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WHAT A DIFFERENCE A YEAR MAKES

In an odd way, 2019 was almost the mirror image of 2018 in terms of stock prices and earnings. Corporate profits grew over 20% in 2018, thanks to the tax reforms and a strong economy, but despite the great earnings, stock returns were negative that year after a sharp fourth-quarter sell-off. Juxtapose this with 2019, when earnings growth was lackluster at best, but all the major U.S. stock indexes were up 20-30%. Earnings and stock prices are supposed to be linked together, so why did they move in opposite directions? During 2018, fears were building that a combination of overtightening by the Fed and an all-out trade war would trigger a recession. Those fears melted away during 2019. In addition to cutting interest rates three times, Fed Chairman Jerome Powell also signaled that future Fed Fund increases would be off the table, as long as inflation remains calm. On the trade front, the U.S. and China finally announced an initial trade agreement, with negotiations already underway for round two. Despite the underwhelming earnings picture, future risks appeared to be under control and bullish sentiment reigned as 2019 closed. Thanks to a 30% price increase, the index ended the year at a pricey 19.8 times trailing twelve-month earnings, up from 14.8 times estimated 2019 earnings at the start of the year.

What was the trend in earnings last year? As 2019 started, the consensus S&P 500 Index earnings estimate compiled by Zacks was $170, but by year's end that number had dropped 4% to $163. Most companies have not released their fourth-quarter earnings yet, so it is possible that strong holiday shopping will provide a final boost, but analysts aren't offering much hope for a Christmas miracle. The consensus forecast from Wall Street analysts indicate that fourth-quarter S&P 500 Index profits will barely beat the tepid third-quarter results. Year-over-year earnings gains are expected to be about 1%, not even beating the rate of inflation. Profit margins on reported earnings held above the long-term average, fluctuating around 9%, but aggregate revenue growth dropped from a peak near 10% in 2018 to only 2.5% by the third quarter of 2019.

The disconnect between the growth in profits and the gain in stock prices puts equity investors in an uncomfortable position. Many stocks have risen in anticipation of better earnings to come, which will need to come through. Even if the S&P 500 Index earnings per share does return to the long-term trend, price/earnings ratios might revert to their norm as well. Despite the risks, we believe that earnings will recover and that easy monetary policies will help.

STOCK PRICES ARE UP, WILL EARNINGS FOLLOW?

The year-ahead (2020) earnings outlook does not appear particularly buoyant now, but we believe there is room for upside surprises as the year progresses. The Zacks consensus for 2020 S&P 500 Index earnings was $172 on January 1, a 5.5% year-over-year increase. Note, however, that the $172 estimate is not terribly different from the $170 estimate for 2019 that was made back in 2018. If revenue growth remains sluggish, S&P 500 Index profit margins will have to recover to levels near the all-time high of 12% to hit that target. Looking within the various sectors, we believe this may be possible, but getting there may not be easy. Recent surveys of Chief Executives and Chief Financial Officers point to a cautious outlook for 2020 and corporate managers may choose to dampen expectations when they announce their quarterly results. Fortunately, the economy might be able to generate some upward momentum that could supply some much-needed support to 2020 revenues.

The U.S. manufacturing sector has taken the brunt of the tariff wars and the overall impact has been negative and broad based. While some industries have benefitted from the tariff pricing umbrella, a Federal Reserve study released at the end of last year indicated that the benefits that some industries received were more than offset by adverse effects elsewhere. According to the Tax Foundation, the dual impacts of lower exports due to retaliatory foreign tariffs and higher input prices here cost U.S. companies an estimated $90 billion and led to 400,000 fewer jobs in the economy. It isn't just the industrial Midwest that has been hard hit. The U.S. Chamber of Commerce estimates that half of all U.S. States have seen at least a quarter of their exports to the EU and China impacted by tariff issues. A thaw in the trade war could reverse some of these detrimental effects. The various tariff reductions already announced as part of the first phase of a new trade deal with China could save American consumers millions of dollars a year, which ought to result in additional sales and profits for U.S. corporations.

