2019 Mid-Year Update: Cautious Optimism Dominates

As we enter the second half of 2019, it's important to understand the factors that have driven market action up to this point and what the trajectory is likely to be moving forward. Westwood's mid-year update details what factors are influencing current market conditions as well as the potential risks and opportunities in the coming months across the financial universe.

First Half Recap

Despite ongoing trade disputes and other moderate economic risks, data sets point to a stable, even healthy domestic economic landscape. Equity markets appear relatively stable supported by 40-year lows in unemployment, low inflation and strong consumer/investor sentiment.

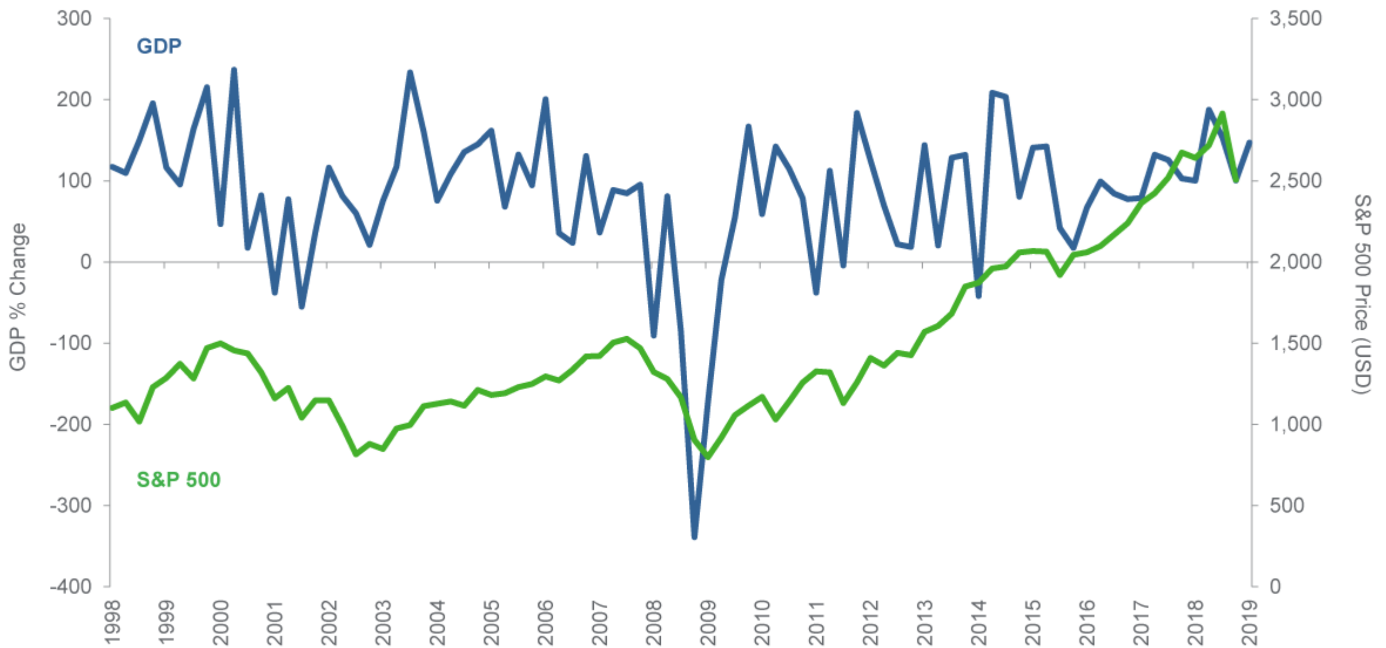
May readings on consumer confidence rose to a near 18-year high from a momentary dip the month prior. The data suggests continued resilience and a consumer who is still optimistic about the future and seemingly unfettered by the ongoing trade dispute with China that has dominated headlines. Although the recent renewal in talks and "tariff ceasefire" by both countries at the G20 summit offers promise that a resolution is closer than we thought just a couple weeks ago.

The U.S. economy advanced an annualized 3.1% in the first quarter of 2019, in line with market expectations, yet unusually strong for a first quarter reading. However, the IHS Markit flash manufacturing index slumped to a 50.1 reading in June, just above the improving conditions line of 50 and the worst reading since September 2009. The weakness also spread to the services index, which fell to a three-year low of 50.7 in June. Contraction in manufacturing and services can be attributed to tariffs and policy shifts that have had dramatic effects on supply chains and sales.

