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An 'insurance' cut?

Profits, margins and valuations look attractive regardless of what the Fed may or may not do.

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Linda Duessel, CFA, CPA, CFP
Senior Vice President
Senior Equity Strategist

Back to business this week after two weeks exploring Ireland, where no one we encountered wanted to debate Brexit! Mellow, mellow, mellow people (if only I liked beer…), and now traveling in D.C. and Richmond where the mood among advisors is much the same. "On pause," "a little cautious" and "picking up some bonds" were among comments shared. One particularly mellow advisor, as we discussed tariffs, commented, "We will get past this doo-doo [or something like that], we always do." "And how impactful are these tariffs anyway?" Yes! I agree with this gentleman! He is really smart! Indeed, corporations enjoy record profit margins, and may very well share the hit of tariffs with consumers. Furthermore, ours is 90% a service economy, which won't feel the brunt of tariffs. Fed Vice Chair Clarida this week said the central bank had some "insurance cuts" in its back pocket and has used them before. Maybe, but it's very rare during an expansion. When they have come, it's because there was big trouble. In 1987, it was "Black Monday," with a nearly 22% single-day plunge in the Dow. In 1995, it was the "bond market massacre," a steep sell-off after the Fed sharply raised rates. And in 1998, it was the collapse of hedge-fund giant Long-Term Capital Management amid the Russian and Asian financial crises. This time, what's the big trouble? A worsening trade war? That may be true for parts of the manufacturing sector but data

here and abroad suggest it's yet to spill over to the much larger and important service sector.

For a moment, forget all this trade angst and Fed insurance talk and look at stock valuations, margins, and revenue and profit growth. Q1's net margin sits atop its 40-quarter moving average, Leuthold says, meaning the last decade has enjoyed an average level of corporate profitability *that's been higher than at any prior single-quarter peak*, something even the foamiest-mouthed stock market bull would have thought unimaginable as the recession came to an end in mid-2009. S&P 500 revenue estimates for 2019 and 2020 have been remarkably stable, keeping forward revenues (the time-weighted average of this year and next year) in record-high territory. Industry analysts expect revenues to grow 4.9% this year and 5.3% next year—solid given discouraging headlines on global trade and economic growth. Since President Trump's May 5th tweet to raise tariffs on $200 billion of Chinese goods from 10% to 25%, consensus estimates have declined just a tenth of a point for 2019 and three-tenths for 2020, indicating that estimates aren't incorporating much downside risk from fresh tariffs plus the Huawei ban. At current levels, the S&P trailing P/E multiple is 17.9 and the 12-month forward multiple is in line with the long-term average of 15.6. If 2019 and 2020 earnings-per-share estimates prove correct, *the S&P is trading at its lowest multiple since 2011!*

Yes, growth has slowed after a Q1 spurt driven by an unsustainable inventory build. The good news is consumer spending is on track for at least 3% annualized growth in Q2, more than double Q1's anemic pace. Domestic final demand is the basic underpinning for the economy, with overseas developments having little impact. U.S. consumers only react to events that directly affect their balance sheet and pocketbook. The recession's clock isn't ticking and won't as long as domestic demand growth does not run under the economy's potential growth rate for consecutive quarters, Applied Global Research says. The Fed continues to say it's data dependent, and the incoming data is generally fine. Unemployment is at a 50-year low, wage growth is rising and consumer confidence at cyclical highs. So the question for the Fed and markets is whether there is anything in the trade war that is big enough to create a meaningful slowdown. So far, the data suggests not. So, why the insurance cuts? I guess that's what we should expect if the Fed

never wants to allow a recession again. Then what? Market melt-up? That would make me worry.

POSITIVES

- **Bad is good?** This morning's surprisingly weak labor market report, with nonfarm jobs coming in at just 75,000 for May, another 75,000 whacked off prior month's gains and average hourly earnings growth moderating, gives policymakers more excuses to remain at bay. Of course, it's really about trade. While quantifying the impact of the trade war is almost impossible, the market seems convinced trade will drive any rate cuts.
- **Services surprise** The Institute of Supply Management said nonmanufacturing activity unexpectedly rose at its fastest pace since February, led by a jump in employment and increased orders. A separate Markit survey wasn't nearly as robust, but the underlying trend suggested continued expansion at a slower rate.
- **Cover for the Fed** The core PCE Index ticked up in April but remained below Fed targets, and revised Q1 productivity and unit labor costs reflect little in the way of price pressures. Overseas, disinflation worries keep mounting, spawning more central bank easing that's pushed the number of negative-yielding bonds to $11 trillion, *20% of all sovereign and corporate bonds outstanding in the world!* There's little sign tariffs have been inflationary. In fact, Strategas says they look to be deflationary on a medium-term basis as consumers and businesses balk at price hikes.

NEGATIVES

- **Manufacturing's global funk** The global manufacturing PMI fell a 13th straight month and dropped below 50 for the first time in seven years. The U.S. reading also slipped to a 30-month low but remained expansionary. Country reports indicate exports and trade concerns are causing a loss of business confidence.
- **Not a good sign for Q2 capex** Construction spending was unchanged in April, contrary to expectations for a gain, as a jump in public construction was completely offset by the biggest drop in private spending since January 2013.

Manufacturing construction spending plummeted on mounting uncertainty related to trade wars.

- **Consumers lose a little powder** Real personal disposable income fell to 1.7% year-over-year in March and April, nearly half of December's pace. This decline does not bode well for housing or auto sales in coming months since income and consumption growth tend to move in tandem.

WHAT ELSE

Peak trade war? No one knows for sure, but Strategas Research wonders if the imminent launch of the Trade War ETF (ticker TWAR, listing pending) will prove to be a sign that the trade war trade has reached its pinnacle.

Not a good month for FAANGS Stock prices aren't the only thing that fell in May for the biggest of big tech (Facebook, Amazon, Apple, Netflix and Google). A recent Harris Poll on corporate reputations dropped Google from 28th to 41 and Facebook from 51 to 94 on the 100-company list, putting the latter alongside Comcast and Sears. Attacking Silicon Valley is one of the few areas where both sides of the aisle are in some agreement.

Time to think 'Mini-FAANGs?' Low-profile small-company technology stocks have matched the performance of their more famous larger-cap brethren, not only since this bull began in 2009, but for 18 years dating back to 2002! Furthermore, the current relative forward P/E multiple on the S&P SmallCap 600 technology category compared to the S&P 500 technology category is only 0.99, or lower than 93% of the time since 2002!

TAGS

EQUITY MARKETS/ECONOMY

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Dow Jones Industrial Average ("DJIA"): An unmanaged index which represents share prices of selected blue chip industrial corporations as well as public utility and transportation companies. The DJIA indicates daily changes in the average price of stocks in any of its categories. It also reports total sales for each group of industries. Because it represents the top corporations of America, the DJIA's index movements are leading economic indicators for the stock market as a whole. Indexes are unmanaged and investments cannot be made in an index.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

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.

S&P SmallCap 600 Index: An unmanaged capitalization-weighted index representing all major industries in the small-cap of the U.S. stock market. Indexes are unmanaged and investments cannot be made in an index.

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