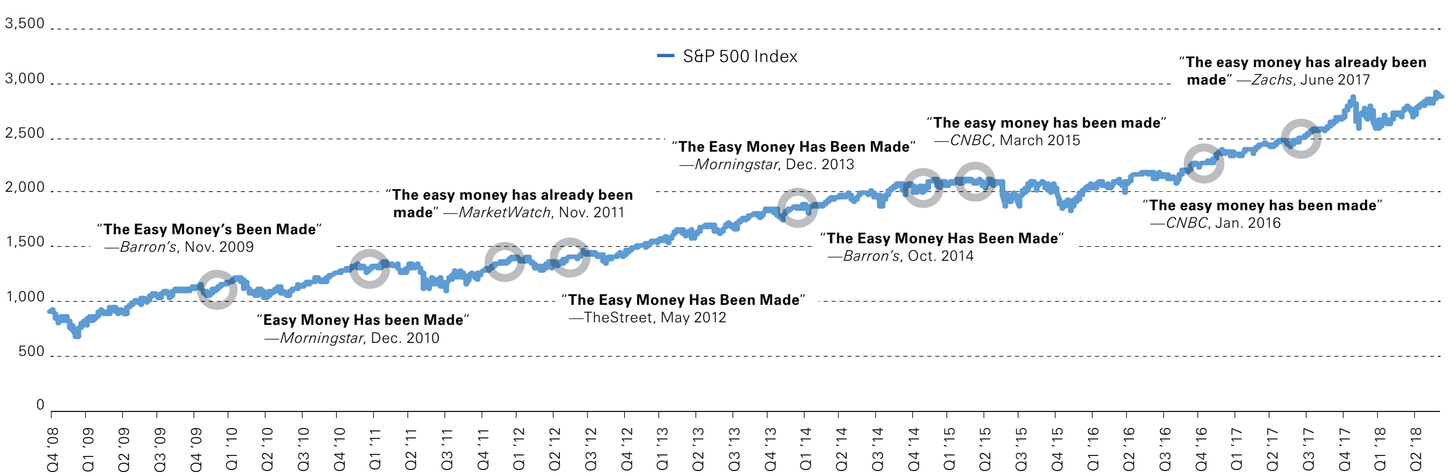
HAVERFORD

2018 FALL OUTLOOK

The Running of the Bull

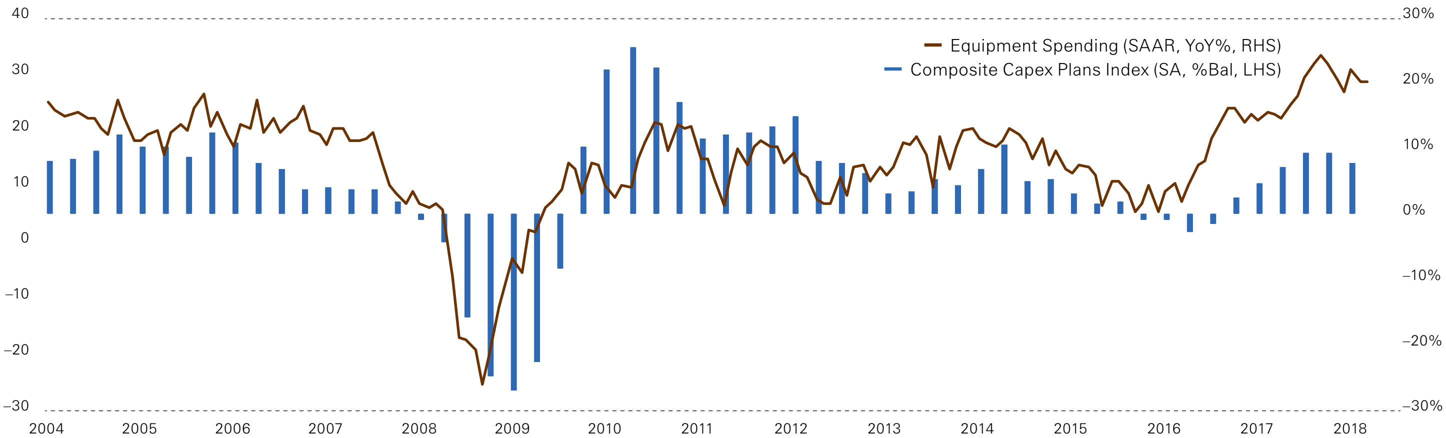
To relatively little fanfare, the U.S. bull market, which began in March 2009, extended into August to become the longest in modern history. In recent weeks, both the S&P 500 and the NASDAQ index recorded all-time highs. We emphasize the lack of fanfare because this has been one of the most unloved bull markets. Perhaps experiencing two severe bear markets since 2001 has permanently altered the risk appetite of investors, millennials in particular. Whatever the reason, strategists and other experts have consistently underestimated the strength and longevity of the current equity market. Throughout this almost 10-year advance, including this year, investors have withdrawn money from domestic stock funds in favor of low yielding bond funds—not a tangible sign of euphoria or exuberance. Historically, bull markets do not end with this type of sentiment.

