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Charting a Middle Course Between Uncertainty and Hope

On a recent trip to London, I had the opportunity to observe history in the making as Britain and its Parliament debated momentous changes to the U.K.'s relationship with the European Union (E.U.). From the outset of the Brexit debate in 2016, the proposed separation of the U.K. from the legal, political, and economic structures of the European union have held potentially significant repercussions for the British and European economies. Indeed, Brexit holds deep implications for economies around the world as well, including our own. As the formal deadline for the separation approaches on October 31st, it is worthwhile reviewing Brexit's significance to investors.

In addition to Brexit, it is also important to review the other macro issues that have weighed on investors for many months and contributed to the stock market's still unfolding correction. These issues include the potential U.S./China trade war, the USMCA agreement set to replace NAFTA, and the global economic slowdown that is increasingly the focus of news-flow.

Examining big picture trends and developments offers insights into the potential impact they could have on our investments, and the emotions they can create in the minds of investors. Emotions can often be counterproductive when making buy or sell decisions. The phrase "fear and greed" comes to mind. Yet, less dramatic sentiments like hope and uncertainty characterize investor psychology at the moment. Emotions are often based less on tangible facts and more on imaginary speculation. Emotions can easily lead investors astray.

While the market's sense of uncertainty has come from concerns about global trade frictions, foreign relations impasses, and economic slowdowns, its high valuations, on the other hand, continue to indicate that investors are hopeful about future corporate earnings prospects and equity returns. When viewed side by side, these two sentiments, hope and uncertainty, offer a glimpse into investor psychology that is worth noting for what it says about the market's current risk level. Because investors are simultaneously hopeful and uncertain they are also more prone to disappointments in the near-term if the macro issues that worry them actually materialize.

The middle course between these polar sentiments is reason and a reliance on what we can know with some degree of certainty.

Against that backdrop, I reiterate my belief that the now decade-long 2009 bull market is alive and well, despite the ongoing 2018-2019 correction. Barring shocks from macro-economic issues, I would expect the stock market to resume its upward climb once valuations have further "corrected" to more normal levels. Overall, the environment remains favorable for the bull market. The factors that give me a degree of confidence are:

1) the continuing strength of consumer sentiment;
2) the continuing rise in leading economic indicators;
3) the positive growth we still see in the global economy, including ours;
4) the cautious investor sentiment that continues to be present, a long-term bullish signal;
5) the continued health of corporate profits growth in the U.S.; and
6) the low levels of U.S. interest rates.

A review of global macro-economic events now playing out, illuminates what is at stake.

Brexit Update

In 2016 the Brexit referendum produced a 52% to 48% split in favor of Britain leaving the E.U. That was considered a clear signal of the people's intent until many voters began complaining that they did not realize they were participating in a *binding* referendum that would compel the government to take action, or they did not understand the referendum's full implications.

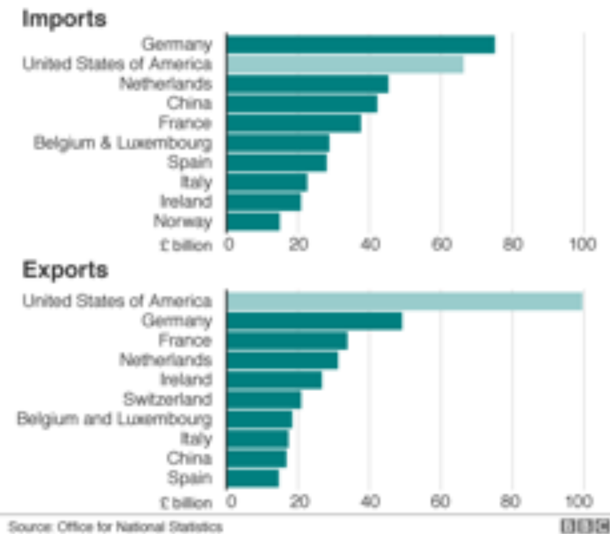
To-date it is unclear exactly what kind of Brexit we will ultimately see, or if we will see Brexit at all. Brexit has been a contentious and muddled issue among the people from the start. With no clear-cut deal, many Britons are now calling for a second Brexit referendum that would allow them to more clearly express their intent. The risk, of course, is that a second referendum might only muddy the waters further and lead to no more clarity on the people's will than we already have.

