A TALE OF TWO MARKETS

March marked the 10th anniversary of the low on the S&P 500 during the global financial crisis. Since then, the index produced an annualized total return of 16.7 percent over one of the best-performing decades for risk assets returns on record. The market rebound in late December last year continued through March, but relied heavily on confidence in the ability of central banks to contain downside risks of slowing global growth. Therefore, the most significant risk to this rebound and low volatility is that central banks lose control of this narrative. In his recent 60 Minutes interview, Federal Reserve Chair Jerome Powell confirmed what we predicted in our 2019 Outlook namely “growth has slowed in some major economies.”

At the March Federal Open Market Committee (FOMC) meeting, Fed policymakers signaled zero rate increases in 2019 and just one hike in 2020, down from two hikes in 2019 and one in 2020 to align interest rate expectations with slower growth momentum. Federal fund futures signal an even more accommodative monetary policy stance, forecasting a full 25 basis point rate cut by year-end.

While March provided plenty for investors to digest, risk-assets proved resilient. Ongoing protests in France, uncertainty around Brexit, back-and-forth U.S.–China trade negotiations and weaker domestic growth and inflation data did not deter the rebound in risk assets. The S&P 500 Index rallied 1.9 percent in March and now stands 20.6 percent above its December lows. The forward price-to-earnings valuation multiple on the S&P 500 Index increased 1.6 to 17.1 during the first quarter and explained a large portion of those returns.

2019 earnings forecast

As earnings season unfolds, it will be instructive to focus on earnings growth and compare full-year earnings guidance to current estimates. Bloomberg consensus estimates lowered their earnings growth forecast for 2019 from 8.1 percent to 2.4 percent, but those forecasts also call for approximately 2.0 percent margin expansion from 2018. Corporate profit trends will be particularly important since recent bank lending surveys indicated tightening of lending standards. If lending standards do not ease quickly, corporations will need to offset higher borrowing costs by reducing capital expenditures, labor costs or cutbacks in other areas. While we expect corporate profit margins to fluctuate over short periods, we acknowledge they are currently high by historical standards in the face of a slower growth outlook. Therefore, we caution investors from reaching for return at this stage of the market cycle.

In contrast to the risk-on sentiment in the equity market, returns in fixed income markets were consistent with mounting growth concerns. High yield credit spreads widened 0.1 percent to 3.9 percent, and the 10-year U.S. Treasury yield fell 0.3 percent to 2.41 percent. The spread between two-year and ten-year U.S. Treasury yields fell 5.0 basis points to 13.9 in March. This month, Fed policymakers outlined a roadmap for balance sheet normalization: slow the pace of reduction starting in May and conclude balance sheet reduction by the end of September.

Yield curve message

We believe inversion on the front end of the yield curve is still sending Fed policymakers a message that monetary conditions remain too tight. While still a low probability in our view, the yield curve could be signaling that monetary policy cannot generate sustained economic growth. For example, starting in mid-2018 (before the European Central Bank ended its asset purchase program), the rise in long-term Treasury yields began to slow as investors called the synchronized growth narrative into question. In our view, this indicates that accommodative monetary policy may need concurrent and forward-looking economic indicators to justify a further sustained rally in risk assets.
Market outlook

Despite the rebound in equity valuations, we remain constructive on underlying fundamentals but acknowledge that elevated valuations likely reduce upside potential from here absent meaningful and sustained earnings growth. Expectations still call for the U.S. economy to grow approximately 2.1 percent in 2019 and Fed policymakers took steps at the March meeting to accommodate slowing growth momentum. Effects of fiscal and monetary accommodation are still working through China, and the European Central Bank recently announced a new term lending facility intended to spur loan growth in the region. Although the U.S.–China trade conflict remains fluid, U.S. officials extended the deadline for further negotiations. Both mounting populism in Europe and Brexit negotiations remain sources of headline risk for markets and bear monitoring.