STRATEGAS
ASSET MANAGEMENT

April 2019

In this month's *Insight*

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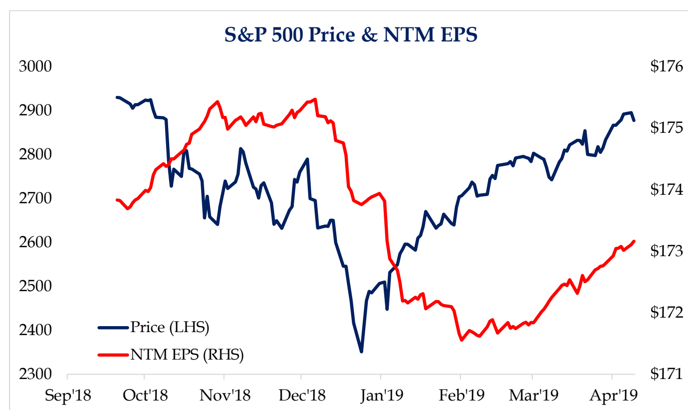
The "Earnings Recession" that Wasn't

While nothing new, questions certainly persist on the durability of the Long Cycle. A cursory look at recent headlines from the financial press (e.g. "Global Growth Enters Synchronized Slowdown," FT) might leave one believing that the worst is upon (and even ahead), as opposed to behind, us. While we would fully acknowledge the pace of domestic growth has moderated and the potential is real for the market advance to fatigue given headline weakness – specifically related to the just underway 1Q'19 earnings reporting season, delays in the construction of a trade deal with China, and a battery of macro miscellany (Brexit; EU auto tariffs; Japan VAT tax increase; U.S. debt-ceiling debate, etc.) – have tempered our expectations for domestic equity returns in the near-term (1 to 3 months) accordingly, overt pessimism seems unsubstantiated to us. Recent data suggest the economy, albeit growing more slowly than perhaps desired, remains on firm footing and has even started to re-accelerate: the U.S. manufacturing PMI ticked-up to 55.3 in March and while the non-manufacturing index dipped for the month, it remains firmly in expansion territory at 56.1; construction spending rose +1.0% M/M in the most recent reading (February); industrial commodity prices (copper, iron ore, steel) remain strong; global auto orders are improving; the U.S. money supply (M2) has started to bottom on a Y/Y basis; and, cyclical shares continue to exhibit leadership (Consumer Discretionary is outperforming Consumer Staples, high Beta is outpacing low Beta, Industrials have outperformed the broader market year-to-date, and Semiconductors have pressed to all-time highs). Weekly jobless claims dropped to 202,000 last week (Apr. 4th), the lowest since 1969! These data underpin the erosion in heightened levels of uncertainty extant at the start of the year. Inasmuch, we maintain our view – once decidedly out-of-consensus but, increasingly, gathering attention, if not acceptance – that policy makers will be able to engineer an economic "soft landing."

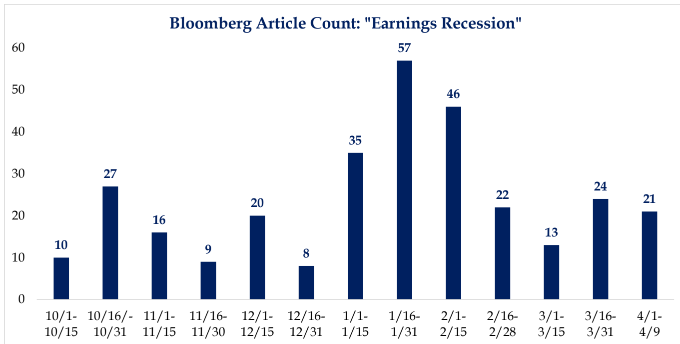
The equity market's move off its Christmas Eve low now ranks fourth by order of magnitude (+23%) among all bear market recovery rallies since 1950 – only Nov'08-Jan'09 (+27.4%), Sep'01-Jan'02 (+24.6%), and Jul-Aug'02 (+24.4%) were stronger –

and is the longest by duration at 70+ trading days. The strength of this move does raise concerns that the market may be overbought in the near-term, irrespective of its fundamental underpinning. In fact, the S&P's rolling 65-day percentage change puts it in the 99th percentile of all historical observations, which has been historically consistent with mixed returns in the near-term but, following a period of consolidation, has preceded above-average returns +6 and +12 months out. Against this backdrop, and acknowledging the need for fundamental follow through, the most intriguing signpost of nascent growth is the recent improvement in profit guidance.



