Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company
Investment Outlook, August 2019

Congratulations to all those who held firm last fall when stocks were on the brink of a 20% bear market decline, commodity prices were plunging, and the 10-year Treasury yield was hovering above 3%. Since that time, the Standard & Poor's 500 Index has experienced its best first half in more than 20 years, and currently stands an impressive 28% above the low it reached on Christmas Eve.

There is a growing consensus among analysts that the second half of the year will be far more challenging than the first. Slower economic growth, made worse by rising tariffs and the ever-present threat of further acceleration in our ongoing trade wars, are contributing to revenue shortfalls, declining margins, and disincentives for companies to invest. Nominal GDP growth is now forecast to fall to its slowest pace since we emerged from the Great Recession in 2009.

Corporate earnings are feeling the pain of the economic slowdown. With 44% of the S&P 500 companies having reported results, 2nd quarter earnings are now expected to be 2.6% below last year's results. To assess the impact of rising tariffs on corporate earnings, it is instructive to divide the index into two groups: companies that generate more than 50% of their sales outside the U.S. (more global exposure), and companies that generate more than 50% of their revenues inside the U.S. Results show that the latter group is generating modest earnings growth of 3.2% on a year/year basis, while companies whose revenues are generated primarily overseas are experiencing an aggregate earnings decline of 13.6%.

Earnings estimates for the rest of this year continue to trend lower, as well. Among the companies that have revised guidance for the 3rd quarter and beyond, 80% have guided estimates lower, according to data compiled by Bloomberg. It is now estimated that S&P 500 earnings for all of 2019 will be 7% below what had been expected at the beginning of the year. It is also somewhat ominous to note that consensus estimates for 2020 remain more than 11% above this year's level, a gain that seems unlikely given the macro conditions that are being forecast.

While lower growth forecasts drove the 10-year Treasury yield below 2% for a time, the stock market has, until now, looked past economic concerns and lower earnings because of a widely held view that a more accommodative Federal Reserve would begin lowering short-term rates. The Fed, itself, said or signaled nothing to discourage such expectations. The market received an unwelcome surprise yesterday, however, when the Fed cut rates 25 basis points, as expected, but hinted that further rate cuts this year were not a sure thing.

This is not the first time Chairman Powell's ambiguity has roiled the market. Recall last December when the Fed not only hiked rates in the face of lower economic forecasts, but seemed to imply that further "gradual" rate hikes might be appropriate. The S&P 500 fell more than 7% in the days following that announcement, and the Fed moved quickly to signal that possibly it had mischaracterized its intentions. Perhaps the market's negative reaction to yesterday's comments will result in a similar reexamination by the Fed of its course, but for the moment markets are baffled and concerned about what comes next.

According to Bloomberg, 25% of all bonds in the world trade at negative interest rates, and J.P. Morgan has speculated that the 10-year U.S. Treasury could be headed toward zero, as well. However remote that possibility may appear to be now, as the volume of negative yielding debt grows in Europe and Japan, global investors seeking a safe harbor and positive returns are likely to look increasingly to the U.S. bond market. If the Fed moves to lower rates in the coming months, which is still a possibility notwithstanding yesterday's announcement, money would likely flow out of money-market funds into bonds in an attempt to lock in yields. The Fed announced that it had ended its balance sheet run-off, and could thus return to quantitative easing. All this is to say that even though U.S. yields have declined dramatically, the current low interest rate environment could persist for a while, and further moves downward are possible. Such an eventuality would be quite favorable for stocks as well, especially those with above average dividends and a track record of raising their dividends on a consistent basis.

While stock prices follow earnings in the long term, in the short term stock prices mostly follow the Fed. This could not be more evident than now, with the market at all-time highs while earnings are declining. The S&P 500 currently trades at roughly 17x next year's earnings estimate, which is above its longer term mean, and 2020 estimates are more likely to be revised downward than upward. Of course, cutting interest rates 50 to 100 basis points raises equity valuations, but that won't help a stock market whose earnings continue to decline in the face of an increasingly fragile global economy.

If the Fed, and central banks globally, are able to engineer a soft landing, that will be the best of all worlds for risk assets in an economy with low interest rates and no inflation. The market is clearly discounting such an outcome, but the risks are rising.

Joseph J. Tascone
Senior Vice President &
Senior Investment Officer

Michael D. Blatt, CFA
Vice President &
Senior Investment Officer

Peter M. Capozzola, CFA
Vice President &
Senior Investment Officer

John E. Shea
Vice President &
Investment Officer

Kevin W. Brimmer
Portfolio Manager

Shelby M. Fay
Portfolio Manager

Chemung Canal Trust Company

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