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The Farr View

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DID YOU SEE US?

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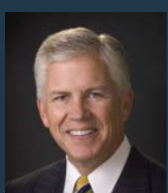

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There is a palpable sense of relief among investors. The classic “V-shaped” recovery that began on the day after Christmas continued throughout the first quarter and into the second. The gains have been broad-based and nearly uninterrupted as investors took advantage of the opportunity to add exposure following several years of scant such opportunities. But while we are quite satisfied with the outcome, we are somewhat concerned that the genesis of the rally had more to do with the Fed than with improving economic fundamentals and corporate earnings growth. The more things change, the more they stay the same.

The Economy

The incoming economic data in recent months have painted an ambiguous picture. There is plenty of evidence of economic resilience in the face of a global economic malaise. But there is also ample evidence to support the narrative of economic weakening. We very well could be heading in to a recession sooner than anyone thought. Or we could simply be in the middle of a transitory economic “soft patch” resulting from a confluence of negative influences. It could go either way. Our best guess is that a recession over the near term remains unlikely. But we also believe that a sustainable breakout from the trend growth rate of about 2% is not yet in the cards either.

It sure seems as though the positive resolution of significant policy uncertainties could prove to be the swing factor that determines the economy’s near-term fate. Unfortunately, and despite our close proximity to the White House, we cannot predict any better than others the ultimate repercussions of the trade negotiations, the Mueller report, the Mexican border crisis, Brexit, or even the outcome of next year’s presidential election. To be sure, there are always wildcards that investors must grapple with. But the magnitude and importance of such sideshows sure seem elevated right now. As such, we continue to closely follow all political and economic developments and how they may affect the investment landscape.

The good news for our consumer-centric economy is that unemployment is very low, wages are starting to grow at a faster pace, and consumers are still able to save at a decent rate. As long as these trends continue, it’s hard to see the economy falling into recession. One of the elusive elements in our 10-year economic recovery has been more robust growth in middle-class incomes. The vast majority of the income and spending gains have been enjoyed by a relatively small percentage of the population. But recent data finally suggest this may be changing. Average hourly earnings rose 3.2% year-over-year in March, down a tad from the 10-year high in February (+3.4%) but still much better than the average over the past ten years. Perhaps more importantly, the improved wage

...Continued

growth is coming at a time when inflation is cooling. The net effect is that middle-class workers are finally beginning to enjoy better purchasing power following two decades of stagnant inflation-adjusted incomes. Higher middle-class incomes, stable inflation and low interest rates are a recipe for continued economic growth in an economy heavily dependent on consumer spending.

Productivity

In addition to weak middle-class income growth, the economic recovery has also been characterized by weak growth in labor productivity. Of course, these two factors are related. One of the principal drivers of higher wages, over time, is growth in labor productivity. If a given worker is able to produce more in a given day or hour, a portion of the spoils of that improved efficiency generally goes to the worker. Unfortunately, labor productivity has ground to a virtual halt since the end of the Great Recession. From the year 2000 until the start of the recession in December, 2007, productivity growth averaged 2.7% annually. Since the recession ended in June, 2009, productivity has averaged just 1.1% annually. This is a dramatic deceleration that can be attributed to many factors, including a relative lack of corporate investment, deteriorating educational achievement, a lack of training for jobs in emerging industries, chronic health conditions such as the opioid epidemic, and deteriorating infrastructure.

Fortunately, we may be seeing a turn for the better. The Department of Labor reported in March that productivity rose 1.9% in the fourth quarter of 2018 – the third consecutive quarter of above-trend growth. More sustainable productivity growth of 2% or more will likely require long-term investments, but we are hopeful the recent improvements can continue.

Growth in labor productivity is one of two factors that add up to any country's economic growth potential. The other factor is the growth in labor, and the news is a little more positive here as well. Better job opportunities are starting to draw people back into the labor force. In fact, the labor participation rate started to stabilize in 2015 and is now modestly above the lows in that year (63.0% compared to 62.4%). This rebound must continue, especially if initiatives to dramatically limit immigration, both legal and illegal, gain support.

It is true that slower global growth will significantly impact earnings growth for US corporations. But there are also several other factors at play that are likely to pressure corporate earnings this year.

How's Corporate America Faring?

Even as the stock market rally has climbed steadily higher, earnings expectations have been falling quite precipitously. As recently as September of last year, economists had been expecting double-digit earnings growth for the S&P 500 in 2019. Those expectations have been brought all the way down to 4% as of this writing. Many have pinned the deterioration on economic weakness outside the US and a strengthening dollar, both of which cut into earnings for US companies that do business overseas. It is true that slower global growth will significantly impact earnings growth for US corporations. But there are also several other factors at play that are likely to pressure corporate earnings this year.

As discussed above, middle-class wages are finally beginning to grow at a more respectable pace. But what's good for workers may not be so good for employers. Higher labor costs, combined with the inability to pass on those higher costs to customers through price increases, mean that corporate margins may be at risk of falling from historically lofty levels. And with unemployment at 3.8%, it's hard to see these wage pressures subsiding anytime soon. We would note that continued gains in productivity could help keep unit labor costs contained. But again, the better rates of productivity growth in recent quarters could prove fleeting in the absence of significant investments.