Too often the Street's effort to arrive at an estimate of corporate profits comes off as a parlor game. But, while not making too much of it, understanding where aggregate profits are heading a year out provides an important information coefficient for the risks and opportunities in the equity market generally and a benchmark for separating superior operators from marginal operators, particularly as the cycle transitions to its later stages (i.e. the Slowing Expansion). To that end, corporate operators certainly had sufficient "global macro" cover – weakening global growth profile, fiscal and monetary policy uncertainty, the protracted U.S. government shutdown, political and geopolitical operating headwinds, and a serious hangover from the market's 4Q'18 sell-off – to dramatically reduce profit guidance for CY'19. With a nagging desire to reduce the lofty estimates they extrapolated from CY'18 tax cut-enhanced growth rates, particularly for 1Q'19, the Street was quick to take their cue, resulting in a decidedly negative revision sequence to the start the year. It is worth considering that for all the discussion of an "earnings recession," Street estimates for 2Q'19 are in line with 4Q'18 while 2H'19 estimates remain above this cycle's 3Q'18 high watermark. As we noted above, with 1Q'19 reporting season underway we'll soon have a fuller picture of the impact the drawdown in corporate activity had on the real economy to start the year. That said, despite their sharp downward revision, we anticipate corporate profits for 1Q'19 to surprise above current estimates given that pessimism was largely rooted in transient headwinds. In the same vein that the Atlanta Fed's coincident GDPNow growth tracker has been notching higher, we can already see, even before the bulk of companies report 1Q'19 results, that the pace of downward estimate revision has moderated materially. So much so that the constant maturity NTM estimate of aggregate S&P 500 EPS bottomed in mid-Feb'19 and has been working higher ever since. Partner this with

evidence that the economy – while slowing – is still growing, and the underpinnings of a stronger-than-expected corporate results may be in the offing for 2Q/3Q'19.



Apart from the "Recession is imminent" faction, our forecast would most acutely diverge from the consensus in the emerging view that the Fed is positioning to cut rates. With the bond market pricing in cuts over the next 9 to 18 months (Fed funds futures show 66% odds of a cut between now and Jan'20.) If nothing else, the Fed pause is working. Activity in interest rate sensitive corners has picked-up (U.S. vehicle sales rose +5.3% M/M to a 17.5 million SAAR in March and mortgage applications for purchase rose +3.4% W/W last week) and the 3-month/10-year U.S. yield curve, after a slight inversion, has moved back into positive territory. We see the yield curve slowly continuing to ease out of near-inversion territory over the next three months with the yield on the 10-year U.S. Treasury ending the year near, but now below, 3.0%. By our math, the hurdle for the Fed to cut rates is higher than the market is discounting. As long as wages continue to grow above +3.0% Y/Y (and they're currently up +3.2% Y/Y) we believe the Fed will find little justification to cut rates.