Against that backdrop of ambiguity, for some months, the British Parliament has been debating Prime Minister Theresa May's Brexit proposals on what has popularly come to be called "the divorce agreement", the final terms of a split from the E.U. Much to the chagrin of parliamentarians and of the prime minister herself, there has been a lack of consensus on how to implement the break. May's Brexit plans were rejected three times by Parliament, prompting members of parliament (MPs) to complain that Britain is now in a national crisis of historic proportions. They may very well be right.

Without a proper and well-planned exit deal with the E.U., Britain, the fifth largest economy in the world, stands to potentially undergo a "hard Brexit" in which all ties with the E.U. will be severed abruptly on the designated date of the country's departure from the union. Every economic, legal, and political aspect of British-E.U. relations could then be thrown into uncertainty and confusion.

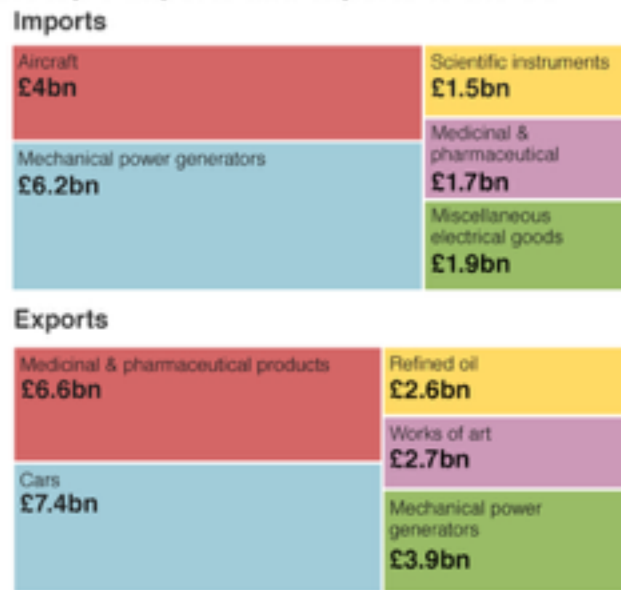
A hard Brexit has the potential to push the British economy into a recession by cutting off the free flow of goods and services between the U.K. and the continent. It has the potential to throw into question the status of E.U. citizens working in Britain, and of U.K. citizens working in the E.U., the question being whether or not they now have the right to work in their respective jobs wherever those jobs may be. And, among many other things, it has the potential to disrupt taxation arrangements between the U.K. and the E.U., creating further opacity over trade and business.

A major factor preventing consensus among MPs and complicating the adoption of a final Brexit agreement in Parliament is that a hard Brexit would leave the border between Northern Ireland, which is a part of the United Kingdom, potentially subject to border controls and tariffs with the Republic of Ireland, which is a staunch member of the E.U. Considering Northern Ireland's tragic history of sectarian violence that has been resolved and calmed only in recent decades, partly because of free trade between the north and the Republic, this would be a situation fraught with peril for the Irish people, and would threaten Northern Ireland's union with the rest of the U.K. Scotland, which like Northern Ireland overwhelmingly voted to stay in the E.U., may find itself again pondering full independence from the U.K. as it did in a 2014 referendum that garnered a 44% vote in favor of independence. A hard Brexit is fraught with dangers for the United Kingdom.



A hard Brexit has global implications as well. With economies around the world now more interconnected than ever, a hard Brexit will almost certainly affect GDP growth in other countries and regions beyond the U.K. and the E.U. Focusing just on the U.K./U.S. relationship, in 2016, the year of the Brexit referendum, the U.K. imported about £65 billion ($85 billion by recent exchange rates) worth of goods from the United States, its second largest import partner after Germany, while it exported almost £100 billion ($130 billion) worth of goods to the U.S., its largest single-country export market. The U.K., on the other hand, is America's seventh largest trading partner by imports and the fifth by exports.

