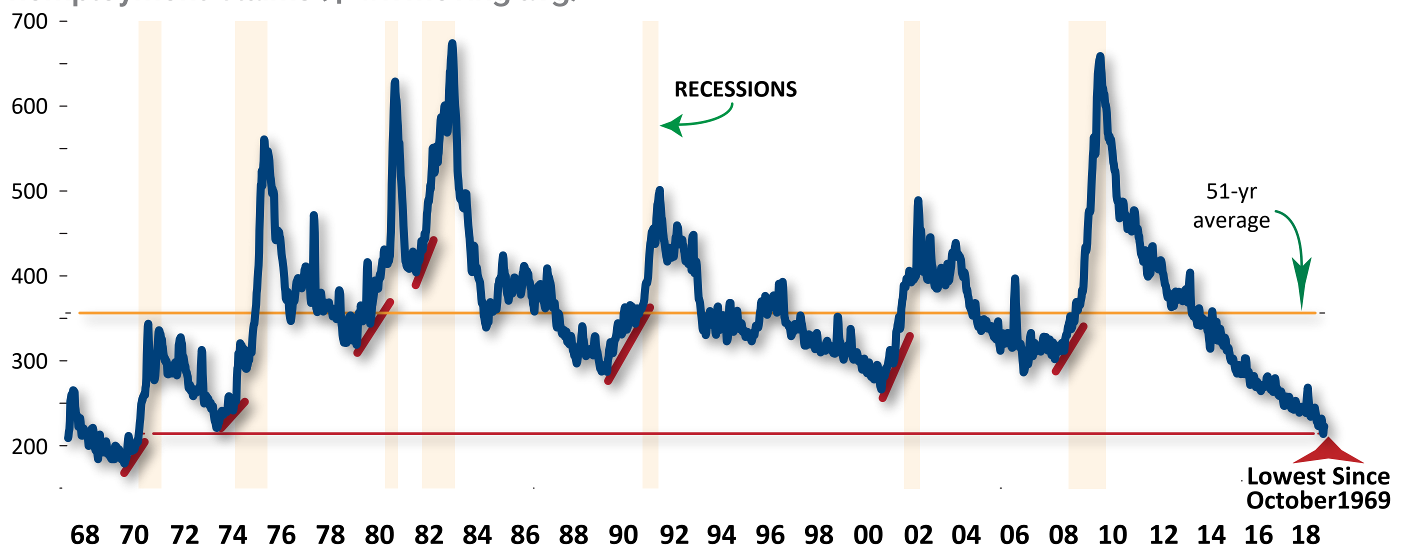
Consumer spending accounts for about two-thirds of U.S. economic activity. The fact that initial jobless claims continue to hover near their lowest levels since the late 1960's reflects strength in the job market, which is critical for our consumption led economy.

The unemployment rate often rises by an average of 0.4% before a recession begins. Right now, the unemployment rate is 3.6%, resting at its lowest level since 1969. The rise in the unemployment rate that would signal a recession doesn't normally happen overnight—historically, it has taken on average over 200 days. If history is any indication, there is a fairly long lead time of seeing weaker labor markets before a recession starts.

However, recessions don't begin when the unemployment rate is high—they begin from low unemployment rate levels like we have today. This is another indicator we are continuing to monitor closely.

