UNCOMMON SENSE

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Leap of Faith: Despite Weakening Fundamentals, Markets Rally to Begin 2019

By Michael Arone, CFA,
Chief Investment Strategist
US SPDR Business

"Go out on a limb. That's where the fruit is."
— President Jimmy Carter

Ain't No Stopping Us Now

Markets are off to a terrific start in the first couple months of 2019. All three of the major US stock market benchmarks have gained more than 10 percent. According to Barron's, the Dow Jones Industrial Average has climbed for eight consecutive weeks, its longest winning streak since November 2017. International developed and emerging market stocks have rebounded, too. And it's not just stocks. Investors' enthusiasm for junk bonds, investment grade corporate bonds and many other risk assets has surged in the new year.

This marks a complete turnaround from the fourth quarter of 2018 when investors feasted heavily on cash and other conservative investments. Why the sudden change in heart? Has the investment landscape improved that dramatically?

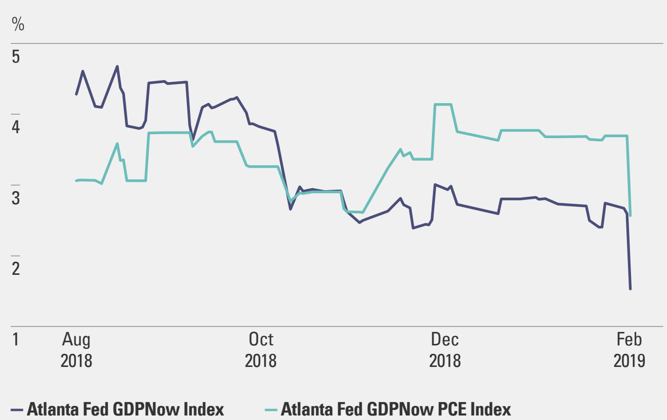
Admittedly, given the fundamentals in late December, asset prices felt wildly oversold on Christmas Eve, making a recovery in stocks likely in the first few weeks of the year. But the year-to-date rally in risk assets is largely being driven by investor expectations that rate hikes by the US Federal Reserve (Fed) will be on hold this year and that a trade agreement between the US and China will be reached soon, boosting global growth. The question is whether investors' confidence will be rewarded.

Au Contraire, Mon Frère

As good as the 2019 return story feels, it might be easier to argue that the investing environment has gotten notably worse in the last few weeks. The February 14 Atlanta Federal Reserve GDPNow forecast for the first quarter is a disheartening 1.5 percent, down from a more respectable 2.7 percent on February 6.

In addition, a trio of important economic data releases from the week of February 11 portrayed a US economy that while not down for the count, is now on the ropes. First, the National Federation of Independent Business (NFIB) Small Business Optimism Index fell to its lowest reading since November 2016. Although the index remains above its long-term average, it has been trending lower for several months and is considerably below last August's peak. Second, December's retail sales were abysmal, falling the most for any month since 2009. Third, industrial production declined in January, its first drop in eight months.

Figure 1: Following the Weakest US Retail Sales Report in a Decade, the Atlanta Fed's GDP and PCE Forecasts Were Revised Sharply Lower



Source: Bloomberg Finance, L.P., 02/19/2019.

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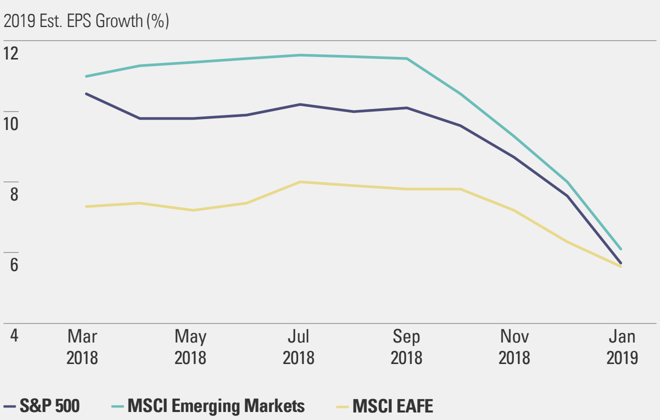
And the hits could keep coming. After peaking at slightly more than 4 percent in the second quarter of 2018, US GDP was a still sturdy 3.4 percent in the third quarter of last year. Investors are waiting anxiously for the initial estimate of 4th quarter 2018 GDP scheduled to be released on February 28.

Not surprisingly, this challenging economic environment has started to negatively affect corporate profits. According to a February 15 FactSet Earnings Insight report, year-over-year earnings-per-share (EPS) growth for the 4th quarter is likely to be 13.1 percent on revenue growth of 7 percent. These solid figures trail expected calendar year 2018 EPS growth of 20.1 percent on revenue growth of 8.9 percent. Shockingly, the report notes that analysts are now forecasting negative year-over-year EPS growth of -2.2 percent for the first quarter of 2019. A staggering plunge in corporate earnings expectations! FactSet also states that 78 companies have issued EPS guidance for the first quarter of 2019. Astonishingly, 76 percent of them have issued negative guidance, well above the five-year average.

However, investors are ignoring these warning signs and aggressively bidding-up stocks. And I haven't even mentioned the negative impact on global growth of the deteriorating economic conditions in Europe and China.

Pinning their hopes on positive outcomes from a more dovish Fed and the US-China trade talks, investors expect improvements in global economic growth, corporate earnings and global trade to remove all the obstacles for this long-running bull market. But is that smart?

