LPL RESEARCH

WEEKLY MARKET COMMENTARY

April 1 2019

THE STOCK MARKET'S FINAL FOUR

John Lynch *Chief Investment Strategist, LPL Financial*
Jeffrey Buchbinder, CFA *Equity Strategist, LPL Financial*

The NCAA Final Four is set. On the men's side, Auburn, Michigan State, Texas Tech, and Virginia are headed to Minneapolis to determine this year's college basketball national champion. On the women's side, UConn and Oregon punched their tickets over the weekend while the other two spots will be decided tonight—Baylor and Notre Dame are the favorites.

Source: LPL Research 04/01/19

The economic forecasts set forth in this material may not develop as predicted.

Please see the *Outlook 2019: FUNDAMENTAL: How to Focus on What Really Matters in the Markets* for additional description and disclosure.

In that spirit, our weekly commentaries discuss our "Final Four Factors" for the markets and economy over the balance of the year. In today's *Weekly Market Commentary*, we share our "Final Four Factors" for the stock market in 2019: policy, the economy, rates, and profits. While we expect a hard-fought battle between these factors and, with it, some market volatility, we still see the potential for further gains for stocks this year. However, given recent strength, the risk-reward trade-off for U.S. equities has become less attractive, as we wrote here last week, and we recommend a market weight equities allocation for appropriate strategies. The Weekly Economic Commentary looks at the four biggest catalysts we think could jump-start economic growth.

POLICY

Policy is our top seed because of its importance in potentially extending the business cycle. Considering monetary policy's limitations with the Fed pausing its rate hike campaign (more on that below), the onus is on fiscal policy to support the durability of the economic expansion. Last year's package of additional government spending of roughly $300 billion over two years (2018–2019) is still giving the economy a boost. Corporations and consumers are saving more in their taxes this year than in 2018. We think the full impact from capital investment incentives that were part of the December 2017 tax reform has yet to flow through, particularly as corporations repatriated roughly $700 billion in overseas profits last year.

However, tariffs and ongoing trade uncertainty have pulled in the opposite direction, dissuading companies from making long-term investments. We continue to expect a U.S.-China trade deal within the next couple of months, as key players—including President Trump—have expressed increasing optimism recently. Both sides clearly want a deal: Trump wants to boost his reelection chances and China wants to support its economy. Although an agreement may be largely priced in to stocks, some tariffs could be rolled back, presenting a possible upside surprise.

On monetary policy, a possible mistake by the Fed introduces recession risk. The revised message from the central bank—that they expect to keep rates unchanged through 2019 and they will stop shrinking their balance sheet this fall—reduce by quite a bit the chances of a mistake this year in our view.

Bottom line: We expect fiscal policy to take the baton from monetary policy and help extend the economic cycle. Trade policy remains a risk, but we remain confident in an eventual deal. Meanwhile, the risk of a Fed policy mistake has fallen, in our view.

Expected Stock Market Impact:

LIKELY POSITIVE

ECONOMY

The U.S. economy has hit a soft patch to start the year. The consensus forecast for first quarter gross domestic product (GDP) growth according to Bloomberg is just 1.5%. Tariffs, the government shutdown, and slower growth overseas are among the reasons for the sluggish U.S. growth. However, first quarter GDP readings this cycle have averaged 1.7%, compared with 2.2% average overall quarterly growth, an indication of weather-related distortions. Looking forward, some temporary headwinds are expected to clear, making a return to trend growth (2.2%) or better likely.

We expect a pickup in capital investment after trade uncertainty clears, leading to improved productivity growth, a key to extending the economic expansion. Meanwhile, the consumer spending outlook remains solid, buoyed by continued gains in employment and wages. We expect a rebound in job growth in March after February's dip (the jobs report is due out this Friday, April 5). Consensus expects wage growth to remain steady at 3.4% year over year, good enough to support healthy spending gains but not enough to concern the Fed; and keep in mind previous recessions were preceded by greater than 4% annual wage gains. Inflation remains well contained overall.

Bottom line: We expect U.S. GDP to grow at a 2.5% pace this year, down slightly from last year's roughly 3% pace but above the 2.2% average pace since the economic expansion began. Fiscal policy and a U.S.-China trade deal may provide a boost.

Expected Stock Market Impact:

POSITIVE

RATES

A pickup in U.S. economic growth and tight labor markets accompanied by steady wage gains, we believe, should help prop up yields and steepen the yield curve. We expect a gradual increase in the 10-year Treasury yield over the rest of 2019 to a potential range of 3% to 3.25% (current rate is 2.47%). However, a Fed (most likely) on hold this year takes one potential catalyst for higher yields off the table and the low end of our projected range may prove more likely. Weakening growth in Europe is depressing their bond yields, also keeping a lid on U.S. yields that are still attractive to foreign bond buyers.

Although the inversions (shorter-term bonds yielding more than longer-term bonds) of parts of the yield curve do point to economic weakness, a number of factors provide important context for investors. These include the small magnitude of the inversion, the short length of time the inversions have been in place, the low absolute level of rates, and the healthy and relatively calm credit markets. Also keep in mind that stocks have historically done well following inversions, as we discussed here.

We favor a combination of investment-grade corporates and high-yield bonds for fixed income allocations as complements to high-quality core bond holdings. This positioning can help take advantage of healthy corporate balance sheets and steady growth while keeping interest rate sensitivity in check.

Bottom line. Over the full year, we expect a gradual increase in the 10-year Treasury yield. A pickup in U.S. economic growth and tight labor markets accompanied by steady wage gains should help prop up yields and steepen the yield curve.

Expected Stock Market Impact:

MODEST POSITIVE
(Modest negative for bonds)

EARNINGS

Steady economic growth points to another year of record corporate profits in 2019. Our forecast for S&P 500 earnings per share in 2019 remains $172.50, representing a little over 6% growth. We believe Wall Street analysts have become overly pessimistic in bringing the FactSet consensus estimates down from roughly $177 in November to just $168 currently, representing a 3–4% annual increase. We expect solid economic growth, resolution to the trade dispute, and improved productivity growth to help drive earnings closer to our estimate. If some or all of those conditions are not achieved, a number midway between our 2019 estimate and consensus may be the most likely outcome.

Historically, corporate revenue is correlated with GDP plus inflation (nominal GDP), which could potentially approach 5% this year. That means profit margins do not have to expand—they could even contract a little—and corporate America could still potentially generate earnings growth near our 6% forecast. Share repurchases will help as they bring down the share counts that go into the earnings per share calculation. Wages are rising but with only very gradual acceleration, constraining cost pressures. The story is the same for borrowing costs, which have risen very slowly in recent years due to range-bound interest rates.

For those worried about the slower pace of earnings growth expected in 2019, history shows that peaks in earnings growth rates have tended to be followed by several years of economic strength and stock market appreciation. That should be reassuring to those who think a now 10-year-old bull market may be getting fatigued.

Bottom line. We expect the S&P 500 to generate mid-single-digit earnings growth in 2019. Though slower than last year's pace, we expect solid economic growth supported by fiscal stimulus, robust manufacturing output, and healthy labor markets to drive another year of record profits.

Expected Stock Market Impact:

MODEST POSITIVE

CONCLUSION

Well, there you have it—our "Final Four Factors" for the stock market in 2019: policy, U.S. economy, rates, and profits. We believe it will be a hard-fought battle between these factors, and they may not all be big winners, but when the "tournament" is over at the end of the year, we believe the S&P 500 will be at or near our year-end fair value target of 3,000. ■

DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

RES-98253-0319 | For Public Use | Tracking #1-837721 (Exp. 04/20)