Continued increases in commodity prices could also eat into margins. According to an article in The Wall Street Journal, "Fueled by output cuts led by the Organization of the Petroleum Exporting Countries and US sanctions on Venezuela

Source: Bloomberg.

and Iran, US crude-oil futures prices rose 32% in the three months through March, logging their biggest one-quarter percentage gain since 2009." If the US and its trading partners are unable to reach agreements, tariff-related increases in commodities like steel and aluminum could also sting.

Profit margins are also likely to suffer from a surge in corporate debt. Data from the Federal Reserve tell us that non-financial corporate debt (banks have reduced leverage) rose 50% to $15.2 trillion from 2010 to 2018. Perhaps more troublesome, though, is the quality of that debt. A recent article on Bloomberg.com read, "According to S&P Global Ratings, the companies rated BBB+, BBB, or BBB- (the three lowest investment grades before they would hit "junk" status and face much higher interest payments) now outnumber all of the companies with some level of A-rated debt. It looks as though companies are 'gaming' the ratings companies, borrowing as much as they can get away with." Indeed, if the economy takes a turn for the worse, many companies that loaded up on debt to buy back stock may find it difficult to service that debt, especially in the event of a rating downgrade. For now, though, credit spreads are not signaling an imminent, systemic problem.

Deteriorating balance sheets (higher debt) and subdued cash-flow growth are also likely to impact another source of per-share earnings growth: stock buybacks. Following many years of elevated stock buybacks, the federal government cut corporate tax rates significantly in late 2017. Various studies show that the lion's share of those tax savings did not go toward growth investments but rather stock buybacks. According to an April 3, 2019 Associated Press article, "Companies in the S&P 500 spent $806 billion on stock buybacks in 2018, blowing away the previous record of nearly $590 billion set in 2007." Such gains are unlikely to repeat in 2019.

Deficits and Debt

I would be remiss not to say a few words on the US government's financial standing. The federal government's tax cuts and spending increases are expected to cause trillion-dollar deficits as early as next year. The deteriorating fiscal condition clearly has not mattered much…yet. In fact, long-term interest rates have dropped significantly even as the deficit has soared. So what's to fear? Well, I can think of a couple of problems. First, the government's capacity to respond to the next recession through stimulative fiscal policy (tax cuts and spending increases) has likely been impaired, and perhaps meaningfully so. Second, investors in Treasury bonds will eventually require higher yields to compensate for the increased risk of lending to such a heavily indebted borrower. You've probably heard me say this many times, but large deficits don't matter until suddenly they do. And as we've seen in the not-too-distant past, the "Bond Vigilantes" can be quite relentless when they smell blood.

A Tale of Two Markets

Those looking to the capital markets for reliable tea leaves are doomed to frustration. As stocks have climbed relentlessly higher, longer-term bond yields have, counterintuitively, dropped precipitously. Let's start with stocks. The magnitude of the gains in stocks so far this year is surprising given the economic backdrop. The price-to-earnings ratio for the S&P 500 has risen to back over 17x forward earnings, up from about 15.5x at the beginning of the year and the 10-year average of about 16x. What makes this more surprising is that this multiple expansion has happened even as earnings estimates have been coming down.

Investors should be well aware that we

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are heading into the 11th year of this economic expansion, a period during which stock prices have increased well over 300%. Corporate profit margins are running near all-time highs, and stock valuations look especially stretched if we assume margins eventually revert back to long-term averages. The risks may be rising that the US will be infected by the slowdown overseas, and a large amount of policy uncertainty remains with regard to trade deals with China, Europe and Mexico. Each of these factors would seem to be cause for some caution on the part of equity investors. Instead, investors appear to be placing decidedly more weight on the Fed's policy reversal. The Fed is out of the way again, and that's all many equity investors need.

Based on the accumulating set of economic risk factors, the decrease in bond yields is easier to comprehend. The yield curve has been flattening and has even become inverted in some places, causing some economists to fear an impending recession. But an outcome that extreme is inconsistent with the strength in the stock market, so there could be other factors driving investors back into Treasury bonds. Most influential among these factors are the recent reduction in inflation (disinflation); a meaningful slowdown in growth outside the US (making the US a comparatively good place for your money); and yes, the most important factor of all, the Fed has announced it is no longer increasing short-term interest rates and will stop reducing the size of its balance sheet later in the year (a program that had been described as being on "auto-pilot" as recently as December).

The markets' reaction to the Fed's abrupt reversal is troubling to me. For the first three quarters of 2018, it almost seemed like we were back to "normal" market conditions whereby good economic news was embraced by stock investors and bad news was met with selling. During this period, stock prices and interest rates rose together in a sign that economic vitality was finally being valued more highly than easy money. But here we find ourselves again as stocks climb steadily higher, within spitting distance of new highs, in the face of a deteriorating economic backdrop and falling interest rates. It sure seems that we have reverted back to the days when "Don't fight the Fed" and "TINA" (TINA stands for There Is No Alternative to stocks) were an investor's only guiding principles. That's probably not a healthy development.

To expect the stock market strength to endure based largely on loose monetary policy and in the face of economic weakness is probably not realistic. Richard Turnhill, global chief investment strategist at BlackRock, said it best when he said that in order for stocks to continue rallying, "The global economy must remain strong enough to quell recession fears but weak enough to keep policy makers on hold." We agree, and that seems like a very fine line to walk.

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