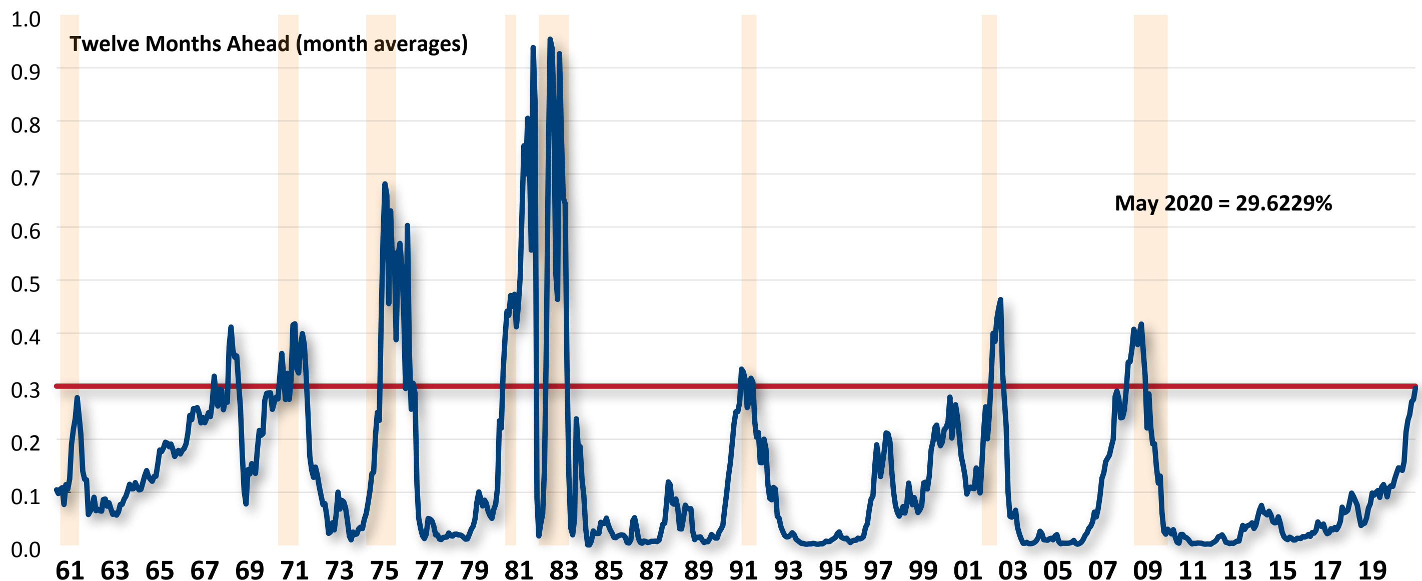
The New York Federal Reserve has a model that uses the difference between the 10-year and 3-month Treasury rates to calculate the probability of a recession in the next twelve months. As shown in **Figure 4** on the next page, this model currently predicts almost a 30% chance of a recession happening in the next 12 months. Each time this model has risen above 30%, a recession has followed. It's close to that mark now, so we see this as another warning sign.

Figure 3. **Unemployment Claims Spike Leading Up to Recession**



Source: Ned Davis Research. For illustrative purposes only.

Figure 4. **NY Fed Probability of Recession in the Next 12 Months**



Economic and market forecasts presented herein reflect a series of assumptions and judgments as of the date of this presentation and are subject to change without notice. Forward-looking statements cannot be guaranteed.

Source: InvesTech Research. For illustrative purposes only.

What's Next?

Fed Policy at the Forefront

With that economic backdrop, what's next for the markets and economy? One of the biggest risks we continue to monitor is the Fed making a policy error. The Fed hiked rates four times last year and nine times during this cycle, and we believe at least two of last year's rate hikes were not necessary.

The Fed has a history of policy mistakes, where they have hiked rates too far resulting in a recession. For example, in each of the last 12 rate hike cycles, manufacturing contracted, an Earnings Per Share recession happened 92% of the time, and 75% of the time the economy fell into recession—that's a pretty good batting average of policy mistakes.

We feared coming into the year that the Fed was on the verge of making another policy mistake, but they seem to have become more data dependent so far in 2019. The prospect of a policy error and rising trade tensions with China have gotten the Fed's attention and their messaging has been a lot more dovish.

The market is forecasting 100 basis points of rate cuts over the next 12 months and a 100% chance of a cut at the July 31st FOMC meeting. Inflation has remained stubbornly below the Fed's 2% goal as secular forces including technology, globalization, debt, demographics, and low inflation expectations are putting downward pressure on inflation.