Another reason to hope for better earnings gains this year lies in the oil patch. The energy sector was one of the biggest drags on S&P 500 Index earnings over the last two years as the fracking boom and poor global economic growth led to a world-wide surplus in oil supply. Analysts are forecasting 40% year-over-year earnings decline when energy companies report their fourth-quarter results. Since October, however, the price of crude has rallied from the low $50/barrel area to around $60/barrel. Part of the reason may be unwelcome (a possible war with Iran), but prices are up, nonetheless. If crude prices can hold near current levels, then the energy sector ought to move from being dead last in profit growth among the eleven S&P 500 Index sectors.

Beyond faster earnings growth, as we mentioned in our last letter, we would also like to see an improvement in the quality of reported earnings. There has been a marked deterioration in quality the past few years, which could lead investors to question the wisdom of paying such high multiples of earnings. We will be examining fourth-quarter earnings reports carefully to see if a stronger economy has led to any improvement on the quality front. Better quality earnings could help support current valuations even if earnings growth remains tepid.

EASY MONEY

Policy makers, not only at the Federal Reserve, but also by the European Central Bank, the Bank of Japan and the People's Bank of China have each been easing aggressively. The ECB started another round of Quantitative Easing in November and on January 1, China cut the required reserve ratio for large banks to the lowest level since 2007. Japan has been in a Quantitative Easing mode for so long that the Bank of Japan now owns over half of all Japanese Government securities.

In retrospect, Fed officials probably erred in 2017 and 2018 when they raised the Fed Funds rate at the same time their balance sheet was shrinking. Each change has the effect of tightening monetary conditions and estimating the impact of either policy separately on the economy and the financial markets is hard enough. It was probably almost impossible in combination. In their attempt to "normalize" monetary policy, liquidity dried up in a corner of the short-term money markets during September, leading to a sharp spike in interbank rates. Perhaps it is no coincidence that the fourth-quarter 2018 stock market collapse followed shortly thereafter. In response, the Fed may be making the same mistake they made earlier, but in the opposite direction by lowering rates and expanding the balance sheet simultaneously. In an October speech, Chairman Powell sought to clarify the reasons behind the Fed's decision to add to its reserves. The Board does not view their decision as another round of Quantitative Easing. Rather, their goal only was to ensure that the repo markets had ample liquidity to function without frequent market interventions by the Fed. The amount of support that they believe is necessary to support the money markets is considerable, however.

In the fourth-quarter, the Fed's balance sheet grew by $400 billion, the fastest rate of expansion since the Financial Crisis, with total earning assets increasing at a 20% three-month annualized rate. While the added reserves appear to have had an insignificant impact on the real economy, it may have been a different story for the financial markets. Abundant flows of cheap money can have a powerful impact on investors. The rotation from safer assets to riskier ones tends to feed on itself, as those who missed the early stages of an advance jump on board. This adjustment period can continue for a long time, even after the kind of strong advances in stock prices that occurred last year.

Late stage market cycles carry additional levels of risk, however. Whenever investor optimism gets overheated, frequent short-term market corrections often follow. Given that stocks are selling at higher valuations, they provide less support during periods of market stress. Over the past decade, we have noted that trading has become increasingly influenced by the actions of high-frequency traders, algorithmic programs by quantitative investors and by the decisions of short-term focused hedge funds. Long, slow equity-market drawdowns now seem like quaint artifacts from a simpler time. When the twin supports of upward earnings and loose money remained in place, however, the longer-term bullish trend did eventually reassert itself.

