STRATEGAS insight

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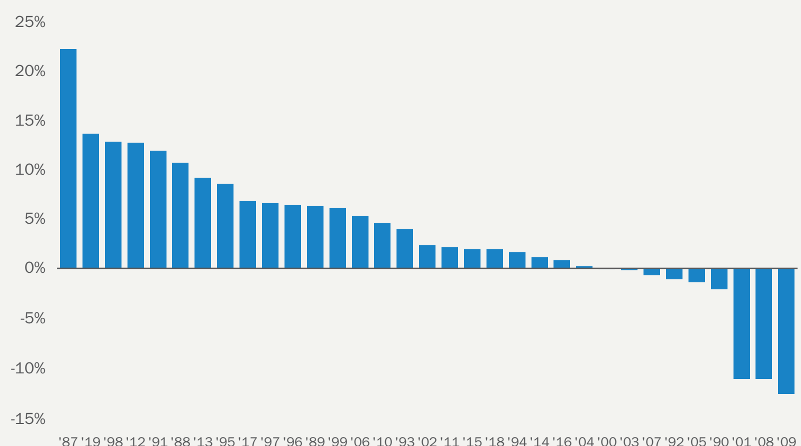
Here's to Ten More Years

Throughout the second half of last year, we highlighted a growing concern over the double-barreled risk of potential policy errors on both monetary and trade fronts. Indeed, data in 1Q2019 has softened. The Atlanta Federal Reserve's (the Fed) GDPNow tracker of US gross domestic product (GDP) remains low, at 0.40% quarter/quarter annual rate for the quarter, and the package of weak US economic indicators continues to mount. US retail sales were revised lower in December 2018; new home sales were down 6.90% month/month in January 2019; and industrial production rose just 0.20% month/month in February 2019 after a January decline). Of course, the Fed has seen the light, pivoting to a more measured pace of policy normalization in early January, followed by the equity market's best start to a year since 1987. Interest-rate-sensitive sectors (housing, autos) have shown a marked improvement, and, more broadly, we have seen a welcome bounce in consumer confidence. (The University of Michigan measure of consumer confidence moved up to 97.8 in March from 93.8 in February). We would not be altogether surprised if the employment measures remained choppy, in an improving trend, heading through midyear, but with wages rising at a still digestible +3.40% year/year, and the unemployment rate falling to just 3.8% in February, the US consumer remains in good shape.

Shifting gears, the status and outcome of trade negotiations with China remain unknown, despite trans-Pacific acknowledgements of progress and the desire to reach a substantive and mutually beneficial agreement. Although we maintain our view that a deal will get done (and that both presidents, Trump and Xi,

