



# It Doesn't Get Much Better Than This

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Timely Thinking.  
Timeless Values.

Everyone should put a visit to Iceland on their bucket list. Roughly the size of Ohio, it is an island nation of spectacular beauty—a visual blend of Hawaii and Yellowstone National Park. Geysers, waterfalls, hot springs, snowcapped mountains, glaciers, green pastures filled with flowers, sandy beaches, and picturesque fishing villages.

In June, I spent a few days in Reykjavik, Iceland's capital. The city was alive with arts, entertainment and adult libations; the weather was clear with highs in the upper 50s—idyllic conditions for a tourist visit.

As I reflected on my brief time there, I thought, "It doesn't get much better than this." Then I recalled a lecture I heard from a local geologist. Iceland, like Hawaii and Yellowstone, sits atop active volcanic systems. For Iceland, 32 volcanic systems feed 132 separate volcanos—some active, others not.

In 2010, one volcano erupted, spewing enough ash into the air to shut down air travel to northern Europe for almost a month. Back in the 1780s, a volcanic eruption killed one-fifth of Iceland's population and over half of its livestock.

Now, Icelanders are not-so-eagerly awaiting the eruption of Katla, a monster volcano lurking beneath the surface of a large glacier. Katla is long overdue to blow its top: it normally erupts every 20 to 80 years, but last erupted in 1918. Increasing CO2 gas emissions from fissures around Katla are early warning signs to geologists that an eruption is fast approaching.

Once I returned to the US, I found myself thinking about the US stock market much like I now think about Iceland. Near idyllic conditions currently exist for the US stock market. Interest rates and inflation are low. Credit is readily available. Labor markets are strong. And while global manufacturing is slowing due to trade tensions, the service-based, consumer-driven US economy is in solid shape as evidenced by the first quarter's 3.1% growth rate. Plus, investors are expecting the Fed to ease monetary conditions further in order to sustain the economic expansion.

These are some of the factors that the S&P 500® index just produced its best first-half performance in over two decades and continues to hover near record highs.

But lurking beneath the surface of current economic and market trends are several problems that could erupt later in 2019 or 2020 and send both stock prices and economic activity lower. What's more, this month the US economy will complete its 121st month of expansion—making it the longest on record. This expansion has reduced the unemployment rate (currently 3.7%) to the lowest level since the late 1960s. As the charts at the top of the next page suggest, low unemployment rates can coincide with peaks in stock prices. Why? Because it can spur inflation pressures which cause the Fed to hike interest rates.

Of course, right now there is little inflation in our economy. Core inflation (inflation ex food and energy) is running just below the Fed's 2% target. Wage inflation, a major driver of core inflation, has recently crept up to 3.1%, but that's still below the 4% gain that has usually worried the Fed. My current view on the US stock market can be summed up as, "it doesn't get much better than this." Recent economic trends are supportive of stock prices, but most of the good economic news seems adequately reflected in current equity valuations. At this writing, the S&P 500® index is at 2980, in line with the 2975 (P/E Ratio 17.5 times \$170 earnings) price target for 2019 that I outlined in my last newsletter. So, I don't see much upside potential in the stock market from current levels, but neither do I see much downside risk in the near term.

