The Rally Continues: A Little Growth Goes a Long Way

MARKET COMMENTARY

KEY OBSERVATIONS
The first quarter’s stock market rally continued right through April, with all equity market segments registering gains for the month. Concerns regarding an earnings recession were mitigated as Q1 earnings registered very modest gains. Stronger than expected economic indicators provided a boost as well.

- **The Fed remains neutral.** The Fed emphatically declared its neutral stance, suggesting that below-target inflation is likely to be transitory. Meanwhile, the Bank of England indicated it may raise interest rates, pending a smooth exit from the European Union.

- **GDP and productivity growth.** First-quarter GDP grew 3.2%—a substantial upside surprise. In addition, productivity grew at 3.6% in the first quarter—the fastest growth since 2014.

- **Corporate earnings slow—but remain positive.** With two-thirds of the S&P 500 reporting, first-quarter earnings growth is running just under 2%.

- **Modest rise in yields and low inflation.** U.S. Treasury yields rose modestly across the curve, even as inflation remained stubbornly low.

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CHART OF THE MONTH
S&P 500 earnings growth: Weak but still positive.

Source: Bloomberg
PERFORMANCE RECAP
Most risk assets remained in the green for the month of April, piling on to the first-quarter rally. Only commodities and international developed-market bonds posted losses, as the oil rally waned, and the dollar strengthened. Credit spreads continued to narrow, driving positive performance from corporate bonds.

EQUITY PERSPECTIVES
Corporate Earnings Slow Down
The much-anticipated slowdown in corporate earnings growth has begun. S&P 500 earnings growth is 2% in the first quarter (with roughly two-thirds of companies reporting), a sharp decline from the 25% growth registered for much of 2018. It’s still a positive number, however, despite many strategists forecasting an earnings recession, with actual declines in corporate earnings.

Some Earnings Growth Is All You Need
A little earnings growth can go a long way in a low interest rate environment. Here’s some quick math (my apologies...).

The valuation formula for a growing annuity is 1/(r-g), where r is the discount rate, and g is the growth rate—and we can use that formula to estimate a price-to-earnings multiple (P/E) for the S&P 500.

- **The discount rate (r).** For equities, the discount rate (r) is also referred to as the expected return on equities—estimated as a premium above the yield on U.S. Treasuries. That premium is generally estimated at 4–5%, so let’s use 4.5%. With the 10-year Treasury yield at 2.5%, r is therefore 7% (4.5% + 2.5%).

- **The growth rate (g).** The growth rate (g) is the rate of corporate earnings growth. So far in the first quarter, this is 2%.
The P/E multiple. Knowing that the discount rate is 7% and the growth rate is 2%, we can calculate our P/E multiple: \( \frac{1}{(7\%-2\%)} \), which equals 20. The S&P 500’s current P/E is 19.

This is admittedly a gross simplification, but the takeaway is a reasonable one: In this low interest rate environment, a small amount of earnings growth has the potential to support modest equity market gains. And with the economy still growing, and productivity gains keeping down cost pressures, it’s not a bad bet.

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

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Time to look at mid-caps
Mid-caps, perhaps the most overlooked equity market segment, deserve a look heading into the second half of 2019. Mid-caps have long outperformed the S&P 500, with the S&P Mid-Cap 400 returning over 2% more annualized return than large caps since the year 2000. However, mid-caps have underperformed over the last five quarters, from Q1 2018 through the first quarter of 2019. Of note, S&P 500 margins were still expanding in the fourth quarter of 2018, while S&P Mid-Cap 400 margins declined noticeably. It may be that some of the downward pressure from shrinking margins that has yet to come for large-cap stocks may be in the rearview mirror for mid-caps.

UK equities may outperform
The FTSE 100, which represents the 100 highest market-cap companies listed on the London Stock Exchange, now trades at half the price-to-book multiple of the S&P 500. There’s good reason for it, with the never-ending trainwreck known as Brexit and the weak Euro-area economy. However, UK equities may be poised to outperform. Why? Because the FTSE 100 has a 17% exposure to the energy sector—triple that of the S&P 500. And while the oil rally may have waned slightly of late, oil prices are substantially higher than their 3-year average. Add to that the potential upside to any reasonable Brexit outcome, and UK stocks may outperform.

The price-to-book multiple is the ratio for comparing a firm’s market to book value by dividing price per share by book value per share.

FIXED INCOME PERSPECTIVES

The Fed: Vehemently neutral
How quickly times change. After all, it wasn’t too long ago that most investors thought that the Federal Reserve was going to raise interest rates in 2019. But the sharp decline in the stock market in Q4, concerns regarding global economic growth, and low inflation led the Fed to tilt its outlook in a considerably more dovish direction. Some, perhaps, took this dovish direction too far—and began anticipating an actual cut(s) in the Fed Funds rate. Chairman Powell threw cold water on this notion by emphatically declaring the Fed’s neutral stance, suggesting that below-target inflation is likely to be transitory. And as challenged as the UK economy is of late, Bank of England governor Mark Carney came out slightly more hawkish than many expected, indicating that the bank may raise interest rates, pending a smooth exit from the European Union.

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Interest rates remain very low
Powell and Carney are reminding us that interest rates today are very low. The current 2.5% yield on the 10-year U.S. Treasury seems particularly low against the backdrop of decent economic growth and low unemployment. Productivity growth may take a bit of the edge off inflation pressures, but even if inflation remains stubbornly slightly below the Fed’s target of 2%, a real yield (deducting inflation) on the 10-year Treasury of less than 1% is nearly unprecedented. Remember, if interest rates rise, bond prices fall, so long-duration bonds may be poised to underperform.
Outperformance potential of hedged corporate bonds
While the U.S. Treasury curve is quite flat (the 10-year U.S. Treasury yield is nearly the same as the Fed Funds rate), the corporate bond curve is not—yields on both investment-grade and high-yield corporate bonds are considerably higher for longer durations. These long-duration corporate bonds, of course, have interest rate risk. The flat U.S. Treasury curve, however, provides the opportunity to hedge that interest rate risk today with very little cost, except the fees associated with the investment.