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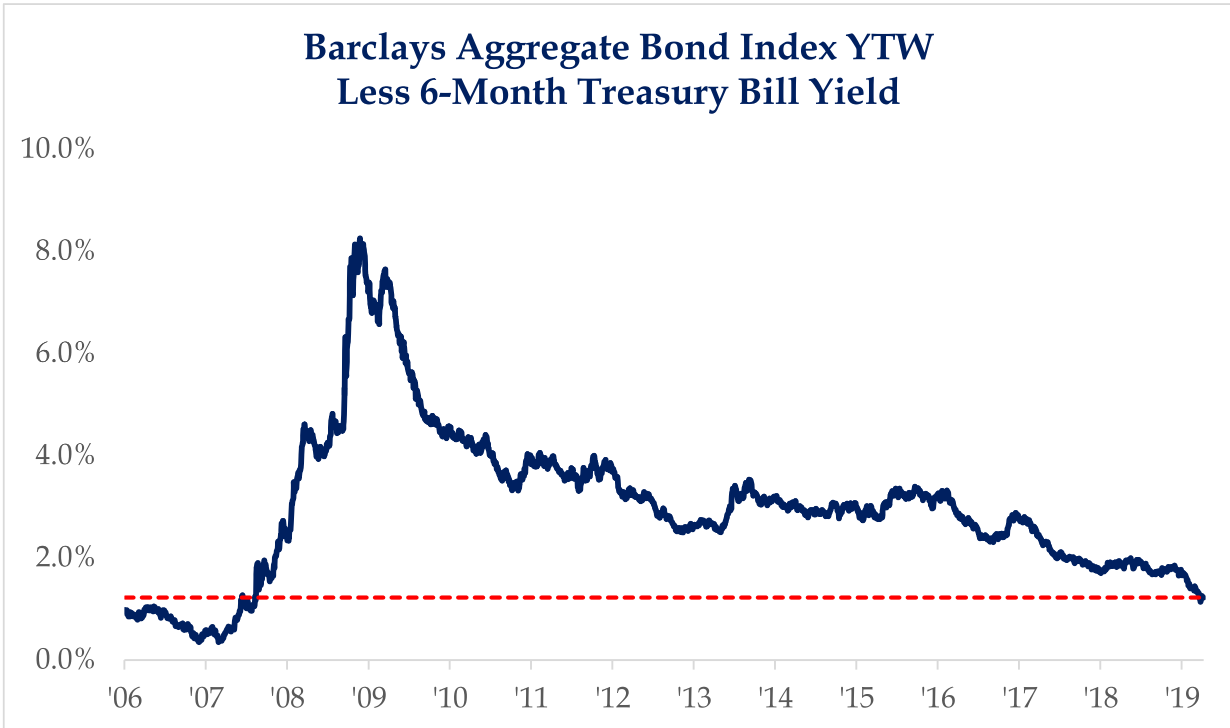
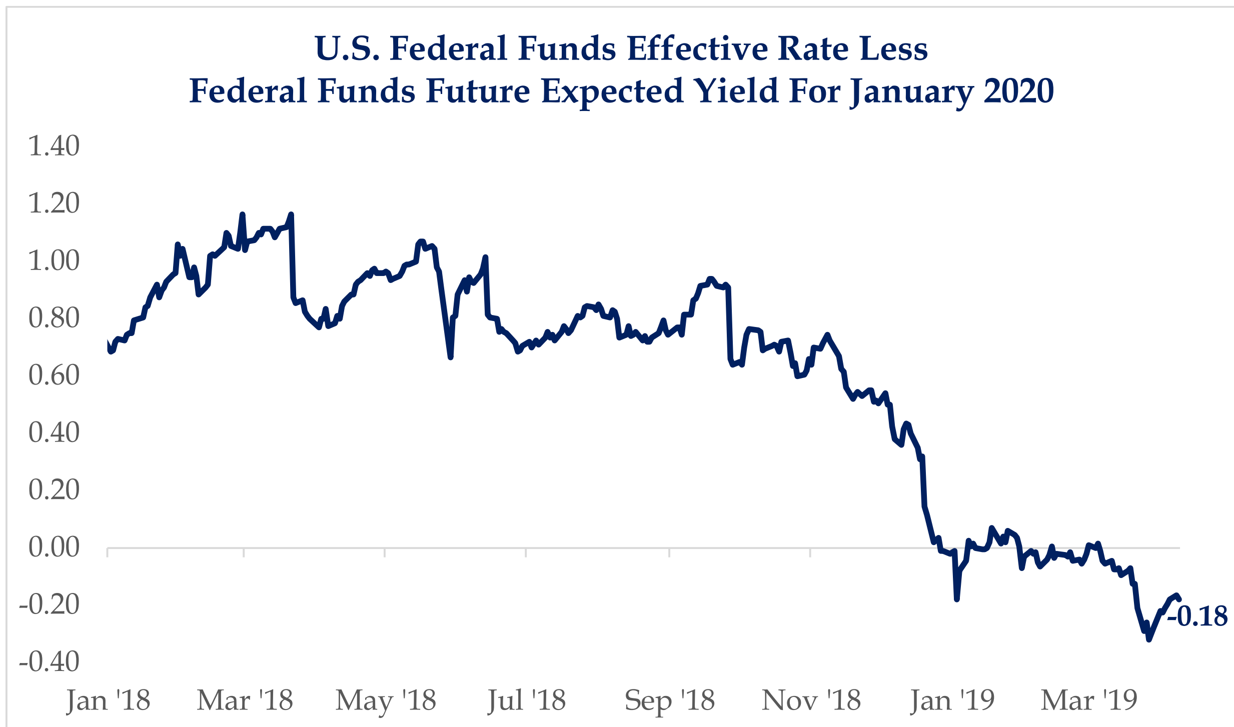
April Recommended Asset Allocation