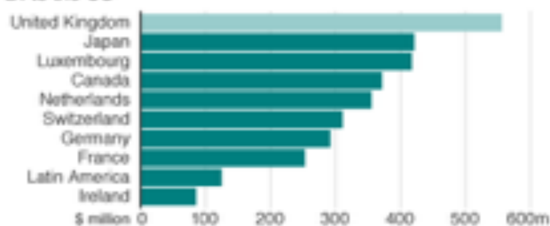
But the U.K./U.S. economic relationship extends further, into what economists call foreign direct investments (FDI). These are money flows from one country to another for the purpose of investing directly in companies, factories, real estate, and various projects and purposes that count as investments rather than as the trading of goods and services. In this category, the U.K. is the largest FDI partner for the U.S., investing about $550 billion into the U.S. economy. This is more than the $410 billion or so that the world's third largest economy, Japan, commits to the U.S. In the opposite direction, the U.S. is the U.K.'s second largest source of FDIs at roughly $650 billion, just behind the Netherlands' $850 billion range. These relationships highlight the importance of Brexit for both American corporations and American investors. There are substantial money flows at risk from a Brexit-induced U.K. recession and the resulting pullback in trade and foreign direct investment that will inevitably occur.



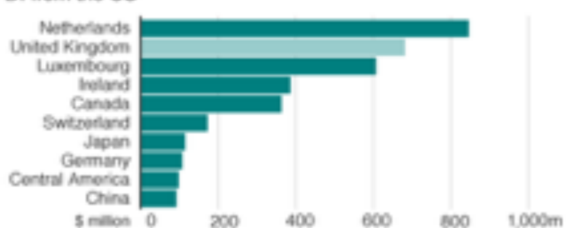
Source: Office for National Statistics

Foreign direct investment in the US

FDI to the US



FDI from the US



Source: US Bureau of Economic Analysis

<u>Other Macro-Economic Events Creating Uncertainty in the Markets</u>

As dramatic and as consequential as Brexit may be to the global economy, including that of the U.S., it is only one of several factors in the international arena that could potentially lower the U.S. GDP growth rate and affect the U.S. stock market, should they occur. As investors face these factors they continue to build a wall of uncertainty.

China Tariffs - The eight hundred-pound gorilla in the minds of many investors remains our trade skirmish with China. If the skirmish escalates into a full-blown trade war, it will have a further direct impact on U.S. economic growth.

Many of America's larger companies have been reporting for some months that disruptions to their markets and supply chains, and the uncertainty that goes with ongoing trade skirmishes, have reduced their earnings. A recent American Chamber of Commerce survey of American companies doing business in China found that 80% of those companies said they had suffered because of U.S. tariffs that are already in place on the roughly $200 billion of Chinese goods the U.S. Administration has sanctioned. Offsetting this, many companies have also been reporting that the detrimental effects of the U.S./China trade skirmishes have been reduced by the substantial tax cuts that corporations received from the Tax Cuts and Jobs Act of 2017 where the statutory tax rate dropped from 35% to 21% for corporations. The net effect so far has been that corporate earnings overall have been stable.

The risk is that an escalation in trade tensions will produce international markets that effectively exclude certain products or product classes, or are subject to substantial and disruptive tariffs and quotas. Closed or limited export markets could more seriously harm corporate profits and stock prices. As with Brexit, here too the lack of clarity has given pause to investors as the world's largest and second largest economies, the U.S. and China, continue to hammer out a new trading relationship.

U.S.-Mexico-Canada Agreement - Much less in the public eye, albeit another point of investor uncertainty that bears watching, is the Trump Administration's replacement of the 25 year-old North America Free Trade Agreement (NAFTA) with the U.S.-Mexico-Canada Agreement, or USMCA. So far, the weight of public commentary seems to lean on the side that says the deal offers little advantage to the U.S. over NAFTA, and may in fact offer some disadvantages, including the potential to raise prices on finished goods such as automobiles imported from Canada and Mexico - the USMCA may impose tariffs on those vehicles. The non-partisan United States International Trade Commission is due to present a full report to Congress in the coming weeks detailing their assessment of USMCA and its impact on the economy. That report may offer investors the clarity they seek on this issue.

