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EQUITY MARKET UPDATE

As of 09/30/19 | Volume 8, Issue 9 | FFTAM.com

September was another month in which the market and the economy were heavily influenced by political developments out of Washington. The month began with a large rally in low-valued, cyclical stocks as the Trump administration hinted at the potential for a smaller, intermediate-term trade deal with the Chinese government at upcoming trade meetings. At mid-month, the Federal Reserve lowered interest rates again, while the President continued his Twitter campaign against Fed Chairman Jerome Powell for not doing enough to boost the economy. By month-end, the rally fizzled as Speaker Nancy Pelosi announced the House would begin a formal impeachment inquiry of President Trump for his conversations with the President of Ukraine to investigate the son of former Vice President and Democratic challenger, Joe Biden. We also received ISM data that showed continued weakness in manufacturing and service activity within the United States. Despite all these events, stocks were able to finish the month with positive returns.

Stocks Rally Despite Impeachment Investigation and Weaker Economic Data

After an August sell-off, the S&P 500 regained positive momentum in September. The index advanced 1.87% for the month and currently sits 1.72% below its July 26th high point of 3,027. Intra-index volatility remained high as investors reacted to economic and political developments. Year-to-date, the S&P 500 is up 20.55%. This is the highest nine-month return for the index since 1997; however, the complexion of the gains are much different than previous periods with such strong performance. First, the large rally was needed to restore the index back to where it was trading prior to the large sell-off in the 4th quarter of last year. Second, the three most defensive sectors—utilities, REITs, and staples—are among the best performers as investors worry about slowing global growth. Finally, since President Trump began his trade war with China in February 2018, the S&P 500 has only gained 3.70%.

The Dow Jones Industrial Average experienced similar results gaining 2.05% in September. A big rally in shares of Boeing and Apple accounted for 41% of the return as investors cheered rumors that President Trump would consider an intermediate-term trade deal with China at upcoming meetings. Year-to-date, the Dow is up 17.51%.

Defensive sectors dominated third quarter ETF flows

Sector	Flow	
Real Estate	$2,126.5B	▲
Consumer Staples	1,640.6	▲
Technology	1,084.9	▲
Utilities	885.6	▲
Communications	488.1	▲
Materials	186.7	▲
Consumer Discretionary	-330.9	▼
Industrial	-574.8	▼
Energy	-1,564.1	▼
Health Care	-3,069.1	▼
Financial	-3,598.7	▼

Source: Bloomberg Intelligence

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SAN ANGELO
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San Angelo, TX 76903
325-659-5987

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325-235-6644

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The NASDAQ had a lower return than the S&P 500 and Dow, gaining 0.54% during the month. The weakness came from a sell-off in shares of popular momentum names like Amazon, Facebook, and Netflix. The index remains the leader in 2019 with a total return of 21.56%. Gains in software services, internet portals, and social media have powered the tech heavy index.

Mid and small-sized companies were the best performers in September with the S&P 400 Mid-Cap and S&P 600 Small-Cap indexes jumping 3.06% and 3.34%, respectively. This was largely the result of interest rates climbing from their August lows and spreads widening among 2-year and 10-year US Treasuries. We have written for months that both indexes have a large exposure to banks. Falling interest rates, along with an inverted yield curve, serve as a double whammy for community bank stocks as net interest margins shrink and the potential for loan losses rises. Year-to-date, mid-cap and small-cap stocks are up 17.86% and 13.44%, respectively.

Overseas Data Remains Weak, and ECB Cuts Interest Rates

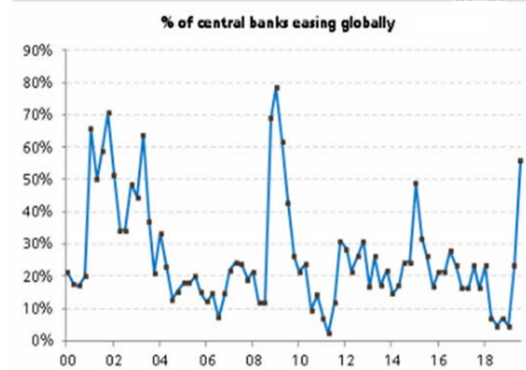
Economic data in foreign markets continued to weaken in September. Chinese Manufacturing PMI edged up to 49.8, but it was less than 50, signaling contraction, for a fifth straight month, while readings for employment and fixed asset investment remained soft. New export orders jumped, but many suspect the improvement came from front-loading ahead of the implementation of additional tariffs.