Strategas Recommended Asset Allocation (Apr'19)										
	Equities			Bonds			Cash			
		70%			25%			5%		
B'mark	MSCI ACWI	60%		Barclays Agg	38%		Cash	2%		
			M/M CHG			M/M CHG			M/M CHG	
	Domestic	35%		Core Credit	21%	-200bps	Cash	5%	+200bps	
	International	35%		Extended Credit*	4%					
Overweight	Dev AC Core	25%		Local Currency EMD*	2%		Cash	5%	+200bps	
	US LC Value	11%		US Dollar EMD*	1%					
	EM AC Core	10%		US High Yield*	1%					
	US MC Value	5%								
Neutral	US MC Growth	2%		Agencies	1%					
	US MC Core	2%		TIPS	0%					
	US SC Core	1%		IG Corporates	9%	-100bps				
Underweight	US LC Growth	8%		US MBS	8%	-100bps				
	US LC Core	6%		U.S. Treasuries	3%					
				ABS/CMBS	0%					

Yield Differential Between Corporates and Cash Narrowest Since 2007

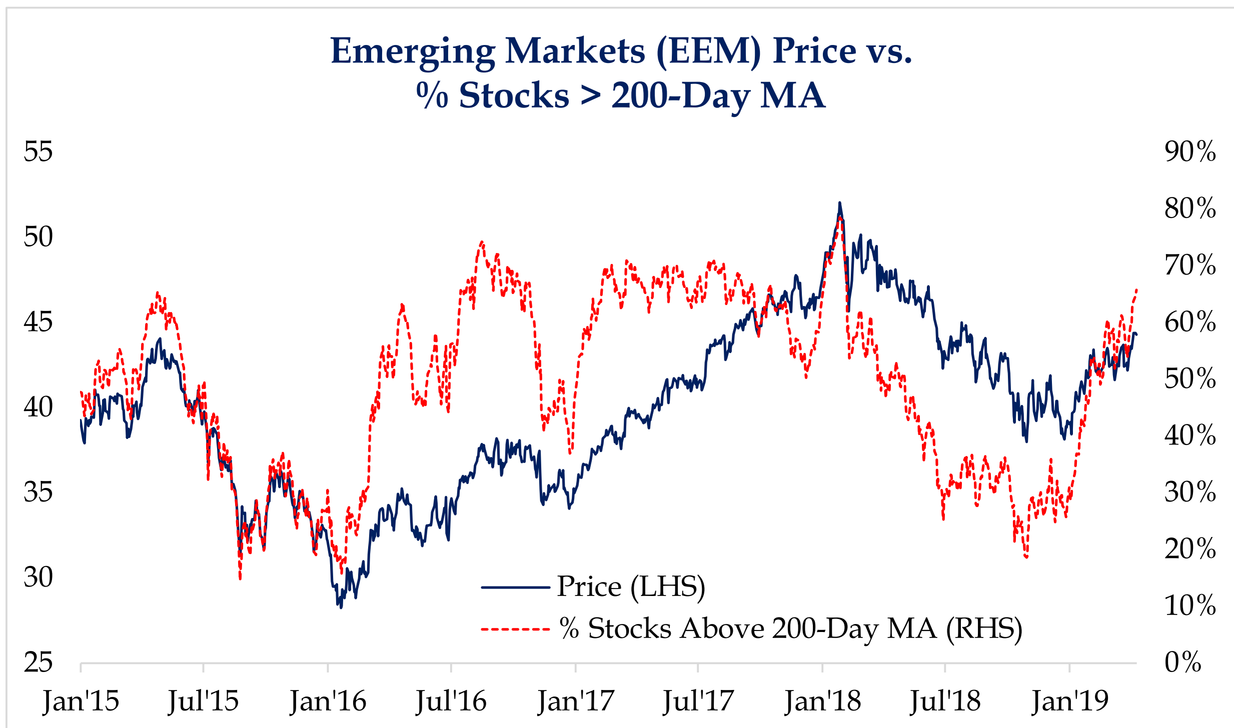


