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Which Way Is the Market Going?

For much of 2018, U.S. growth benefited from the impact of the 2017 Tax Cuts and Jobs Act, deregulation, and a fiscal stimulus in January of 2018. At the end of the fourth quarter of 2018 the market sold off on worries of the Federal Reserve's tightening and an impeding U.S. recession from the global slowdown. The federal-funds rate had increased by a full 1% in 2018 at the same time that the Federal Reserve shrank its monetary base by nearly $400 billion, both actions taking liquidity from the market.[1] Global growth has been weighed down by a slowing Chinese economy and their significant deceleration in investment spending.[2] In the first quarter of 2019, the U.S. equity market rebounded with the S&P 500 Index increasing 13.65% for the first quarter of 2019. The resumption of U.S. growth stocks' market leadership for the first quarter of 2019 surprised investors since the fourth quarter 2018 pullback had portended an end to growth on a strong run. If the U.S. economic growth continues to the end of second quarter of 2019, this would mark the longest business expansion in U.S. economic history.

U.S. unemployment is at record lows. Wages are beginning to increase after a long stagnation. Personal income grew by 4.5% in 2018, but at an annual rate of 5.7% in the last half of the year. Labor productivity increased by 1.8% in 2018 compared to 1.1% in 2017, and only an average of 0.5% from 2012 through 2016. The productivity increase is the reason why the rise in wages has not led to inflation. Now that liquidity is being injected into the economy by the recent Federal Reserve's March 2019 decision to hold interest rate increases and limit bond repurchasing, consumption should continue to grow, particularly helping the consumer sectors of housing and autos. The University of Michigan's Consumer Confidence Index has almost fully recovered its drop in January 2019. Consumption makes up 70% of the U.S. economy.[3] Although the U.S. consumer has been the driver of the U.S. economy during the recovery, the new driver needs to shift to capital expenditures (capex) in 2019. As capex has been delayed from uncertainty, muddle through economic growth has resumed, and monetary policy has been recalibrated to match.[4]

Recent U.S. data in the first quarter of 2019 suggests that an uninterrupted up market has been challenged. The economic data points are mixed, and U.S. growth momentum has slowed although remaining positive.[5] Strategas Securities, LLC believes that the economy has slowed but the Federal Reserve "has stopped tightening in time to avoid a recession, but not soon enough to avoid an

inversion."[6] As expected the Federal Open Market Committee (FOMC) left the federal funds target range at 2.25% to 2.5%, which is below the pace of wage gains. If, however, wages and core inflation turn below 3% in 2019, the Federal Reserve's tightening in 2018 will be considered far more excessive that it first appeared at the end of 2018. The current bond market believes that the Federal Reserve has over tightened by about 0.40%, which should not trigger a recession. The bond market is doing much of the work for the Federal Reserve resulting in a window for refinancing and easing liquidity strains. Real yields are declining in the one to five year part of the curve pushing yields down roughly by 50 basis points, even before the Federal Reserve is forced to cut interest rates.[7]

The U.S. accounts for nearly one-quarter of the world's GDP. The U.S. has become the largest exporter of energy. The petroleum trade deficit has seen a sharp drop from $7 billion in January 2018 to $916 million in January 2019. This is due in part to the increase in crude exports where year-to-date average levels have increased 85% year over year.[8] The U.S. is also the largest importer of good and services in the world, consuming about 14% of total exports. It is also the largest export destination for China, India, and Germany and the second largest for Japan. These four major economies are heavily dependent on exports, nearly half of Germany's GDP comes from exports, so a global decline in demand has the potential to affect their financial systems, employment, and political dynamics.[9] Regarding growth, much will depend on China, which is the second largest economy. Over the past five years according to the World Bank, almost 50% of global gross domestic product (GDP) growth in dollar terms has come from China.[10]

Bond yields around the world have slipped this month as central banks have signaled they are willing to keep interest rates low for a significantly longer time than investors had expected just one year ago.[11] The European Central Bank (ECB) left rates unchanged and introduced a new refunding called Targeted Long Term Refinancing Operation (TLTRO III), which could be bullish for the euro and help Spain and Italy. European fiscal policy is also set to be loosened this year, and last year's euro weakness will contribute to easier financial conditions. European banks, handicapped by negative interest rates, slow growth, and regulatory scrutiny, are receiving a reprieve from the ECB even though they have had money-laundering scandals driving compliance costs higher.[12]

Data abroad remains weak as Germany, the largest economy in Europe, is in contraction territory. At 143% of Gross Domestic Product (GDP) corporate debt in France is twice that of the United States. In the U.K., Brexit remains a near term concern for equity markets although as time passes a hard Brexit appears inconsequential. Delaying a deadline for a longer period is a path of least resistance, but there is no guarantee that the extra time will produce a conclusive outcome.[13] Italy has seen the rising cost of capital with exploding bond yields. A weaker outlook in Europe has put downward pressure on long-term interest rates.[14] Trade tensions from tariffs and an economic slowdown in overseas countries are weakening trade

volume, especially exports, from Europe and Japan.[15] For all of the headline risks, recent improvement in the Euro area's leading economic indicators and month over month industrial production suggests that the results in Europe will not be as negative as the forecast.[16] The MSCI EAFE (USD) Net Index rose 9.98% for the first quarter of 2019.

The global growth slowdown has had more to do with Chinese fiscal policy on limiting credit expansion and the resulting capex slowdown than any trade negotiation pressure. China has recently loosened the regulation of its financial sector to improve credit growth. Although the Chinese credit growth will most likely not rise as much as previous releveraging cycles because their economy is in better shape, their action bodes well for global trade in the second half of 2019. A U.S. trade deal with China is questionable as the Chinese want to impress upon the world that their economy is strong enough to handle the repercussions from turning down a U.S. trade deal if it fails to serve their interests. Since the credit cycle is the dominant driver of Chinese growth, deleveraging will be temporarily less important. In 2019 stronger Chinese growth will help the European export sector with significant export exposure to China. European domestic demand will benefit from a more accommodative fiscal policy and lower bond yields. The decline in bond yields will be especially helpful to Italy. If global growth accelerates in the second half of 2019, international stocks should do well. Stronger global growth will also benefit Japanese multinationals, but the Japanese companies focused on domestic growth may suffer if the government raises the VAT sales tax in October of 2019.[17] The U.S. dollar will most likely continue to move in the opposite direction of global growth. When global growth accelerates, capital flows from the U.S. to the rest of the world, demanding less dollars.[18]

Martin Investment Management, LLC believes with the Federal Reserve's recent position to be patient and with no systematic financial problem on the horizon, the U.S. economy will most likely continue to expand. Low global inflation and current global monetary policy present a strong environment for equities. We will continue to monitor macro factors for our investment perspective. While macro factors are important to our outlook, investors are not well served trying to make investment decisions based only on this information. We believe that investing in profitable companies with quality characteristics and secular growth trends is a more reliable source of investment return over time.

Wishing you a warm and wonderful spring season!

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Note:

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