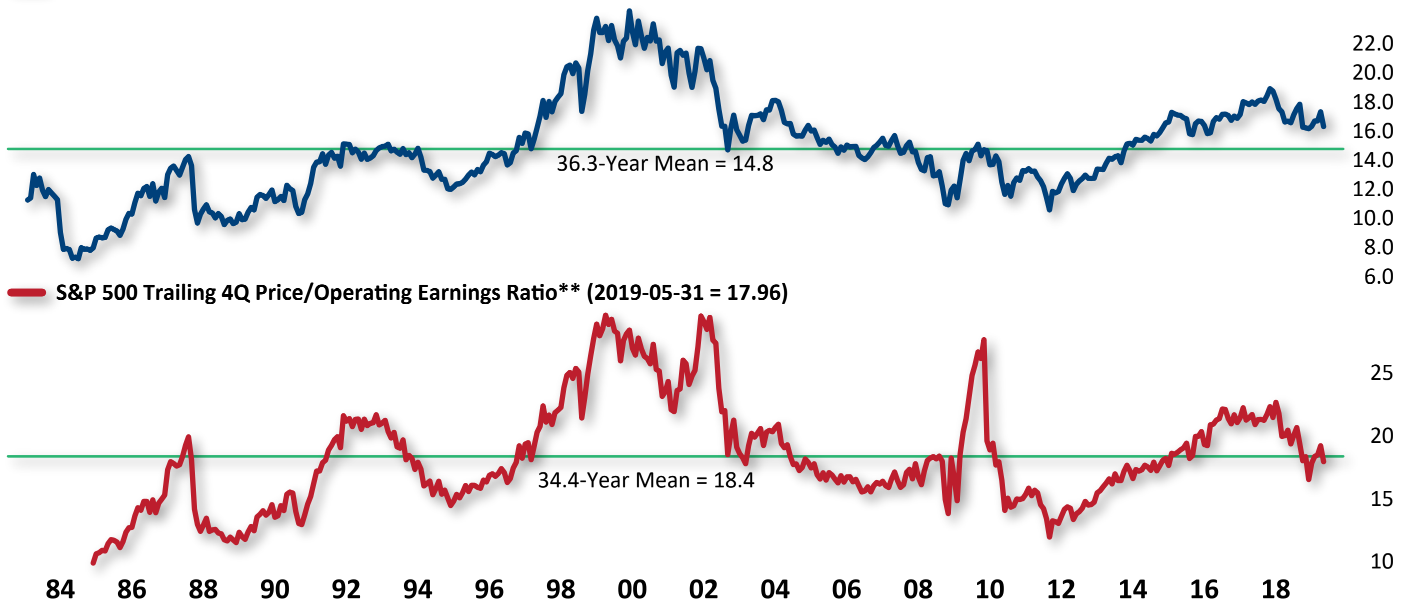
We find it hard to believe that the Fed will cut this much in an environment where GDP grew 3.1% in the first quarter, the unemployment rate is 3.6%, the S&P 500 is at record highs, and credit markets are functioning normally. We think the Fed will likely make a rate cut in July, but a big decision-making factor will be the state of trade relations with China going into the Fed's July 31 meeting.

Earnings: Slowing but Still Growing

As shown in **Figure 5** on the next page, the S&P 500 Index is currently trading at roughly 17 times next year's earnings (as measured by price-to-earnings ratio, or P/E) and a little under 19 times trailing earnings. Continued earnings growth and a relatively flat market since January 2018, combined with a wide trading range has resulted in multiples contracting to more reasonable levels.

Today's valuations are hardly extreme, and the P/E ratio on the S&P 500 is in line with its long-term average. That said, today's valuation is roughly 20% below the January 2018 peak and roughly 35% below the 1999 top. We believe current valuations support a bullish resolution to the market in the second half of the year.

Figure 5. **Valuations in Line with Long-Term Averages**



Source: Ned Davis Research. For illustrative purposes only. Past performance is not indicative of future results.

Earnings are currently expected to grow by 8.9% for the full calendar year 2019. That number is likely to come in some as the second half of the year progresses. Normally we see analysts revise their quarterly earnings expectations down throughout the year. However, fourth quarter expectations have not been reduced yet. Granted, year-over-year comparisons are easy in the fourth quarter, but given the slowing economic trend, we could see those revised lower. In addition, trade war uncertainty has likely not been fully reflected in expectations yet. Given the fair valuations we just saw, the market can likely stand some further estimate reductions.

It has been a very interesting market with a very wide dispersion in sector and style performance. For example, at the beginning of June, J.P. Morgan's Chief U.S. Equity Strategist wrote to clients that "value is currently trading at the biggest discount ever."

After a decade when growth stocks have outperformed their cheaper rivals, the median forward price-to-earnings ratio of the cheapest portfolio of the S&P 500 is trading seven points less than the broader index and the growth/value relationship has been stretched to historic extremes. However, we believe that when the current regime mean reverts back toward a more normal growth/value relationship, portfolios that employ a value-oriented investment process should benefit as value factors get rewarded.

