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Americas CIO View

Oil and credit risks contained, low S&P profit-recession risk

Interest-rate, dollar and now oil volatility, push S&P to near correction again

Heightened volatility in interest rates, U.S. dollar (USD) and West Texas Intermediate (WTI)/Brent crude-oil prices are the main drivers in the near corrections of the S&P 500 since September end. First, 10-year U.S. Treasury yields jumped from 2.8% to 3.25% on falling-unemployment-related inflation fears; if yields exceed 3.5%, a fair S&P price-to-earnings (P/E) ratio is likely under 18. Then a stronger USD vs. Chinese yuan (CNY), euro (EUR) and pound sterling (GBP) from U.S.-China trade tensions, Italy-EU fiscal tensions and Brexit. Then, oil prices swooned on supply as producers overly prepared for Iran sanctions, causing wider credit spreads and the S&P to test its October lows.

Interest rates, dollar and oil are still in a range supportive of healthy growth

Despite the recently heightened volatility, all three have managed to stay within a range supportive of the economy and equities, in our view. Treasury yields retreating from recent highs and slowing their ascent relieves some U.S. housing risk. The Trade-Weighted U.S. Dollar Index stayed below 100, posing a manageable headwind to S&P earnings-per-share (EPS) growth. While current oil prices threaten our 2019E Energy profits, at $55-65/bbl WTI and $60-70/bbl Brent oil will keep Energy profits stable and at the upper part of the range to deliver about 10% EPS growth in 2019. We believe global economic growth will slow in 2019 and we expect S&P 500 EPS growth to slow too; likely to about 5% in 2019 from 25% in 2018. But we remain confident that S&P EPS will be up in 2019 and above $170. As growth slows in the U.S. and abroad, we think the 10-year Treasury yield stays well below 3.5% and the U.S. Federal Reserve (Fed) slows its hikes.

High-yield credit spreads widen on oil weakness, risks mostly at small caps

High-yield (HY) credit spreads spiked to above 800 basis points (bps) during the plunge in oil prices back in 2015-2016. The oil-price decline since early October is nowhere near the severity of 2015-2016 and companies have improved their ability to operate profitably at lower oil prices since then. Yet in recent weeks, HY credit spreads widened from 360 to over 400bps as $55/bbl oil will pressure balance sheets at many smaller energy firms. We do not consider this widening of credit spreads to be systemic, nor a lead indicator of deteriorating macro conditions. We disagree that credit is a lead indicator in this regard, we see credit as simply reacting to commodity markets and view this credit risk as contained to commodity producers. We think WTI oil is likely to be well supported at $55/bbl and should average $60-65/bbl in

In a nutshell

- Interest-rate, dollar and now oil volatility push S&P to near correction again
- Interest rates, dollar and oil are still in a range supportive of healthy growth
- High-yield credit spreads widen on oil weakness, risks mostly at small caps
- Fed should slow pace of hikes, given contained inflation & slower growth ahead
- Relative valuation of Growth vs. Value stocks at historic average

2019. Most S&P 500 companies are investment-grade-rated, only 11% of issues are rated BB+ or below, whereas 84% of the Russell 2000 with a credit rating is junk-rated. Albeit most small companies do not have credit ratings; they rely more on bank debt. S&P 500 leverage has gone up since 2015, but it's still at low levels compared to history. But Russell 2000 net debt / EBITDA (earnings before interest, tax, depreciation and amortization) is at rather elevated levels.

Fed should slow pace of hikes, given contained inflation & slower growth ahead

We expect the Fed to hike again in December. Four hikes this year is fine, given that inflation climbed from below to be more solidly at the Fed's 2% target. But we have long argued that inflation is likely to get stuck at around 2% for the rest of this cycle. We think the consumer price index (CPI) is peaking and likely to soften. But regardless, we focus on labor-market conditions, not oil prices. Average hourly earnings should continue to grind upward on rising productivity. Productivity-driven wage growth is not inflation. It is prosperity! Unit labor costs have and should remain stable at about 2%. At the same time, we expect real gross-domestic-product (GDP) growth in the U.S. and around the globe to slow in coming years. Europe and Japan are still far from raising their benchmark interest rates. The Fed should feel less urgency to hike overnight rates after 2018.

Relative valuation of Growth vs. Value stocks at historic average

Value stocks outperformed during the S&P's near-correction, but this is attributable to Defensive Value, as Cyclical Value and Cyclical Growth performed similarly. However, we don't expect Value to outperform Growth in the medium to long term. The valuation premium of Growth vs. Value is not rich: Russell 1000 Growth ex FANG[1] is trading at a 16% premium vs. Russell 1000 Value ex Financials, which is slightly below the historic average of 19%, while the EPS growth of R1000 Growth ex FANG is 23% vs. 18% for Value ex Financials. We continue to prefer Growth over Value.

[1] Facebook, Amazon, Netflix, Google

Glossary

Basis point

One **basis point** equals 1/100 of a percentage point.

Brent

Brent crude is a grade of crude oil dominant in the European market.

Brexit

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

Chinese yuan (CNY)

The **Chinese yuan (CNY)** is legal tender on the Chinese mainland and the unit of account of the currency, Renminbi (RMB).

Consumer price index (CPI)

The **consumer price index (CPI)** measures the price inflation as a percentage, year over year, of a basket of products and services that is based on the typical consumption of a private household.

Correction

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

Earnings per share (EPS)

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.

EBITDA

EBITDA (earnings, before interest expenses, taxes, depreciation and amortization) is an accounting measure calculated using a company's net earnings, before interest expenses, taxes, depreciation and amortization are subtracted.

Economic price-to-earnings (Economic P/E) ratio

The **Economic price-to-earnings (Economic P/E) ratio** is the CROCI's adjusted P/E ratio, based on economic data rather than the traditional accounting data. It can be thought of as the ratio of a company's Tobin's Q (market value of total assets over the economic replacement value of those assets) to its real cash return on the total economic assets.

Euro (EUR)

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.

Fiscal policy

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Gross domestic product (GDP)

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.

Growth stocks

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

High Yield (HY)

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation

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

Investment grade (IG)

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Junk bonds

Junk bond is a colloquial term for a high-yield or non-investment-grade bond.

Pound sterling (GBP)

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

Russell 2000

The **Russell 2000** is an index that captures the 2,000 smallest stocks of the Russell-3000 index, which again comprises 3,000 small- and mid-cap U.S. listed stocks.

S&P 500

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

Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Trade-Weighted U.S. Dollar Index

The **Trade-Weighted U.S. Dollar Index** tracks the performance of the U.S. dollar relative to other world currencies.

Treasuries

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).

U.S. dollar (USD)

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

U.S. Federal Reserve Board (the Fed)

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

Unit labor costs (ULC)

Unit labor costs (ULC) measure the average cost of labor per unit of output.

Value stocks

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

West Texas Intermediate (WTI)

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

Risk warning

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High Yield Fixed Income Securities – Investing in high yield bonds, which tend to be more volatile than investment grade fixed income securities, is speculative. These bonds are affected by interest rate changes and the creditworthiness of the issuers, and investing in high yield bonds poses additional credit risk, as well as greater risk of default.

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