Waterstone Advisors, LLC
10 Brook Street, Walpole MA 02081
Tel. 978-828-2188
vha@waterstoneadvisorsllc.com
www.waterstoneadvisorsllc.com

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Political Risk Enters, Stage Right!

Impeachment is Dramatic, but Earnings Drive the Markets

Politics rarely ranks as one of the most important things investment advisors consider when making buy or sell decisions for their clients, except perhaps once every four years when the country chooses a new president. The rest of the time we typically concern ourselves with mundane economic observations, industry developments, and with corporate earnings. These are the typical drivers of stock prices. Occasionally we give some thought to tariffs and overseas events such as Brexit, but that's about as exotic as our thinking normally gets.

Yet, in the last few weeks we have had a new factor to consider, the possible impeachment of a U.S. president and what that might mean for the markets. Political risk has now entered the investment stage with all the flourish of a Shakespearean character that's sure to engage the audience as the drama unfolds.

Since presidential impeachments are rare events, with only three examples in all of U.S. history, we can only speculate how the story of the current impeachment inquiry will unfold and what it might mean for portfolios. Impeachment adds to the air of uncertainty that has been hanging over markets since the introduction of tariffs on Chinese products last year. It is one more factor to consider when making investment decisions.

Impeachment is Dramatic and Highlights a New Short-term Factor: Political Risk

Only three times in the 243 years of the Republic's existence has a president been impeached. The first was Andrew Johnson in 1868, the second, Richard Nixon in 1973, and the third was Bill Clinton in 1998. In none of these cases was the president actually convicted by the Senate as charged by the House of Representatives. A conviction would have resulted in the president's removal from office. In Johnson's case the senate fell one vote short of conviction, while Clinton was bolstered by a Democrat-controlled senate that voted not to convict. Nixon, on the other hand, resigned before he could be convicted and removed.

How did the stock market react each time and what conclusions, if any, can we draw from these few examples?

The short answer is that, in each case the stock market ultimately did what you might expect it to do if impeachment were viewed as an economic factor, like GDP growth or industrial production. Impeachment amplified whatever the existing economic condition of the country was, and pushed the stock market in the direction in which it was already headed prior to impeachment. In other words, it was not a trend changer for the stock market.

Looking back at the impact of Johnson's impeachment, in 1868, there was not yet a Dow Jones Industrial Average (1896), or an S&P 500 Index (1957), both of which are bellwethers of the American stock market. Financial data for that time period are not readily available, but according to a recent article in U.S. News and World Report "The inquiry into Johnson began Feb. 24, 1868, and markets fell 0.3% by March 31 of that year. By the end of June, following Johnson's acquittal in the Senate, markets were up only 1.5% from their late February levels, according to figures from Global Financial Data." The markets did not move much during the impeachment's brief timeframe. Perhaps that was due to the fact that the American economy was still recovering from the devastating effects of the Civil War which had ended only three years earlier, and Johnson's impeachment was small by comparison to economic and social concerns.

In Nixon's case in 1973 to 1974, the economy had been in a recession since November 1973. The stock market had begun falling months prior to impeachment and kept declining until after Nixon's resignation in August 1974. In the following year, 1975, after the end of the recession, the stock market saw a 37% rise post-impeachment, having fallen about 50% previously.

And in Bill Clinton's case the dot-com bubble overshadowed everything, including his impeachment proceedings from October 1998 to February 1999. The stock market's focus was on the ascent of the technology sector, and no amount of political distraction was going to change that to the negative. It was the era that then Fed Chairman Alan Greenspan famously dubbed a time of "irrational exuberance".

The Backdrop to Impeachment 2019: A Slowing Economy and Declining Corporate Earnings

So, if impeachment proceedings are likely to magnify existing economic and market conditions, what are the current circumstances we can expect to see more of?

For the better part of a year, the U.S. economy has been slowing as tariffs and trade uncertainties have prompted CEOs to pare back capital investments. While the economy still enjoys strong consumer spending, rising wages, historically low unemployment, low interest rates, and low inflation, and leading economic indicators continue to signal expansion, other key measures of economic activity are weakening beneath the surface, and deserve our attention.