Figure 2: Earnings Growth Expectations for CY 2019 Have Steadily Declined, With Q1 Potentially the First Quarter of Negative Growth in the US Since Q2 2016



Source: FactSet as of 01/31/2019

A Wishy-Washy Fed Could Restart the Cycle

I'm not sure investors can trust the Fed to deliver on its promises of limited rate hikes in 2019. Chairman Powell suggested that the target fed funds rate was nowhere near neutral in early October, sending markets into a tailspin. The elusive neutral rate is the interest rate that neither stimulates nor slows the economy. Then, in a near one-eighty at the end of November, Powell claimed the fed funds rate was just below the neutral rate. Despite market skittishness, on December 19 the Fed raised its target interest rate for the fourth time in 2018. And in an encore performance in the post-FOMC meeting press conference, Powell heaped effusive praise on the strength of the US economy and was steadfast regarding tighter monetary policy in 2019. This shocked investors and when the markets imploded in late December, confusion over the future path of Fed interest rate hikes was a major contributor to the selloff.

Since the December 19 meeting, Fed officials including Powell have carefully walked back their promises of tighter monetary policy in 2019. Also, Fed officials have shown an openness to re-examine the reduction of their balance sheet.

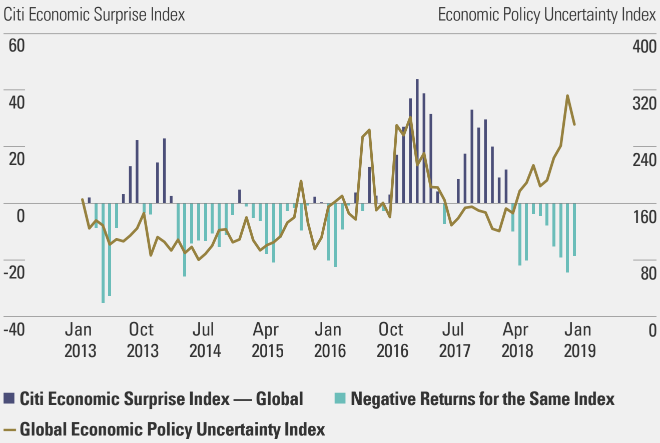
But if the US economy is as strong as Powell insists, why is the Fed pausing? The Fed is exercising patience because it is concerned about growth and believes too much tightening may have already occurred. So, why would investors view this kinder, gentler Fed positively?

Investors also expect the US and China to reach a trade agreement that might spur better US and global economic growth and lead to an increase in inflation expectations. And, with the unemployment rate at multi-decade lows, the tight labor market may also result in wage acceleration. If this scenario of higher growth and greater inflation plays out, investors should expect the wishy-washy Fed to abandon promises of easier monetary policy and restart the tightening cycle that began at the end of 2015.

When There Is Trust, No Proof Is Necessary When There Is None, No Proof Is Possible

Despite the news stories reporting progress, I also question whether a US-China trade agreement will be the silver bullet that investors have been hoping for to increase global growth and corporate profits. *The Wall Street Journal* reported on February 15 that in the latest round of US-China trade talks, senior officials from both sides have made some progress toward "a memorandum of understanding," a bare-bones pact that could serve as the framework for a deal that Presidents Trump and Xi could finalize at a future summit.[1] Further negotiations are scheduled to take place in Washington, DC during the week of February 18.

Figure 3: For the Last Several Years, the Market Was Supported by Positive Economic Fundamentals and Falling Uncertainty; Both Have Reversed



Source: Bloomberg Finance, L.P., 02/19/2019.

But a memorandum of understanding is a far cry from an ironclad trade agreement between the two nations. Trump's quick trigger temperament and China's notorious track record of empty promises doesn't instill a great deal of confidence that the trade dispute will be permanently settled. In fact, as the two superpowers jostle for global influence, issues beyond trade are likely to result in further conflicts between the countries.

Importantly, even if a trade compromise is reached with China, the Trump administration is still fighting a trade war on multiple fronts. Investors could observe a flare-up with Europe regarding auto tariffs. The US will likely have to renegotiate a new trade agreement with Britain after Brexit. No easy task with one of the US' largest trading partners. Finally, because Democrats now control the House of Representatives, the United States-Mexico-Canada Agreement (USMCA) has a much tougher path through Congress. Democrats seem resistant to moving the agreement forward, despite the benefits for US autos and auto workers. With these new political constraints, the administration's ambitious global trade agenda could remain under duress for the next two years and possibly longer as populism spreads around the globe.

It's Not a Sprint, It's a Marathon

Stocks and other risk assets are flying high to start 2019. Oddly, especially on the heels of the 2018 selloff, investors are ignoring weakening economic data and crumbling corporate profits that don't support such strong enthusiasm for risk assets.

A great deal of this year's rally is a result of the powerful potential investors see for a one-two combination of a more dovish Fed and a US-China trade agreement. However, investors may be miscalculating the positive impacts of both outcomes. Even if everything goes investors' way this year — and that's a big if — stocks can't sustain this pace of performance. In fact, at today's growth rate, the S&P 500 Index would reach 5,200 by year-end — more than double where it started 2019. That's highly unlikely.

Therefore, I expect returns to moderate soon and bouts of volatility to resurface. Investors should increase the quality of their investments, get defensive in bonds and lean into fiscal policy beneficiaries in 2019.

[1] Lingling Wei and Bob Davis, "Chinese, US Trade Negotiators Inch Toward a Broad Agreement," *The Wall Street Journal,* February 15, 2019.

Glossary

Earnings Per Share (EPS) The portion of a company's profit allocated to each share of common stock that serves as an indicator of a company's profitability.

Gross Domestic Product (GDP) The monetary value of all the finished goods and services produced within a country's borders in a specific time period.

S&P 500 Index A popular benchmark for US large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

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State Street Global Advisors One Iron Street, Boston MA 02210.
T: +1 866 787 2257.

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