MARKET COMMENTARY

First-Quarter Rally: But Will It Be Sustainable?

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KEY OBSERVATIONS

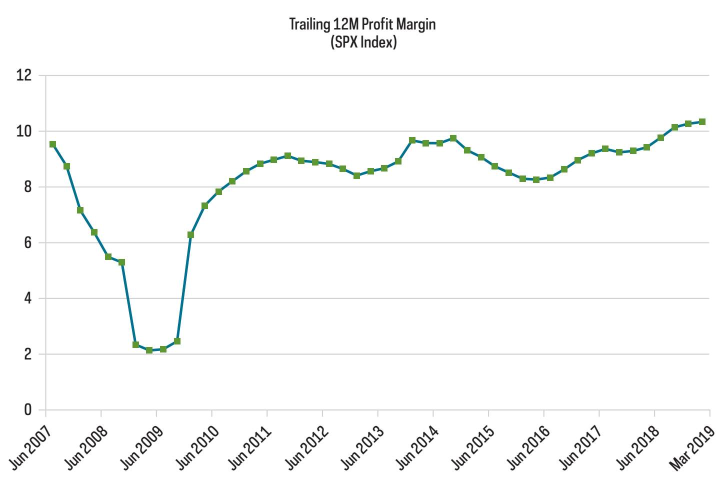
March month-end marked the end of a substantial first-quarter rally in both stocks and bonds. Investors are wrestling with the question of whether dovish central banks will be sufficient to sustain the equity rally, even as economic growth may be slowing.

- **Downgrades in growth estimates.** The Federal Reserve downgraded its estimate of 2019 growth from 2.3% to 2.1%. This followed a similar downgrade from the European Central Bank, which downgraded its estimate for European 2019 growth from 1.6% to 1.2%.
- **Weak retail results.** While weak retail sales numbers in December and January could be dismissed—both due to seasonality and a suspected government shutdown-induced lapse in data integrity—the weak February results cannot be so easily dismissed, reinforcing the notion of a slowing economy.
- **Longer-term interest rates supporting market prices.** While the price-to-earnings ratio of the S&P 500 is now modestly higher than its long-term average, longer-term interest rates dramatically below their long-term average may support equity market prices despite slowing economic and earnings growth.
- **Bond market vigilance required.** Bond market complacency could prove unwise, as longer-term interest rates, now substantially lower than one year ago, may begin to rise, even as growth and inflation may drift lower.

The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

CHART OF THE MONTH

Peak margins may pose a challenge to equities.