Chart 1: The Unloved Bull Market



Source: Collaborative Fund, FactSet Research Systems

Chart 2: Capex Plans vs. Actual Capex



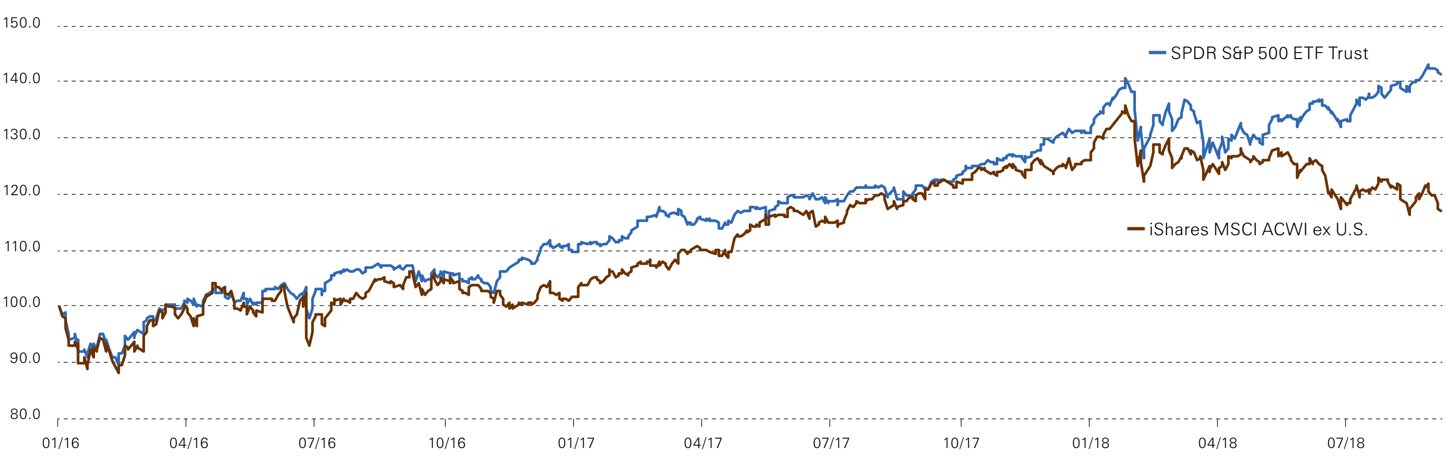
Source: Strategas Research Partners, August 2018

One could understand investors' skepticism in the first eight years of the bull market given the tepid U.S. economy and global strains, particularly in Europe. However, 18 months ago we witnessed the start of a synchronized global advance led by U.S. economic growth, which has accelerated to north of 4%. Although international economies have cooled somewhat in 2018, the U.S. economy is firing on nearly all cylinders as we head into the final quarter of the year. Consumer spending is strong while consumer confidence has soared to its highest level since 2000. All measures of business confidence remain elevated. Capital spending is improving due to the corporate tax cuts and the ability to immediately expense equipment expenditures. Manufacturing and industrial production continue to improve. Moreover, employment trends—including strong job creation and moderate wage gains—are all positive.

Despite all the positives, we will still have our laundry list of worries as we head into the final quarter of the year. Trade tariffs, the flattening yield curve, and the mid-term elections will continue to dominate the headlines and in all likelihood will create volatility for equities. This is a good time to highlight one of Haverford's rules of investing: Do not let politics get in the way of investing. Every two years, pundits tell us this is the MOST important election of our lifetime. Regardless of the outcome of the midterms, the U.S. economy will likely continue to expand and corporations should grow their earnings and deliver dividends.

Investors' fears, of trade issues in particular, are evident in the sharp divergence of performance between U.S. and international markets. Global equities were highly correlated over the past 18 months, but since the second quarter, international stocks have underperformed the U.S. markets by 15%.

Chart 3: S&P 500 vs. the Rest of the World



Source: FactSet Research Systems, September 6, 2018

In contrast to overseas markets, the recent advance to all-time highs in the United States suggests that domestic equity investors are much less concerned about the possibility of a global trade war. Given the momentum of economic activity, the United States can likely withstand the impact more easily than almost any other nation. Tariffs are a tax by another name. They help the few and hurt the many, namely consumers who ultimately bear the burden. However, Trump's tidal wave of fiscal stimulus will likely more than offset the pain of tariffs. We remain hopeful that the U.S. market's assessment is correct and a global trade war does not materialize from the current negotiations.

An inversion of the yield curve—when short-term rates are higher than intermediate or long-term rates—has preceded the past four recessions, albeit with lag time of one to two years. A flattish yield curve, where we are now, does not have that predictive record. In fact, the yield curve was flat for five years, from 1994–1998, while the economy expanded and the stock market rose. Numerous Fed officials have indicated in speeches that they have no intention of purposefully inverting the yield curve. It has paid to take the Fed at its word throughout this 10-year expansion.