Presidential Impact

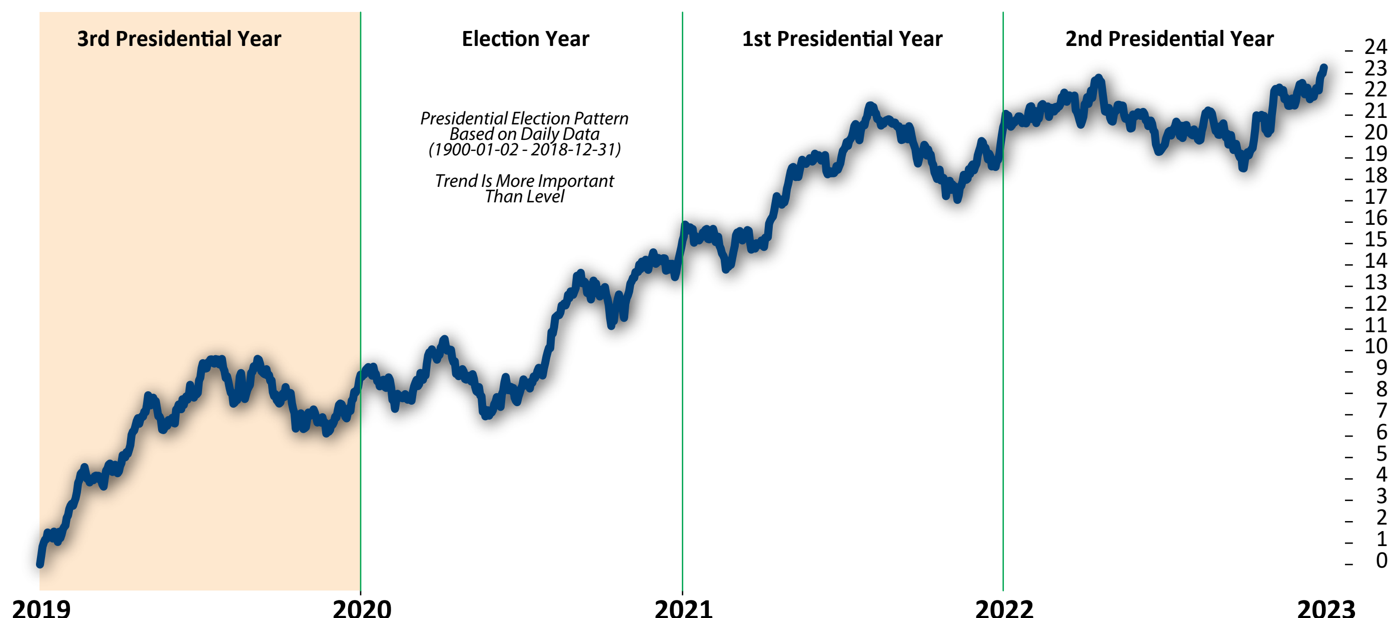
One reason why we were bullish on the market coming into this year was the presidential cycle. From a historical perspective, there have been 30 presidential elections since 1900 and 18 post-WWII presidential election cycles.

The pre-election year, currently 2019, has historically been by far the strongest performer of the four-year cycle as **Figure 6** on the next page illustrates. In the post-WWII period, the S&P 500 has averaged a 16.1% gain in the pre-election year. In addition, during an election year the S&P 500 has advanced 82% of the time for a median gain of 9.5%.

Shifting to Fixed Income

We are seeing some pessimism creep back into the markets, even as the market is trading at record highs. There have been massive outflows from stocks and massive inflows into bonds. The level of outflows from stock funds signals that investor emotions have taken hold, especially as we witnessed record outflows in the fourth quarter of last year. On the flip side of that coin, bond fund inflows have been pretty consistent with a seemingly insatiable appetite for fixed income investments.

Figure 6. **2019 Should be the Best Year of the Four-Year Presidential Cycle**



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It seems logical that money would be pouring into fixed income here in the U.S. given the attractive rate differential with the rest of the developed world. Even though rates are low here in the U.S., they are still positive. Rates are much lower across the globe with $12.5 trillion worth of sovereign debt trading at negative interest rates.

In addition, a Bank of America Merrill Lynch asset allocation survey showed that investors are currently more bearish today than any time since the 2008 Financial Crisis. According to the survey, equity allocations saw the second biggest drop on record, while cash holdings jumped by the most since the 2011 debt-ceiling crisis. The report noted that concerns surrounding the trade war, fears of a recession, and monetary policy ineffectiveness all contributed to the bearish sentiment.

Rate Cuts on the Horizon?