Market Expectations Are For The Fed To Cut Rates

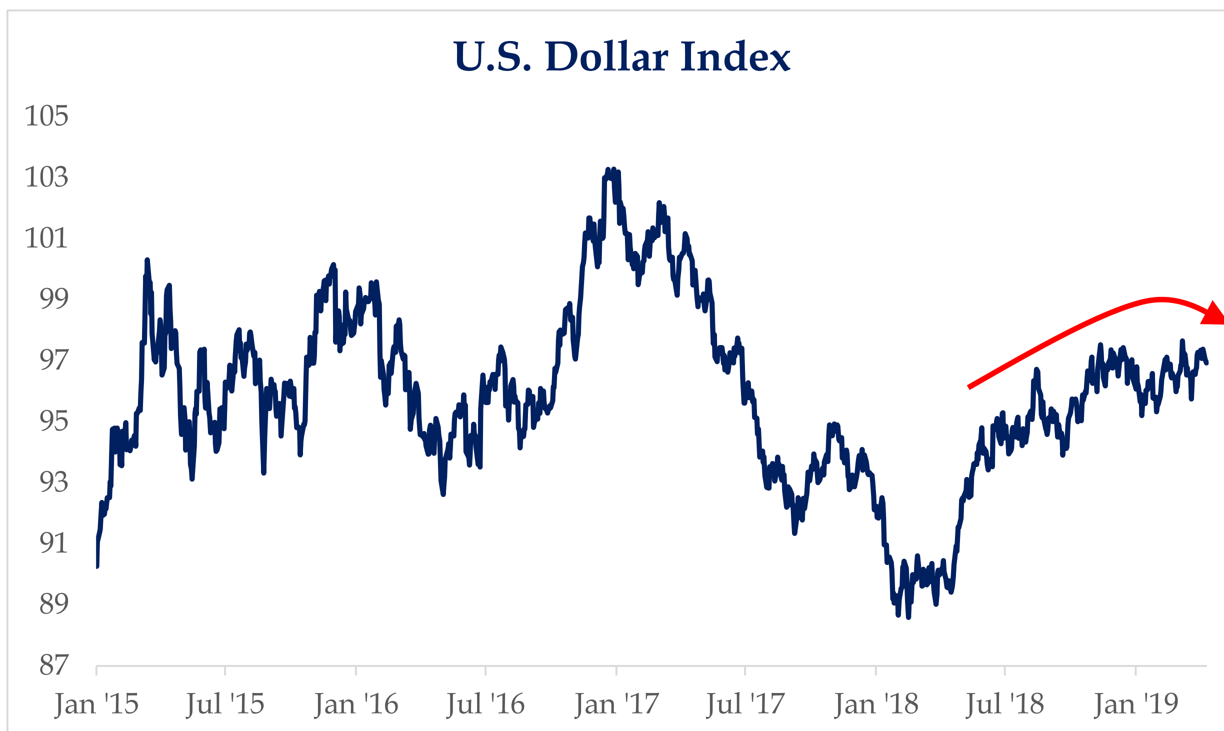


Manufacturing In China Starting to Showing Life After 3 Months of Contraction

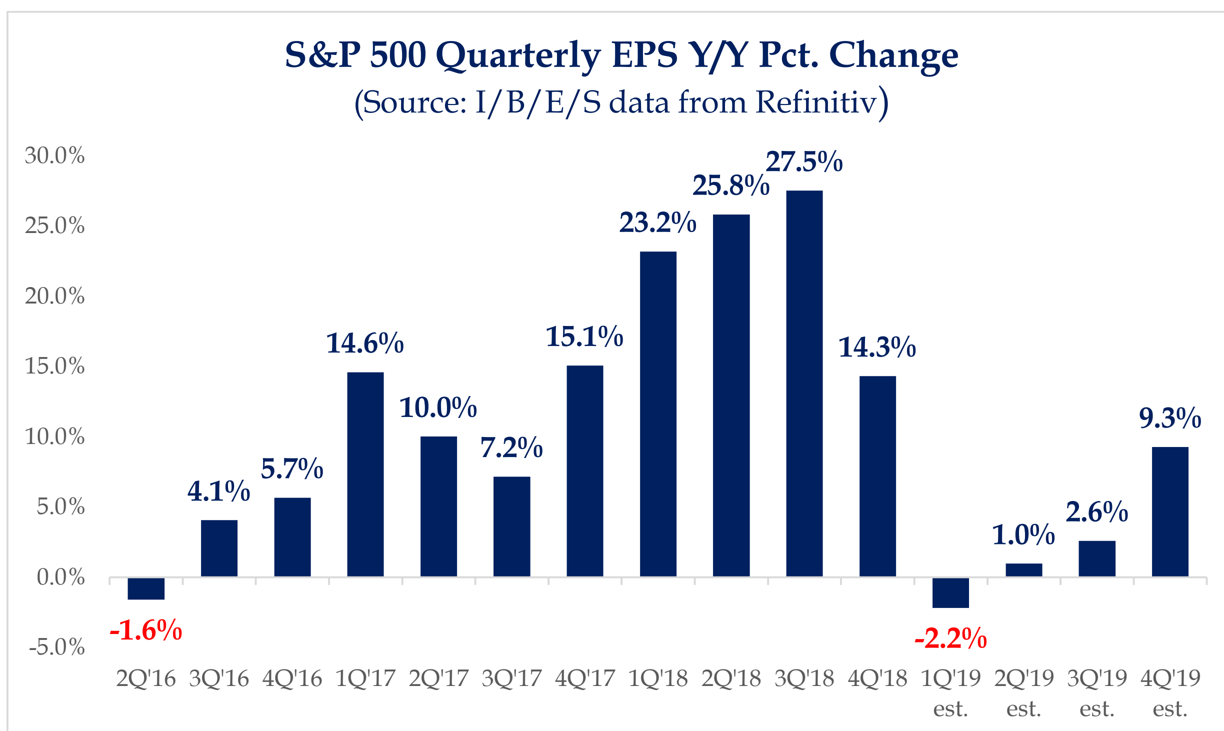
Equity Rally In Emerging Markets Broad Based



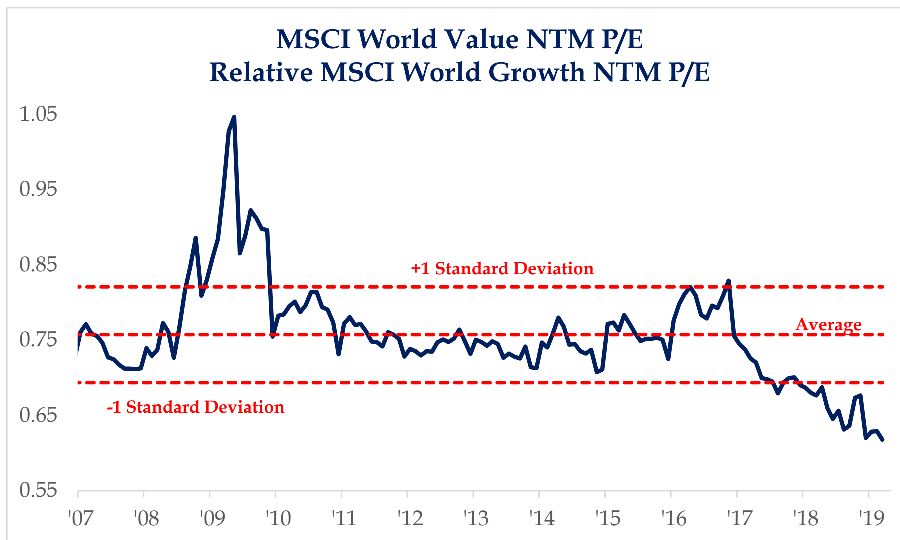
The Dollar Remains Strong, A Dovish Fed Gives Cover For Other Central Banks To Be Dovish

