



## Weekly Update: Proceed with caution

11-02-2018

**I split my week with visits to Hershey** in my home state—my host gave me box of chocolates!—and Jackson, Miss., in the Deep South. In both cases, I was speaking to large groups of bank trust officers. Neither exhibited any signs of panic. Maybe that's to be expected given their occupation, but it does bring to mind a common theme of this correction—investor sentiment has been sanguine relative to the magnitude of the sell-off, adding to conflicting signals on whether the bottom is in. Put another way, the market has corrected faster than sentiment has changed, and that tends to be bearish for forward returns. Not that the market has to be negative, only that there's more work to do, particularly on investor psyches. While post-election seasonality favors relief in the weeks ahead, the 2,765 to 2,850 range on the S&P 500 could be a hurdle as technical damage typically requires a longer-term repair. In corrections of similar magnitudes in 2011 and 2015, the bottoming process took months. Some worry divergences in market internals and breadth indicators indicate we're already in a bear market, but such divergences have persisted for months, even years before prior bull trends ultimately reversed. Others worry the widening gap, or spread, between yields on high-yield bonds and comparable maturity Treasuries may be foreshadowing a recession, as was the case prior to the 2001 and 2007-09 downturns. But this deterioration just a month after high-yield spreads hit a multiyear low likely reflects concerns about the impact rising rates may have on leveraged firm earnings, free cash flow and balance sheets.

**Even though Q3 earnings have been** more than solid so far, with earnings per share (EPS) on target for 26% growth, many are focused on disappointing guidance and potential peak earnings growth. EPS growth does appear to be slowing, although P/E multiples have been declining all year. Many lay the lion's share of blame for October malaise at the feet of Fed Chair Powell and President Trump, the former for suggesting as many as five more rate increases into 2020 and the latter for his insistence on levying punitive tariffs on an expanding list of Chinese goods. Both courses are viewed as headwinds to economic growth over the next 12 months. But while GDP and earnings growth rates may be peaking, history suggests the economy and the business cycle is merely shifting into its slowing expansion phase, which tends to be the longest phase of a business cycle. Strategas Research says it also is one in which active strategies tend to perform at their best relative to passive strategies, as an earlier cycle environment in which a rising tide lifts all boats (and thus all indexes) no longer is present. For much of this year, the FAANGs (Facebook, Amazon, Apple, Netflix and Google aka Alphabet) and small caps have led the market, but this past month saw defensive and dividend-oriented stocks move into the lead. Given the late-cycle signals in some of the data, Renaissance Macro believes this shift will last for the next six months, with defensive names outperforming cyclical stocks by more than 200 basis points.

**Thursday's rally had a lot to do** with reports that Trump and China President Xi Jinping talked and may be nearing a trade deal. But that view was dismissed this morning, prompting an about-face in stocks that in pre-trading were up strongly. All eyes are on the scheduled meeting between the two in early December at the G-20 summit (we'll have more about what is at stake in a piece in two weeks). It wouldn't be shocking to see Trump come out of the meeting with an announcement similar to the one he made after European Commission President Jean-Claude Juncker's visit to the White House in late July, with the two agreeing to place their trade threats on hold and negotiate. A lot is at risk, as the U.S. is only applying a 10% tariff on about \$250 billion worth of Chinese imports, but that could rise to 25% on about \$550 billion in January if no deal is struck. The trade war comes at an awkward time for the China, which since 2015 has been trying to both restructure its economy and deal with mounting bad debt. To fully excise late-cycle worries and begin talking about 3,000+ for the S&P again, there needs to be an acceleration in non-U.S. growth, and that just hasn't been evident in recent data out of China or the rest of Asia and Europe for that matter. While the rest of the world was having bear markets, the U.S. was hanging in. That is still Federated's base case but caution is merited.

