Federated

Nothing really matters

A pullback not only is expected, it will be welcomed by many.

Published 03-08-2019

Linda Duessel, CFA, CPA, CFP
Senior Vice President
Senior Equity Strategist

My affable colleague entertained me with the song from Queen as we maneuvered through traffic ("got to drive aggressively here," where the HOV lane requires three people in the car) in Northern California this week, with stops in San Francisco, Walnut Creek, Oakland and Pleasanton. Advisors are poising for a market pullback from the recent S&P 500 2,800 level and expect to invest "dry powder" at the bottom of a range around 2,500. Indeed, the bull is rooting for a consolidation here. It is highly unusual for a surge in equities like we've seen year-to-date, especially amid an economic downtrend. Markit's survey of purchasing managers shows global manufacturing in its second-longest decline in 21 years (*more below*), while in the U.S., tracking estimates of real economic growth are just above water. The Atlanta Fed's GDPNow estimate for the current quarter *is just* 0.5%. This may explain the puzzle behind why bond yields have failed to follow equities since Dec. 24. Maybe the bond markets are hedging an equity downside scenario as negative economic surprises pick up. While volatility rose the past week as momentum stalled, the cross-asset backdrop for risk-taking remains strong and the highs for the year are likely not in. That said, it's important to keep in mind that returns rarely follow a straight line. Historically, there's better than a 50% chance of a 10% decline during a year, with the typical decline around 13%.

Northern California is so chill! In the week in which Goldman Sachs announced that suits and ties are now optional, a nod to the preferences of the millennial generation, I was told that “nobody wears ties here.” Of course, my Federated colleagues here do, while the ladies seem to be as professionally dressed as ever. What about the ladies?! (I get the same feeling in my annual trip to Honolulu, where the gentlemen wear aloha suits and we suffer in our heels. SMH!) Consensus among Bay Area advisors is for an impending downdraft, with a number of signals at or near record levels, meriting near-term nervousness. For example, when price-multiples (P/E) have resided in their top quintile and the unemployment rate has resided in its lowest quintile, as has been the case since October 2017, forward 7-year annualized total returns for the S&P historically have been just 2.9%, according to Leuthold Group. Yet the S&P so far has beaten these historical odds with a cumulative total return of 14% during that 16-month span. Also, a measure of global policy uncertainty developed by economists Scott Baker, Nicholas Bloom and Steven Davis has risen to near record highs, a level Cornerstone Macro says historically has implied a pending slowdown in earnings growth. After leading this rally, laggards from the December low have begun to stall; the same is true for high beta versus low beta stocks and small caps versus large. Declining issues traded at twice the volume of advancing issues the past week, and hedge-fund managers cut their net exposure and added to defensive sectors. This calls for ballast! A stalled rally could give the S&P a great deal of symmetry for a top formation, something admittedly lacking at the December lows.

With Wednesday marking the 10-year anniversary of the infamous 666 intra-day low, what’s happened since? The S&P’s 10-year rolling total monthly return has swung from -30% as of Feb. 28, 2009, to 364% as of the end of last month. On a daily basis, the return is 405% from the March 9, 2009, closing low. This reading has been eclipsed in only three time periods historically, all also around 10 years after major lows in the early 1940s, early 1980s and the 1987 crash. They did not necessarily mark the end of a secular bull, as the first move above 350% came with *over a decade left in the last two secular bulls*. Wherever I went this week, the subject of cannabis investing kept coming up—a local informed me that cannabis makes more money than wine in Sonoma County. Pick your chill! California doesn’t have the corner on this subject, BTW, as a West Virginia advisor on a conference call this week remarked that “Not a day goes by that I’m not asked about cannabis investing.” My hotel in Marin County, one of the most expensive

ZIP codes in the U.S., is just a 5-minute drive from San Quentin, one of the most notorious maximum security prisons in the country. But I'm sleeping soundly here, because I am chill, chill, chill.

POSITIVES

- **No recession in the near-term** The Institute of Supply Management's monthly survey said services activity in the economy rose the most in a year to a 4-month high, with new orders and business activity increasing at their fastest pace since August 2005. Ned Davis Research said that when combined with moderating activity in a companion survey of manufacturers, the reports correspond to 2.6% real annual growth in the economy.
- **Housing data surprises** New home sales rose at annual rate of 621,000 in December, a 7-month high, versus expectations for a decline. And January housing starts jumped 18.6%, while permits rose again. This, and the recent turn up in builder sentiment, suggest the spring season could mark a turning point, aided by improving affordability thanks to lower mortgage rates and moderating prices.
- **Job growth still healthy** Despite this morning's big headline miss, this week's measures of labor-market health were solid but indicate gains are likely to moderate going forward. February nonfarm jobs rose just 20,000, a 17-month low and well off January's upwardly revised 311,000 spike, but there was a lot of noise that impacted the number (weather, government shutdown, etc.). Household gains were a robust 255,000, the unemployment rate fell to 3.8% and household earnings rose to a cycle high 3.4% year-over-year (y/y). ADP's separate measure of private payrolls increased by 183,000, the fewest in three months.

NEGATIVES

- **Global manufacturing in a sustained slowdown** It decelerated a 10th straight month in February, its longest losing streak in 10 years. Just 63% of countries reported expanding activity, the smallest share in 3.5 years and down from a near-perfect 97% a year ago. Manufacturing contracted in the eurozone, Japan and

China, but there were bright spots as activity accelerated in India, Mexico and Brazil.

  - **Q4 GDP almost certain to be revised down** December's trade deficit finally came in and was much worse than expected, hitting monthly and yearly cycle lows of $59.8 billion and $621 billion, respectively. Both exports and imports declined, and October's and November's net deficits were revised further down. Elsewhere, December construction spending unexpectedly fell, dropping the y/y increase to a 7-year low.
  - **We're going to hear a lot about trillion-dollar deficits from here on** The fiscal year federal deficit is projected to top $1 trillion for the first time since 2012, pushing its share of GDP to 4.5%, its highest since May 2013. While the tax cuts have spurred more investment spending and economic growth, the base broadening hasn't been enough to offset the combination of lower rates and increased government spending, especially for defense.

WHAT ELSE

A real deal could take a long time It's not just intellectual property theft and technology transfer that are likely to drag out reaching a long-lasting trade deal between the U.S. and China. The Institutional Strategist believes what happens in the South China Sea, with its massive oil reserves and crucial sea lanes for marine transport and the proximity of Chinese military bases to the Philippines, should be part of the talks. Secretary of State Pompeo mentioned the Chinese threat to the Philippines even as the U.S. and North Korea talks were ending in no deal.

I'm available if you've got a board needing attention A Bank of America study concluded that the economic gender gap in the U.S. is narrowing at a snail′s pace and, if nothing changes, won't close for 202 years. The U.S. lags other developed nations in both pay and policy gaps, while the average S&P board seats four men for every woman, with a woman at the helm of just 5% of companies. Europe, on the other hand, has seen a surge in the percentage of women on corporate boards and in executive suites. Equity investors should take this positively as stocks that have seen rising diversity on boards have seen lower volatility in earnings and dividends.

My New York boss will never buy this Pittsburgh was named one of the 10 best places to live in the U.S., according to a list put together this week by Livability.com, and eighth out of 100 cities with a population between 20,000 and 1 million. Of course, we're used to such accolades around here. Just last year, the Economist ranked us the second most livable city in the U.S. and the 32nd most livable in the world.

Connect with Linda on LinkedIn

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.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio, in comparison to the market as a whole.

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

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

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.

Federated Equity Management Company of Pennsylvania

3932262379