Market & Economic Outlook 2019 – October Update: Market Sentiment Expects a Trade Deal

Outlook Summary:

U.S. equities have remained resilient since the S&P 500 index set a new all-time high in late-July, experiencing modest pull backs followed by reversals that have kept the index near highs and in a narrow range. As of 10/9/19, the S&P 500 was at 2,914, 3.7% below the 7/26/19 all-time high, and up 16.2% (excluding dividends) in 2019. Investors continue to navigate market headwinds including slowing U.S. GDP growth, flat corporate earnings, and weaker than expected growth in international markets. We connect each of these headwinds to trade uncertainty, as we believe that the U.S. trade dispute with China has negatively impacted both global GDP data and the outlook for earnings growth in the U.S. Since early 2019, our view has shifted from expecting a comprehensive permanent trade agreement to now looking for an interim or partial trade agreement that removes some tariff uncertainty but does not solve structural disagreements. We believe investors would react positively to an interim trade agreement, as it could improve earnings visibility due to the potential for renewed business investment and sustained consumer confidence. Progress on a trade deal remains elusive, however, creating uncertainty that weighs on our market outlook.

Our fair value estimate for the S&P 500 is 3,010, unchanged from July, and represents a 3.1% gain from the index closing price on 10/9/19, and a 20% gain from 12/31/18. We believe that investors should remain committed to their long-term investment plans; identifying quality companies across sectors, and invest according to a well-defined portfolio objective.

Our 3,010 S&P 500 price target represents a P/E of 17.2x current next 12-month (NTM) FactSet consensus EPS estimate of $175.51. The index currently trades at 16.6x that estimate, which is above the average S&P 500 P/E of 15.7x since 2000 (in a range of 10x to 27x). At year-end 2018, the S&P 500 P/E multiple was 14.5x, its lowest valuation in five years. Typically, we associate lower S&P 500 P/E ratios with a downturn in earnings and/or economic activity, and often a fear of rising interest rates that could put the brakes on growth. The earnings outlook has softened in 2019, with full-year estimated EPS growth for the S&P 500 of 2% (all in 4Q19), and we expect modest earnings growth to continue in 2020. Equity valuations have not been subject to higher interest rates, as U.S. Treasury bond yields have moved substantially lower in 2019. As of 10/7/19, the U.S. Treasury yield was 1.55%, compared to 2.00% on 6/30/19 and 2.68% on 12/31/18. We attribute three factors to the decline in long-term rates. The most concerning is that bond investors fear lower than expected GDP growth that could lead to necessary fed funds rate cuts. Also driving lower interest rates, however, is the absence of inflation, which in 2019 has trended well below the Fed’s 2.0% target; and extremely low global long-term interest rates, with the U.S. 10-year yield among the highest in global markets (creating foreign demand for U.S. treasury bonds). While we expect slowing U.S. GDP growth to 2.2% in 2019 (vs. 2.9% in 2018) and 1.8% in 2020, we do not see a recession forming. This could support modestly higher long-term interest rates next year, but at levels remaining well-below historical averages, which should be constructive for equity valuations. We believe that gains in equity markets will be tied to sustained earnings growth potential in the mid-single digit range of 4% to 6%.

### MSCI Emerging Markets (USD)

**Value** | **Price Return** | **Total Return** | **All-Time High** | **% from High**
--- | --- | --- | --- | ---
2,976.74 | 18.7% | 20.6% | 3,025.86 | 1.7%
26,916.83 | 15.4% | 17.5% | 27,359.16 | 1.6%
7,999.34 | 20.6% | 21.5% | 8,330.21 | 4.1%
1,523.37 | 13.0% | 14.2% | 1,740.75 | 14.3%
1,889.36 | 12.6% | 16.2% | 2,388.74 | 26.4%
1,001.00 | 5.5% | 8.1% | 1,338.30 | 33.7%
77.78 | 1.4% | 3.1% | 157.95 | 100.9%
106.24 | 6.1% | 8.5% | 111.03 | 4.5%

