HIGHTOWER
RDM FINANCIAL GROUP

Market Update
MAY 13, 2019

Introduction

From last Fall through the first several months of 2019, equity markets quickly moved from a risk-off environment to a risk-on environment. Investor worries initially included too many rate hikes by the Federal Reserve Bank, weak economic growth overseas, trade tensions with China (and other countries) along with the potential for a recession and an end to the almost 10-year old economic expansion in the United States. Throughout this period (and the past several years), we recommended that investors maintain their investment discipline and avoid making rash decisions regarding their portfolios. At least so far, this has turned out to be a prudent decision.

Over the past few months trade talks with China appeared to be making progress (President Trump had in fact indicated multiple times that a trade deal looked increasingly likely). However, President Trump (in one of his many tweets) gave the Chinese until the end of last week to finalize trade negotiations or risk having tariff rates raised significantly on several hundred billion dollars in exports. We now know that there has been an escalation in tariffs with the U.S. raising the tariff rate from 10% to 25% on $200 billion of imports from China (with the threat of raising the tariff rate to 25% on the roughly $350 billion in Chinese imports not currently being penalized). Both sides have a lot to lose and ultimately, we believe that an agreement between the two sides is likely to be reached. Unfortunately, the recent breakdown in talks indicates that both sides are not yet willing to agree on major structural reform issues. Thus, after a significant rally off the December, 2018 lows, equity markets could be in for some near term volatility.

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From our viewpoint, the fundamental economic backdrop for the most part remains supportive for U.S. financial markets. While there are risks (which we outline later on in this update) we believe the probability of a recession at least so far in 2019 remains a low probability event. Moving beyond current trade negotiations with China, the U.S. economy currently appears to be on fairly solid footing. Positives include a rebound in GDP growth this past quarter, continued job growth, 3% plus wage growth along with a rebound in consumer confidence (after dropping at the end of 2018). Interest rates and inflation also remain range bound for now and in January the Federal Reserve Bank stated that it plans to keep rates on hold through the end of this year. Yes, there are concerns. For example, the ISM Manufacturing Index fell to 52.8 last month (the lowest since October, 2016), corporate profits have slowed considerably from last year (although they are forecast to improve somewhat as the year goes along), economic growth overseas remains weak and the trade dispute with China is still unresolved.

As investment advisors, one of the most important things we do is work with clients to develop the appropriate asset allocation. This is the appropriate mix of investments needed to help clients stay in their seats despite the inevitable ups and downs that come with investing in financial markets over time. Since 1980, the stock market has advanced 79% of the time but equities (the S & P 500) have experienced an average intra-year decline of 13.9% along the way (source: JP Morgan Asset Management). In other words, it's important not to panic when we see occasional pullbacks and corrections that are a normal part of the investing process. For reference, as of mid-day on May 13, 2019, the S & P 500 had declined about 4.9% off its recent all time high (while still up 12.2% year-to-date) – source: Factset.

At almost 17x forward 12-month earnings, valuation levels for the S & P 500 are no longer as inexpensive as they were to start the current bull market 10 years ago or at the start of this year. Future market gains will likely be driven by an increase in corporate profits as opposed to an increase in valuation levels. Forward looking indicators like weekly jobless claims, the monthly Leading Economic Index, credit spreads, real rates and new orders (while off cycle highs) remain supportive. At some point in the future, the economy will once again experience a downturn as both consumers and business leaders turn more cautious. The recent breakdown down in trade talks with China likely indicate a rise in market volatility over the near term (which could lead to a

