SlateStone WEALTH

Balancing Your Life Goals with Financial Results

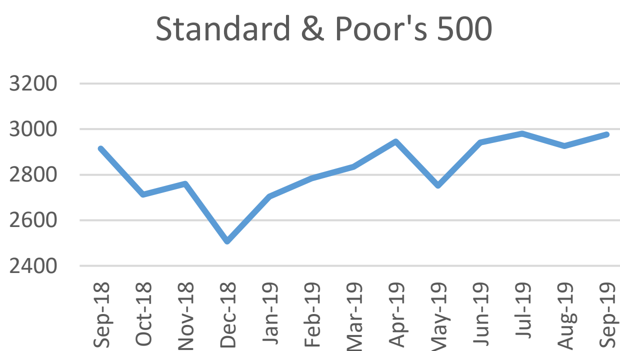
Investment Review & Outlook

October 2019

Review

Global economic growth is down-shifting, but not stalling at this point. The geopolitical threats are abundant, but not overwhelming the markets up to this point. Corporate earnings are the driving force behind share price movement, but we may be at a tipping point going forward.

Trade issues and political uncertainty are negatively impacting the manufacturing sector on a global scale. So far in 2019 the S&P 500 Index has struggled to advance beyond the 3000 level. The question is do we have enough earnings growth to breakout to the upside. The answer to the question will come from the US consumer. Strong employment growth has boosted consumer confidence and the ability to spend. But, can the services sector continue to expand if the manufacturing sector continues to decline?



Source: Bloomberg, October 7, 2019

Earnings growth expectations for the S&P 500 Index have been slowing along with the economy. Year-over-year earnings growth for the third quarter is expected to be flat to slightly negative. Standard & Poor's consensus earnings expectations for the fourth quarter 2019 show a sharp rebound in growth largely as a function of an easy year-over-year comparison. This is very similar to the setup going into the fourth quarter of last year. Last year's disappointment relative to earnings expectations going into the fourth quarter, led to a sharp sell-off in share prices in the final quarter of 2018. We bought into the "easy comparison" argument last year but are skeptical regarding those very strong earnings growth expectations given the global economic and political uncertainty.

Global Markets

On a total return basis the S&P 500 has risen over 20% in the first nine months of 2019, but that number falls to just over 4% for the last twelve months due to the 14% drop in the fourth quarter of 2018. The S&P 500 has been in a narrow trading range between 2850 and 3000 over the last several months. The STOXX Europe 600 Index and the Nikkei 225 have displayed similar volatility and trading range characteristics.

Federal Reserve interest rate cuts along with negative interest rates in Europe and Asia have pushed US interest rates lower so far this year. Relative interest rates among sovereign debt issuers are a significant driver of foreign exchange movements. The US benefits from its reserve currency status as well as positive interest rates, which is reflected in the ongoing strength of the US Dollar.

Equity Market Performance
To 30-Sep-2019, in US Dollars

	3rd Quarter 2019	12 Months 9/30/19
MSCI World Index	0.5%	1.8%
Europe	-1.8%	-0.8%
France	-1.7%	-1.6%
Germany	-4.0%	-7.1%
Switzerland	0.3%	12.0%
United Kingdom	-2.5%	-2.9%
Japan	3.1%	-4.7%
Pacific, ex Japan	-5.2%	3.0%
EAFE	-1.1%	-1.3%
USA	1.4%	3.5%
Emerging Markets	-4.3%	-2.0%

Source: Morgan Stanley Capital International,
Total return, dividends less withholding tax reinvested

Data sources: Standardandpoors.com, Bloomberg, MSCI.com *Continued on page 2*

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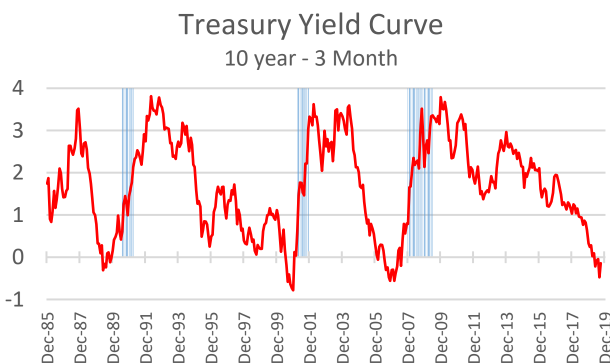
Outlook

When thinking of the abundant geopolitical risks including trade tensions between the US and China, the US and Europe, Brexit, and potential flash points from Hong Kong to the Middle East, it is beyond our limited abilities to quantify the potential economic impact or timing. But, as global economies slow, the risk of a political crisis tipping the global economy into recession increases.