**Data Source:** FactSet
The S&P 500 gained 1.7% including dividends in 3Q19, as the June rally continued in July, driving new highs for the S&P 500, Dow Jones Industrial Average, and Nasdaq Composite indices. After a mini sell-off in August, gains resumed in September, driving the S&P 500 higher. Small capitalization stocks did not recover from losses in August and the Russell 2000 small cap index ended 3Q19 down 2.4%. For 2019 year-to-date (YTD) through 9/30/19, investors enjoyed strong gains in most equity and fixed income asset classes. U.S. large cap stocks led the way, as the S&P 500 delivered a total return of 20.6%, while the Russell 2000 total return was 14.2%. Most non-U.S. equity markets posted gains as well; the MSCI Europe, Australasia, and Far East (EAFE) index posted a return of 16.2% and the MSCI Emerging Markets index gained 8.1%. Many fixed income investments also rallied, driving interest rates lower. The Barclays U.S. Aggregate Bond index posted a YTD total return of 8.5% through September.

Tariff and trade news caused most of the market volatility during 3Q19, seemingly more important to investors than evolving trends in U.S. consumer spending and business investment, and two interest rate reductions by the U.S. Federal Reserve Bank (Fed). Market gains in late-June into July were prompted by a “tariff truce” meeting between President Trump and China President Xi at the G7 Summit; August market declines followed an end to the truce, as President Trump announced scheduled new tariffs on $300 billion of China imports; and September market gains followed a delay in many of those tariffs to 12/15/19, and newly scheduled trade talks. While we acknowledge that news on trade negotiations are imprecise and often come in the form of a Presidential tweet, it is hard to deny that investors are watching developments closely. We believe that current equity market valuations are assuming positive developments in the China trade negotiations because it appears relatively clear that ongoing trade uncertainty has weighed on business and capital investment, and contributed to consumer confidence backing off from peak levels.

What worries us? We continue to monitor a pause in U.S. earnings growth, a slowdown in U.S. business investment, and weaker manufacturing outlooks in the U.S. and abroad. Each of these trends worsened in 3Q19 from 2Q19 and largely contributed to the Fed’s decision to cut short-term rates twice in the quarter. In our view, a more accommodative Fed can offset some of the headwinds created by trade war uncertainty, but that trade progress in the form of a de-escalation of tariffs or intertrade agreement is important to provide a potential catalyst for global business investment and a boost to GDP growth. We are less worried in the near-term regarding the political firestorm that is brewing in Washington D.C. as President Trump faces impeachment hearings led by the House of Representatives. Investors have largely dismissed this threat, primarily because the potential disruption caused by an ultimate impeachment appears unlikely at this point due to push back from the Senate. Similarly, we also believe it is too early to make economic and market predictions on next year’s presidential election as the democratic nominee and party platform remain highly uncertain. As we move through 2020, however, the election cycle will be of high importance to investors.

A Pause in U.S. Earnings Growth. S&P 500 quarterly earnings growth was flat year-over-year (Y/Y) in both 1Q19 and 2Q19 and is estimated to turn negative in 3Q19 for the first time in the last 13 quarters. Earnings growth has faced difficult comparisons in 2019 against very strong 2018. We expect the dollar strength headwind to lessen as we approach 2020, although it did not weaken in Q3 as we expected in our mid-year outlook. Consensus earnings growth for full-year 2020 is 10.8% as of early October. This number appears aggressive to us, but we believe that earnings growth can resume in 4Q19 and through next year in the low single-digit range driven by modest sales growth, mitigation of rising costs, a more favorable U.S. dollar, and reduced shares outstanding from stock buybacks.

