MARKET COMMENTARY

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Wildermuth WEALTH

Market Strong but Slowing Earnings Growth May Signal More Coming Challenges

The first seven months of 2019 have been very generous to U.S. and global equity investors, providing gains that have sent many large capitalization indexes to new highs while setting records for the pace of increases along the way. The highs come despite a slowing economy that has prompted Fed promises of rate cuts to offset global economic weakness.

Still, with about 45% of companies reporting earnings through July 26th, over three quarters of the companies show earnings higher than original estimates, which helped push markets even higher. While earnings are frequently above estimates given analysts' regularly conservative outlook, the latest positive round of earnings reports encouraged investors worried about shrinking profits and the pace of slowdown. Yet, the good news only slows the earnings contraction to an estimated 2.6% from the original 3% decline expected, and recent earnings improvements may not buoy investor enthusiasm about U.S. equity markets longer term.

With the global slowdown, increasing tariffs, and ongoing trade tensions, earnings for the S&P 500 are projected to increase only 1.7% on the full year compared to expectations of 3% only a month ago. Investors already appear to have priced in lower U.S. interest rates, and the Fed's ability to impact the economy through easing rates is limited given already low rates. Beyond the U.S., central banks face even more difficult prospects with some economies already at negative interest rates.

Beyond earnings, second quarter real GDP growth slowed to 2.1%, which reinforces claims of a potential slowdown, but growth was better than the original 1.8% consensus estimate. Consumer consumption and government spending were both better than expected. Strong June retail sales helped and provided a welcome change to first quarter's anemic numbers.

Daniel Wildermuth
CEO of Wildermuth Advisory, LLC

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Unfortunately, the trends do not appear to favor strong future growth. The growth in consumption and government spending both appear to result from the rebound from the first quarter government shutdown rather than a sustainable shift. Government spending will likely fall even more because the growth largely resulted from a deflator for federal nondefense spending.

Since this is likely to reverse later in the year, growth figures were probably shifted forward.

Unfortunately, fixed business investment seems unlikely to offset expected second half consumer and government spending weakness. Business investment was weak in first quarter and worse in second quarter. Still, after months of weakness, orders were stronger in June. Since weak business-fixed investment is the economy's primary vulnerability, the June report might indicate that the economy is not as vulnerable as it appeared a month ago. If so, weak GDP estimates could be revised up a bit.

With the economic expansion beyond the 10-year mark, only now is job creation slowing down which likely signals the elimination of labor slack. As employment market slack disappears, job growth slows, the employment rate reaches full-employment levels, and wage growth steadies at rates consistent with productivity growth. Historically, when these three events occur, it has signaled the end of a recovery. Still, while growth often slows at this point, this does not mean that a recession is imminent as economies can continue growing at full employment levels for extended time periods.

These and other factors are pushing the recession discussion forward. Global weakness, particularly in powerhouses China and Germany, also are stoking global concerns. The notable economist, Gary Shilling, who has predicted several recessions over the past 40-years, has stated that a recession might already be underway in the U.S. However, he notably follows up this statement by predicting that a downturn, if it occurs, would likely be fairly mild.

In another bearish sign, a growing number of money managers are embracing a strategy designed to benefit from problems with junk-bond loans, particularly those with extremely low credit ratings. The emergence of this particular collateralized loan obligation underscores inves-

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tors' concern over the health of corporate loans and a growing belief the U.S. economy is due for a slowdown and possible recession after more than a decade of expansion.

While growth worries increase, possibly the most concerning issue is equity market valuations. July's strong gains following the best first half of a year for the S&P 500 since 1997 have pushed U.S. stocks toward their richest valuations of the year. As of Friday the 27th, the S&P 500 traded at 17 times its earnings over the next 12 months, its highest level since late September of last year, just before the stock market's fourth-quarter selloff. That is above the 10-year average of nearly 15 times, according to FactSet.

While this measure is slightly elevated, its higher level is more concerning against the backdrop of two other broad issues. The first is the slower economic and earnings growth already mentioned. The second is the elevated level of the P/E 10, CAPE or Shiller PE ratio. This ratio was originally developed by legendary economist Benjamin Graham (famous partly because he was Warren Buffet's mentor) and popularized by Yale professor and Nobel laureate Robert Shiller.

To better understand current valuations against long-term trends, it divides current stock prices by multi-year earnings averages. In the short-term, the P/E10 tends to be a fairly poor predictor of stock market returns, but it has been much more accurate on a longer-term basis. When the ratio is higher, meaning the prices of stocks are higher relative to average earnings over the past 10 years, longer-term returns are normally muted. Conversely, low ratios usually offer an attractive buying opportunity.

Today, the P/E10 ratio sits at around 29-30, which is the 95th percentile. Only two bull markets have produced higher ratios – 1929 before the big crash and 1999 before the dot.com bust. Still, this may mean little in the short-term. The slowing economy is still growing, earnings are still increasing albeit at a slower pace, and many fundamental measures remain solid if not exciting. In addition, markets often continue at elevated or depressed levels for extended time periods due to many, many factors.

However, the elevated ratio suggests that U.S. stock market prospects in the longer term are more limited. While a recession still seems unlikely in the nearer term, much good news is already priced into stocks and finding good values in equity markets appears to be difficult. As a result, we are unenthusiastically neutral on stocks. Prospects for strong returns appear to be dimming with the global economy while the likelihood of a correction has risen along with prices.

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