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Traub Capital 2019 Q4 Outlook

Background

This quarter's outlook covers the horizon to the end of 2019 and starts the look into 2020. For background, it would be good to see just where we are and compare our position to where we thought we would be. The main themes of the Q1, Q2 and Q3 reviews were the overall market level, the increased volatility, the interest rate yield curve inversion and the impact of the China "trade war".

The overall level of the market as measured by the S&P 500 is close to where we thought it would be when we wrote our outlook for the year in January (in fact even somewhat better than expected). It is up 28% since the low reached last Christmas, up 20.5% year to date (through September), but up just 4% since the end of September 2018. In our outlook written in first quarter of 2019, the S&P 500 had just completed a 20% plunge. Our assessment of the situation projected that the US economy would not suffer from a recession and that S&P 500 would recover from the Q4 2018 plunge to achieve an all-time high by about September 2019. We feel very fortunate that the US economy continues to maintain good growth, that no recession is on the horizon and that the stock markets have indeed recovered all of that 20% loss. The gain from a year ago is very modest, but that modest increase is masked within the very strong gains since the low reached in December 2018. We are similarly fortunate to have maintained or slightly increased our equity positions rather than decreasing our equity exposure last December when the headlines were unnerving. The market volatility has indeed persisted and we expect that volatility to continue.

Not matching our expectations, the interest rate yield curve remains in an unusual trough shape with short term and long term rates higher than intermediate rates. We expect the yield curve will revert to a more normal shape as we note below.

Finally, we expect good progress on the China "trade war". We have just returned from a financial trade conference on the subject hosted by financial experts on China. The general consensus among our Chinese colleagues is that there will be bits and pieces of progress made over the next year or so because it is very much in the interest of President Trump as well as the best interest of President Xi. This view matches ours, but is in a bit of contrast to what seems to be the generally held view of stock market observers here in the States.

All-in-all, we are quite pleased to see that our forecasts for this year have played out well and have rewarded our portfolio positions.

Looking Forward

The major themes looking forward are the continued market volatility, the continued growth of the global economy, albeit modest, the reversion to a more normal yield curve, and progress on the US-China “trade war”. Favorable outcomes on each of these themes will serve to drive the overall continued upward trend of the global equity markets. We will look at each topic individually below.

Volatility

Volatility will continue. We have seen volatility as a short-term effect. It will continue to have a short-term impact. At year-end, it is hard to know whether we will be on the high side of the volatility wave or the low side. Neither the high, nor the low, however, should last for very long, but the volatility will show in the year-end gains or loss for the market as tallied for 2019. We are not in the business of predicting quarter-to quarter movements. We feel the market is fairly valued at its present level of 2977 as measured by the S&P 500 at end of September. Volatility could drive it easily up or down by 10% by year-end. Take your pick, but the overall volatility should be short lived, bringing the market back to trend in the space of a few quarters. The overall market trend will be driven by the global and the US economic growth as noted below.