Global Economic Slowdown - The markets are also concerned about the slowing pace of economic growth, in Europe, China, the United States, and beyond. The International Monetary Fund (IMF) predicts that global GDP growth will decline from last year's 3.6% to 3.3% this year. In light of the disruptions to global trade brought about by the U.S./China dispute, as well as Brexit's anticipatory effects on companies domiciled or operating in the U.K. and the E.U., a global economic slowdown should not come as a surprise. The global economy is more interconnected than it ever has been - a disruption in one or more spots can affect the whole.

The Overall Effect - Investment analysts often talk about "visibility", meaning conditions that allow them to more clearly see the earnings potential of companies and industries into the future.

The sum total of the uncertainties created by Brexit, U.S./China tariffs, the USMCA, and slower global economic growth is to create an environment where there is less visibility, and therefore, more uncertainty. Uncertain times inevitably discourage investors from taking risks, and instead bid them to take cover in safer assets such as treasury securities or cash.

While macro issues are always worthy of our attention for their potential impact on corporate earnings, they do not necessarily impact stock prices in ways that precisely match our expectations and scenarios. Anyone who has spent time trying to anticipate the direction of the stock market on the basis of macro events alone, knows that on any given issue, there may be several potential outcomes that make precise prognostication difficult.

High Valuations Signal High Expectations and Hope

Valuations, on the other hand, have greater immediate and practical use to investors as they offer clues into the psychology that drives the stock market during any given timeframe.

Since the bottom of the stock market in March 2009, valuations have been rising steadily to the point where they are now well above their historical averages. That is true for many individual stocks, as well as the S&P 500 Index, which is a measure of the broad market. Currently the S&P's Price-to-Earnings ratio stands at 22, well above its long-term average of 15. Other measures of valuation are similarly stretched. These substantial valuation gaps are a reasonably reliable signal that investors expect corporate earnings to rise substantially in the foreseeable future and that current share prices are worth paying in order to receive those future earnings streams. I see it differently.

High valuations are a sign of hope and high expectations among investors. From long experience I can say with some confidence that overvalued markets can persist for long periods of time. They do not necessarily signal the end of a bull market, but they should be treated with caution the higher they rise. The opposite of high expectations and hope is disappointment, and disappointment can easily lead to selloffs that lower portfolio values. That is the great risk with markets that trade at stretched valuations.

The Positive Case for the Bull Market

While stock market valuations remain higher than I would like to see then, and while I believe the market will continue in correction mode for some months, if not longer, I also believe that the 2009 bull market is still intact. As evidence, I offer updates on the six reasonably reliable factors that I mentioned at the start of this letter.

Consumer sentiment remains positive - In March, the Conference Board's Consumer Confidence Index increased to 124.1 from January's 121.7. The Board indicated that "Confidence has been somewhat volatile over the past few months, as consumers have had to weather volatility in the financial markets, a partial government shutdown and a very weak February jobs report. De-

spite these dynamics, consumers remain confident that the economy will continue expanding in the near term."

Leading economic indicators are still flashing expansion, albeit at a slower rate - The Conference Board's most recent report states: "The Conference Board Leading Economic Index (LEI) for the U.S. increased 0.2 percent in February to 111.5 (2016 = 100)." The Board stated that "The US LEI increased in February for the first time in five months…February's improvement was driven by accommodative financial conditions and a rebound in stock prices…"

Global growth and growth in the U.S. are expected to stay positive - The International Monetary Fund expects global GDP growth to be 3.3% in 2019 and 3.6% in 2020. While these are slightly lower estimates than the IMF had been predicting just a few months ago, they are nevertheless very strong numbers that indicate continued economic expansion. The IMF expects U.S. GDP to rise by 2.3% this year and 1.9% next year. They see Chinese GDP growing at 6.3% and 6.1% in the same time periods. While they see growth globally, they have been saying for some time that they also see rising risks to worldwide GDP growth, most notably from U.S./China tariffs and from a hard Brexit. They also see risk from the high debt levels carried by both the public and private sectors around the world.