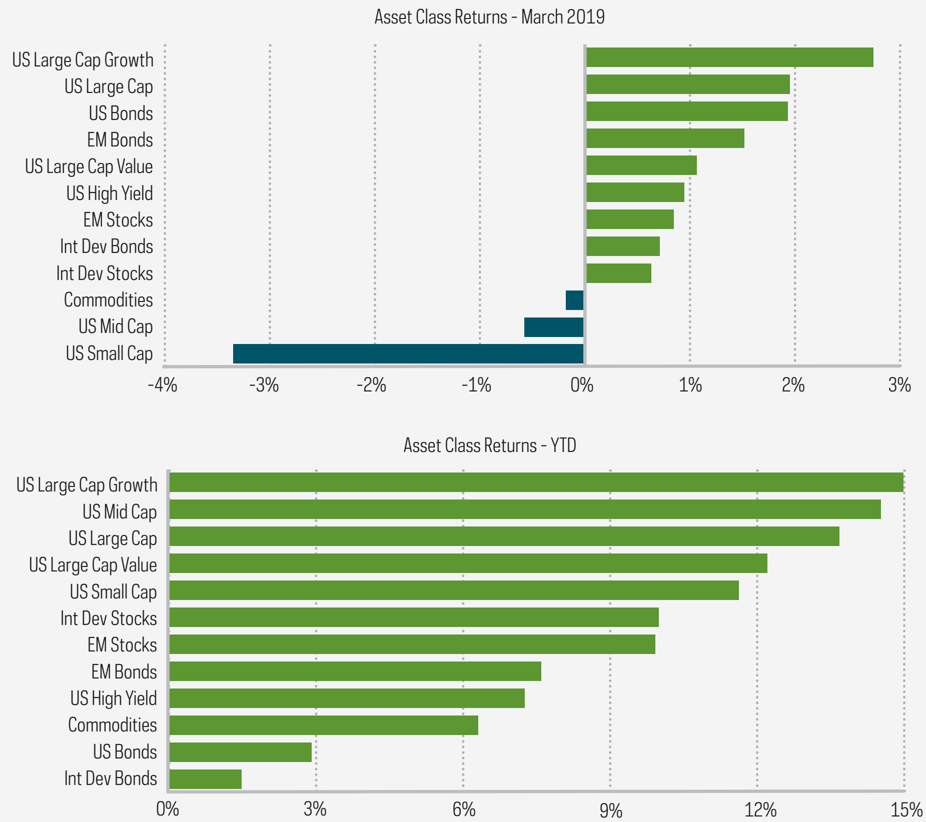


Source: Bloomberg

PERFORMANCE RECAP

Most risk assets remained in the green for the month of March, capping a powerful first-quarter snap-back from the fourth-quarter sell-off. Only U.S. mid- and small-cap stocks posted negative returns. The lower quality, higher leverage and lower profitability of small-cap stocks, in particular, leave them vulnerable to diminished expectations for the U.S. and global economy. Government bonds and corporate bonds posted strong positive performance, as longer-term interest rates fell and credit spreads narrowed.

PERFORMANCE SNAPSHOT



Source: Bloomberg

EQUITY PERSPECTIVES

Equity valuations and interest rates

Equity valuations must be considered in the context of interest rates, since low longer-term interest rates imply higher P/E multiples. While the S&P 500 began the year trading near its long-term average P/E ratio of just under 17X, the first-quarter rally drove that ratio to just under 19X—a bit higher than the long-term average. Meanwhile, the 10-year U.S. Treasury yield stands below 2.5%, which is substantially below its long-term average of over 6%. In that context, 19X looks quite reasonable. And to keep matters extremely simple, if 2019 earnings growth comes in at the current consensus level of 10%, and the S&P 500 P/E multiple remains flat, the S&P 500 earnings growth may rise 10% by year-end.

Margin erosion

Of course, 10% this year is not a given. As noted in our chart of the month, S&P 500 margins are now higher than their pre-crisis peak. Among the items that could put pressure on margins is the erosion of pre-tax margins driven by the corporate tax cut. Economic principles tell us that companies in competitive industries are likely, over time, to see those tax cuts pass to customers in the form of lower prices. It follows that companies with some pricing power, which may be able to avoid some of this margin erosion, may be a better bet as 2019 continues to unfold.

Share buybacks

Companies buying back shares may deserve a bit of extra scrutiny in 2019. Companies should return cash to shareholders if they have more cash than they need for worthwhile investment opportunities. But companies that buy back shares are specifically signaling that they only have temporary excess cash. Companies with sustainable abilities to generate more cash than they need are more likely to increase their dividends. The S&P 500 Buyback Index actually underperformed the S&P 500 in the Q4 sell-off. That's a pattern that may continue.

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Emerging markets

Outside the United States, emerging market equities may have an edge over developed market equities. Emerging market equities are trading at a P/E discount to developed market equities even with an anemic European growth forecast. And while emerging market equities have generated lower gross margins than developed market equities, return on assets and equities have been higher. More efficient use of capital can be a particularly useful trait in a slowing economic environment. Finally, emerging markets have historically been outsize beneficiaries of dovish central bank policies.

FIXED INCOME PERSPECTIVES

Low interest rates, growth, inflation and Treasury yields

Longer-term interest rates are low—very low—but so are growth and inflation. Bond investors seem to have taken their cue from the Fed and the ECB, both of which downgraded their economic growth forecasts and concluded that slowing economic growth must be a bullish sign for government bonds. But the coast may not be as clear as it looks. The yield on the 10-year U.S. Treasury is now below 2.5%. That may be too low, as the long-term average yield on the 10-year U.S. Treasury is over 6%, and the long-term average inflation (core CPI) is a bit under 4%. Today, inflation is struggling to stay in the 2% range, but even if inflation dropped to, say, 1.5%, the long-term relationship between the 10-year U.S. Treasury and inflation (the real yield) suggests a yield of at least 3.5%.

The Fed's balance sheet

Some bond investors took extra comfort from the Fed's indication that its balance sheet will be reduced only to $3.5 trillion—nearly four times its pre-crisis size. The growth of the Fed's balance sheet through quantitative easing was indeed a key force suppressing the level of longer-term interest rates. There are, however, indications that as large as $3.5 trillion seems, it may actually be a neutral level.

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Why? Consider that the Fed's balance sheet stood at roughly $500 billion at the beginning of the century and had grown to nearly $1 trillion just before the crisis. This reflected the natural growth of the balance sheet for more or less operational reasons. It follows that, even in the absence of quantitative easing, the balance sheet could be at least $2 trillion today. Combine that with some other esoteric and technical "inside baseball" operational reasons as to why the balance sheet may need to be a bit bigger, and it may very well be that $3.5 trillion is a lot closer to a "neutral" balance sheet size—and may not be a force suppressing longer-term rates. And in the absence of that force, normalization of the longer end of the yield curve—and commensurate losses to bond investors taking duration risk—may be part of the story of the second half of 2019. It shouldn't be much of a surprise, then, that investors took substantial assets out of longer-term U.S. Treasury bond ETFs in March.

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