Rising short-term interest rates in the United States are having repercussions around the world as investors seek higher-yielding assets. The U.S. dollar has gained 6% on a trade-weighted basis over the past few months, putting further pressure on international markets already worried about the economic impact of tariffs. The strengthening dollar has weighed heavily on countries with precarious government finances and significant U.S. dollar debt, such as Turkey and Argentina, both of which have suffered sharp depreciation of their currencies.

While neither of these countries is particularly meaningful to global equity markets, the possibility of contagion spooked emerging market investors. The combination of higher rates, a stronger dollar, and rising trade wars led to a sharp correction in emerging market equities, with the index falling nearly 20% from its peak in January. Adding to the pressure are signs that China's economy is slowing, with fixed asset investment growing at its slowest pace in two decades. The slowdown reflects China's deliberate attempts to curb borrowing in an effort to contain credit risks and prevent an overheating property market. With the threat to implement tariffs on nearly all of China's trade to the United States, the Trump administration is betting that China will not want to risk further damage to their economy.

Developed equity markets have also performed poorly, with European and Japanese equities falling 3–4% in USD terms year-to-date compared to the 8% return for the S&P 500. In addition to currency weakness and trade war fears, recent international economic data has softened. The Purchasing Managers' Index and other business sentiment indicators have been trending lower since the beginning of the year. The U.S. economy continues to outperform its global peers on almost every metric; this is unlikely to change until trade negotiations are resolved amicably.

The strength of the U.S. economy has driven corporate profits to record levels. S&P 500 earnings growth in the second quarter hit 25%, the highest quarterly rate since 2010. More than 80% of companies reported better-than-expected profits, another multiyear record. Tax reform has clearly boosted earnings, accounting for roughly half of the increase, but revenue growth of 10% and margin expansion made up the rest. Earnings estimates are accelerating into the second half of the year, with the market now expecting 21% growth in 2018. Rarely have corporate profits looked so healthy. As earnings accelerate, valuations become less expensive, and U.S. equities now trade at reasonable levels. The S&P 500 currently trades at a P/E ratio of 16.8x next 12-month earnings, slightly above the long-term average.

U.S. equities also are benefiting from reduced tax rates on the repatriation of overseas profits. Companies will repatriate an estimated $700 billion this year, equivalent to 3.4% of GDP. Much of this windfall is funding share buybacks and debt reduction, generating further earnings growth. With over $1 trillion in cash remaining overseas, remittances will continue for several more years, further supporting equities.

Fixed Income

The effects of rising short-term interest rates in the United States are not only adversely affecting global markets, but also providing opportunities and risks for fixed income investors. We have noted in prior *Outlooks* the relative attractiveness of shorter-term U.S. fixed-income instruments. The Federal Reserve has raised the Fed funds rate to 2%, and they will likely increase it again at the September meeting. We have taken advantage of the rise in short-term rates by investing more heavily in shorter-duration bonds. Duration is a measure of a bond's sensitivity to a one percentage point move in interest rates; if interest rates immediately move by one percentage point, a bond with a duration of 5.0 will adjust in value by 5%. Floating rate notes based upon 3-month LIBOR, which have virtually zero duration risk, have been a key component of our client portfolios for the past year. Income on these bonds rise with rates while protecting principal. The resulting structure of a typical bond portfolio we manage is a yield above 3% (which is in excess of current inflation rates) with a duration of only 3.5 to 4.0. We believe this portfolio structure will serve clients well if rates continue to rise.

In addition to interest rate risk, municipal bonds can also experience issuer risk (i.e., credit risk). The National Association of State Budget Officers released a study showing how much state finances have recovered from the 2008 financial crisis. State reserves or "rainy day funds" now exceed the levels available before the recession, with $55 billion in total set aside by the 50 states. This improvement in reserves is part of the reason that Standard & Poor's does not have a single state on downgrade watch or negative outlook for the first time in a decade. The market interprets a downgrade watch as a downgrade being possible within six months and a negative outlook as the possibility of a downgrade within two years. The absence of the possibility of a single downgrade in the next two years across 50 states is a very positive outlook. Even with that outlook, we will continue to emphasize strong protections for bondholders in state and local municipal bonds in client portfolios, as we know how much those protections mean when outlooks are not as positive.

Bull markets do not die of old age, and the current economic backdrop looks robust enough to sustain this market past the 10-year mark. Businesses and consumers are confident. Inflation remains in check. Monetary policy is tightening but still supportive. The boost from tax reform and fiscal stimulus will continue to drive corporate profits into 2019. As always, risks remain, and we will continue to watch for issues that have the potential to disrupt our outlook. Trade negotiations may take some time to be fully resolved, but we expect this may create some investment opportunities, given the wide disparity of global equity returns so far in 2018.

All data as of September 17, 2018, unless otherwise noted.

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