A Slowdown in U.S. Business Investment. Non-residential fixed investment is reported by the U.S. Department of Commerce in its quarterly GDP report. It measures investment by private businesses and other institutions in equipment, structures, and intellectual property, and comprises approximately 14% of GDP. We view this data as the best indicator of U.S. business investment trends. Business investment growth was on a steady growth trajectory since late-2016 through mid-2018. Quarterly Y/Y investment peaked in 2Q18, remained strong in 3Q18 and has trended substantially lower for the past three quarters. In fact, while Y/Y growth remained modestly positive, business investment was a slight drag on 2Q19 GDP growth as quarterly GDP growth is measured on a sequential change from the previous quarter on an annualized basis.
b easis. Intellectual property investment has remained solidly positive over the past year with weakness driven by a decline in investment in equipment and structures. Several factors contribute to the weaker data, including a leveling off of oil and gas drilling investment following a multi-month increase; but we attribute a meaningful part of the slowdown to the China trade dispute and the investment delays caused by tariff uncertainty. In our view, a trade agreement with China would help to avoid a multi-quarter slowdown like we saw in 2015.

Declining Manufacturing Data. The outlook for manufacturing activity (and also services) is updated through business executive surveys that identify trends in production schedules, purchased manufacturing materials, and staffing levels, etc. Two prominent companies, the Institute for Supply Management and IHS Markit, conduct monthly widely-followed surveys that are rolled into a purchasing managers index (PMI), and followed closely by economists. Both companies publish an index with a base of 50; a reading above 50 suggests that manufacturing activity is expanding, while below 50 reflects contraction. Global manufacturing PMIs among major U.S. trading partners (Eurozone, Japan, U.K. and China) peaked in late 2017, trended lower throughout 2018, and each fell below 50 (contraction) earlier this year. The U.S. PMIs, on the other hand, remained at very high levels (55 to 60) throughout 2018, signifying a healthy manufacturing outlook. But those high readings peaked in late 2018, and moved quickly lower in 2019, and the ISM Manufacturing PMI was below 50 in both August and September. The peak and steady decline of the U.S. manufacturing PMI over the past year coincides with increasingly negative trade rhetoric beginning in the middle of 2018, which has likely caused businesses to delay or scale back capital projects and adopt a more cautious forward looking view. Manufacturing comprises a relatively small portion of U.S. GDP (the service sector is several time larger), but is important for corporate earnings and investment that drives innovation and future economic growth potential. While we have watched the weaker manufacturing data closely we have commented that the services sector is healthy and continues to point to growth; but, in recent months the ISM non-manufacturing (Services) PMI dropped from the high 50s to low 50s, coming in at 52.6 in September, a 3-year low. We expect the services data to stabilize, as many services feed into consumer spending, and other measures of consumer health: employment trends, wage growth, and personal income, have remained strong.

Since our July Market Outlook the Fed has implemented two rate cuts. The Federal Open Market Committee (FOMC) twice cut its fed funds overnight target interest rate by 25 basis points (bp), first on 7/31/19, and again on 9/18/19. The July cut was the first Fed rate decrease since December 2008. This was a stark reversal from 2018, when the Fed raised rates four times, and today the fed funds target range is 1.75% to 2.00% compared to 2.25% to 2.50% at the end of last year. Following the July rate cut, Fed Chair Jerome Powell held a press conference to discuss the Fed’s action and said that despite a favorable outlook for the U.S. economy the Fed was cutting its fed funds target “to insure against downside risks from weak global growth and trade policy uncertainty.” Following the September meeting, and additional rate cut, Mr. Powell again highlighted the “insurance” strategy as he indicated that the Fed’s goal is to keep the U.S. economy strong and provide...
insurance against “ongoing risks.” The Fed called out weakness in business investment, exports, and manufacturing output, attributing the malaise to slower growth abroad and trade policy developments. The Fed has clearly stated that it does not set economic policy, including trade policy, and will follow its mandate to foster stable prices (inflation) and strive for maximum employment. So, if trade uncertainty creates GDP growth headwinds, it is appropriate to use monetary policy (in this case lower interest rates) to potentially ease the negative impact of those headwinds. On the heels of the December 2018 Fed rate increase, investors correctly (in our view) worried the Fed was tightening at a time when the U.S. economy was slowing. Perhaps, at the time, the Fed misjudged the slowdown in business investment or prospects for flat earnings, but that has changed now, and the Fed is prepared to cut rates further if supported by additional weak economic data.