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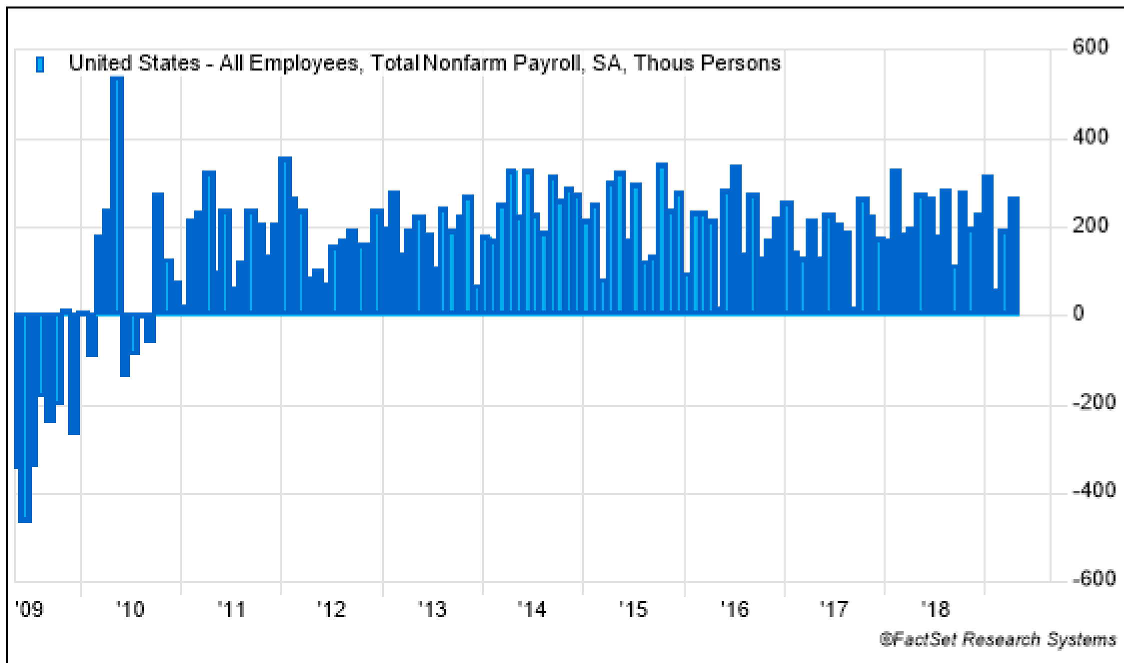
short-term pullback or correction). However, at least so far based on recent economic data, we believe that talk of a recession at this point appears premature.

The Economy

The headline number for U.S. payroll employment was positive last month, rising 263,000 in April (see chart below – source: Factset) with modest upward revisions for the past two months. For reference, the average increase in payrolls so far this year has been 205,000 per month versus an average increase of 200,000 per month over the prior three-years. Overall, 65% of all industries added workers in the latest month (a healthy sign). While the headline jobs number was quite positive, other details of the jobs report were not quite as strong as the headline number. For example, the average work week declined slightly to 34.4 hours and the labor force participation rate declined 0.2 points to 62.8%. As a result of the lower labor force participation rate, the U.S. unemployment rate ticked down 0.2% points to a 50 year low of 3.6%. Lastly, average hourly earnings (i.e. wages) rose 0.2% last month (up 3.2% on a year over year basis). Wage growth may have plateaued over the past few months, but remains above 3% on a year over year basis. With inflation contained, we believe that this kind of wage growth should help support healthy consumer spending in the months ahead.



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This month the ISM Manufacturing Index remained above 50 (signaling expansion) but fell 2.5 points to 52.8, representing the lowest level since October 2016. For reference, the index peaked at 60.8 in August 2018 and has moved lower since then as a result of slower global growth, unresolved trade issues and a stronger U.S. dollar. Within the ISM report last month, new orders and production grew near their slowest rates since August 2016, the employment index fell 5.1 points (the most since July 2011) and both imports and exports contracted (likely a sign of weaker growth overseas). Lastly, the level of new orders dropped below inventories for the first time since August, 2012.

The weaker ISM manufacturing Index suggests a slower pace of manufacturing output over the near term. According to the Institute for Supply Management (which puts out the ISM report), the April ISM Manufacturing Index corresponds to approximately 2.9% real GDP growth. If the ISM Manufacturing Index stabilizes around current levels (give or take a few points) and starts to move higher over the second half of the year, that would be a positive sign. Further weakness, if sustained (due to trade wars, weaker economic growth overseas or a drop in CEO confidence levels), would be a concern.

Separately, we also look at the services side of the economy. The ISM Non-Manufacturing Index fell 0.6 points in April to a reading of 55.5. This represents the lowest level since August 2017, but remains consistent with above-trend growth in the economy. The pullback from the cycle high of 60.8 last September suggests decelerating growth on the services side of the economy over the near term. Within the report, various indicators were mixed. Business activity edged up in April, new orders and employment growth both moderated somewhat and export and import orders both rose.