Chinese Premier Li Keqiang warned that GDP growth of 6% or higher would “not be so easy” given the worsening global outlook. He said industrial output growth in China was at a 17-year low, while retail sales growth continues to decline. To make matters worse, Reuters reported that President Trump is considering options to limit US investor capital flows into China.

Europe remains the epicenter for weak economic data. The Citi Eurozone Economic Surprise Index now stands at -65, its lowest reading since February. Much of the economic shortfall is coming out of Germany. Manufacturing PMI in Germany is near its lowest levels since the financial crisis of 2008-2009. Globally, the results are not much better. JP Morgan’s Global Manufacturing PMI Index has been in contraction territory for five straight months. All of this is mainly the result of weak global trade, which has declined for three consecutive quarters for the first time since 2008-2009.

In response to the weakening data and geopolitical uncertainties, the ECB cut its deposit rate to a record low -0.50%. They also announced a new quantitative easing program in which the central bank would purchase 20 billion euros worth of bonds a month beginning in November. They also eased the terms of their long-term loans to banks and introduced a tiered deposit rate to help the struggling banking system.

Figure 26: Central banks have responded strongly to the uncertainty—highest percentage of easing since GFC



Source: UBS, Haver [Note: chart is quarterly]

With so many central banks providing fresh monetary stimulus, international bond yields have collapsed in 2019. Globally, negative yields now encapsulate over $15 trillion in government bonds, with Japan comprising $7 trillion of that total.

Like their American counterparts, international stocks gained in September with the MSCI EAFE and MSCI Emerging Market Indexes returning 2.89% and 1.90%, respectively. Year-to-date, MSCI EAFE has gained 13.39%, while MSCI Emerging Markets has returned only 6.14% due to a stronger US dollar and Chinese economic weakness.

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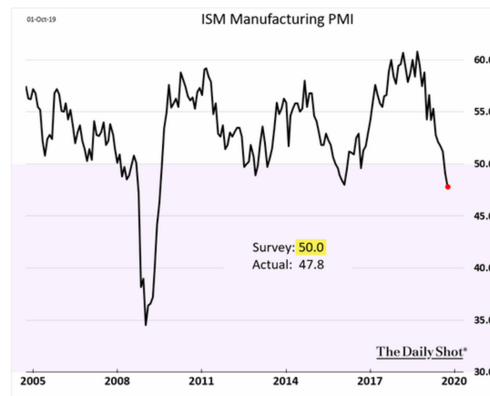
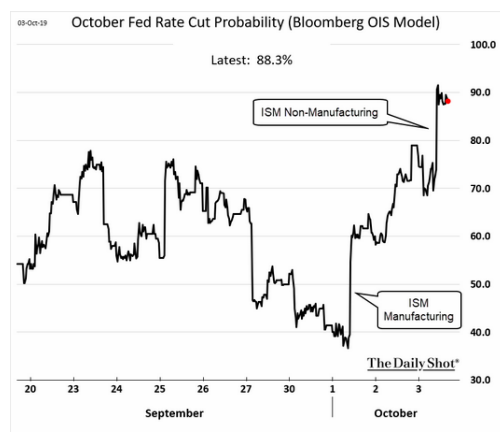
Global Economic Weakness Drags Down the US Economy

Although the current economic expansion in the US is now the longest on record, the debate about whether the economy can withstand global weakness grows more intense. The labor market remains a bright spot for the US economy. Unemployment is at 50-year lows, wages are rising, and the economy has created jobs for a record 107 straight months. This has been good news for the US consumer which is increasingly becoming the most important factor in keeping the current economic expansion alive.