Investor sentiment continues to be cautious – Somewhat counter-intuitively, cautious sentiment is often a longer-term bullish sign for stocks, hinting at the possibility that any positive news flow could prompt investors to move their cash reserves into stocks. However, sentiment is a trickier factor to gauge with precision than hard variables like GDP growth. It requires more of a gut feel and anecdotal evidence rather than the pinpoint-accuracy that a statistical indicator can provide.

Investor caution can be seen in the stock market's broad sideways movement since the correction started in early 2018 (please see S&P price chart below). Reading the financial press, the number of bearish articles is still high, and that is another potentially bullish signal. If we look at the CBOE's Put/Call ratio for something more mathematically based, we can see that the ratio now stands at 0.98, indicating something of a balance between puts (bearish sentiment) and calls (bullish sentiment). Yet, as recently as December 2018 it stood at 1.82, the most bearish reading in 23 years. Overall, negative investor sentiment is a good prerequisite for a bull market. Another prerequisite is reasonable valuation levels. While valuations are still high as hope continues to outweigh the rising level of caution in the minds of investors, valuations are in fact slowly trending down (please see P/E chart below).

Cboe Total Options Volume - Put/Call Ratios

Dates with the Highest and Lowest Put/Call Ratios

During the Period from Sept. 27, 1995 through Dec. 20, 2018

	Highest P/C Ratios			Lowest P/C Ratios	
1	20-Dec-2018	1.82	1	26-Dec-1997	0.30
2	27-Feb-2007	1.70	2	16-Mar-2006	0.32
3	21-Aug-2015	1.69	3	7-Apr-2000	0.37
4	5-Mar-2007	1.67	4	23-Feb-2000	0.37
5	14-Mar-2007	1.66	5	14-Jul-2000	0.38
6	23-Mar-2018	1.54	6	9-Mar-2000	0.38
7	26-Jul-2007	1.53	7	12-Jul-2000	0.39
8	16-Aug-2007	1.53	8	10-Mar-2000	0.39
9	17-Jan-2008	1.53	9	8-Jun-2000	0.40
10	20-May-2010	1.53	10	3-Mar-2000	0.40

Source: Cboe Exchange, Inc. The ratios are based on preliminary reported volume or on cleared volume. www.cboe.com/data

***Interest rates are still favorable, and corporate earnings are still expected to grow* -** For now the Federal Reserve seems willing to keep interest rates exactly where they have been for the past few months, in a range between 2.25% to 2.5%. That pause in rate hikes is welcome news for equity investors as it benefits corporate earnings growth. Earnings estimates compiled by FactSet Research indicate that Wall Street analysts expect S&P 500 profits to grow by 3.6% in 2019, while sales are expected to grow by 4.9%. Last year's actual earnings and sales growth rates for the S&P were 20% and 8%, respectively. They were aided by the 2017 corporate tax cuts. This year's figures appear less impressive, yet when viewed in the context of a long economic cycle that started ten years ago, they should be seen as welcome news.

Charting a Middle Course Between Uncertainty and Hope

At any given point in time, investors face a host of unknowns and risks. It is the very speculative nature of the markets that offers us not just risks, but also opportunities and rewards over time. It is important to acknowledge the risks, and to identify the opportunities on the basis of what we know and what we can count on in reasonable measure.

My analysis, which is based on what we reasonably know, suggests that the current stock market correction will play out through much of 2019, and possibly longer. Higher-than-average market valuations may continue to revert further toward their historical average levels as company earnings unfold throughout the year, and as complicated macro issues play out one by one, offering investors more clarity.

In the midst of uncertainty and hope, charting a middle course between these polar sentiments seems the most prudent path forward. Macro issues, high valuations, and market corrections will come and go. Staying true to what the economic and corporate evidence shows us as the year progresses is the best strategy for balancing risks on the one hand, with opportunities and rewards on the other.

S&P 500 Price Chart

S&P 500 Price-to-Earnings Ratio (Source: macrotrends.net)

Disclosures

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