Retail sales have also been mixed in the first half of the year, as standouts in online sales by Amazon and Walmart were offset by more closures of brick and mortar stores from many competitors. Slowing motor vehicle sales still bested estimates, positively surprising analysts, and solid restaurant sales growth has reinforced the fact that Americans are still robust in their spending, according to Kiplinger.

Investors seem to be attributing a portion of the economic slowdown to trade and tariff related factors, which *should* be transitory and *hopefully* lead to an economic rebound once agreements are in place and tariffs are removed. This, along with accommodative rate policy and minimal inflation, are likely why equity markets have shrugged off risks and pushed stocks into record territory. Historically, there's also been little correlation with GDP and S&P 500 return. Little or no progress on trade disputes over the next few months is likely to exponentially decrease business and consumer confidence.

GDP Growth vs. S&P 500 Prices



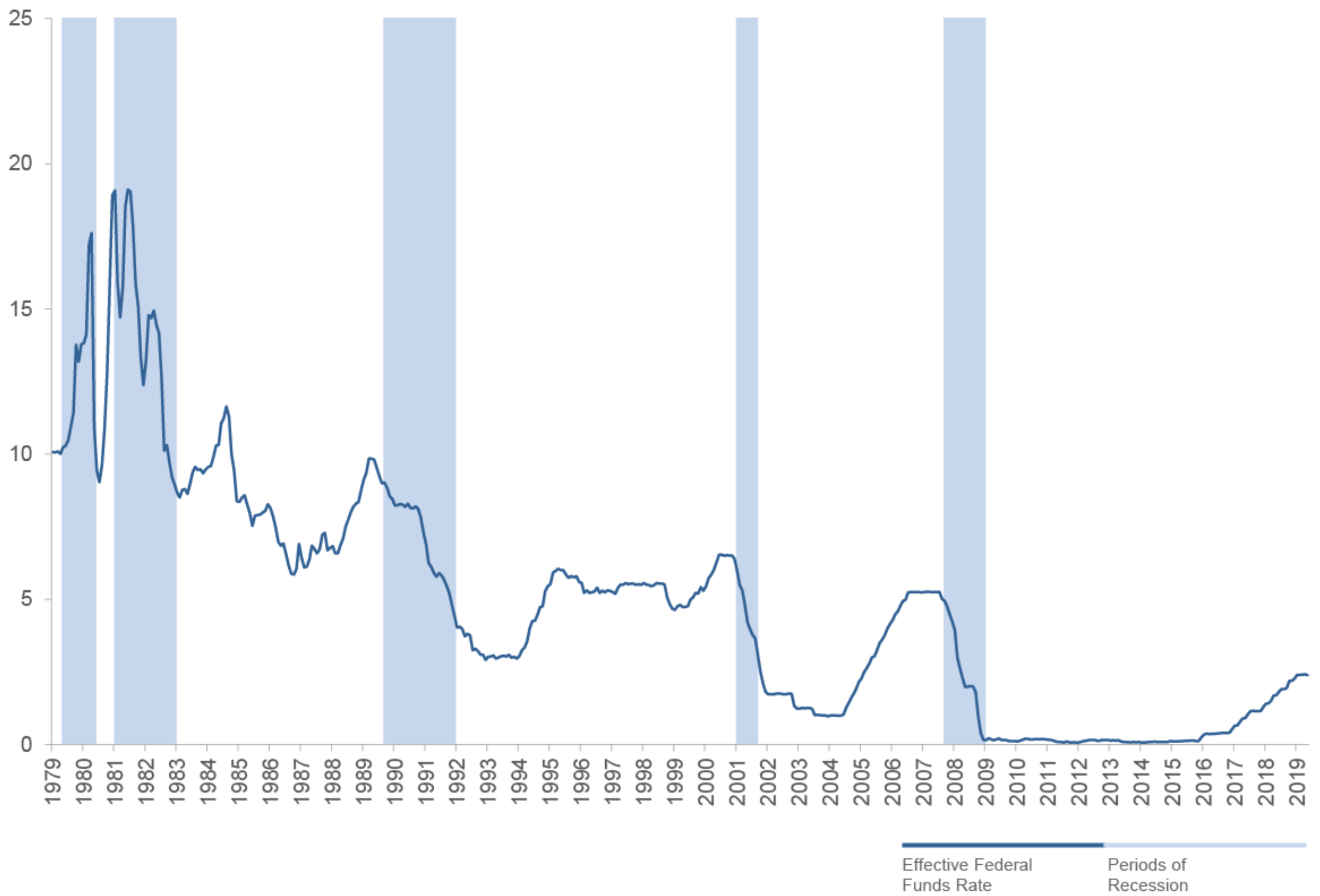
Source: Federal Reserve Bank of St. Louis

