Positive surprises update: 2 out of 5 ain't bad (so far)

Developments are breaking the way we thought they may, boding well for our year-end forecast of 3,100 on the S&P

Published 02-22-2019

Stephen Auth, CFA
Executive Vice President
Chief Investment Officer, Equities, overseeing all of Federated's equity and asset allocation products globally

Earlier this year, we published a list of **five positive surprises**, defined as market-moving upside events that are both likely and non-consensus. Together, we see these forces driving the market toward our 3,100 S&P 500 forecast by year-end. Here's an update on where we are as we close out February and the all-important fourth-quarter earnings season.

1. **The conversation shifts from "synchronized global slowdown" to "synchronized global stimulus" and ultimately "synchronized global re-acceleration."** Amid Q4's doom and gloom and skepticism over the January bounce, this idea seemed out of place. It's less so now. Already, the Fed has more or less announced it's on hold till midyear at least and is hinting that balance-sheet contraction may be short in the tooth. Talk of a policy shift toward allowing core CPI to exceed the long-stated 2% target for a period of time is in the air. China already has begun stimulating its slowing economy, using some but not all of its policy levers to achieve a soft landing. European Central Bank President Mario Draghi hinted at his last news conference that more quantitative easing could be on the way. And around the world, at least four central banks already have announced interest-rate cuts this

year. Last week for the first time, I heard an analyst on one of the business stations mention "synchronized global stimulus," so the shift of sentiment in this direction may have begun. Call this one-half down, one-half to go.

2. **The China-U.S. relationship moves from "generational conflict" to "friendly cooperation."** This is still not consensus, although the market increasingly seems to be leaning in favor of some kind of trade deal getting done. The common denominator of agreement within the market appears to be that enough of a deal will happen to prevent another tariff hike (from 10% to 25%), but that protections around intellectual property (IP) theft will be hard to come by and a tariff cut is unlikely. We smile at this, largely because the consensus within the media is that our president is outmatched and outgunned by President Xi and therefore unlikely to win any concessions. Newsflash: President Trump already has. At Federated, our analyst teams and I meet with the management teams of the world's leading companies on a regular basis. For years, it was clear to us that if a company wanted to do business in China, the one-on-one negotiation with the government was pretty simple: "give us your stuff if you want access to our markets, or we'll get it from your competitors instead." This game is now dead. By shining a light on China's decades-long IP theft, companies are now pushing back and the Chinese are giving in. Trump just needs to give Xi a face-saving off ramp. We expect he will —that's Chapter 6 from his book. Since December, I'd say the consensus has moved from "No Deal" to "Weak Deal." Once Trump's team gives China an off ramp on IP, we'll be going to "Strong Deal" and from there, in the honeymoon period following the likely pleasant round of golf at Mar-a-Largo, from "Generational Conflict" to "Strategic Partners." For now, I'll give this surprise one-third out of 1.

3. **Oil moves to $90.** With the global recession fears ebbing and some sign of discipline out of OPEC, oil this year already has moved up from $54 to $67, about 36% of our $90 forecast. The rest should come as global demand re-accelerates above consensus forecast, and ex-U.S. supplies remain tight. I'll take one-third out of 1 here, thank you.

4. **Treasury yields stabilize between 2.5% and 3%.** Frankly, this already seems to have happened. With the Fed on hold and Europe and Asia moving back into deflation-fighting mode, there just seems to be little upward pressure on rates. Since the big fourth-quarter fall in yields, there has been little upward rebound—despite the stock market recovery. This to us is a sign that global buyers for U.S. Treasuries abound. Too early in the year to declare complete victory yet, but let's call this one 75% done.

5. **The market cracks through the old highs and a buying panic ensues.** This one is the big bear fear at the moment. As all good traders know, stocks rising on bad news is bullish, and that is precisely what happened in the just-completed earnings season. Although Q4 numbers were solid, earnings guidance was negative and on balance, full-year 2019 growth estimates were trimmed from 7.1% to 4.9% through the course of January and February. Stocks on the other hand are up 19% off the panic-driven Dec. 24 lows, implying that the market was expecting far-worse news out of earnings. While 3,100 seemed crazy on Dec. 24, a full 32% away, the 19% move just got us 59% of this surprise. We'll round this down to 50%, as the rest of the going will surely be tougher than the bounce from the oversold lows.

Interestingly, if you consider the sum of the first four surprises—the fundamentals that will give us the fifth—we are just shy of 2 out of 5, or 40%. The market's move (50% of our "fair value" target of 3,100 since December's low) would suggest to us that S&P could be a bit ahead of itself at the moment, although the doomsday consensus at the lows was even worse than we imagined. Either way, there's clearly room for more upside from here, although nothing goes up in a straight line and some accident or another seems overdue. It seems likely, for instance, that next week's March 1 trade deal deadline will be missed, and there's clearly the chance for the market to be upset as both sides air their reasons for the miss. Or maybe Trump even lets the tariff hikes through to jack up pressure on Xi. If that occurs, all the better; the likely sell-off will create more fuel for the next advance.

TAGS

EQUITY MARKETS/ECONOMY

DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Consumer Price Index (CPI): A measure of inflation at the retail level.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Stocks are subject to risks and fluctuate in value.

Federated Global Investment Management Corp.

1509247970

Federated®