GROWTH STOCKS STILL LEAD

Last year marked another year of outperformance for the high growth, high momentum stocks that have led this bull market for the past decade. Our Core approach is a blend of growth and value, so we do have some representation in this area of the market, but our valuation discipline has limited our exposure. We acknowledge that investors will always be willing to pay a premium to own faster growing companies, but a high-priced growth stock should be able to meet or exceed analysts' expectations. For most of this cycle, the glamour growth stocks have done just that. The slow pace of recovery from the Financial Crisis made growth difficult for many businesses, allowing the growth pack to run rings around them.. In retrospect, their results justified the premium valuation they enjoyed over more mundane companies. Historically, however, it has been dangerous to extrapolate earnings trends too far. Few corporations have been able to maintain their excess growth rates for as long as analysts forecast. Human nature suggests that people will gravitate toward whatever has recently done the best and there is always a desire to participate in an exciting new area of the economy. Whenever there is excessive crowding into one area, there is a greater risk of overpaying to participate. Evidence is growing that investor optimism may have pushed valuation differences too far.

First, the relative valuation differential between growth stocks and value stocks has rarely been as wide as now. This is not because value stocks are grossly mispriced. Relative to their own history, value companies are well within normal parameters. Growth companies, however, are selling at the very high end of their range. A Bank of America/Merrill Lynch study showed that the relative price/earnings gap between momentum stocks and value stocks is now a two standard deviation event. In the last 20 years, this has only happened twice. If the spread in relative earnings growth had widened, this might make sense, but the growth differential actually has narrowed. When this has occurred in the past, value stocks managed to outperform growth stocks by wide margins. We will be curious to see if this happens again.

SHIFTING TOWARD QUALITY IN BONDS

Although bonds should also benefit from easier monetary policies, currently we believe stocks offer a risk/reward tradeoff in the current environment. This conclusion is based partially on the low starting yields available in the bond market today and the amount of spread compression that occurred in the higher risk areas of the fixed-income markets during 2019. Overall corporate credit quality is not impressive and debt levels have risen. Much of the increase in corporate debt has been used to fund mergers and acquisitions, dividend increases and share buybacks, which has been a boon for the stock market. Using bonds to fund research, install new plant and equipment or improve operations has become less prevalent. Ironically, from a macroeconomic standpoint, the reluctance to expand capital spending may have prevented a classic overinvestment boom and bust cycle and lengthened the recovery. At the same time, continually leveraging balance sheets does increase the level of financial risks present in the economy.

At this juncture, we are particularly concerned about the lowest rung on the quality ladder, below investment grade paper. This is not an area of the market where we have traditionally invested, but we did add some exposure after the Financial Crisis when interest rates fell to extremely low levels. Interest rates have returned to the same low levels and we saw another rush by investors to grab any securities that offered above-average yields. We are not tempted to join them now. Today's yields may not accurately reflect the amount of risk being carried by investors, especially when many low-quality bank loans and bonds offer few meaningful covenants to protect lenders. Without strong covenants, lenders have less leverage over corporate managers to force restructurings or belt tightening. Lack of covenants may initially reduce the number of bonds getting into trouble, since fewer companies will experience a technical default (exceeding the terms of their covenants). At the same time, lenders may be lulled into a false sense of security and may end up being surprised when an issuer can't pay. Given the degree many balance sheets have been stretched, rates of recovery may fall below expectations when the next recession hits. At this point, the high-yield securities that we purchased earlier in the cycle are in run-off mode and we will be emphasizing higher quality bonds from this point forward.

A LITTLE MORE OPTIMISTIC, BUT ONLY A LITTLE

The financial environment today is unusual. Monetary policy is easy at a time when the labor market is rather tight. Growth has been slow, but steady, and inflation seems well controlled. Once again, the markets are relying on easier monetary policies to keep the expansion moving. This has been bullish for asset prices. Our Market Advisory Group has a history of being very sensitive to the risks of a potentially overheated financial environment. Historically, we have preferred to maintain a level of caution, even if stock prices continue to charge higher. We base our outlook on the most probable forecast, but with a keen eye toward risk management in case a lower probability event occurs. Therefore, we believe only modest bullishness away from neutral is the prudent position.

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