THE FED

At its first meeting in 2019, (this past January), the Federal Reserve Bank emphasized that there is not a strong case for an interest rate move in either direction. This represents an important change in policy from a central bank that appeared ready to raise rates several more times in 2019. Put simply, the Fed appears likely to remain on the sidelines throughout 2019. For investors concerned that the central bank might tighten policy too aggressively and choke off the current expansion (we would include ourselves in this camp), recent comments from the central bank is welcome news.

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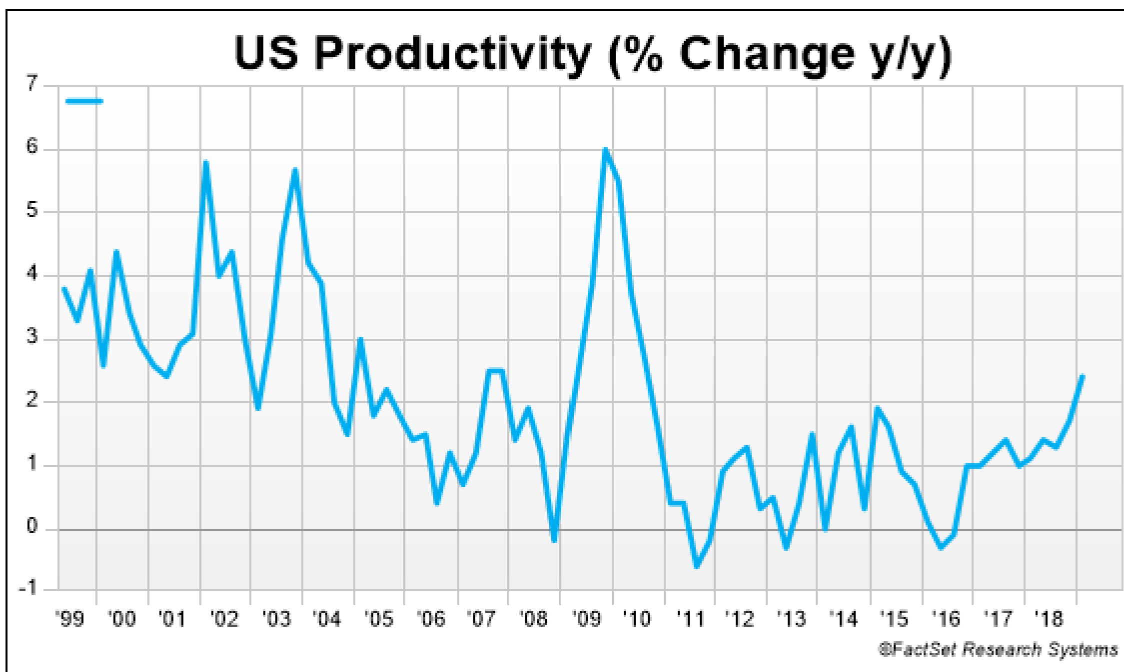
The Federal Reserve Bank has what is called a dual mandate – to achieve full employment and price stability (i.e. stable inflation). With the unemployment rate currently at a 50-year low and the economy generating steady job growth, the employment mandate appears to have been achieved. On the inflation side, the central bank has mostly failed to achieve the 2% level of inflation they have been targeting based on the Fed's favorite inflation gauge called the Personal Consumption Expenditures Price Index or PCE. According to this index, the year over year rate of inflation currently stands at 1.6% and except for a brief period in 2018, has remained below the 2% level for much of the past 7 years). You can certainly argue that the central bank is not accurately tracking inflation. However, based on the Fed's data (which is what matters most for the markets), the Federal Reserve Bank should be in no rush to raise rates any time soon (and may actually lower rates later this year if the economy slows down).

