



In this month's Insight, Nicholas Bohnsack summarizes the questions that have garnered the most attention now that the summer break is behind us.



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## ***Back to School: Answers to our Most Frequently Asked Questions***

A series of Trump-trade-tweet-induced drawdowns knocked the wind out of the market's run-up to fresh, all-time highs in late-July (the S&P 500 Index closed at 3,025 on July 26, 2019). In spite of this, August's market action proved to be a relatively range-bound affair capped by a welcomed advance into the Labor Day holiday. For the year, stocks remain well ahead of their lower, 2019 calendar year closing prices (with the S&P 500 Index up 20% year to date as of this writing). This move notwithstanding, investors have become increasingly focused on the (presumably) increased prospects that the economy could enter into recession sooner than they had previously thought. Thus, a healthy dose of attention has shifted onto bond market action, as global liquidity and severely low sovereign yields across the G10 have brought considerable market pressure—on top of the already vocal urgings of the Trump Administration—on the Federal Reserve (the Fed) to cut the overnight rate more aggressively.

It was against this backdrop that my colleagues and I sat down for our latest discussion on the economy and markets. Our research team circles the wagons each week for a wide-ranging discussion where we share notes from the road; observations from our research; and highlights and interesting takeaways from items read and people met, all in an attempt to cut through the noise of the day and test the integrity of the house view. With the traditional summer break now behind us and—for many future investors—the back-to-school season in full swing, the volume and intensity of client questions that peppered our conversation were notable. We summarize below our answers (and best guesses) to a few of the questions that garnered the most attention.

## What is the chance of a US recession now?

The chance of recession has clearly risen (we are using ~30%). However, for the time being, the US consumer remains a key area of strength, keeping both the US and global economy in expansion territory. To maintain a handle on whether the economy “will” or “will not” slide closer to contraction, we are watching a number of key risks to growth:

- 1) The looming Brexit deadline (10/31/19)
- 2) Italy bond yields, which remain elevated
- 3) The forthcoming Japan VAT tax increase (10/1/19). As our head of Asia-Pacific sales offered, ‘if they’re not buying ahead of the tax, they’re not going to buy after it.’
- 4) What does the Fed’s language look like after additional rate cuts?
- 5) Can oil prices hold at \$50 for WTI, an important threshold for the energy patch?
- 6) Will the US impose tariffs on EU autos?
- 7) How do US-Sino trade talks progress (and how do similar issues between Japan and South Korea resolve)?
- 8) How do the Hong Kong protests reconcile?

## Should investors be optimistic about the upcoming US-China trade talks?

Since talks between the US and China broke down in early May, negotiators from each side have held several face-to-face meetings, which have only resulted in more tariffs. The greater likelihood over the last several months has skewed toward an escalation (rather than a de-escalation) of tensions. Much of the emphasis appears to have shifted from largely commercial considerations toward more national security-centric issues, making White House National Security Advisor John Bolton’s resignation on September 10, 2019, an interesting development. In short, however, no discernable progress has been made on the substantive issues separating the two sides. Policy actions on both sides—China’s devaluation of the yuan, Fed rate reductions, etc.—effectively acknowledge the negative impact the resulting uncertainty is having on their

respective domestic economies. But without an easing of tensions ahead of a planned meeting in October, we view it as unlikely that a large deal will emerge in the near term. Although not our base case, we would place higher odds on a less ambitious, face-saving deal emerging—an increase in China’s purchase of US agriculture products in exchange for the US granting Huawei relief and delaying the increase of tariffs slated for October 1.