As stated, our “stable” situation is not without risks, but given the late stage of the current expansion, consumers and institutional professionals remain cautiously bullish. The “V” shaped recovery in stocks was fueled by an “about face” in the projected interest rate trajectory by the Federal Reserve (Fed).

A year ago, the Fed was positioned to continue to push rates well above the 3% level, but dramatically changed tone during the equity selloff of 2018. The Fed stands ready to “do what it takes to sustain the expansion,” but is obviously limited in what it can do if growth slows sharply.

Trade disputes with China and other countries, along with softening economic data flow, both support the Fed’s more dovish stance, which most believe will result in more than one rate cut in 2019.

Effective Federal Funds Rate



Source: Federal Reserve Bank of St. Louis (FRED)

First Half Highlights

- Federal Reserve shifts to a more accommodative stance; rate cuts seem all but certain in 2019
- Trade talks between the U.S. and China "went south" unexpectedly
- Flat yield curve confirms economy is in late cycle
- Earnings growth flat to negative in the first half (full Q2 results will be revealed after publication), moderate growth expected in back half
- Robust GDP growth seen in the first quarter likely to slow later in the year
- Positive economic drivers in many developed and emerging markets could foster continued growth if trade disputes are settled

Equities

As of June 28, the S&P 500, Dow Jones Industrial Average and Nasdaq have registered year-to-date returns of 17.3%, 14% and 20.7%, respectively. The S&P 500 made fresh all-time highs in June, while the Dow closed just 75 points short of its October record. The Nasdaq made new records in late April.

The S&P 500, a balanced and commonly used barometer, closed at $2,940 on June 28. Full-year consensus earnings estimates are roughly $167 per share, giving the index a forward PE of 17.6, which is above the five-year average of 16.5, but not by much. Second quarter revenue growth is still expected to be close to +4%.

On average, earnings growth has been flat to negative thus far, with semiconductors dragging the tech sector lower in Q2 — earnings per share (EPS) from that sector is expected to drop nearly 37% in the second quarter compared to the same quarter last year. There's potential for further volatility in tech as quid pro quo legal and legislative actions from the U.S. and China complicate B2B relationships.

Basic materials, conglomerates, construction and aerospace are all seeing continued weakness in earnings growth in the second quarter, while energy, finance and transport are expected to return positive growth.

Unfortunately, yield trajectories are likely to weigh on the finance sector moving forward and further hamper this underperforming sector's performance.

