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Traub Capital 2019 Q3 Outlook

Background

In the past 20 months, the US stock market has seen five major turns where the level of the S&P500 index has moved more than 10% - first up (in December 2017), then down (through March 2018), then up (through September 2018), then down (through December 2018) and finally up again to finish in June 2019. You could look at this level of volatility and conclude that there is a lot of uncertainty and you should run. Or you could look at the volatility in a different light.

We choose the different light. Actually, in the first half of 2019, the market has played out roughly in line with our thoughts going into the year – namely that we would see increased volatility, that the S&P500 index would recover to its previous high of 2935 set in September of 2018 and that the market could be somewhat higher still by the end of 2019. Just getting back to the previous high, the market needed to rise over 20% from its low point in December 2018.

As we stand on July 3rd, the S&P 500 has indeed recovered and now has achieved a new record high level of 2996 eclipsing the September 2018 high of 2935. We have also seen the increased volatility that we envisioned. The net effect of the market movement coupled with the volatility is that the overall change since the end of January 2018 is a modest increase of around 6%.

In the long bull market from 2009 until now, we have seen another similarly lengthy period with little gain. That period was April 2014 through February 2016 where we saw the market treading water for almost two years. It is interesting to note that following the period of treading water in 2016, the market started a new drive upward gaining 40% in the next two years, before taking its current break.

Does this mean we are headed for another 40% gain in the next two years? We wish investing was that simple. But if history repeats, we could see a substantial gain after a lengthy period basically treading water. However, we do believe that a modestly higher value for the S&P 500 is more likely than one that is substantially lower. The driving forces there are not necessarily those that are likely to move the market dramatically higher in short order, but rather it is the lack of forces that are likely to move it dramatically downward in short order.

What we will show in this outlook is: 1) the market is not "too high", 2) that the known potential setback scenarios are not likely to trigger a market setback, and 3) that the chances of continued recovery far outweigh the chances of a major setback. The conclusion is that staying the course is the best present scenario.

Is the Market "Too High"?

Bull markets do not die of old age. They die from excessive valuations or from some large, unforeseen external impacts. At the moment, the S&P 500 is priced at 16.5x forward earnings. This level is right at the five year average.

Forward earnings look good. The general economic growth picture is good. Earnings have experienced a bit of a setback so far in 2019 but will recover in 2020. Annual GDP growth continues at 3%. Interest rates are low. Inflation is minimal. The US is adding jobs at a good clip, without triggering much wage inflation. A cut in interest rates by the Fed is widely expected. Technology is allowing companies to grow earnings faster than the general sales growth of the economy. The banking and financial sector is well funded. Overall, the domestic economic picture has a very solid foundation and there is just nothing here that looks out of hand. We have covered these items in greater detail in previous outlooks, so we don't feel the need to go over that ground again since little has actually changed.

What we do want to look at are those situations that are believed to be catalysts for downward movements and determine if those concerns are valid.

China Impact

First on the list of possible downward catalysts is the US-China "Trade War". In previous outlooks we have pointed out the overall size of the maximum tariffs is, by itself, of insufficient size to trigger a major blow to the economy.

On July 1, China and the US agreed to a truce in the dispute following a meeting with President Xi of China and President Trump of the US. The markets reacted positively, but not radically so. You would have to conclude that the markets were expecting a likely positive outcome and have priced that positive outcome in.

We have no "insider knowledge" of events within the Chinese political system. However, we believe an eventual cooperative way forward is the most likely scenario. Looking at the situation from what we can believe is the Chinese side we see the following picture. President Xi has more to lose than to gain with an extended dispute.

First, China needs agricultural imports. With the growing middle class in China, the diet is adding considerable quantities of pork. Pigs eat soybeans and China does not grow that many to keep up with the demand. The US, and to a lesser extent Brazil, are the only places to get large quantities of soybeans. These two countries each export over $20 billion of soybeans every year. Argentina comes in a very distant third at just $2 billion exported. On the import side, China takes $40 billion of soybeans. Mexico is a long distant second at $2 billion imported. Brazil cannot double its production of soybeans. No other country produces very many. Without imports form the US, there is simply no place where China can purchase $20 billion of soybeans to take up the slack. On May 29, The South China Morning Post reported a 14.5% jump in the price of pork because pigs eat soybeans and the supply is so restricted.

Second, President Xi needs the support from the rising middle class in China. China still has a large number of very poor farmers with very little knowledge of the world outside of their village (of the 1.4 billion people in China, over 1 billion have never been on an airplane). However, the rising middle class is not as easily governed by traditional autocratic methods. Much of the middle class population does not understand the US / China trade dispute, but the group does have some access to outside information. It has a lot to lose and will not give it up quietly. The middle class is the group that is the key to the consumer economy and the innovation economy that represent the hopes of the Xi government.

