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The slow boat to China

Our melt-up scenario has melted with the prolonged trade talks, but not our longer bullish view on the year.

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Stephen Auth, CFA
Executive Vice President
Chief Investment Officer, Equities, overseeing all of Federated's equity and asset allocation products globally

Recent developments in the trade wars have surprised many, including us, about the speed with which a China trade deal is likely. Two weeks ago a deal seemed imminent. Then, the Chinese apparently miscalculated by attempting to back off at the last minute on the enforcement language in the agreement. This was followed by a seemingly inevitable "Art of the Deal" response from President Trump, escalating his demands on intellectual property protection and stepping up pressure against Chinese national champion Huawei. As both sides dig in for trench warfare, our expectation of a quick resolution has dropped considerably. With it, the odds of a near-term market melt up are lower.

This said, our stance on the market remains positive and our year-end target of 3,100 on the S&P 500 remains intact. With fundamentals on all other fronts otherwise on track, we see the market now grinding higher through the rest of the year, with quicker upside risk if and when President Trump gives President Xi the appropriate off-ramp from a war that China's export-driven economy, frankly, cannot win.

U.S. economy re-accelerating

The U.S. domestic economic picture looks very solid. Leading indicators such as industrial production and housing are ticking higher, responding perhaps to the Fed's more neutral policy stance as well as improved stability around the world, trade war aside. Although labor conditions are tight, productivity numbers have finally started to grind higher after many years of declines. Inflation remains a non-issue. As signs of economic re-acceleration proliferate, concerns about "late cycle" are fading. We see these conditions continuing well into next year, and our full-year economic growth forecast is an above-consensus 2.6% for the U.S. and could go higher when our macroeconomic policy committee meets tomorrow.

Earnings stabilizing

The big takeaway from the just-completed first-quarter earnings season is that, while not great, companies on balance surprised to the upside. More importantly, the forward forecast for all of 2019, which had been in a state of steady downgrades since September, finally stabilized and actually ticked up as the season progressed. Consensus 2019 earnings for the S&P are now running at $166.53, just below our own forecast of $170, which would give us 11% year-over-year growth. We think there is minimal risk, at best a dollar or two, to these numbers from the trade war. Many companies have already incorporated 25% tariffs into their guidance and a combination of productivity gains and selective price hikes also will help them.

Fed policy supportive

The Fed remains in a neutral stance, a big shift from where we were in the fall correction when new Fed Chair Powell seemed to be telecasting a plan to keep hiking until he caused a recession. Importantly, if the China trade-war impact becomes worse than we or they expect, the Fed has sufficient policy flexibility to react by cutting rates from levels that are considerably higher than our major G-7 trading partners. On the Chinese side, we anticipate their government to implement additional policy stimulus to offset as much as possible the drag from a trade slowdown; this additional stimulus from the world's second-largest economy should also bleed into U.S. financial assets.

China deal inevitable at some point

Although sabers on both sides are rattling loudly at the moment, the reality is that a trade deal with China is simply inevitable at some point. On the Chinese side, as much as they like to dream of a domestic-driven economic growth plan, the harsh reality is their entire economy is built around the largest export machine ever built, and that will change only gradually. In the meantime, their economy will suffer significantly from the present intensification of the measures and counter-measures, and sooner or later, they will need to shift their stance. On the U.S. side, although our economy is less trade-dependent, many of our companies are; supply chains and the like are highly intertwined and shifting them would take enormous time and expense. So at some point, we also will need a deal. With a deal clearly in the interest of both parties, any sensible base case has to assume that a deal will get done. “Not if, but when.”

Valuations attractive given downside/upside balance

Finally, we see valuations pretty attractive at present levels. The S&P is valued at 16.5 times our 2019 forecast for earnings, and only 15.5 times 2020’s forecast. That is historically cheap, not rich, for the fundamental backdrop outlined above. From here, we see relatively limited downside and significant upside, either slowly or quickly depending on the next move on the trade front. So for now, it looks like we’re on the slow boat to China. At least it’s heading in the right direction.

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