Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

Investment Outlook, July 2019

Congratulations to all those who refused to panic and held their positions last fall when stocks were on the brink of a 20% bear market collapse, commodity prices were plunging, and the 10-year Treasury yields were hovering above 3%. The Standard & Poor's 500 Index has just experienced its best first half in more than 20 years, and now 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 future 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 unattainable given the macro conditions that are being forecast.

So in one corner we have slowing growth and lower earnings, while in the other corner we have lower long term interest rates and a more accommodative Federal Reserve that is set to begin lowering short term rates. For investors, it seems like this market is running with one foot on the brake and one on the gas. As future earnings estimates continue to move lower, stocks are mostly reacting to expectations that lower interest rates can pull the economy out of its current slowdown and extend this historic economic expansion even longer.

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, as expected, the Fed moves to lower rates in the coming months, money will likely flow out of money-market funds into bonds in an attempt to lock in yields. Another pool of funds into the bond market could come from the Fed, should it return to quantitative easing once it ends its balance sheet run-off in September. All this is to say that even though U.S. yields have declined dramatically, a move higher is not inevitable, and further moves downward are possible.

While in the long term stock prices follow earnings, in the short term stock prices 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.

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