Nationally, housing prices have been rising this year, but at a slower pace than last year. The S&P/Case-Shiller 20-City Composite Home Price Index registered a 6% increase in 2018, while the rate has fallen to about 2% at present. Zillow reports a similar trend, with housing prices growing by 4.8% over the last year, but expected to grow by 2.8% in the next 12 months. And perhaps most dramatically, apartment prices in Manhattan are reported to have fallen by 14% this year, partly from a loss of income tax deductions from the 2017 tax legislation on high priced real estate, and partly from the absence of Chinese buyers who appear to be staying away due to trade, immigration, and capital flow uncertainties. The Financial Times estimates that Chinese buyers invested $39 billion into Manhattan real estate in 2016, $42 billion in 2017, but only about $15 billion in 2018. This year's figure is likely to be considerably lower than last year's.

The Institute for Supply Management's (ISM) report, indicated that the Purchasing Managers Index (PMI) that measures manufacturing activity across the nation, fell to a level of 47.8% in September, that is down from 59.8% in September of 2018, indicating a substantial slowdown in manufacturing activity over the course of a year. Corporate respondents to the PMI survey noted that China tariffs were continuing to have a cooling effect on their industries by injecting both higher costs and higher uncertainties, making planning and capital deployment difficult for companies across the board. The cutting of supply chains for individual companies has also had a dampening effect on business activity. And to-date, it does not appear to be the case that corporations are passing on higher tariff-induced costs to consumers. If they do, we can expect to see a slowdown in consumer spending.

The one figure that effectively sums up economic activity and economic growth or decline is gross domestic product, GDP. Since the end of the Great Recession roughly nine years ago, inflation adjusted real GDP growth has averaged 2.3% per year. For the past three years, it has been 2.4% in 2017, 2.9% in 2018, and is expected to end at about 2% this year. This quarter it is anticipated to register at 1.8% on an annualized basis, a marked deceleration from the longer-term averages. That may not be too surprising considering the anecdotal evidence from major corporations regarding tariffs, severed supply chains, and policy uncertainties from Washington.

In further evidence of a general economic slowdown, Factset Research projects that corporate earnings growth in the third quarter will be negative -4.6% once all S&P 500 companies report their results in a few weeks' time. This will continue a trend that has been in place for the last three quarters where corporate earnings growth has been declining. This "earnings recession" is not unusual, except it comes, counterintuitively, at a time when corporate tax rates have been slashed dramatically and consumer spending is healthy. The trade and supply chain disruptions that companies have been reporting for over a year are now weighing negatively on corporate activities and profitability.

The U.S. Treasury market has also been signaling possible economic weakness ahead. For much of this year, short-term interest rates have been higher than long-term interest rates, in an "inverted yield curve". Historically, inverted yield curves are seen as a signal that a recession might occur in the months ahead. In recent weeks, the yield curve has reverted to its normal upward sloping trajectory and some investment strategists have taken that as a signal that a recession is now unlikely in 2020 or 2021. I disagree with this view. It is normal for an inverted yield curve to right itself after some time, and to still be a valid signal of a recession down the road. From my point of view rather than saying "this time it's different", the more prudent approach would be to heed the inverted yield curve's warnings and to position portfolios to weather a possible recession and the stock market downturn that may accompany it.

The Long-term Bull Market Remains Intact Despite a Potential Recession

In my conversations with clients and friends, one question pops up from time to time: how can I say that we are still in a bull market and also say that stocks are heading down or sideways, *and* that a recession is a possibility? Doesn't a bull market mean that stocks are going up and the economy is healthy?

This is where we have to make a distinction between the short-term and the long-term. The accepted definition of a bull market is a stock market that moves up *over time*. The timeframe is typically years, rather than months. During that period, actual recessions can and do occur as they did during the bull markets of the 1940s and the 1950s. Moreover, during bull markets the *possibility* of a recession can also crop up as a concern for investors. Since March 2009 the U.S. stock market has been in a bull market uptrend. It is this long-term trend that I expect will continue for some time, despite the potential for a recession on the horizon.