PRODUCTIVITY

Earlier this month productivity data was released and the data (on a y/y basis) posted the highest increase since 2010 (see chart below – Source: Factset). Productivity is closely watched by economists because it is one of the two pieces (along with growth in the labor force) that helps determine the level of GDP over time. Higher productivity means that more output is being



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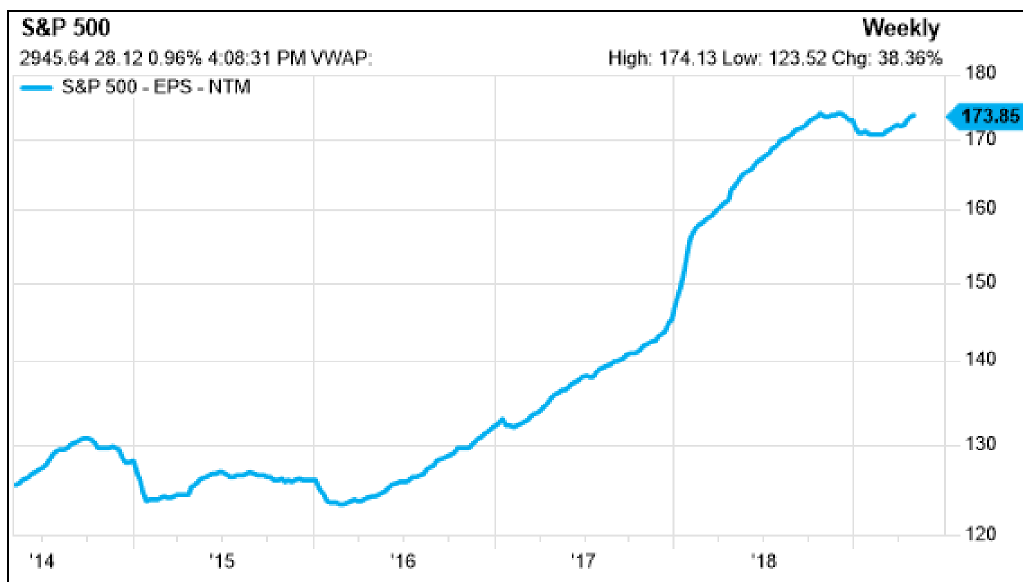
generated given the level of capital. If productivity levels continue to rise over the next several years, that would help increase economic growth, boost wages and increase the chance that the economy may be able to continue growing without leading to a pickup in inflation. The last point is important because if inflation remains contained (as it has in recent quarters), that takes pressure off the central bank to raise rates and potentially raise rates too aggressively.

Earnings and Valuation

At the end of last year, Wall Street analysts forecast that first quarter EPS (for the S & P 500) would rise 2.9% on a year over year basis. During the first quarter, analysts cut their estimates to a low of minus 4% (mid-way through the most recent first quarter). A majority of companies have now reported first quarter earnings and it looks like final results will come in closer to unchanged on a year over year basis. In other words, once companies began releasing their numbers, analyst EPS estimates started to rise. According to recent data from Merrill Lynch (Revisions Ratios, April 29, 2019), the three-month average of analyst upward versus downward EPS revisions for 2019 has increased for a second straight month. Recent data indicates that the downward trend in EPS may be coming to an end and that the outlook looking ahead may be improving. The chart below provides a line chart of for the S & P 500 looking at estimated EPS over the next 12 months (source: Factset). All the way on the right-hand side of the



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chart, it appears that the trend in earnings may be starting to inflect higher (a positive sign similar to early 2016).

Looking ahead, year over year EPS for companies in the S & P 500 are currently forecast to decline -1.2% this quarter, rise 0.8% in the third quarter and jump +7.8% in the fourth quarter of this year. For 2020, the current estimate is for S & P 500 EPS growth of 11.2% with all 11 sectors of the market currently forecast to generate positive growth and six of 11 sectors forecast to post double digit EPS growth. As investors, you always want to look a few quarters ahead. While things can certainly change in the economy and the markets between now and the start of 2020, we believe the outlook for corporate profits next year is starting to improve. Over time, stock prices tend to follow the direction of corporate profits. Thus, it will be important to keep an eye on the outlook for EPS over the next several quarters. We will have more to say on this topic as the year unfolds.

What Keeps Us Up at Night?

Earlier this year equity markets celebrated their 10-year anniversary and this summer, the economic expansion is also likely to reach the 10-year mark as well. Looking back, this recovery (in terms of GDP growth) has been the weakest in the post WWII period (source: Federal Reserve Bank). As a result of this more moderate expansion, the economy has not built up the kind of excesses often seen in previous expansions. We believe that this has helped maintain the current long-lasting expansion so far.