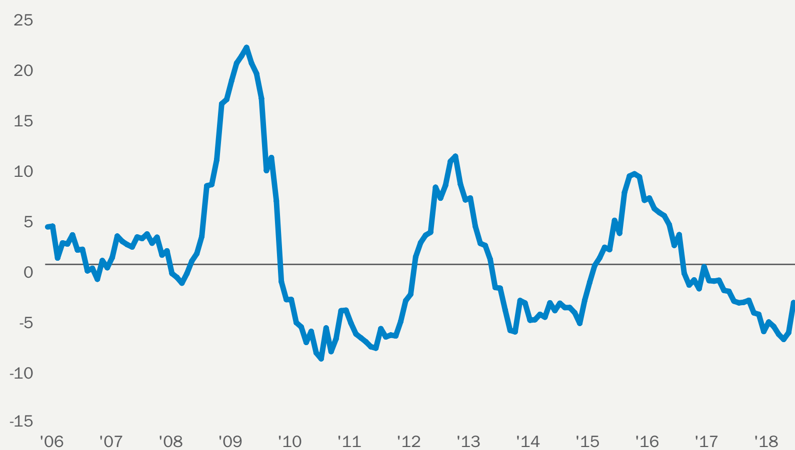


Source: Strategas

want a deal), further delay raises the risk that business confidence—*and more importantly, capital investment (capex)*—will remain restrained. This is an important consideration domestically when considering the supply-side inducements woven throughout the fiscal stimulus passed in December 2017. Tax cuts have made an important contribution to maintaining an expanding US economy, but corporate participation needs to improve for it to re-accelerate in a meaningful way. As Strategas' chief economist, Don Rissmiller, reminds us, 'business spending on hard assets is generally larger, more cyclical, and more volatile than spending on soft assets. "Soft spending," like on technology, tends to be initiated when businesses are looking for increased security and/or efficiency while brick-and-mortar projects tend to be put in motion when existing capacity is becoming strained.' To wit, data from China has been weak as well. Consumer-focused economic stimulus has not worked well in China (retail sales, production, and the PPI are all still weakening) and policymakers have teed up business-focused measures to try to stimulate the economy. The question is whether China too can work in the vacuum with no trade deal. Uncertainty surrounding international trade is a hip check to business spending—on both sides of the Pacific. Stay tuned.

As legendary investor Sir John Templeton said, "bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Although hints of *optimism* undoubtedly emerged in the wake of President Trump's election in 2016, the slowdown in the global economy over the last year tempered any universal embrace, and the emergence of weaker data in the US over the last six months has led to a near full rerack of investor *skepticism* over the durability of the long cycle and integrity of the bull market. However, despite the presentation of peak uncertainty and the sharp sell-off in equities last year—*frankly, in most asset classes*—the most unloved bull market in history marked its tenth anniversary on March 9, having risen more than 2160 points on the S&P 500 Index as of March 19, 2019, an increase of 325% over its intra-day low of 666 on March 9, 2009. Given the slowdown in global growth, we could reasonably expect a pause in the upward trajectory of stocks. But with the market trading at 16.5x current year 2019 earnings expectations, and the yield on the 10-Year U.S. Treasury Note at 2.6%, the actual risk-reward profile of the market is favorable. We expect volatility to remain elevated in the quarters ahead—which *is good for active share*—as the global economy works through transitory pressures and proceeds through its slowing expansion phase, and we believe recessionary pressures will remain sufficiently subdued to allow the equity market to maintain its upward trajectory.

Bloomberg China Credit Impulse
(12 Month Change)



Source: Strategas

We have been consistent—and remain comfortable—with the view that the US economy is not likely to fall into recession any time soon, yet we must acknowledge the emergence of a softer growth profile and the likelihood it will persist, at least for the first half of the year. In concert with the sharp rally in domestic shares off the late-December 2018 low, the environment seems well situated to taper our exposure to the US stock market. Although we remain broadly constructive on equities, the remaining risks appear to favor international equity markets in the intermediate term (six to 12 months). International shares have been strong in recent months, particularly across the emerging economies, and though

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hardly gangbusters, global growth appears to be bottoming ahead of the US. We have maintained an above-benchmark allocation to emerging markets shares since November 2018, and recently increased exposure to developed markets.

With the decision to taper exposure to domestic equities being perhaps more obvious, economic green shoots (note the European LEIs) have piqued our interest. Steady internal demand continues to buoy growth. Contained inflation expectations should keep the European Central Bank from making similar "mistakes" as the Fed did by seeking to normalize monetary policy too soon or too quickly. Wage growth also remains subdued. Although sovereign yields (notably German bunds) remain under pressure, contributing to extended weakness in the banking industry, financial conditions in Europe have modestly eased, owing to additional fiscal and extended monetary policy accommodations. To be sure, the global economy is only in the early stages of finding traction, so we will be monitoring the data closely and reassessing our position as we move into the end of 2Q2019.

We were reminded this week of an old gardener's proverb, '*things that grow quickly, die quickly; things that grow slowly, die slowly.*' Here's to ten more years!

Advisor Takeaway:

In the wake of softening US economic indicators, the Fed's pivot to lower rates prompted a stock market rally followed by an uptick in consumer confidence, suggesting that despite choppy employment numbers, wages are rising, unemployment is low, and the US consumer appears to be in good shape. However, the delay in resolving trade issues with China, coupled with its sluggish economic data, could trigger a slowdown in business spending, prompting investors to question whether the long cycle is nearing an end. A reasonable 16.5 P/E ratio, combined with a 2.60% yield on the 10-Year U.S. Treasury Note, support a more optimistic outlook, despite increasing volatility. Slowing US growth points to a more favorable outlook for international equities, both developed and emerging markets, at least in the intermediate term, as the ECB appears to be avoiding the Fed's error of raising rates too quickly. The bull market grew slowly, recently celebrating its ten-year anniversary, so it could have more room to roam.

About Strategas

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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