### Positives

- **Pay on the rise** This morning's jobs report said October average hourly earnings for production and supervisory workers rose 3.1% year-over-year (y/y), their fastest pace in a decade, while a separate report earlier in the week found wages for all private sector also accelerated at a 3.1% rate in Q3, their fastest pace in 11½ years. That increase lifted the Employment Cost Index to its biggest gain since the second quarter of 2007, although unit labor costs were still up a muted 1.2% y/y. One reason: productivity is improving (more below).
- **Productivity on the rise** It grew at a 2.2% annualized rate in Q3—the third best reading in the three years. The spring quarter was upwardly revised to an even stronger 3%, making for the best back-to-back quarterly

performance in four years. If productivity continues to trend higher, potential output growth should pick up, creating room for a longer expansion and subdued inflation pressures. If it doesn't, then potential growth likely will suffer, inflation pressures will build and real GDP growth will slow again.

- **Consumers in a buying mood** The Consumer Confidence Index hit an 18-year high in October, suggesting continued above-trend economic expansion led by robust household spending. Both present conditions and consumer expectations improved to their best levels since Q4 2000, abetted by job and wage growth. A separate government report said personal consumption continued to be robust in September.

## Negatives

- **How tight can the labor market get?** Everyone agrees strong job growth is desirable and we got that in October, with nonfarm jobs jumping 250K and the ADP's survey of private payrolls increasing the most in eight months. But this growth is beginning to pinch employers. Widespread skilled-worker shortages have started pitting small businesses against bigger companies, ADP said, with the latter winning because of their ability to offer better pay and benefits. The shortages could start to slow payroll growth, as already hinted at in online help-wanted ads. They plunged last month to 2012 lows on widespread deterioration across regions, states and occupations.
- **Recession watch** Core capital goods orders slipped again in September, while a survey of manufacturers by the Institute of Supply Management (ISM) found activity moderated somewhat in October as escalating trade tensions appeared to cut into orders. Surveys by Markit and the National Association of Credit Management reflected similar findings, as did four of six regional ISM surveys. Activity remained easily expansionary and above trend in all the surveys, but the softening on top of guidance in earnings reports has reinvigorated "late-cycle" talk.
- **Recession watch** Several multiyear trends appear to be breaking, with oil prices falling through key support, the dollar moving up off its bullish base, the yuan firming and credit spreads hitting yearly highs. Renaissance Macro says one must respect it when there's a breakdown of multiyear trends amid structural double tops.

## What else

**Who cares about the midterms?!** Fiscal policy outcomes in the short run probably won't be significantly different regardless of how next week's election turns out. Cornerstone Macro is skeptical of any further tax cuts and equally skeptical that there will be an impetus to cut the deficit under any potential election outcome. Instead, spending on defense and domestic spending is likely to trend higher, with a major infrastructure package only likely under an unlikely Democratic sweep scenario.

**October is the cruelest month** If the S&P's low of 2,641 on Oct. 29 holds, it would become the 13th low out of a total 47 correction troughs since 1931 that were made in October—28% of all lows. Similarly, if the Dow low on that day also holds, it would become the eighth October low out of a total of 34, meaning nearly 24% of all Dow correction lows in the past 87 years also occurred in October. Dudack Research calls this an "amazing" record for October. *Amazing?* How about unnerving.

**I'm told it's like having a nice glass of wine** A Gallup survey finds 66% of Americans support the legalization of cannabis, up from 64% in 2017 and a meager 12% in 1969. Momentum began accelerating in the 2000s as more states began to pass medical laws, which finally led to majority national support for the first time in 2013. The support cuts across party lines and generations, with a majority of Democrats, Republicans, millennials, GenXers and baby boomers all in favor.

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## Recent Equity

**Orlando's Outlook: Powerful October jobs rebound**

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**Orlando's Outlook: Strong consumer drives solid Q3 GDP**

Philip Orlando

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**Secular bull call intact but 3,100 on the S&P may have to wait till 2019**

Stephen Auth

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Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks and may be more volatile than investment-grade securities.

Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The Conference Board's Consumer Confidence Index measures how optimistic or pessimistic consumers are about the economy.

The Employment Cost Index (ECI) is a quarterly measure of compensation costs for U.S. businesses.

There are no guarantees that dividend-paying stocks will continue to pay dividends.

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