The Fed also updated its Summary of Economic Projections at its 9/18/19 meeting. Its 2019 GDP median GDP estimate increased to 2.2% from 2.1% and its 2020 estimate was unchanged at 2.0%. The core inflation target remained at 1.8% and 1.9% in 2019 and 2020, respectively, and the estimated year-end fed funds target was 1.9% for both 2019 and 2020. This suggests no more rate cuts in 2019 despite two more FOMC meetings (10/30/19 & 12/11/19), although the fed funds futures market is pricing in an 80% chance of a rate cut at the October meeting and a 36% chance of two more rate cuts by year-end. Given a two-year Treasury yield of 1.52% and a 1.75% (low end) fed funds target, we believe that bond investors believe the Fed should cut the overnight rate at least one more time. One more rate cut, along with an interim trade agreement, could provide improved economic visibility and lead to higher long-term rates. On 7/31/19, the 2-year Treasury yield of 1.87% compared to the 10-year yield of 2.02%. Today the 10-year yield is 1.66%. Even if long-term rates move higher, we do not expect a dramatic move higher, and Treasury rates remaining near historically low levels increases the relative attractiveness of high quality equities.

All Eyes on the U.S. Consumer. U.S. consumer spending has not only been the driver of 2019 U.S. GDP growth, but is also the bright spot in the global economy. Consumer spending is always important as it comprises 68% of U.S. GDP, but it is even more important this year as U.S. business investment has slowed, residential investment remains low, and global economies have weakened (to be sure, government expenditures have also contributed positively to GDP in 2019). Personal Consumption Expenditure (PCE) data is reported by the U.S. Department of Commerce in its quarterly GDP report (and updated monthly through the income and outlays data). It measures consumer expenditures on goods and services, including multiple line items helpful in identifying consumer spending trends. 2Q19 GDP data rebounded from weaker trends in 4Q18 and 1Q19, and made its strongest contribution to quarterly GDP growth since the fourth quarter of 2017. Several consumer categories have been strong in 2019, including household consumption, and both durable and nondurable goods. Monthly data revealed slowing growth in August compared to June and July, which could be attributed to trade concerns, but the monthly trends in 2019 through August were more consistent than in 2018, which was a strong year for consumer spending.

<table>
<thead>
<tr>
<th>U.S. Consumer Spending (PCE) - Quarterly Y/Y%</th>
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<tbody>
<tr>
<td>2Q19: 2.64%</td>
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</table>

Data source: FactSet as of 6/30/19

The Department of Labor reported a 136,000 (K) net increase in nonfarm payroll employment in September and revised the August data to 168K from 130K previously reported. Over the past six months, the U.S. created a monthly average of 154K new jobs compared to 216K one year ago. Given the economy is near full-employment (the unemployment rate is just 3.5%), slowing monthly jobs gains is expected and should be more in-line with the monthly increase in the civilian labor force of an estimated 125K. Full employment should contribute to strong consumer confidence, bolstering consumer spending, which will also be tied to wage gains. Average hourly earnings grew 2.9% in September 2019 vs. 2018, which was the first time the Y/Y growth rate fell below 3.0% in 14 months. We believe Y/Y wage gains of 3.0% or higher are important to keep consumer spending on a strong trajectory.