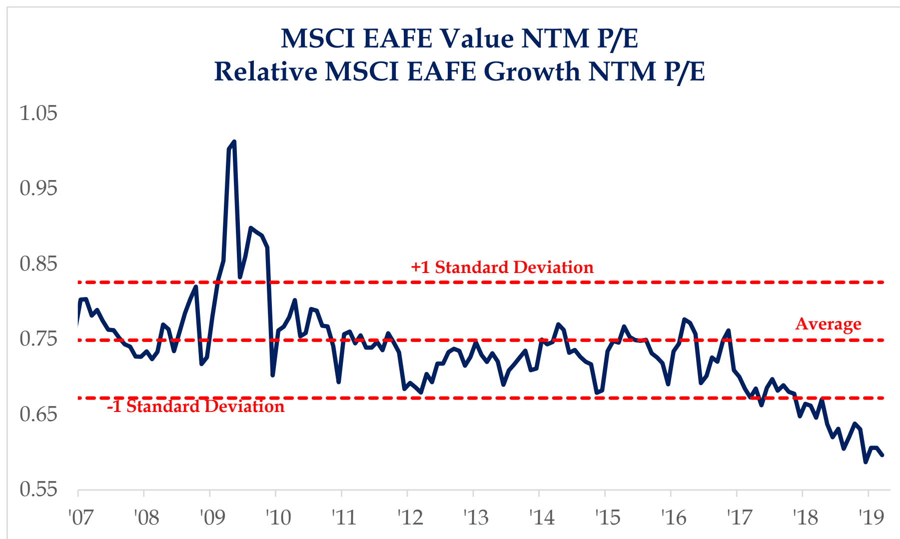


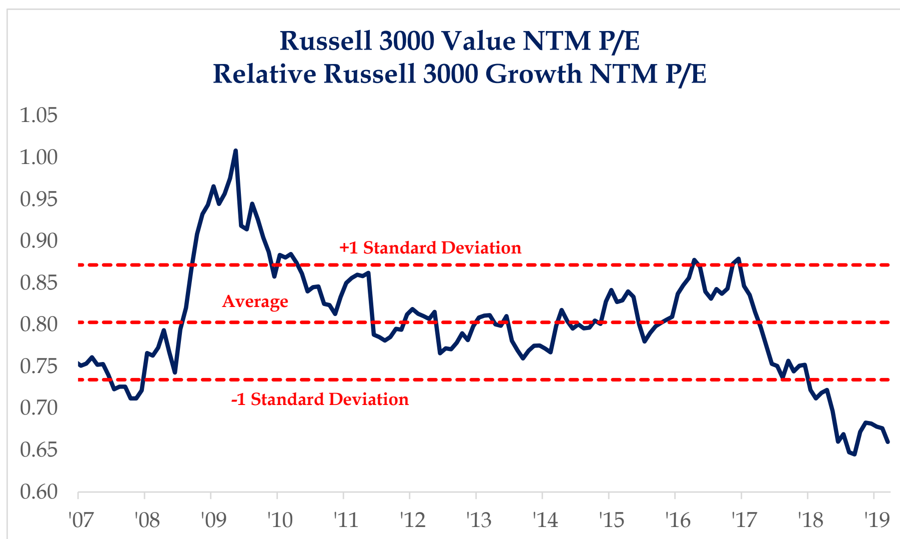
1Q'19 EPS Expected to Be Negative In The United States; Should Re-Accelerate As The Year Moves On



The Undervaluation of Value Is A Global Phenomenon







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