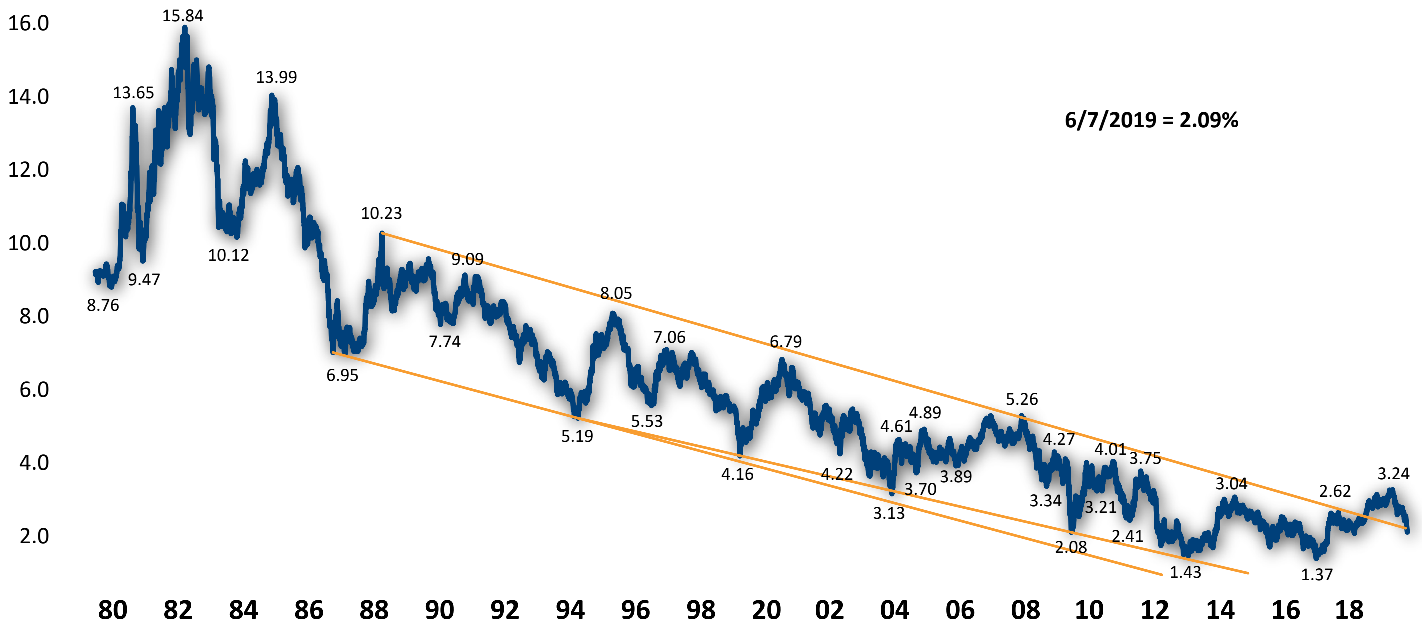
The seemingly insatiable appetite for U.S. Treasuries has resulted in a steep drop in yields (as shown in **Figure 7**) as the market discounts Fed rate cuts. At the June FOMC meeting, the Fed left interest rates unchanged but prepared the market for future rate cuts. The post-meeting statement adopted a dovish bias that emphasized increased uncertainties about the outlook and muted inflation pressures.

They continue to expect that a "sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2% objective" are the most likely outcomes "but uncertainties about this outlook have increased." The statement said they "will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion."

We believe that the Fed is taking a data dependent stance and signaling that if the economy weakens from here, or risk assets return to correction mode, they will likely cut rates in July. If the economy holds steady, or there is a trade deal, they likely won't make a change. With the market now pricing in 100 basis points of rate cuts, there is a chance that the market may be disappointed.

There are good points on both sides of the rate cut argument. On one side, the decline in manufacturing surveys, tumbling inflation expectations, the inverted yield curve, economic uncertainty, and an insurance policy against a worsening trade war makes the case for rate cuts. On the other hand, we have a record high in the S&P 500, full employment, 3.1% real GDP in the first quarter, tight credit spreads, and the moral hazard of cutting rates.

Figure 7. **Steep Drop in Yields**



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Credit Spreads Steady, but Credit Quality Deteriorates

Credit spreads have remained tame most of this year and have come in substantially from their peak in the 4th quarter. Given our economic outlook, we expect credit spreads to stay mostly contained until economic conditions worsen.

As you can see from **Figure 8** on the next page, spreads are just below their mean level over the past 35 years. Since the Great Recession ended, there have been several bouts of credit weakness where spreads spiked higher—2011, 2015, and 2018. Each one of those weak periods was primarily due to growth scares that proved to be temporary. As we move deeper into the late stages of this economic expansion, we believe there will be similar episodes of volatility.

There has been a deterioration in credit quality over the past couple years. Over 50% of both the U.S. and European investment grade corporate bonds are trading at the bottom rung of investment grade ratings. The amount of debt rated BBB is currently larger than the entire high yield market.

This has caused concern about the spillover effect on the high yield market if a large share of these BBB bonds gets downgraded to junk. Our view is that this will present a tremendous opportunity should it occur, and we believe we are well positioned to capitalize on this opportunity through our active and tactical approaches to managing fixed income.

