STRATEGAS insight

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Is the Long Cycle at a Crossroads? Focus on Earnings and Interest Rates

For too many investors, the insight of Kipling's famous observation – in essence, *to keep one's head when everyone around you is losing theirs* – is, unfortunately, never clearer than after periods of general panic, in which having failed to keep anything about them, they regretfully reacted in haste. Although it is said that 'chance favors the prepared,' it also can be reasonably posited that odds are improved for the fortunate few who possess a heightened sense of awareness and exercise calm and measured cadence when taking actions during periods of uncertainty. This measured approach during bouts of acute market stress compels us to disavow the ancillary arguments "supporting" our base case and chart a course solely by assessing its fundamental merits.

Investors clearly suffered through just such an episode late last year on fears that weakness across international economies would combine with errors on the domestic policy front – *specifically related to trade and monetary policy*[1] – and conspire to threaten the durability of the long cycle. The fear was palpable: From the S&P 500 Index's all-time high of 2,941 on September 21, 2018, prices compressed just slightly more than 20%, to an intraday low of 2,347 the day after Christmas. Although the sell-off was dramatic, we were struck by the outsized emphasis investors placed on worst-case outcomes, given the clear threads of tangible strength in the domestic economy. These include a healthy US labor market; strong domestic consumption; and historically low interest rates. We viewed this as an irrational assignment of risk-weighted probabilities. Additionally, although certainly difficult to accept given its *social impact*, the government shutdown's transient nature and limited *economic impact* were being credited for providing a mathematically unjustified headwind to corporate activity and economic growth. Our own reassessment agreed directionally with the consensus (i.e., *the US economy was likely to experience a slower rate of expansion moving forward, more in step with its global trading partners*), but we did not solve for the same order of magnitude. Instead, we forecast economic activity to surprise above the consensus's severely lowered expectations. **We have maintained an above-benchmark allocation to equities (70% versus a benchmark 60%/40% stock/bond portfolio) and a below-benchmark allocation to fixed income (27% plus 3% cash) in our global allocation portfolios.**

The same S&P 500 Index that plunged so dramatically during the fourth quarter has subsequently rallied more than 18% off the December 26, 2018 low to roughly 2,775 on February 21, 2019, highlighting the increasingly tenuous nature of investor confidence. We are reminded of an important market barometer: When investors' focus is on the long-dated fundamental outlook – *What will earnings be next year? When will the next recession occur?* – the market generally will

[1] See Strategas Insight from July 2018, *Assessing the Four Horsemen of the Economy*

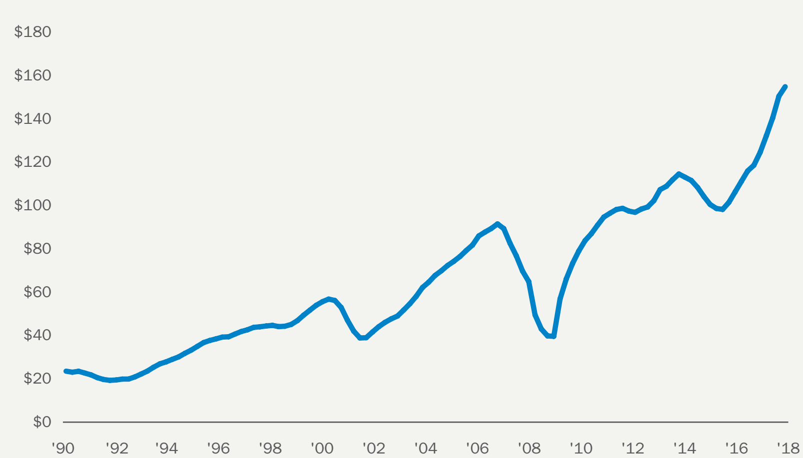
have support underpinning any near-term volatility. Conversely, when the focus is on near-dated machinations – *What will the Fed minutes say? What will payrolls be this month?* – we have found sufficient evidence to expect "shoot first" responses to unexpected developments. The contours of recent market action underscore this point. After capitulating to a decidedly negative view during Q42018, market participants largely reversed course and adopted a relatively optimistic framework as we turned the page into 2019. How long will this more bullish phase last? And, how will it ultimately reconcile?

At the center of this debate are the two fundamental building blocks of risk asset prices–earnings and interest rates.

On the earnings front, the introduction of demonstrably lower corporate tax rates 14 months ago accounted (CP) for roughly an eight-percentage-point boost in aggregate corporate profits, and this was on top of already strong organic growth (~12 pct. points) evident throughout 2018. Though the Street originally extrapolated this profile linearly into 2019, we always viewed the consensus as too high in the aggregate, believing estimates likely would be revised lower into a more realistically achievable range. Of course, the effect of the tax-rate adjustment was always going to largely anniversary from the growth calculus in Q12019. But, the combination of the protracted government shutdown, uncertainty about the ultimate outcome of US-Sino trade negotiations, softer economic conditions abroad, and the threat of tighter financial conditions on the domestic front gave companies sufficient cover in this package of "global macro" headwinds to level set forward guidance during the Q42018 reporting season. Although it is unlikely, *in our view*, that any of these inputs will have an undue, or lasting, impact on either the economy or corporate profits, we have been surprised at just how aggressive the Street has been in revising down their own Q12019 and calendar year 2019 estimates. Longtime readers of our work will recall how sufficiently rare it has been for our estimates of aggregate S&P 500 Index earnings per share (EPS) to be higher than the Street. (We are estimating index EPS of $172 for 2019 versus the Street's $169.) It is certainly not merely optimism on our part, but rather a function of the higher weight we place on guidance revision in our estimate framework. To be sure, this approach does not always make us right, but we are comfortable saying it has left us closer to the mark over the years. In short, we remain comfortable with our estimate of $172 for 2019.