Looking ahead over the next several quarters, our biggest concerns include: 1) the recent breakdown in trade talks with China (along with a protracted trade war); 2) weak economic growth overseas; and 3) rising deficits (which represent a longer-term concern). Right now, U.S. consumers look like they are on pretty solid footing (due to rising wages, continued employment growth and healthy confidence levels). Given that consumer spending currently represents about two thirds of the U.S. economy, if something comes along and causes a change in consumer behavior, this could have a negative impact on the U.S. economy.

Addressing the trade issue, at 12:01 last Friday morning the U.S. officially increased the tariff rate from 10% to 25% on $200bn of imports from China. Goods exported from China to the United States as of last Friday will be subject to the higher

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tariff rate (until further notice). Goods that were exported prior to last Friday (but that have not yet arrived in the United States) have been grandfathered in at the previous 10% tariff rate. In theory, this means that a majority of the tariff increase will probably not hit until 2-3 weeks from now (since it takes time to ship goods from China to the United States).

This modest delay might create a window during which the U.S. and China can continue to negotiate and work out an agreement. That said, the fact that there is no agreement in place has increased the probability that tariffs will increase on the remaining roughly $300 billion in imports from China that the U.S. has not yet finalized. The impact on the U.S. and global economy is uncertain but not likely to be positive. Ultimately, tariffs act like a tax that add to uncertainty and are likely reduce the level of economic growth. According to research from Strategas (U.S. / China Trade – May 10, 2019), should policy makers not make a deal, U.S. GDP will be reduced by approximately 0.5% on an annual basis as a result of lower investment and reduced consumer and business confidence. We will be monitoring the situation and evaluating any portfolio adjustments to make in the period ahead.

How are We Positioned?

It may sound like old news to many of you who have been reading our market updates over the past several quarters, but within our investment portfolios, we remain overweight growth versus value, the U.S. versus overseas and large capitalization stocks versus small capitalization stocks. These trends will eventually change, but they continue to remain in place (for the most part) so far in early 2019. Among various sectors of the market, our highest conviction remains in the technology sector. Looking ahead over the next several years, we see a number of disruptive industry trends (i.e. 5G, artificial intelligence, robotics and autonomous driving) that we are looking to include in our investment models. While we like the long-term outlook for the technology sector, it's important to keep in mind that we will always remain somewhat diversified in our investment portfolios.

Summary

The trade concerns with China have not gone away and remain an important factor for investors and the markets. Commentary from the Trump Administration over the past few months indicated

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that trade negotiations were progressing and that odds of a deal were rising. We still believe a trade deal with China is possible and we are likely to hear more from both sides in coming weeks. If the United States slaps a 25% tariff on all exports from China for a sustained period of time (and China retaliates), this could have a negative impact on U.S. economic growth, corporate profits and global financial markets.

Over the past several months (from the fourth quarter of 2018 through the first quarter of this year) financial markets moved from a risk-off to a risk-on environment. Heading into 2019, investors faced a number of concerns ranging from a possible recession, additional rate hikes by the U.S. central bank, a trade war with China and a slowdown in growth. Addressing this list of concerns: 1) in January the Federal Reserve Bank stated that they plan to remain on hold for the remainder of this year; 2) based on recent data, a recession (to us) seems like a low probability event this year and 3) the U.S. economy has clearly slowed but still appears likely to generate moderate growth in 2019.

For now, we continue to keep an eye on business fundamentals that include economic data like GDP, corporate profits, interest rates, inflation and Fed policy. To us, the economy is neither too hot nor too cold right now. We are also keeping an eye on the health of the U.S. consumer, which represents about two thirds of the U.S. economy. Despite the length of the current expansion (currently the second longest in the post WWII period), we continue to expect a period of moderate growth ahead. Equity market valuation levels are no longer cheap and the boost from recent tax cuts are likely behind us. While a recession does not seem imminent, we may have to prepare for some additional volatility as we go through the next several months.

As always, we welcome any comments you may have.

Respectfully,

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VIX Volatility Index – The VIX Index is a gauge of equity market volatility.

RDM Financial Group

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