Third, China is having distinct problems with Hong Kong. Severe protests are currently underway in Hong Kong. China cannot afford protests of this kind and support the "one country, two systems" approach they need to establish to support a reunification with Taiwan. Nor can they afford similar confrontations with their own people that can result from high inflation, fewer jobs, autocratic rule, restrictions on the food supply, etc.

Fourth, China needs western technology to develop world-class products and services. President Xi has already stated that people and companies will be compensated for stolen technology, so he acknowledges the problem and knows a solution is needed to the issue of intellectual property. This is a key trade item in the trade discussions.

In short, President Xi is not holding a lot of cards. Now let's look at the situation from the US side. Here President Trump is not holding a lot of cards either.

First, President Trump needs votes from the heartland. These are the states that carried the election for him in 2016. These are also the states that are rural in character and have not benefited as much from the economic expansion enjoyed by the rest of the country. These are also the states that produce agricultural goods and having $20 billion of soybeans rotting on the export docks is not going to make these people happy.

Second, President Trump needs the support of the middle class in the US. These are the people that shop at Walmart and are looking at significantly higher prices on goods they buy that are made in China. Higher prices of goods from China have a known and immediate impact, which is what they see from the US / China trade issue. The US may indeed gain better protection to intellectual property or more jobs but those gains are far away in time and most likely far away from their home town. The middle class is not going to look favorably on the trade-off when they immediately see higher prices on goods and the intellectual property protections or the job gains are not that clear and distinct.

Third, President Trump needs to point to a significant accomplishment before the next election. A denuclearization of North Korea could be that accomplishment. Every meeting with President Xi and President Trump has been preceded with a meeting of President Xi and President Kim (of North Korea). Talks are now back on between North Korea and the US. There has to be a connection between the China / North Korea meetings and the meetings between China and the US. A North Korea card is the one card that China can play and it is a good one that President Trump needs.

President Xi needs a deal. Trump needs a deal. Wall Street is expecting a deal. We have seen a number of signs that point to a deal. First, China and the US are now talking again. That is a positive. Second, China has agreed to resume the purchase of soybeans. Third, Trump has agreed to loosen the restrictions on Huawei. Both sides have left enough room to declare "victory", while allowing the other side to declare "victory" as well. The different visions of that victory are clear when reading the newspapers here in the US and comparing them to the newspapers we also read from China.

So Trump needs a deal. Xi needs a deal. Neither one is holding a lot of cards that would prevent a deal. Wall Street is expecting a deal. Xi is placating his opponents within China. Even the real impact of "no deal" is not enough to dislodge the overall economic expansion in the US. We have seen signs of a deal. The only conclusion you can draw here is that the probability of a "no deal" derailing the US economy is very, very low. In our opinion, what needs to happen is the structure of a deal worked out so that both sides can declare a major victory.

The conclusion is that the China – US trade dispute will not escalate to the point that severely disrupts either economy. At the moment, the press coverage of the dispute is far greater than the economic impact. We expect the discussions will not be concluded quickly and could continue for many, many months. We do expect, however, that the media attention will start to wane and the spotlight will shift to another arena when it becomes clear that the events in this matter do not justify the extensive coverage.

Other Factors

We have spilt a lot of ink here discussing the China – US trade dispute, so let us look more quickly at the balance of the factors that could cause a short-term market setback.

First is the "Yield Curve". We discussed the "inverted Yield Curve" in previous reviews. Towards the end of March 2019, short-term interest rates were higher than the 10-year treasury rate for a period of 6 days. This "inversion" caused a slight dip in the progress of the market. Since the end of May, we have a similar inversion, but no headline press coverage and no detrimental market impact. Currently, very short-term interest rates are 0.30% higher than the 10-year rate. It is widely believed that the Fed will make a reduction to the very short-term rates by at least 0.25% shortly, which should flatten the curve, reducing the importance of this issue.

Second is "uncertainty". Markets do hate uncertainty and we have plenty of that at the moment. I suppose we could get more, but the bet is for less uncertainty as the election starts to unfold and some of the world problems lessen in importance.

Finally is "euphoria". This is the most hated stock market recovery on record and that worry and hatred continues. The market continues to climb the wall of worry and money flows back up the hatred. Money is flowing out of stocks and into bonds as the prices of equities continue their rise. It is when the funds start flowing the other way that we need to get worried. At the moment, there is plenty of money sitting on the sidelines that could come back into the equity markets. Price earnings ratios are in line with the five-year averages. There is nothing that calls out "euphoria", and once euphoria gets here, it's time to start moving to the exit. That time has yet to arrive.

Conclusion

We see no reason in this outlook to change our original view for the year – namely a new market high somewhere in 2019 (which we have already seen), increased volatility (which we have already seen) and some probability of a further modest gain, which we should see going forward.

Thank you all for being clients of Traub Capital Management and please let us know if there are items in the newsletter this quarter that need more explanation or that do not give some clarity to the foggy world of investing.