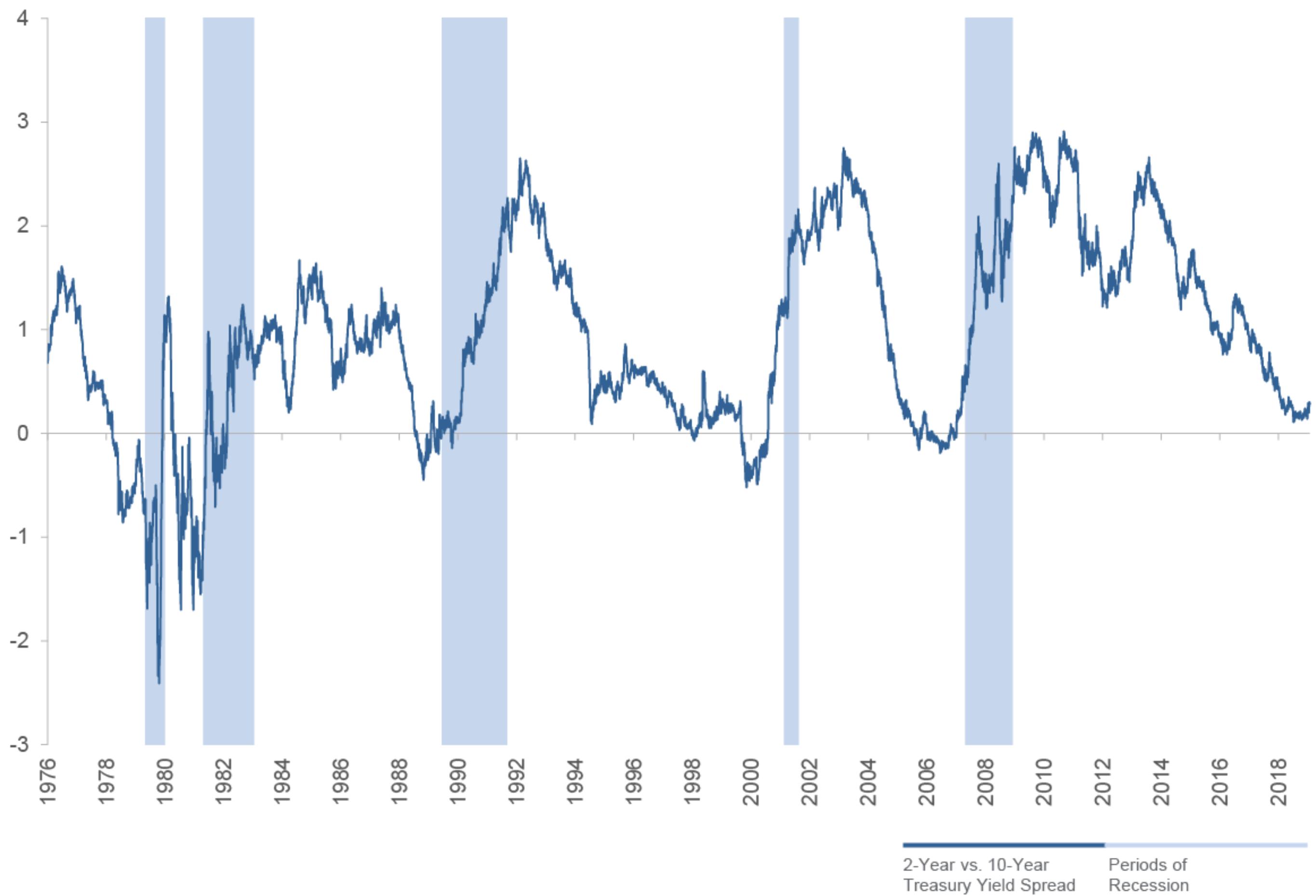
Credit Markets/Fixed Income

One major concern that lingered on investors' minds in the first half of the year was the narrowing spread between the 2- and 10-year Treasuries flattening and going inverted. The popular (and arguably more reliable) 2 and 10 pair has not inverted yet, but other duration pairs, such as the 3-month and 10-year have. These formations, namely the 2 and 10, have historically boded poorly for equity markets — at best they are signs of a late cycle of economic expansion.

As it stands today, the 2- and 10-year yields are 1.79% and 2.03%, respectively. This yield spread of just over 24 bps is roughly 9 bps less than the end of June reading last year. The curve will certainly remain a hot button and trigger for investors, but there is no guarantee that a flat curve spells recession. The shift in Fed policy from what was a rising rate environment may cause temporary disruptions in normal yield spreads until a trajectory for rates and the economy becomes more clear. The latter will be a function of data consistency, with the former crystalizing over the next few Federal Open Market Committee (FOMC) meetings.

Up until the first half of 2019, bond investors were concerned with rising rates (falling prices), but those sentiments have shifted. Conversations now are shifting more to the credit risk side of the equation as many trade and regulatory questions remain unanswered and future economic health gets a bit harder to predict.

2-Year vs. 10-Year Treasury Yield Spread



Source: Federal Reserve Bank of St. Louis (FRED)

Commodities

After a sharp correction in tandem with stocks late last year, crude prices rallied for much of the first quarter, aided by an increasingly accommodating Fed until a glut of supply pushed prices back down to $51.14 during Q2. The U.S. accounted for 98% of global oil production growth in 2018, according to BP Energy. Oil consumption continued to make records globally, although the rate of demand growth is slowing.