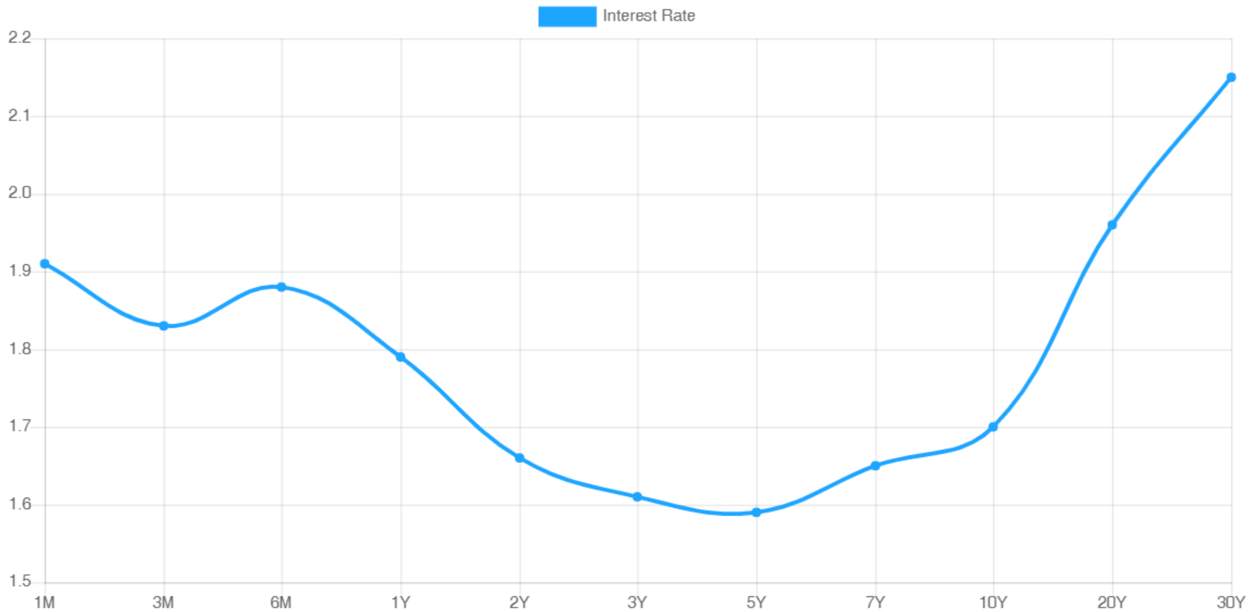
Global and US Economic Growth

Global economic growth will continue and the major markets of Europe and Japan will continue to be outpaced by better growth in the US economy. Economic conditions in this country are extremely good with jobs being created at the rate of roughly 150,000 per month. Job growth at this level outpaces the general increase in the working population. The very low level of unemployment we have been experiencing here now for several years, means that the labor force participation rate continues to improve. Increased participation also couples with people working at more than one job. Job growth translates directly into increased wage earnings. Increased earnings translate directly into increased spending, which translates directly into increased corporate revenues. Adding to the upward economic trend is the overall increase in wages, which currently is about 4.5% year over year.

We are forecasting about 2 1/2% annualized growth in the US economy for the next year.

Interest Rate Yield Curve: Federal Funds and Inflation

As shown below, the interest rate yield curve is in a very unusual trough shape, with both short-term and long-term rates higher than the mid-term rates.



A more normal yield curve would have lower levels of short-term rates and generally higher mid-term rates. We expect this more normal shape to be established in 2020 for two reasons. First, the Federal Reserve Bank will push very short-term rates lower with one or two more cuts of 0.25% in the Federal Funds rates, before putting short-term interest rate cuts on hold for 2020. The rate cuts should take the very short-term rates down to the 1.5 to 1.6% range.

The 5 year, 7 year and 10 year rates will be pushed up with modest increases in inflation. We project by the end of 2020 that inflation will be running above 2% for the first time in over a decade. Inflation will increase for five reasons: increased money supply, increased labor costs not completely offset by productivity increases, increased oil prices due to international turmoil, increased housing costs, and increased healthcare costs.

Inflation is driven by the money supply. When there is more money in the money supply to buy a fixed amount of goods and services, prices go up. The broadest measure of the money supply is known as Divisia M4. From the low of the market in March of 2009 through the end of 2017 the annual increase in the money supply was a very modest 2.25%. In contrast, since the end of 2017, the growth in the money supply is 4.51%. Since the overall real US economic growth since the end of 2017 is only 2.7%, inflation will make up the difference. That difference is 1.8%, in sharp contrast to the zero difference in money supply growth and overall economic growth from 2009 through the end of 2017. Inflation averaged well below 2% from 2009 to 2017, but going forward, the increase in money supply will be a major driver of inflation, helping to bring the inflation rate up to a bit over the Federal Reserve target of 2%.

Labor costs are now increasing at the rate of 4.5%. For the years 2009 to 2017, labor cost increases were very modest at less than 2.5% and more than offset by gains in labor productivity resulting from enormous business investments in technology. Productivity gains are no longer keeping up, so labor costs are increasing, which will lead to increased product costs, which will lead to increased prices.

Oil costs are increasing. The last major bout of inflation suffered in the US was from 1973 to 1981. This inflation was driven, in no small measure, by the price of oil, which increased from less than $4 per barrel to over $40 per barrel – a tenfold increase and at a time when the US economy was considerably more dependent on oil than it is today. There will be no increase in oil prices like those seen in the late 1970's. Through last year, overall oil prices had been declining modestly. But in the last month, oil prices reversed, heading higher due to attacks on the Saudi oil industry. The attacks show the vulnerability of the Saudi oil infrastructure, in spite of defensive measures currently in place. The Saudi oil supply will be back to full output shortly, but there will be a continued premium on oil prices due to the vulnerability of the Saudi infrastructure and the increased probability that some, or all of it could come under attack, severely and quickly constraining their ability to supply to the world market.