### **The S&P 500 Index has broken out of the 2,822-2,945 range... Now what?**

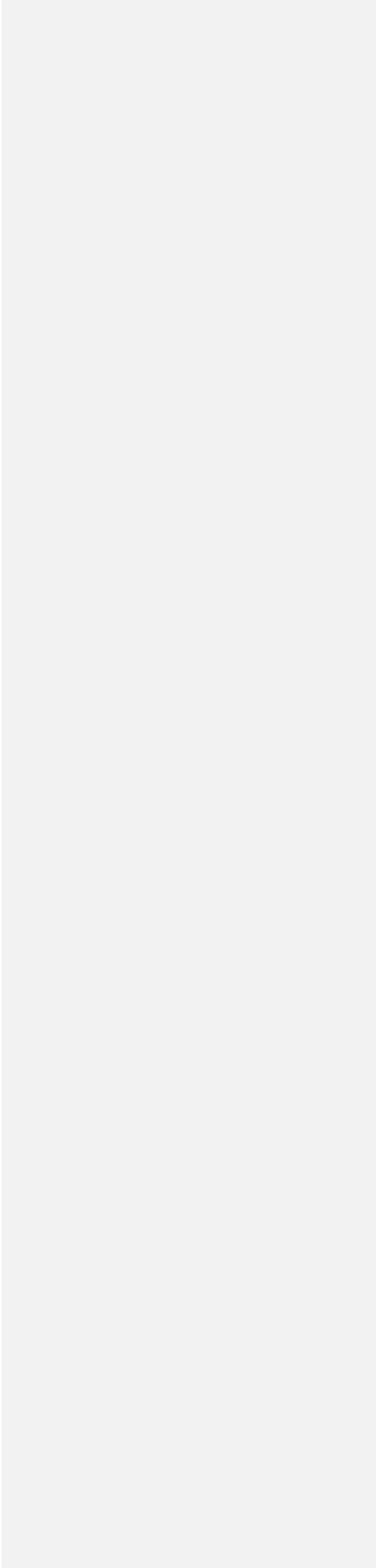
After spending the entire month of August in a ~4% range (2,822 to 2,945), the S&P 500 Index broke out last week. Our overall view is that positioning remains restrained (speculative net exposures are flat in the latest CFTC data), and breadth is probably stronger than it is given credit for (the NYSE Advance/ Decline Line has hit a fresh high). Low volatility ETFs have captured the bulk of flows this year (up about \$18 billion), but we are beginning to see some nascent signs of improving cyclical share performance, which threatens increasingly defensive portfolio positioning. In particular, the semiconductors-software relationship has broken in favor of semis (we view this as bullish), and global Consumer Discretionary shares (both developed ex. US and emerging markets) have started to firm. Nothing changes the fact that the entire US interest rate curve still trades below the federal funds rate, but credit conditions also remain benign throughout most corners of the world.

### **Is there a chance the market replays last year’s fourth-quarter weakness?**

The fourth-quarter weakness in 2018 was largely a function of interest rates: The Fed was tightening last year, whereas it is easing this year, the reason why interest rates are relatively low now. Although the market fell nearly 20% from late September until it bottomed on December 24, a not insignificant part of the decline occurred after the Fed tightened on December 19.

## **What is Strategas' view on earnings? How do the next twelve months shake out for earnings across the cap spectrum?**

Earnings and revenue growth came in better than expected for 2Q2019 (3.2% year over year for earnings and 4.7% year over year on the top line). We view this as a result of expectations being lowered too severely at the beginning of the year, as investors were in the throes of two developing policy errors (trade and monetary) and the partial government shutdown. That said, a look through 2H2019 and into 2020 does show some signs of economic softening. This is largely the result of escalating trade tensions, most notably with China, offsetting the fiscal stimulus passed in the 2017 tax cut. Our focus remains on the linkages among: A) the impact of trade policy on global manufacturing; B) the impact of manufacturing on corporate earnings volatility; and C) the position of corporate profits as a leading indicator of future employment growth and capital spending. Current softness has manifested most acutely in the outlook for small and mid-cap companies. Estimates of next twelve months (NTM) earnings for small and medium-sized companies have been revised down meaningfully since trade tensions reaccelerated in late April and early May. Worth highlighting, however, is the resilience of the large cap earnings outlook to this trend. NTM estimates for large cap shares were \$174.45 on May 23, eclipsing their previous high of \$174.44 on December 6, 2018, just as the market sell-off was accelerating into “peak” trade war concern. And they have continued to rise (now standing at ~\$177.10 for the year ahead). Currently, 12.1% of the Russell 1000 Index comprises companies that produce no profits, which is only slightly above the longer-term average of 10.9%. Of these 121 companies, 31 are concentrated in the software and services industry group. In the Russell 2000 Index, 36.6% of the index contains companies that make no money, and in fact, this is the greatest share since early 2010, following the financial crisis. Perhaps not surprising, the dominant industry group here is pharma and biotech, making up more than one-third of the nonearning companies.



With the Fed appearing to be accommodative in the near future, clarity on trade should give confidence to corporations. In turn, this will boost capital expenditures, ultimately leading to higher profits for companies and thus extending the current bull market.

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