Recently, a string of attacks along the Strait of Hormuz and a refinery explosion in Philadelphia sent the prices of crude and RBOB gasoline markedly higher. Crude ended the June regular sessions up 23.7% year to date, at $66.55 per barrel, while gasoline prices were up 46.9% to $1.94 a gallon during the same period. And while some are concerned about supply after the U.S. imposed deeper sanctions on Iran, several countries, including India, are prepared to step up and fill supply needs to keep prices in check. America's record production growth and capacity could also easily fill that void.

Precious metals have also seen price increases, with gold reaching a six-year high of $1,421 in June, and not-as-precious silver also rose to a high of $15.56 last month from its May low of $14.30. Gold is likely to garner favor as a safe haven and weakening U.S. Dollar hedge — expect continued support as 2019 moves on.

Industrial metals had a tough year so far as tariffs and slowing manufacturing growth here and abroad (namely China) dragged on consumption. Expect pressure to remain, unless a trade deal with China gets done and tariffs are lifted.

Market Outlook

Westwood sees continued growth in the economy, albeit at a slower pace. A virtuous global economic cycle remains intact and is supported by extremely accommodative central banking maneuvers. Central banks are still carrying elevated balance sheets, which help keep volatility low, infuse credit, etc. Market participants are also enjoying elongated low-rate policy communications (reduces future uncertainty), while the Fed and many of its peers have already shifted or are shifting rate and inflation targets in a more dovish manner.

It was interesting to hear Federal Reserve Chair Jerome Powell offer what can be interpreted as (near) direct support for equity markets. Fed actions in the earlier part of the year confirm this theory as the about face in hawkish policy was directly correlated to the sharp correction in stocks. These observations seem to indicate continued support for the wealth effect … something unusual for a central bank and certainly not a mandate of the Fed.

All this means supported credit and equity valuations at current levels and above. Despite the positives, we haven't seen great economic data coming through. Our focus will be on CFOs for potential CapEx spending to keep the cycle in action.

Wage inflation is fair, but should remain tempered. Wage increases haven't developed into big jumps in the core Personal Consumption Expenditures Price Index (PCE). We expect to see PCE core inflation to also remain tempered in the back half of the year. And that lack of inflation right now is one key to keeping the central banks accommodative. Global banking rates are also on our radar as they can motivate U.S. Fed policy rates.

U.S. corporate earnings are set to continue to grow at a decent rate but not elevated pace. European corporate earnings expectations are aggressive and unlikely fully priced in European equity markets. Value- and defensive-oriented sectors are likely to perform well after muted performance relative to growth.

Outlook Positives

- **Fed supportive of markets** – One of the main drivers of continued prosperity is that the Federal Reserve is likely to remain accommodative for as long as it takes and has vocalized its support for the expansion. Global Central Banks are also engaged and working to support this same theme
- **Inflation** – Remains low and is likely to stay that way barring a surge in energy (crude) prices, which we believe is unlikely
- **Modest expectations** – Equity markets have set the bar low for earnings growth; valuations are not extremely rich
- **Sales and profits remain positive** – Earnings and revenue growth are expected to remain positive for the year
- **Americans still buying and borrowing** – Consumer confidence is high, unemployment is low and wages are increasing modestly

Outlook Risks

- **Trade** – Ongoing trade disputes will continue to increase headline and actual risk, with the potential to slow capital investments from corporations, accelerating a slowdown
- **Italy** – Remember Greece in 2011? There are bigger risks to domestic markets from a faltering Italian economy. We continue to monitor developments and have assigned a risk factor that could blossom into something more systemic, especially for an already embattled Eurozone.
- **Increased volatility** – Expect volatility to rise as growth will be more selective in the coming months. The tide will no longer lift all ships — investment selection will require added precision
- **Late-stage recession fears** – We still believe a recession is *not* around the corner, but further deterioration in data sets could trigger selling pressure in equities and/or corporate actions that deepen a slowdown
- **Unexpected policy shifts** – The current administration could abruptly shift its policies in a way that adversely affects commerce and/or trade

5 Things to Watch in the Coming Months

1

Interest rates – As it stands now, the Chicago Mercantile Exchange's FedWatch shows markets are pricing in a 100% of easing policy by the FOMC's December 11 meeting, with an 88% chance of two rate cuts before year end. It's safe to say that the accommodative policy of the Fed is adding dramatically to confidence in the economy and the stock market. A shift in the current dovish stance or the lack of a cut by fall may trigger increased volatility in the stock market and/or decrease business' confidence. Lower

rates and a healthy job market should continue to stimulate borrowing and the housing market, further strengthening consumer confidence.