With respect to interest rates, the Federal Reserve (Fed) has taken great pains to articulate a dramatically slower pace of policy normalization. This pivot to a more dovish "wait-and-see" approach has moderated concern about the yawing discrepancy, as Strategas chief economist Don Rissmiller has described it, between the level of interest rate the economy can withstand and the level of interest rate the market will accept. This has provided not just a boost to markets, but also an important dose of confidence to corporate operators. The divergence was exacerbated last fall by inconsistency in the Fed's communication program, most notably by Chairman Powell's assessment of the policy being 'a long way' from neutral. For now the Federal Open Market Committee (FOMC) has paused. (Remember when the futures market was pricing in **four** hikes in 2019?) We expect both the Chairman and his contemporaries to be very

S&P 500 Trailing 12 Month Operating EPS



Source: Strategas

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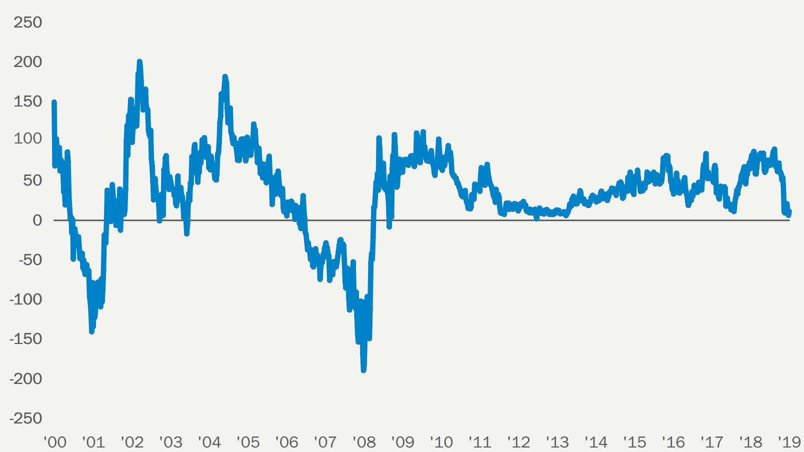
directed in their communication going forward. Despite some suggestion that the Fed made a "U-turn" with its decision to pause, after ten rate hikes in four years (one in 2015; one in 2016; four in 2017; and four more in 2018), there is plenty of cover to measure the impact of the program to date. There appears little impetus to raise rates any time soon.

Expect some additional focus to be paid to two key data points. First is the terminal size of the Fed's balance sheet (which currently stands at ~$4.x trillion). Although the Committee continues to structure the finer points of a revised runoff plan, we would soft circle $3.5 trillion, which could allow it to be completed in Q42019, as opposed to 2020. The market should view this positively. The second is the slope of the yield curve. Inversions are generally viewed as a symptom of a policy error, and the Fed, particularly Chairman Powell, is mindful of this.

Taken together, it would be imprudent to take the "all clear" from the 18% relief rally. We remain constructive on the economy in the intermediate term (six to 12 months), but investors are wise to anticipate continued volatility in both the equity and credit markets. Although time is an important salve against a sharp retest of last year's support, true "v-shaped" bottoms have been rare over the past 75 years. With the yield on the 2-year U.S. Treasury Bill slightly above 2.5%, and the yield curve sitting at a worryingly "flattish" 16 basis points, it is clear that bond investors are still concerned by a lack of breadth in the growth narrative. Put another way, we are bullish, but the market needs more evidence. Stay sharp—we are not out of the woods yet.

U.S. 2-Year Treasury Yield Less Fed Funds Rate (Bps)



Source: Strategas

Advisor Takeaway:

With the benefit of hindsight, investors may have overacted to the fear of an international economic slowdown coupled with errors on the domestic policy front, which resulted in the 20% sell-off in the S&P 500 Index from September 21, 2018 through December 26, 2018. Confidence clearly was shaken, despite a healthy US labor market, strong domestic consumption, and historically low interest rates. The market's rally of more than 18% from the low indicates the panic may have subsided for now, as investors develop an optimistic framework underpinned with longer-term corporate earnings expectations of around $172 and the Fed's wait-and-see approach to further interest rate hikes. However, as the Fed continues to unwind its balance sheet to an expected $3.5 trillion, and the slope of the yield curve remains barely positive, bond investors appear to be concerned about somewhat sluggish growth. The market rally thus far is bullish, but more evidence is needed to signal we are finally out of the woods.

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Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **Gross Domestic Product (GDP)** rate is a measurement of the output of goods and services produced by labor and property located in the United States. **Real Gross Domestic Product (GDP)** is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. **Nominal Gross Domestic Product** is gross domestic product (GDP) evaluated at current market prices. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **PCE (Personal Consumption Expenditure) Index** of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. **FAANG** is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The **North American Free Trade Agreement (NAFTA)** is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The **Seasonally Adjusted Annual Rate (SAAR)** is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The **Atlanta Fed GDPNow** forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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