In shorter timeframes, the stock market can move down or even sideways as it "corrects" within the longer-term bullish trend. "Correction" is a technical term usually implying that the stock market rose too far above its mean and had to pull back in order to be more in-line with its historical average. "Correction" can be used to talk about stock market valuations in addition to stock prices, so that when valuation measures such as price-to-earnings (P/E) or price-to-sales (P/S) get too high, we would expect them to "correct" closer to their historical levels. If valuations or prices decline below historical averages, stocks can be said to be oversold (a technical term), or cheap (a fundamental term). In either case, they might signal good buying opportunities from a value and price standpoint.

Corrections are good for the long-term performance of the stock markets. They allow the frothiness of the markets to dissipate and for important fundamental factors such as sales, earnings, and profit margins to have a greater effect on share prices compared to investor sentiment. Sentiment is much more volatile and can lead the markets to unreasonably high valuations and prices, both of which may have little basis in the fundamental business conditions of underlying companies.

The Long Game

As the impeachment drama unfolds in the coming weeks or months, we can expect to see greater volatility in the stock market, including volatility to the downside. Impeachment is an unsettling process for the nation and the contentiousness we are likely to witness for weeks on end will inject further uncertainty into an already uncertain business climate and stock market.

Since January 2018, the Dow Jones and the S&P 500 have essentially been treading water in a sideways movement as investors have waited for the tariffs and trade issues to be resolved. Impeachment adds a new risk factor that investors have to consider and is likely to push the markets in the direction in which they have been traveling since the start of 2018: sideways-to-down.

Nevertheless, barring significant changes in economic, legislative, or political factors that would negatively impact corporate profitability, I believe the longer-term 2009 bull market remains intact and is likely to take share prices higher over time once the current correction has run its course. My view for this long-term outlook is supported by several factors, among which are:

- **Removal of political risk and policy uncertainty.** The eventual resolution of both the impeachment process and trade policy uncertainties could go a long way to boosting sentiment and confidence among corporate CEOs by allowing them to more confidently make big capital deployment and strategic planning decisions for their companies. And as sentiment tends to be contagious, investors will take their cues from CEOs and will view stocks more positively.

- **The consumer is still strong**. Unemployment is at 3.5%, a 50-year low, and household debt-to-income levels have declined from about 13.25% to roughly 9.5% over the past ten years as individuals and families have deleveraged. Both unemployment and lower personal debt levels are positive underpinnings to consumer spending which accounts for almost 70% of U.S. economic activity.

- **Interest rates and inflation** are both positive for long-term growth. The 2% Fed Funds rate and inflation rate of 1.7% support continued economic expansion. In the near-term, the Fed may cut interest rates further if the U.S. economy slows.

- **The dollar and the U.S. stock market** are still attractive for much of the world's investors. The number of troubled places around the world where economic and/or political factors make for unattractive investing is fairly high now. Economic growth in Europe and China are either weak or declining. Japanese GDP growth is decelerating, and Russia's political fickleness makes it unreliable from either a stock market or direct investment standpoint. The U.S. dollar faces challenges to its primacy as the world's most popular reserve currency, but for the moment alternative currencies are generally unattractive for investment or trade.

- **Corporate earnings growth** has been flat for the better part of 10 years, perhaps because of consumer deleveraging. In the future, earnings have plenty of room to run up at a faster clip. Corporate tax rates in the U.S. are now low by historical measures and may boost corporate profitability over time. The regulatory environment has also gotten more favorable toward companies and their ability to create profits.

- **Stock market valuations** are still high by historical measures, but have come down and may be heading lower. Lower share valuations will make stock ownership more attractive. Patient watching could pay off. This is one of the reasons I have been advising a go-slow approach to deploying cash into the stock market for some time. Buying into an overvalued market is a risky proposition and can be antithetical to successful investing.

Whatever the effects of political risk may ultimately be, keeping our eyes on the long game will substantially help us to put impeachment into its proper place within the stock market's long continuum, and will see us through the present uncertainty.

V. Henry Astarjian