

THE HOME STRETCH

Stocks rose modestly in the third quarter, but the S&P 500 is roughly flat versus a year ago, while bond yields are down approximately 160 basis points. The Federal Reserve raised interest rates in September and December of 2018 and cut them in July and September of this year. Corporate profits have slowed and will most likely be down on a year/year basis for the quarter just ended, but are forecast to improve in the fourth quarter as earnings comparisons become easier. The net effect is that weaker earnings and much lower interest rates have offset each other when it comes to equities.

The U.S. economy is in decent shape but still slowing, while the U.S. consumer and employment rates are the bright spots. Manufacturing is very weak, primarily due to trade. The weakness started abroad in 2018, but is more evident in the U.S. with the U.S. Purchasing Managers Index (PMI) for September at 47.8. Anything below 50 signals contraction. The export component was 41.0. Manufacturing is a small part of the U.S. economy but matters for corporate profits—which are a leading indicator for capital expenditures and future job growth. The weaker PMIs have caused some economists to forecast a 2020 recession, but we disagree. The PMIs have a long lead time and both monetary and fiscal stimulus recently have been revived, both here and abroad. The most likely scenario is for the U.S. economy to keep expanding at the 1 ½ to 2% rate. A favorable resolution to our trade issues, particularly with China, would increase these odds.

With all the negative headlines around, there has been talk of the end to the U.S. bull market, which now has passed its tenth year. Again, we find fault with this reasoning since none of the usual symptoms are present. To begin with, bull markets do not end with investors in a cautious mode but with euphoria, something far from present-day sentiment. They also typically feature heavy inflows into equity market funds, the opposite of what has been currently happening. A further condition is a big pick up in merger and acquisition activity, as well as initial public offerings, and, instead, both remain restrained. Lastly, market tops are associated with rising real interest rates and widening credit spreads. In contrast, current credit spreads are well-contained, and interest rates are falling, not rising.

In our July letter we referred to the fact that sometimes it pays to listen to the markets themselves, rather than the headlines. We see more evidence that this should continue to be the case today. The market internals are strengthening both in terms of advances and participation, and the percentage of stocks with an upward sloping two hundred-day average has recently reached a new high. Also worth noting is the calendar, since mid-October usually marks the start of the year-end rally. With any favorable resolution to our current trade disputes, we would not be surprised to see the popular averages at new highs.

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