Housing prices are heading up. A shortage of construction workers constrains the supply of new houses. Construction workers left the industry in droves with the Great Recession and have not returned in full force. The reasons will fill a book, so we will not go into it fully here. Housing costs are headed higher with the current rate of increase in housing in the US now running at 3.4%.

The final driver of inflation will be health-care costs. Healthcare now constitutes roughly 20% of the US economy. Cost increases in this sector have been relatively modest at 2.7% for the years 2015 through 2018. For 2019, inflation in this sector of the US economy is now heading higher at the rate of 4.3%.

None of the above five factors will drive inflation past the 3% range, but they will support our forecast of overall inflation nudging above the Federal Reserve Bank's target of 2%. Rates on 10-year Treasury notes are determined primarily by inflation. So we will see the 10-year rate nudge a bit higher while short-term rates work their way lower, restoring the normal shape to the interest rate yield curve.

Progress on the US- China "Trade War"

In the previous outlook, we argued that the "trade war" should not be a major impediment to corporate earnings, nor to the general upward trend of the stock market. We argued that, even if fully implemented, the magnitude of the proposed tariffs were sufficiently small as to not have a material impact on corporate revenues. We also argued that both President Trump and President Xi really needed to make a deal. In the past quarter we have seen more evidence of the above presumptions.

Prices of pork in China are up almost 50% from last year. Pork is a mainstay of the diet of the middle and upper class members of the Chinese population. In years past, China imported a very significant quantity of soybeans from the US and soybeans are a major component of the diet for pigs. Much media coverage has been given to the Swine Flu that has struck pigs raised in China as the reason for the increased price in pork. However, the statistics do not back up the magnitude of the connection between the Swine Flu and the price of pork and lack of sufficient food for the farm population will have the result that has been seen - an enormous rise in the price of pork.

There is some progress made on the trade talks and the door has been opened for US exports both of pork as well as soybeans, so that is a start. The trade delegations continue to meet and the need for both presidents to make a deal is evident. We do not foresee any grand pronouncement of a “settlement of” or “end of” the dispute. We do expect that the trade talks will continue and that good news will be dribbled out from time-to-time as progress is made. Similarly we see headlines continuing to make pronouncements aimed at strengthening bargaining positions. The process may well drag out for quite a while. It will eventually lose its market moving impact the longer it takes for resolution but more good news than bad on the trade front will bode well for the markets.

Investor Sentiment

One new concept in this quarter’s review is investor sentiment. The most reliable gauge of how “regular” investors feel about the market is taken by the Association of Individual Investors and published each month. The latest measure is 29% bullish, 37% neutral and 33% bearish. The long-term historical averages are 38.0% bullish, 31.5% neutral and 30.5% bearish. Investor Sentiment is a contrarian indicator. By the time that most people feel bullish, they have already made all the investments they deem appropriate and are not likely to make more. When investors feel most bearish, they have sold their investments, converted to cash and have little left to sell. Sentiment, at the moment is unusually pessimistic with bears outnumbering bulls (it’s typical for bulls to outnumber bears in this survey)– a thus a good sign for the future. So if you are feeling dour on the prospect of further stock market gains, you are in the majority. The market hitting new highs coupled with investors believing the worst is ahead, sets up the classic “Wall of Worry” that the stock market loves to climb.

Looking Forward Conclusions

Every week, the company Factset compiles the earnings all analysts expect for the S&P 500 companies and averages them to define an earnings consensus. For 2020, the consensus earnings estimate for the S&P 500 average is $182.32. With the S&P 500 price level of 2,938 as we write this, the Price/Earnings ratio on forward earnings is 16.1, roughly matching the average P/E ratio of the past 5 years of 16.6. At this level, we believe the market is fairly priced.

What we see at this juncture looking out are a number of signs that point to support a positive return for the stock market and a dearth of signs that point to negative returns. Factors arguing for positive returns are continued global and US economic growth, a return back to a more normally shaped interest rate yield curve, progress on the US – China trade issues and bleak investor sentiment.

The normal factors that cause major declines – namely: recessions, hugely negative legislative regulations, and investor euphoria are simply not on the horizon. Volatility will continue and will push markets higher or lower for relatively short periods. The volatility will be hard to sit through, but the markets should return to their generally upward and positive trends within a few months. We also look forward to a comprehensive view of 2020 in our next quarterly review.

As always, we thank you for your faith in Traub Capital management and are more than happy to discuss in more detail any of the concepts put forth in our quarterly outlooks.