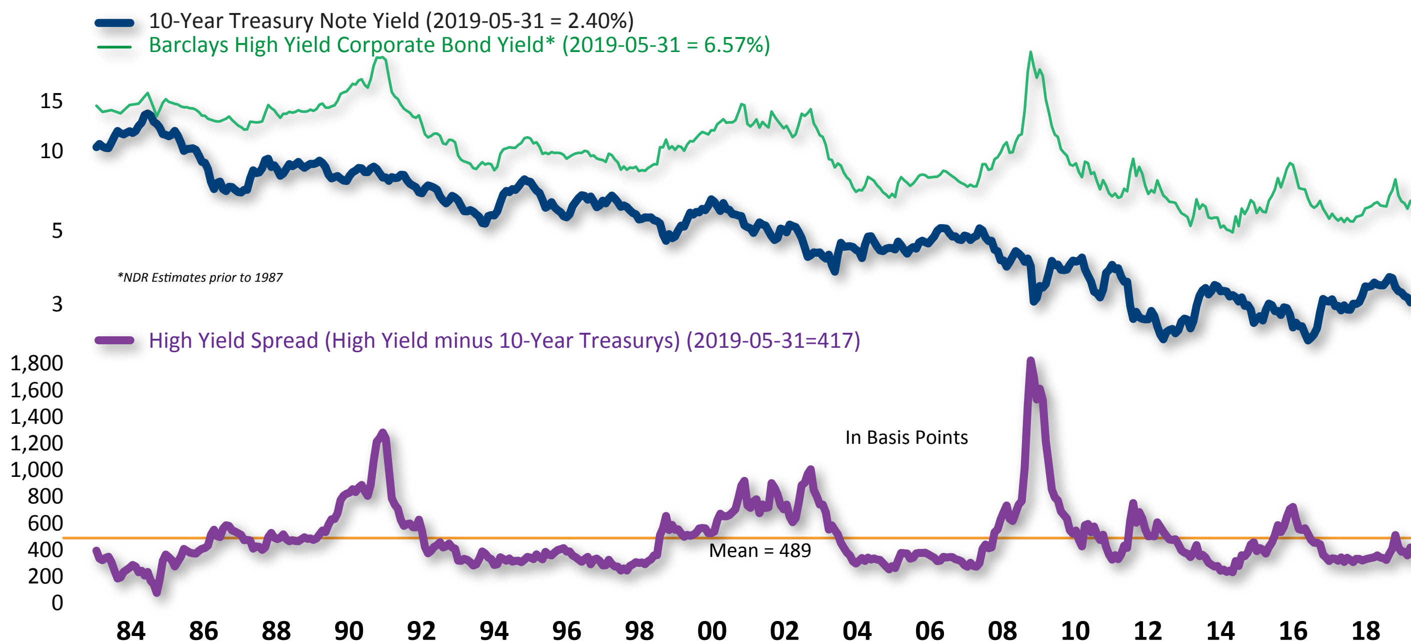
A downgrade cycle is not a problem today as net debt relative to cash flow is near its mean level over the past 50 years and interest coverage ratios currently stand at five times interest payments. The low interest rate environment has allowed companies to restructure their debt and improve coverage while taking on more debt. However, the additional leverage will likely have consequences down the road.

Stubbornly Low Inflation

There have been a lot of questions about why inflation has remained below the Fed's target despite the record amount of monetary stimulus since the Great Recession. We believe there are several reasons inflation has remained stubbornly low including: technology, globalization, cheap overseas labor, demographics, and the amount of total credit market debt.

