Partner Talk®

PRUDENT MANAGEMENT ASSOCIATES

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Market Update

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With the arrival of the end of the first quarter, questions about the state of the economy and the level of the stock market are common. Is a recession on the horizon? Is the U.S. stock market over-valued? What is the bond market telling us about the economy? Considering these issues is the goal of this month's Partner Talk.

Implications of the political environment are perhaps receiving more attention than ever. Much of the concern relates to the potential impact of unresolved trade disputes. The prospect of agreements with both China and Europe are uncertain and the revised U.S. – Mexico agreement is still not completed. If these disputes are not resolved, a negative impact on U.S. economic growth will likely result and downward pressure on market values will result.

On the positive side, the absence of trade agreements has not yet led to a significant drop in the stock market. Indeed, the S&P 500 index was up by 13.65% in the first quarter. This strong first quarter more than made up from a large decline observed in the fourth quarter of 2018. Nonetheless, continued trade disagreements could pose a problem for the market in the near future. However, while acknowledging this possibility, the behavior of the market during the past few months suggests that investors have concluded that continuing trade disruptions will have only a modest effect on the U.S. economy.

Most economists expect real economic growth to decline in 2019 even with resolution of the trade issues. In 2018, real economic growth was a robust 3%. However, the GDP growth forecasts for 2019 are much lower. For example, the median GDP growth forecast for Federal Reserve Board members released on March 20th is 2.1%. While this number does not itself point to a recession, it does suggest that corporate earnings may be lower than previously anticipated. In fact, a close look at corporate earnings growth expectations does reflect this pessimism. Aggregated earnings growth for the S&P 500 for calendar year 2018 was almost 23%. In contrast, according to FactSet, the expected earnings growth for 2019 is 3.7% -- a dramatic decline.

Ultimately, earnings do drive market values. An interpretation of the corporate earnings estimates follows from an analysis of the price to earnings ratio for S&P 500 stocks. A high price to earnings ratio can be a signal of over-valuation. Currently, the price to earnings ratio is 21.24. While this value is slightly elevated relative to historical norms, it is not unusually high. It does not send a strong signal of over-valuation.

What about interest rates – another key valuation factor? In January, the Federal Reserve appeared to concede that the fed funds rate was increased too aggressively in 2018. Based on this, the Fed suggested that fewer increases are to be expected in 2019 and not until at least June. Further, in March, the Federal Reserve stated that it no longer expects to raise rates until 2021. This “dovish” stance is always welcomed by market participants, and is believed to reduce downward pressure on the market.

However, the message from the bond market is mixed. Recently interest rates have sent a signal creating some concern. The yield curve has become inverted – meaning that annual yields for short maturity government obligations are higher than annual yields for longer maturity government obligations. For example, as of April 1, the yield on a one-year U.S. Treasury Note is 2.42% whereas the yield on a five-year U.S. Treasury Note is 2.30%. This interest rate pattern is of concern because historically an inverted yield curve has been associated with a recession approximately one year in the future. Because investors typically require greater returns when they loan their money for longer periods (the longer the period of the loan the greater the risk to the lender), the inversion also suggests that financial policy may be distorting typical market incentives. However, because the inversion is minimal at this point predictions of an upcoming recession are quite uncertain.

In summary, there are many factors to consider when analyzing the valuation and risk of stocks and bonds. At PMA, we include these factors in our analysis as we strive to control risk and to achieve high risk-adjusted performance. We will be discussing these factors and others when we meet for our quarterly investment committee meeting on April 18th.