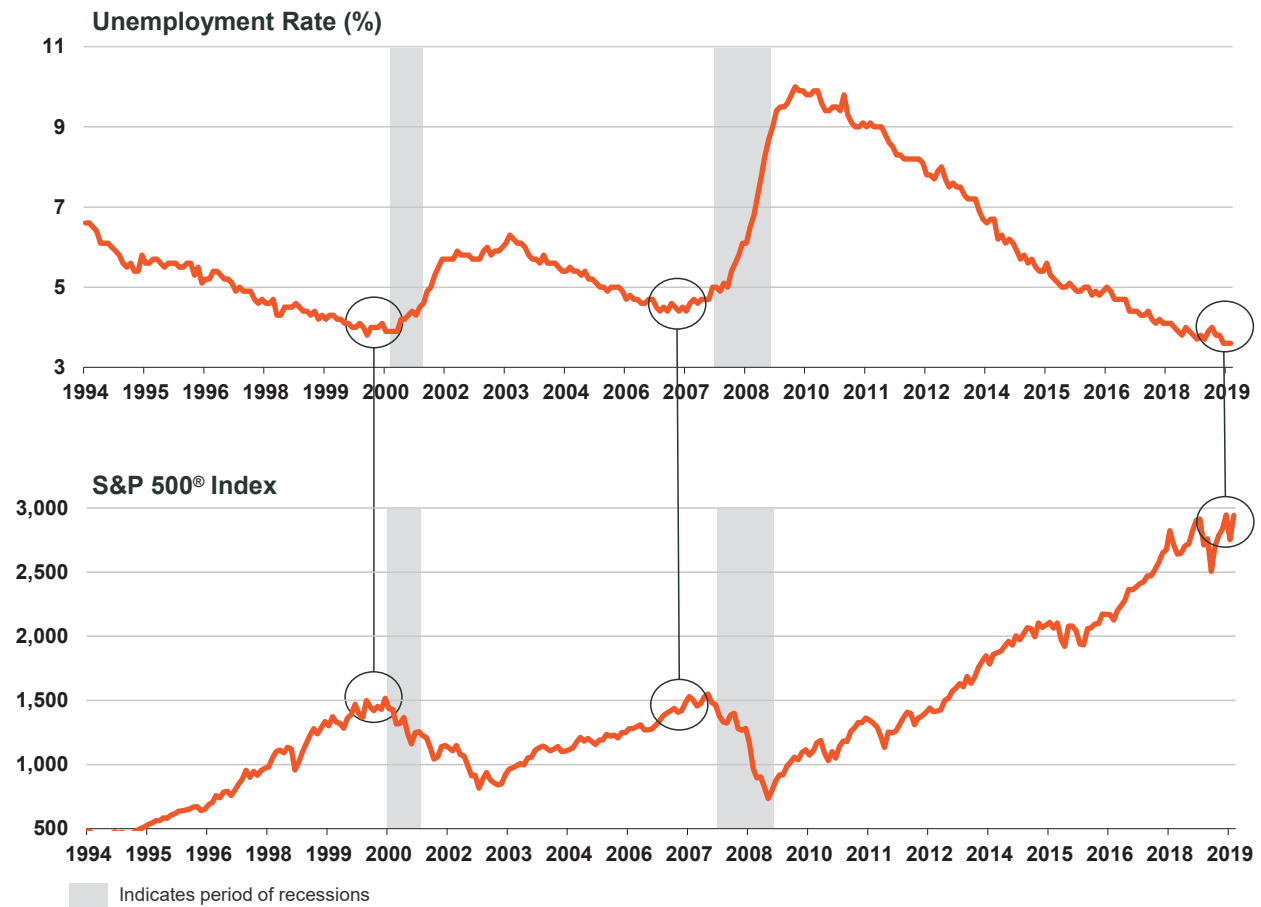
The most significant change in the investment landscape since my last newsletter is in interest rates. In my letter of April 10, 2019, I wrote, "Inflation pressures from rising energy prices and tight labor markets should push longer-dated fixed income yields higher and keep the yield curve from inverting." I was wrong. Longer-term interest rates declined sharply during the quarter as global manufacturing activity weakened due to the trade war. The yield on the 10- year Treasury note dropped from 2.4% in March to 2.0% in June. This drop inverted the yield curve,

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## The Unemployment Rate vs. The Stock Market



Sources: Bureau of Labor Statistics, Bloomberg, Atlanta Capital as of 6/30/19.

i.e., long bond yields dropped below money market yields. At this writing, 10-year Treasuries yield 2.1% compared with three-month T-bills of 2.2%, so the curve is inverted but not by much.

Historically, an inverted yield curve has been a reliable early warning sign of an approaching recession and a bear market in stocks. The lead times between a yield curve inversion and a recession are six to 24 months—shorter for a bear market. Since 1955, an inverted curve preceded all nine recessions, with one false positive occurring in the mid-1960s.

Could the current inverted curve be another false positive? The case that it could be is based on two factors. First, there's the argument that \$13 trillion in government debt globally (mostly in Europe and Japan) has negative yields. For example, the German 10-year note yields a negative 0.35%. As a result, the paltry positive 2.1% yield on the US 10-year note looks good by comparison. The existence of negative interest rates on so much foreign sovereign

debt has artificially depressed yields in the US, so the argument goes. These negative rates didn't exist in prior interest rate cycles.

Second, if the inverted yield curve was really signaling economic trouble ahead, one might expect that credit spreads would be widening. They are not. Credit spreads—the premium in yields that lenders demand for holding lower quality vs. higher quality debt—have not widened in recent months, despite the deterioration in global economic conditions. Widening credit spreads, like a yield curve inversion, are usually a reliable early warning sign of economic trouble. Credit spreads have remained tight in recent months, suggesting readily available financing for lower quality companies and little fear about the future on the part of lenders. This condition could change quickly, however. Remember November and December of 2018 when the junk bond market virtually shut down?