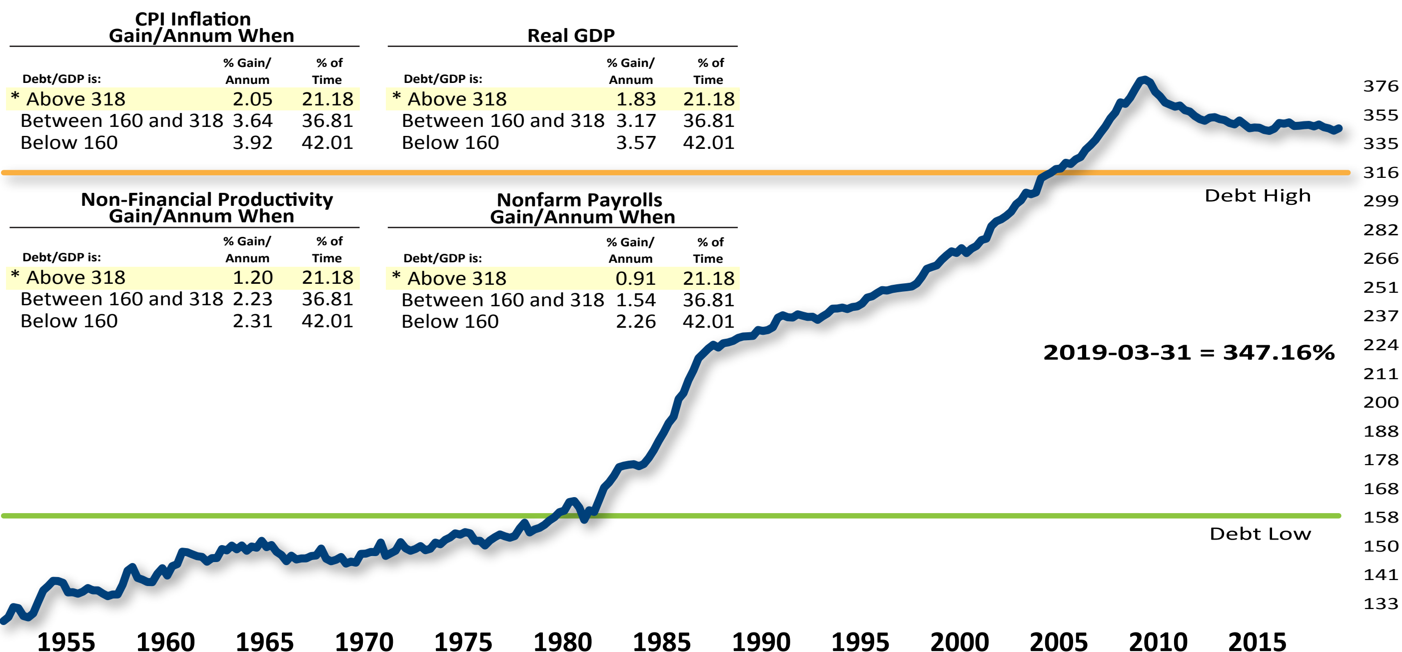
Figure 9 on the next page shows that as the amount of debt as a percentage of GDP has risen, the rate of growth in inflation, real GDP, productivity, and payrolls have all declined. Ultimately, debt is deflationary, and it crowds out today's savings which are tomorrow's investments and takes resources away from productive economic uses in order to service the debt. This chart also sums up why we are in the midst of the weakest economic recovery on record.

Figure 8. **Spreads Just Below Their Mean Level**



Source: Ned Davis Research. For illustrative purposes only. Past performance is not indicative of future results.

Figure 9. **Growing Debt Drags on Economic Growth**



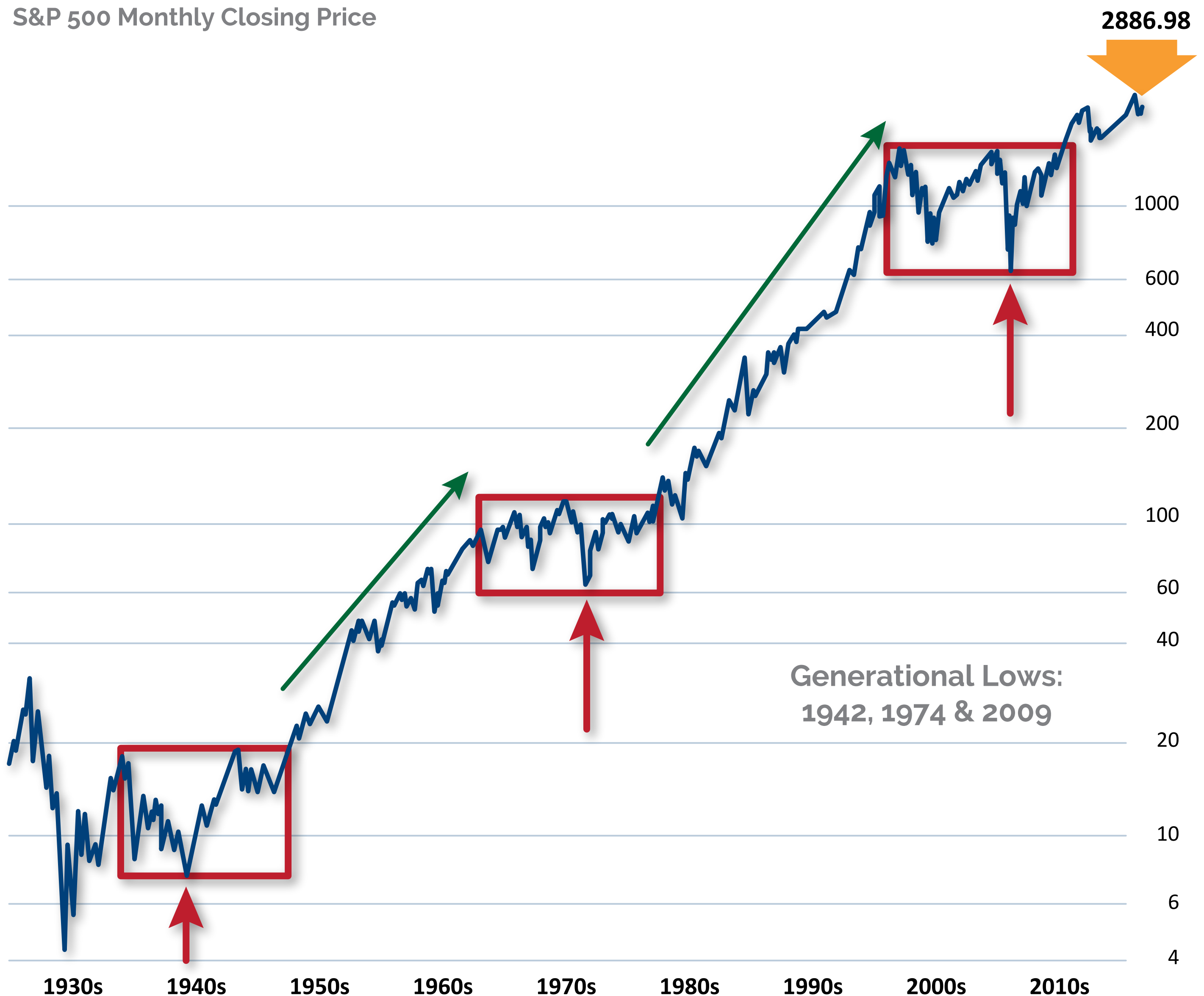
Source: Ned Davis Research. For illustrative purposes only. Past performance is not indicative of future results.