On the Yield Curve side, the 2- and 10-year spread still has not gone inverted, and when that spread hits zero (or negative), the average recession is still roughly a year away. In addition, equity markets typically don't start experiencing the downdraft until six months out from a recession. The bottom line is that we (and the FOMC) are watching this pair and, presently, it seems as though we have a couple good innings left in the bull's ball game.

2

Energy – Oil prices have rallied as of late due to headline risk. While there is always the threat of war with Iran, we hope that a diplomatic resolution, though likely partial, should be enough to avert military action that would spike energy prices. With ample supply and slowing demand growth, crude oil prices should remain near current levels.

The U.S. Energy Information Administration (EIA) estimates worldwide crude prices to average $67 in 2019 and 2020. Gasoline prices, which started the summer 38% cheaper than 2018, and were headed lower, may remain elevated as supply is hindered in the short term from the devastating explosion at Philadelphia's Energy Solutions refinery. That said, there is more than enough gasoline to meet demand according to the most recent Lundberg survey of U.S. fuel markets, so supply concerns may be overinflated.

Keep in mind that several states have also increased taxes as of July 1, which may add to prices moving forward. Energy costs directly impact consumers, but lower profit margins can also hurt some energy companies.

3

Corporate profits/margins – As revenues slow and with margins already squeezed for many companies, it will be interesting to see what corporations do to maintain earnings growth. For now it seems that companies are still hiring, but many, like the automakers, are consolidating. So while earnings expectations are tempered, executives may need to take action if organic growth isn't enough to keep growth in the black. FactSet still estimates calendar year 2019 earnings growth of 2.8% on revenue growth of 4.5%.

4

Tariffs and trade – At the time of writing, President Trump and President Xi Jinping have just agreed to a tariff cease-fire of sorts during a G20 meeting. The leaders of the two largest global economies halted plans for new tariff actions and will go back to the negotiating table to (hopefully) get a deal done. Current tariffs will remain in place, which are already having apparent effects on the communist nation. Recent (non-government issued) data on China's manufacturing sector showed a sharp drop in activity into contraction territory.

Extending an olive branch, Trump also said he would loosen the ban on Huawei, allowing U.S. companies to sell their products to the Chinese tech group, even though it remains blacklisted.

Obviously, an agreement will not be not an easy task as both sides have failed to reach a compromise after 11 rounds of talks that last ended with increased tariffs. Investors are hoping the reset, along with weakening economic data and shaky business confidence from both countries, will help spur a deal. The lack of a solution to what has grown into the “world’s biggest trade tiff” would most certainly derail best-case scenarios and weigh heavily on sentiment and CapEx spend.

5

Global economic health – The majority of the largest global Central Banks are already in accommodative modes where needed. On average, inflation is low across the globe, with few exceptions. Japan, China, Canada, Mexico, the EU and others are all heavily dependent on healthy U.S.-Chinese economies, without trade barriers. It’s fair to say that all want to see an agreement on the trade dispute between our two nations and perhaps a few more.

We are watching closely as the Eurozone’s third largest country, Italy, has slipped into recession three times in the last decade, and is showing continued signs of weakness despite ECB stimulus. The country has the highest unemployment rate behind Greece, running neck and neck with Spain. Germany is also feeling the effects of trade disputes and Brexit uncertainty as its economy slowed with industrial production as a primary drag.

An end to the U.S.-China trade dispute and clarity on Brexit (which still has a myriad of uncertainties), should help bolster EU economies and should quell many risks.

Published on July 1, 2019.

The information contained herein represents the views of Westwood Holdings Group, Inc. at a specific point in time and is based on information believed to be reliable. No representation or warranty is made concerning the accuracy or completeness of any data compiled herein. Any statements non-factual in nature constitute only current opinion, which is subject to change. Any statements concerning financial market trends are based on current market conditions, which will fluctuate. Past performance is not indicative of future results. All information provided herein is for informational purposes only and is not intended to be, and should not be interpreted as, an offer, solicitation, or recommendation to buy or sell or otherwise invest in any of the securities/sectors/countries that may be mentioned.