Through 10/9/19, 10 of 11 S&P 500 sectors posted YTD gains, but since the end of July sector leadership has changed. The outperformance of the S&P 500 in 2019, and recovery from 4Q18 declines, has been broadly represented across multiple sectors, led by Technology, Real Estate (REITs), and Utilities. Only Energy posted a YTD decline, and all other sectors, except Health Care, posted double-digit returns (at least 10%) before dividends. Since the S&P 500 set an all-time high in late-July, the index has traded in a range below that level. From 7/31/19 to 10/9/19, only three sectors posted gains: Utilities, REITs, and Consumer Staples, while some of the early year leaders, representing growth stocks, Technology and Consumer Discretionary, lagged. We attribute several factors to the relative outperformance of these three sectors. First, Utilities, REITs, and Consumer Staples are more defensive, especially Utilities and Staples, as many constituents...
will be less exposed to slowing GDP growth. Second, S&P 500 Utilities (3.1%), REITS (3.1%), and Consumer Staples (2.8%) all have average dividend yields above the S&P 500’s current yield of 1.9%. Many investors have purchased dividend-paying equities as an alternative to plunging yields in fixed income securities. Third, they are a short-term earnings play, as 3Q19 S&P earnings are estimated to decline 4%, with just three of 11 sectors projected to generate Y/Y earnings growth. This includes 3Q19 projected growth for Utilities and REITs, and only a modest decline estimated for Consumer Staples. In our view, these two-plus months of outperformance might not be sustainable, as we continue to favor cyclical sectors over defensive ones. Our sector weight outlook is included later in this report.

**S&P 500 Sector Performance: Since 7/31/19 & YTD through 10/9/19**

Data source: FactSet consensus, S&P 500 earnings are expected to decline 4% in 3Q19 with revenue growth of 3%. Results in 2Q19 reflected earnings that were flat (but better than down 3% expected) and revenue growth of 4% (as expected). In Q3, Y/Y earnings gains are expected from just three of the eleven S&P 500 sectors, led by Utilities (expected up 4%), REITs (up 3%), and Health Care (up 2%). The sectors with the largest expected earnings declines in Q3 are Energy (expected down 37%), Technology (down 10%), and Materials (down 9%). We advocate that long-term investors build portfolios of quality companies that are diversified broadly across sectors. Investors should monitor sector allocations relative to benchmarks and be aware of where sectors are overweight and underweight relative to their portfolio goals. Investors should look to rebalance positions based upon those goals, but rarely do we recommend being “all-in” or “all-out” of a sector. Our current 2019 sector allocation recommendations, versus the S&P 500 index weight, are discussed below.

**S&P 500 Sector Recommendations - October 2019**

<table>
<thead>
<tr>
<th>GICS Sector</th>
<th>S&amp;P 500 Weight by Market Cap</th>
<th>WM Research 2019 Outlook</th>
<th>Notes</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology</td>
<td>22.2% marketweight</td>
<td></td>
<td>diversify across tech industries, top performing 2019 sector</td>
<td></td>
</tr>
<tr>
<td>Health Care</td>
<td>13.7% marketweight</td>
<td></td>
<td>political headwinds create underperformance, valuations attractive</td>
<td></td>
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<tr>
<td>Financials</td>
<td>12.7% overweight</td>
<td></td>
<td>gave back 2Q gains on Fed cuts, strong balance sheets, patience required</td>
<td></td>
</tr>
<tr>
<td>Communications Services</td>
<td>10.4% marketweight</td>
<td></td>
<td>be selective, some companies to face regulatory scrutiny</td>
<td></td>
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<tr>
<td>Consumer Discretionary</td>
<td>10.2% marketweight</td>
<td></td>
<td>consumer trends positive, but remain diversified beyond retailers</td>
<td></td>
</tr>
<tr>
<td>Industrials</td>
<td>9.2% overweight</td>
<td></td>
<td>attractive valuations, could extend rally on positive trade news</td>
<td></td>
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<tr>
<td>Consumer Staples</td>
<td>7.7% underweight</td>
<td></td>
<td>strong defensive appeal, global exposure limits upside, watch valuations</td>
<td></td>
</tr>
<tr>
<td>Energy</td>
<td>4.4% marketweight</td>
<td></td>
<td>global demand &amp; geopolitical concerns, low expectations, look for quality</td>
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<tr>
<td>Utilities</td>
<td>3.6% underweight</td>
<td></td>
<td>strong defensive and domestic appeal, but sector is expensive</td>
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<tr>
<td>Real Estate (REITs)</td>
<td>3.3% marketweight</td>
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<td>low interest rates are here to stay and are a positive driver</td>
<td></td>
</tr>
<tr>
<td>Materials</td>
<td>2.7% marketweight</td>
<td></td>
<td>vulnerable to global weakness, look for pricing power</td>
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</table>