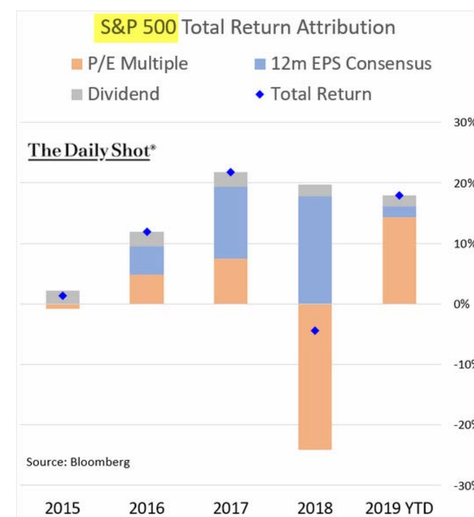
Amid persistent trade uncertainty, factory output in the United States has weakened for six straight months. This mirrors the manufacturing slowdown in China and Germany. The September ISM Manufacturing PMI reading of 47.8 was a 10-year low. The survey showed contraction in manufacturing production, employment, new orders, and exports. To make matters worse, the ISM Non-Manufacturing PMI weakened to its lowest level since August 2016. Although the 52.6 reading is still in expansion territory, investors worry that the economic weakness overseas, along with political uncertainty at home, is beginning to weigh on the service sector which accounts for 80% of US economic activity. The weak ISM surveys caused many economists to lower their 3rd quarter GDP forecasts to sub-2%.



With economic growth weakening and central banks around the world providing more stimulus, the Federal Reserve cut interest rates by 25 basis points for the second time this year. During his press conference, Fed Chairman Jerome Powell acknowledged risks to his positive economic outlook. If the economy should weaken further, he promised "a more extensive sequence of rate cuts." Currently, the market has priced-in an 88% probability of another rate cut in October.

Earnings Growth Remains Elusive, but S&P 500 Dividend Yield Exceeds Treasuries

The gains in September slightly increased the forward PE ratio on the S&P 500. Currently, the index trades at 16.90x forecasted earnings for the next twelve months. This is an increase from the 14.90x forecasted earnings seen at year-end, and it is above the 10-year and 30-year average of 15.06x and 15.78x, respectively. Almost the entire rally in stocks this year has come from PE multiple expansion.



Earnings season is about to begin. Given the economic challenges cited in our last three write-ups, along with the 3rd quarter of 2018 representing the high-water mark for profits, one should expect this quarter's earnings to look like the results we saw during the 2nd quarter. Currently, analysts are forecasting a year-over-year earnings decline of 3.7%. If this should come to fruition, it would mark the first time earnings have declined for three straight quarters since the 4th quarter of 2015 through the 2nd quarter of 2016. We have already seen an earnings warning from FedEx, and FactSet said a record number of technology companies have issued negative EPS

guidance for the 3rd quarter. Fast forward to 2020, and things are not much better. Analysts have begun to bring down their 2020 EPS estimates, but they are still looking for 10.6% earnings growth next year. That will be difficult to achieve without an uptick in economic growth from a trade deal.

The most bullish investors cite central bank accommodation as a positive catalyst for stocks. We believe further rate cuts will not stimulate economic activity at the same pace as the past because absolute rates are already near record lows and what plagues the global economy is lack of business investment due to trade uncertainty, not oversupply of goods and services. However, one could make the argument the bond market has already priced in this fear as the yield on the 10-year US Treasury is far less than the dividend yield on the S&P 500, something we have not seen since the European debt crisis of 2011.

Our Outlook and Strategy

The US economy is on firmer footing compared to other countries around the world; however, we are beginning to see weakness in manufacturing, services, and inflation. The state of the consumer remains strong as the labor market continues to add jobs. Most data points in our proprietary economic checklist indicate the US economy is in the late stages of the economic cycle. With growth slowing and the yield curve inverted, it is hard to imagine stock PE multiples expanding much further than current levels. We expect the stock market to experience higher bouts of volatility with any additional gains coming from earnings growth and improving geopolitical conditions.

We remain quiet on the trading front. Most of our trades in 2019 took place during the first quarter when we used the stock market rally to trim earnings risk from our portfolios. We were rewarded as volatility increased throughout the spring and summer.