MARKET COMMENTARY

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Wildermuth WEALTH

Turmoil Abounds While Markets March Higher

Investors always face uncertainty, yet an unusually high level of macro events are shaping global markets today. The U.S.-China trade war continues to dominate headlines, moving markets up and down as hopes for a resolution ebb and flow. The ongoing trade dispute is contributing to a slowdown in Chinese growth which dropped to a 27-year low in second quarter.

Slowing European economies, partially driven by trade restrictions, have prompted the European Central Bank to lower rates into negative territory. Europe's challenges are part of an ongoing slowdown in global growth and decline in manufacturing, even in the U.S.

An unresolved and seemingly directionless Brexit continues to inflict ongoing uncertainty on businesses and governments. As business confidence wilts amid the Brexit chaos, HIS Markit projects that the economy will shrink again in third quarter resulting in two consecutive contracting quarters, the definition of a recession.

As if not wanting to be outdone, the U.S. has decided to add to the chaos through starting an impeachment inquiry into President Trump. The Democrats' decision to embark on only the fourth impeachment effort in history in a hasty and unconventional manner will add to uncertainty in Washington now and the upcoming election.

With all these conflicts grabbing headlines, U.S.-Iran tensions and the suspected attack Iranian attack of Saudi Arabia have largely faded into the background. Wars impacting energy would normally be major news, but in today's environment, the story largely moved off the front page in a matter of hours.

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returns since 1926, rewarded investors this year with gains exceeding 3% (barring a meltdown on September 30th).

The market's strength could be interpreted as out-of-synch with broader economic trends given all the negative news, but investors appear reasonably confident that the longest post-war economic expansion will continue at least in the short-term. More specifically, investors appear to remain confident that corporate earnings, a primary driver of equity market returns, will remain solid despite various weakening global economic trends. Concerns about a near-term recession seem to have largely waned, and nearly all U.S. markets remain just below all-time highs.

While equity markets are driven by countless factors, most of them can be classified into the three broad categories of corporate earnings growth and expectations, interest rates and inflation, and equity market valuation levels. Investors continue to drive equity markets up based on solid corporate earnings and expectations for future increases. Ultra-low interest rates, which keep borrowing costs down while providing easy access to capital have contributed to corporate profits, and the Federal Reserve's implicit pledge to keep rates down all add to investor confidence that earnings will continue growing and avoid a recession that could hurt corporate earnings.

In reviewing the above challenges, any of them could severely impact markets, but some likely present a much greater threat than others. The U.S.-China trade war rightly receives much attention because of the impact it has on trade and economic growth, but the impact to date, while real, remains limited. Furthermore, President Trump has an election to consider—assuming he's not impeached. If the trade war starts to impact growth too much, resolution of key issues will likely arise while other challenges are shuffled into the future.

Slowing global growth is likely a bigger concern. Yet, this concern has existed since the financial meltdown of 2008, and again, this likely only slows U.S. growth rather than derailing it. Within this framework, Brexit likely has minimal impact on the U.S. Companies have been positioning for various outcomes since the March 2017 vote.

The Iran-US conflict or a Middle-Eastern war involving Iran and various oil states could have a much bigger impact. As a low-likelihood event, this is not factoring

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into investor considerations significantly, but a war or significant skirmish could be highly destabilizing because of the significant global impact on energy.

The most concerning issues for U.S. equity markets most likely revolves around politics. Normally, at this stage of an election cycle, the acting president plots to keep the economy as strong as possible given its historical impact on elections. As seemingly anything but a normal president, Trump continues to toy with a trade war as part of his negotiating strategy. Some would say his approach is admirable given its potential long-term economic benefits, but it almost certainly hurts his re-election prospects. It seems likely that Trump lessens the pressure in this area as the election draws closer.

The impeachment efforts are possibly much more destabilizing because of their election impact. To date, nearly all Democratic candidates have been spouting fairly bizarre economic policies that would be quite detrimental to economic growth. Yet, this is normal during primaries, and markets tend to ignore the rhetoric at this stage. Regardless, as long as the Senate and House are split, or a least Democrats do not secure a super-majority across both chambers, markets seem unlikely to become unhinged given the underlying strength of the economy.

Still, they can be significantly impacted. When Candidate Obama moved ahead of Candidate McCain leading up to the 2008 election, markets reacted sharply as fear rose regarding his progressive agenda and lack of attention to economics. While there were obviously many contributing factors to the sell-off that took the S&P500 down 57% from its high, the route continued while investors struggled to gain confidence in an administration far more concerned with health-care than the broader economy.

For now, it simply looks like the U.S. is in a slowdown rather than the beginning of a recession. The labor market remains solid and most indicators are weakening, but not disastrously. Barring a significant outside disruption, moving into a severe recession seems unlikely, at least before elections.

Possibly the biggest challenge may be the future growth of equity markets. Markets probably will not drop sharply without an unexpected jolt, but it is hard to identify any scenario that delivers strong equity returns over the next few years. Valuations, particularly when viewed against longer term averages, are simply too high and growth is slowing not accelerating. Given all these factors, we remain unenthusiastically neutral on U.S equities while projecting longer term returns well below the fantastic numbers generated during the last decade.

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