Data source: D.A. Davidson Wealth Management Research 10/10/19 (S&P 500 sector weights as of 10/9/19)
Wealth Management Research Investment Cycle Gauge

**Economic Indicator**

Bearish | Neutral | Bullish
---|---|---

Changes from prior indicator: modestly lower, as GDP trends track lower

**Earnings Indicator**

Bearish | Neutral | Bullish
---|---|---

Changes from prior indicator: none, earnings growth to resume in 4Q19?

**Equity Market Indicator (2019)**

Bearish | Neutral | Bullish
---|---|---

Changes from prior indicator: no change to fair value estimate

Source data: D.A. Davidson & Co., as of 10/10/19

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Market Indices: The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Indices provide a general source of information on how various market segments and types of investments have performed in the past. Index performance assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. You may not invest directly in an index. Past performance is not an indicator of future results. The Russell 2000® Index is a market cap weighted index that measures the performance of the 2,000 smallest companies in the Russell 3000® Index. The S&P 400 Index is a market cap weighted index comprised of U.S. stocks in the middle capitalization range, generally considered to be between $200 million and $5 billion in market value. The S&P 500 Index is a market cap weighted index that is designed to measure the US large-cap equity performance. The index is composed of the 500 leading publically traded US companies based on size, liquidity, industry, and profitability criteria. The Dow Jones Industrial Average is a price weighted index that tracks 30 large, publicly-owned companies trading on the New York Stock Exchange (NYSE) and the NASDAQ. The MSCI EAFE® Index (Europe, Austral, Asia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

Other Disclosures:

The forward S&P 500 price-to-earnings ratio (P/E) is a valuation measure, calculated by dividing the price of the S&P 500 index over the weighted average earnings per share (EPS) estimate of each company in the index. Earnings are based on “forward” consensus estimates expected over the next 12 months (NTM).

The yield of the 10-year U.S. Treasury bond is a widely followed barometer of the current U.S. interest rate environment.

S&P 500 earnings growth reflect the year over year change in operating earnings on a per share basis. Earnings data are aggregated for all S&P 500 constituents and are measured according to the relative market capitalization weights for each company. Estimated earnings are the combined FactSet estimates of analysts covering each company included in the index.

Non-residential fixed investment is an indicator of U.S. corporate capital expenditures (capex), measured by the amount spent on structures, equipment, and software. Seasonally adjusted annual rate (SAAR) is used to normalize data by adjusting for seasonal changes in business and economic data for a more accurate comparison between different time periods.

The ISM Purchasing Managers' Index (PMI) is an indicator of the outlook for the manufacturing (PMI – Manufacturing) and services (PMI – Services) sectors of the economy. The index is based on a wide survey of company executives in these sectors. A reading above 50 indicates expectation for expansion compared to the previous month; a reading below 50 suggests contraction. Seasonally adjusted (SA) is used to normalize data by adjusting for seasonal changes in business and economic data for a more accurate comparison between different time periods. United States and Euro Zone data is provided by IHS Markit, Japan data is provided by Nikkei, United Kingdom data is provided by the Chartered Institute of Procurement & Supply, and China data is provided by Caixin.

The Treasury yield curve displays the market interest rate across different contract lengths for U.S. Treasury bonds, indicating the relationship between the interest rate and the time (“term”) to maturity.

The yields of the 10-year and 3-Month U.S. Treasury bonds are widely followed barometers of the current U.S. interest rate environment. The spread is the difference in interest rates between the two securities.

U.S. Personal Consumption Expenditures (PCE) is an indicator of the growth in consumer spending.

Country GDP estimates are aggregated and redistributed by FactSet. This does not constitute investment advice or recommendations of any kind. Estimates data is provided for information purposes only. IMF-Global GDP estimate is the International Monetary Fund’s World Economic Outlook last published on 4/2/19.