

# The Advisor

A quarterly publication from Ables, Iannone, Moore & Associates, Inc.

## Market Update – *Fourth Quarter, 2019*

**THE MARKETS ARE LOCKED IN A STRUGGLE.** The S&P 500 turned in a 1.7% gain in the third quarter, led by the defensive sectors of utilities, real estate and consumer staples. Looking at the factor-based performance of the index the leader was Low Volatility followed by the Dividend Aristocrats, both highlighting the cautionary posture of investors. Further evidence of the risk-off narrative was the Barclays US Aggregate Bond Index outperforming equities, rising 2.3% in the third quarter. The yield on the US 10-year bond closed the quarter at 1.68%. Bonds are largely viewed as a flight to safety, with US Treasury bonds considered worldwide as a risk-free investment. To help illustrate the current tug-of-war market environment, let's lay out a snapshot of both the bear and the bull case:

THE BEAR	THE BULL
<ul style="list-style-type: none"><li>• Trade War, precisely China</li><li>• Brexit impasse</li><li>• The Fed will fumble monetary policy</li><li>• GDP growth is stalling</li><li>• Manufacturing is in contraction, if not recession</li><li>• Corporate profits are under pressure</li><li>• Q4 earnings are being revised lower</li><li>• The Leading Economic Indicator index is slipping</li><li>• The market looks expensive, trading 17 times its forward 12-month P/E ratio vs its 10-year forward P/E historical average of just 14.9</li><li>• The yield curve inversion is a clear warning of an impending recession</li></ul>	<ul style="list-style-type: none"><li>• US/China Phase 1 trade agreement</li><li>• Brexit progress</li><li>• The Fed is still accommodative, cutting rates</li><li>• Unemployment is at 50-year lows</li><li>• Services is in expansion, and it constitutes a greater % of GDP</li><li>• Q3 earnings are surprising to the upside</li><li>• 2020 estimates show solid growth</li><li>• The consumer is strong, which makes up over 2/3 of GDP</li><li>• The market trades in-line with its 5-year forward 12-month P/E ratio and is at fair value, if not undervalued, considering inflation</li><li>• 25% of global debt is negative yielding, the US is a safe haven</li></ul>

That clears things up, does it not? To say the current environment is polarizing would be an understatement. Point for the bear. Counterpoint for the bull. The tension builds, reflected in bouts of volatility, the news headlines scream, the tug-of-war rages on. This is all a natural part of capital markets, driven by supply, demand and future expectations. Okay, so where does the current market go from here? Let's look at three scenarios.

**We're on the brink of disaster.** Earnings miss badly and growth evaporates, recessionary pressures build and this market is overvalued. Here is what transpires for this scenario to unfold: The trade war with China escalates and the USMCA trade deal falls apart. Brexit worsens without resolution. Cracks widen in manufacturing while services begin to contract. Business investment dries up followed by a slowdown in hiring and consumer sentiment collapses. Housing momentum starts to roll over. Retail sales disappear. The yield curve stays inverted, credit spreads widen and a flight to safety is on while the Fed chases a solution from behind the curve.

**Headwinds remain, but so does economic strength.** In this scenario, the economic data holds firm thereby reducing the threat of recession. A moderate growth environment churns forward which makes this market fairly valued. Here is how this might look: There is no substantial end to the trade war but things do not escalate. USMCA progresses through Congress. Earnings and estimates deliver Goldilocks results, not too hot and not too cold. Manufacturing finds a bottom and begins to rebound as the US and China do put together a phase 1 agreement. Housing, retail sales and services continue to exhibit strength on the back of the consumer. Global central banks remain accommodative while the Fed continues to monitor the data and adjust its monetary policy to reflect real-time conditions.

**Headwinds clear, smooth sailing ahead.** If the headwinds clear and stronger growth resumes, it paves the way for more economic prosperity and this market looks undervalued with plenty of opportunities to be had for several more years. This scenario is the easiest to depict by simply taking the opposite side of the bear case: The White House is incentivized to end the trade war with China given the election year is quickly approaching. China, just as well, needs an agreement to stem the economic decline it is facing. The prospects of worldwide trade momentum spurn a Brexit resolution and Congress cements the USMCA deal into place. Business uncertainty is diminished and capital expenditure increases. Low unemployment remains but wages climb in the tight labor market, furthering the strength of the consumer. Innovation and expansion are rewarded. Forward earnings estimates are revised higher in anticipation of solid earnings execution. There is little doubt the market would rip higher under this scenario and continue pushing forward until inflation, the dollar, commodities pricing and the Fed take the reins, steering the narrative back to, *how long can this last?*

So, there you have it. The current bull case, the bear case and three outcome scenarios. Where do we stand? We remain cautiously bullish. From our viewpoint, we do not see an imminent recession. We are not finding material evidence that the secular trends we follow are disappearing or that the economic conditions have worsened to the point where de-risking entirely away from equities makes sense. That is not to say the market will not go down and there will not be volatility along the way. In fact, we fully anticipate political rhetoric to take center stage as we head into the election year. Noise of impeachment, collusion, the deep state and (fill in the blank) – it is a part of our system, Right and Left. Volatility most certainly will come to the markets from this. However, we continue to stress the importance of keeping the long-term in focus and remember that history, as a guide and not gospel, tells us opportunity and reward comes to the patient investor. Or as Charlie Munger famously said, “The big money is not in the buying or selling, it’s in the waiting.”

As always, thank you to our clients for the many referrals and allowing us to continue working to meet your needs. Please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, we take our role as fiduciary very seriously. If you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. We will happily provide you with an unbiased opinion based on your specific situation.



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