We have been talking about the "inverted yield" curve since last March. Normally, the yield curve (a graph of US Treasury interest rates plotted against the length of time to maturity) inverts when the Federal Reserve is pushing over-night interest rates higher. This time the Fed has been cutting short term rates, but longer-term interest rates have moved even lower. When 3-month Treasury Bills offer a higher yield than 10-year Treasury Notes the yield curve is "inverted" as represented by the red line falling below zero on the chart below.



Note: Blue columns represent recession periods. Source: Bloomberg, October 7, 2019

An "inverted curve" has been a reliable indicator of looming recession. However, the arrival of recession, on average, takes about a year from the onset of a curve inversion. The expectation that the Fed will cut short-term rates again at the end of October would potentially push the line back above zero. But, note the line typically has been back above zero prior to the arrival of past recessions. The best-case scenario is that we are headed into a global economic slowdown. If a recession is just over the horizon the current consensus S&P 500 earnings estimates may be overly optimistic.

Real GDP Growth - YoY %				Market P/E
	2018	2019	2020	7-Oct-19
US / S&P 500	2.9	2.3	1.7	19.4
Eurozone / Stoxx 600	1.9	1.1	1.0	18.4
UK / FTSE 100	1.4	1.2	1.1	17.5
China / CSI 300	6.6	6.2	6.0	13.8
Japan / Nikkei 225	0.8	0.9	0.3	15.3

Source: Bloomberg, October 7, 2019

The Fed has cut the Fed Funds overnight interest rate twice this year. The markets currently put a 70% probability that there is another cut coming at the end of October. There has been disruption in the "Repo" market for short-term funds. This suggests a lack of adequate funding in bank reserves. The argument is made that another cut in the Fed Funds rate along with a potential return to "Quantitative Easing" is the appropriate prescription to ameliorate the problem. The Fed is not alone, the European Central Bank and the Bank of Japan continue to add monetary stimulus to the global economy. While it is clear Central Banks can choke off an economic expansion, it is uncertain if printing more money can sustain one.

The threat of recession is real, and we do not believe that the impact on earnings is adequately reflected in the current consensus earnings expectations. We continue to use consensus earnings data from the Standard & Poor's website for want of a better data source. If earnings come in lower than expected due to weak economic data, we would expect the market P/E to be higher than those shown below as the world's Central Banks will push incremental liquidity into the global banking system. We want to be conservative as to where the S&P 500 may trade a year from now, so hypothetically, we do not expect the market to break-out to the upside of the recent 3000 price barrier before the middle of 2020. We hope our expectations are too conservative, but we also want to be realistic.

Standard & Poor's 500				
	Annual Earnings	%Change Y-o-Y	Price/ Earnings	Year-end Price
Dec-12	86.51	-0.5%	16.5	1426.19
Dec-13	100.20	15.8%	18.5	1848.36
Dec-14	102.31	2.1%	20.1	2058.90
Dec-15	86.53	-15.4%	23.6	2043.94
Dec-16	94.55	9.3%	23.7	2238.83
Dec-17	109.88	16.2%	24.3	2673.61
Dec-18	132.39	20.5%	18.9	2506.85
Dec-19e	145.72	10.1%	19.6	2850
Sep-20e	159.84	9.7%	19.7	3150

Source: Standardandpoors.com October 7, 2019

On the fixed-income side, we use bonds in balanced portfolios to mitigate the risk inherent in equity investing and to provide liquidity for unanticipated expenses. We will continue to be very conservative in our bond investments. But when the yield curve begins to "steepen" there may be an opportunity to increase income levels through extending our average maturity.

This document contains certain forward-looking statements about future possibilities and there are no guarantees that the views and opinions expressed will come to pass. Charts and graphs included are intended as educational aids and should not be the basis of any investment decision. Certain information has been derived from third-party sources believed reliable.
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