The Long-Term View

It's important to keep the longer-term view in perspective, especially when in the midst of volatile times. We have been bullish on the secular outlook for stocks since early on in 2009, and we have not wavered on that outlook. To highlight that opinion, we have concluded the past several Market Outlooks with the below chart (**Figure 10**) detailing the very long-term perspective of the equity markets.

This chart shows the S&P 500 monthly closing price dating back into the 1920s. The three boxes in red highlight the last three secular bear markets. Note that once the market eclipsed its prior secular peak, it continued higher for many years. The prior two secular bull runs lasted 22 and 18 years and we believe this is the same environment that we are in today. We are now over 10 years into this secular bull market, and if history is any guide, the probability of additional secular gains is high.

Figure 10. **Generational Lows: A Long-Term Perspective**



Source: Merrill Lynch Research. For illustrative purposes only. Past performance is not indicative of future results.

Conclusion

We came into the year with a bullish outlook as we expected continued but slowing economic growth. The U.S. markets have delivered solid gains, and we expect further gains in the second half of the year. As a result, we are adjusting our upside target on the S&P 500 to 3100 (from 2900 in January), but also think the range of outcomes is wider than usual over the next six months given uncertainty on the trade front, Fed policy actions, and slowing U.S. economic activity.

Economic indicators suggest continued economic growth, but at a slower pace. In our opinion, the risk of recession remains low as LEI and labor market statistics are strong, but the yield curve is beginning to flash warning signs and there are many risks to the outlook that could roil the markets.

Top on the list of risks is the ongoing trade war with China. Conditions are in place for emerging markets to outperform this year with falling interest rates and a U.S. dollar that has plateaued and may be vulnerable. However, emerging markets' relative outperformance also boils down to an agreement on the trade front.

The Fed's pivot to a more dovish bias is complete and the market is discounting 100 basis points worth of rate cuts over the next 12 months. While we expect the Fed to cut rates, we believe the market's expectation is too aggressive. The growing debt burden continues to act as a drag on economic growth and has a deflationary influence. That has contributed to the "lower for longer" interest rate environment we're in today, and why $12.5 trillion of global sovereign debt is trading at negative rates.

Overall, our outlook is for continued economic growth for the remainder of the year and well into 2020. Economically speaking, we will be in unchartered territory as we enter the longest economic expansion on record, and safe to say, late in this maturing economic cycle.

About the Author

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As Clark Capital's Chief Investment Officer, Sean oversees all of the Firm's investment activities and heads the firm's portfolio team. Sean joined the firm in 1993 and is responsible for asset allocation and investment selection for Navigator Investment Solutions as well as directing ongoing market research and contributing to the development of proprietary products. Sean is a member of the Clark Capital Investment Team and the Executive Team. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean holds the Chartered Financial Analyst® designation and is a member of the CFA Institute (formerly AIMR) and the Financial Analysts of Philadelphia, Inc. Sean is considered an industry expert and is often asked to appear on CNBC and Bloomberg television to share his views on the market. In addition, Sean has been featured in a number of articles in nationally distributed business journals and newspapers.

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Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

The volatility (beta) of an account may be greater or less than its respective benchmark.

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