

MACRO AND EARNINGS NO WORSE THAN FEARED, BUT IS THIS RALLY JUSTIFIED?



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IN A NUTSHELL

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AN OCTOBER TREAT: STRONG EQUITY RALLY AS MACRO DATA ARE NO WORSE THAN FEARED

October was a treat for global equities as third quarter U.S. gross domestic product (GDP) and S&P 500 earnings per share (EPS) were no worse than feared and the threats of higher tariffs on China and Brexit uncertainties were pushed out to December. We think it is fair to characterize the U.S. economy as doing a bit better than feared with 1.9% GDP growth on healthy consumption and service job creation, despite contractions in non-residential investment spending and exports.

However, S&P 500 EPS, which are more sensitive to manufacturing, capital expenditures (capex) and trade will likely finalize at down 3% year-over-year (y/y) led by declines at sectors sensitive to those drivers. We remain concerned about the earnings outlook for those sectors and neither recent macro reports nor management outlooks suggest a visible upturn or reliable bottom in earnings at Energy, Materials, Industrials, or at many Consumer Durable Goods or Retailers. We found results and outlooks more encouraging at Technology, Health Care and the biggest U.S. banks. Our conclusion is that a less risk-averse stance is now warranted, but we struggle to find justification for rotating toward the troubled sectors. Thus, we look to reposition toward a more neutral stance on beta and value vs. growth, but little at our sector weights. We raise our S&P 500 2019 end target from 2850, which assumed high correction risk this autumn, to our full fair-value estimate of 3000, but maintain our "Next 5%+ Down" view as S&P 500 exceeds this fair value and risks still exist. We cut Utilities and Real Es-

tate Investment Trusts (REITs) to equal from overweight, add to our Health-Care overweight, and reduce our Industrials underweight.

TRIMMING 2020E S&P 500 EPS FROM 173 USD TO 170 USD, 4% GROWTH

Third quarter results and fourth quarter guidance confirm our 163 U.S. dollar (USD) full 2019E¹ S&P 500 EPS. This means that 2019 S&P 500 EPS will be up 0% vs. S&P 500 EPS delivered by index constituents in 2018 and up about 1% on a current constituent's basis. At the 2019 start, our 2019E S&P 500 EPS was 172 USD or up 5.5% and bottom-up consensus was 176 USD or up 8%. We cut our 2019E S&P 500 2019 nearly 9 USD through the year as new tariffs on China imports exacerbated the global slowdown. While tariffs are not the only factor to monitor, we would likely cut our 2020E S&P 500 EPS to about 165 USD if additional China tariffs are imposed or raise to about 175 USD if most of the current tariffs were removed. Our new 2020E S&P 500 EPS assumes no further tariff hikes or cuts until after the U.S. election.

FED FULLY DELIVERED ON ITS "INSURANCE" RATE CUTS: WHAT FROM HERE?

The U.S. Federal Reserve (Fed) opened the door to the notion of insurance federal-funds-rate cuts this summer as trade and global risks intensified. The Fed rightly argued it could afford this insurance given that inflation remained below its target. The Fed then delivered these insurance cuts in rather quick succession in July, September and October. The message now is that further cuts are unlikely

¹ estimate

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without further deterioration in the data, particularly the labor market. In our view, this means that a continuation of flat profits in 2020 might not be met with more cuts unless it affects jobs. In our view, this suggests continued caution on exposure to cyclically sensitive non-financial profits albeit perhaps a better outlook for owning big banks.

WE ARE SKEPTICAL ABOUT BEARISH U.S. DOLLAR VIEWS, BUT MAYBE A BIT SOFTER IN 2020

Provided the Fed stays on hold, we find it unlikely that the U.S. dollar materially weakens. The United States continues to prove itself resilient vs. global challenges and self-sufficient. U.S. nominal and real interest rate are the highest in the developed world. If the Fed cuts rates further in 2020 that likely comes with rising recession risks, which typically spurs a flight to safety and U.S. Treasuries despite lower U.S. interest rates. Thus, we see the dollar as well supported, but with material upside should global-macro conditions deteriorate and some small downside particularly vs. pound sterling (GBP) and euro (EUR) should the developed-world

economy demonstrate an ability to stop its deceleration in 2020. Without significant weakening of the dollar, we see limited upside to oil prices in 2020.

CYCLICAL VS. DEFENSIVE, FOREIGN VS. DOMESTIC, LARGE VS. SMALL, GROWTH VS. VALUE

These macro calls are very controversial right now and the cacophony of opinion amidst unclear real time data has us unwilling to take a strong view at this time. But given the uncertainty, we think it best to maintain at least some small tilt toward stronger regions, sectors, industries and stocks. We deemphasize rates of change or attempts to call a turn and rather we focus on where earnings growth is healthy now and where the valuations are reasonable. We acknowledge the need to be conscious of valuations at growth stocks, but we still find it hard to abandon our long standing preference for profitable growth stocks over cyclical value stocks. That said, we think big U.S. banks are an attractive cyclical value play, which we still prefer over Energy.

GLOSSARY

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

A **correction** is a decline in stock market prices.

A **developed market (DM)** is a country fully developed in terms of its economy and capital markets.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

The **euro (EUR)** is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

In economics, a **nominal** value is not adjusted for inflation; a real value is.

The **pound sterling (GBP)**, or simply the pound, is the official currency of the United Kingdom and its territories.

Real Estate Investment Trusts (REITs) are companies, mostly listed, that own and often operate various types of real estate. They are obliged to pay out a minimum of 90% of earnings.

The **real interest rate** is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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