## Lower earnings, lackluster outlook

While concerns about a trade-induced global economic slowdown sent interest rates lower last quarter, it also caused me and most other market analysts to lower our earnings expectations for 2019. About 40% of S&P 500® index earnings are foreign sourced, so a global slowdown has a big effect on earnings. What's more, many companies are beginning to experience profit margin pressures from rising labor and raw materials costs. I now predict the S&P 500® index will post operating earnings per share of \$165 this year, up a slight 2% from 2018 levels. That puts the market's price/earnings ratio at 18 times. While this P/E is above the market's long term average of about 16, it is still reasonable given low prevailing interest rates and inflation.

Why do I have such a lackluster outlook for the equity market, i.e., not much upside, not much downside? First, let's consider the limits on the stock market's upside. There is, of course, the sluggish earnings growth environment juxtaposed against a market valuation (18 times earnings) that seems to adequately reflect many of the positive forces underpinning the market. Little earnings growth and no P/E expansion limit price appreciation.

Next, there's that pesky signal from the inverted yield curve. My years in the investment business tell me to ignore that signal at my peril. It may be a false positive, but until it goes away, I will remain cautious on the equity market.

## Political imponderables

Then there are the host of political imponderables. September's sure-to-be-nasty budget negotiations could result in another government shutdown, if not a debt downgrade. The Trump administration's seemingly indiscriminate use of tariffs has the potential to further slow international trade, disrupt supply chains and curb capital spending—a crucial ingredient to keep a late cycle economy going.

Soon, investors will begin to focus on the 2020 presidential election. Economic and tax plans promoted by several leading Democrat contenders are likely to have an adverse impact on stock prices should one of them make it to the general election. So far, the lunacy in Washington—from both sides of the aisle—has had little impact on the stock market. That's about to change.

If the above sounds a bit dour, let's examine what limits the stock market's downside. For one, the US is currently the strongest major economy in the world with a strong currency and attractive bond yields relative to other developed countries. Thus we remain a magnet for both foreign and domestic capital.

Another factor limiting the downside is the US bond market. Bond yields simply don't offer much competition for stocks. The dividend yield on the S&P 500® index is currently 1.9%, in line with the yield on 10-year Treasuries. Historically, when the S&P 500's dividend yield equals or exceeds the Treasury yield, stocks outperform

bonds. Recall that with equities, the investor usually gets income from dividends plus the benefits of earnings growth, which hopefully produces capital appreciation. Not so with bonds.

Beyond the Treasury market, high quality long dated municipal bond yields are now below 2%\*. Investment grade corporate bonds yield around 3%\*. Below investment grade bonds (junk bonds) yield about 5.8%\* currently, but their yield advantage over higher quality issues—the credit spread—is narrow by historic norms and does not seem to adequately compensate investors for the additional risk.

In contrast, it is quite easy to find good quality companies in the Utilities, Real Estate, Communications Services, and Consumer Staples sectors of the equity market with dividend yields of 3% to 4.5%\*.

I believe the environment for both stocks and bonds will grow more risky in the year ahead. Predicting the exact timing of the next crisis is about as easy as predicting when Iceland's Katla volcano will erupt. However, we do know that most US recessions are preceded by the reckless buildup of debt. In the run up to the Great Recession of 2008-2009, it was consumer mortgage debt. Today, the debt buildup has been concentrated in the corporate and government sectors—federal, state and local. In the fourth quarter of 2018, we got a taste of how fragile investor psychology can be: stock prices declined almost 20% and the IPO and junk bond markets seized up. It was a warning shot investors should heed.

Wise investors will use the currently prevailing “near idyllic conditions” in the economy and the credit markets to prepare for tougher times ahead. Don't abandon the stock market, but do emphasize higher quality stocks that could provide competitive returns in a more volatile market as well as some downside protection in a bear market.

The persistence of very low interest rates has caused a proliferation of investments in lower quality, often illiquid debt instruments, i.e., the Great Yield Chase. At some point in this economic cycle, as with nearly every cycle, there will be a liquidity crisis, sparked by too many yield chasers (junk bond, leveraged loan and structured credit investors) trying to unload their illiquid positions all at once. This is when credit spreads suddenly widen and investors suddenly realize that the world is changing for the worse.

Until then, enjoy your summer and remember: It doesn't get much better than this.

\*Source: Factset as of 6/30/19

## About Risk

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