New Albany
Investment Management

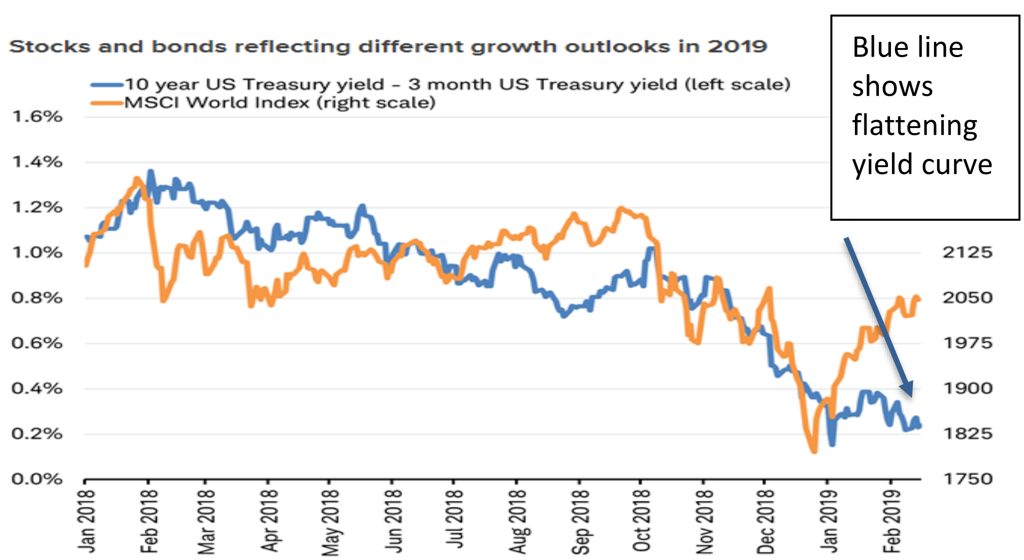
March 14, 2019

Diverging Markets:
Stocks Rising while Earnings Growth and Bond Rates Fall

Since the start of the new year, the stock market has been on a torrid rise. It seems all the fears driving prices down in the 4th Qtr of 2018 have dissolved and the assumptions of better things to come are supporting the positive momentum for stocks. It is smooth sailing ahead as far as stocks are concerned, and yet both the data and bond market are telling a different story. Recent economic data has weakened, earnings forecast have dropped dramatically, and a significant drop in bond rates is signaling weakness lies ahead. This divergence is not unusual for short periods of time, but eventually some kind of ‘correction’ will ensue. The question is: will stock prices fall to match lower earnings expectations, or will the economy pick up steam and push bond rates higher again?

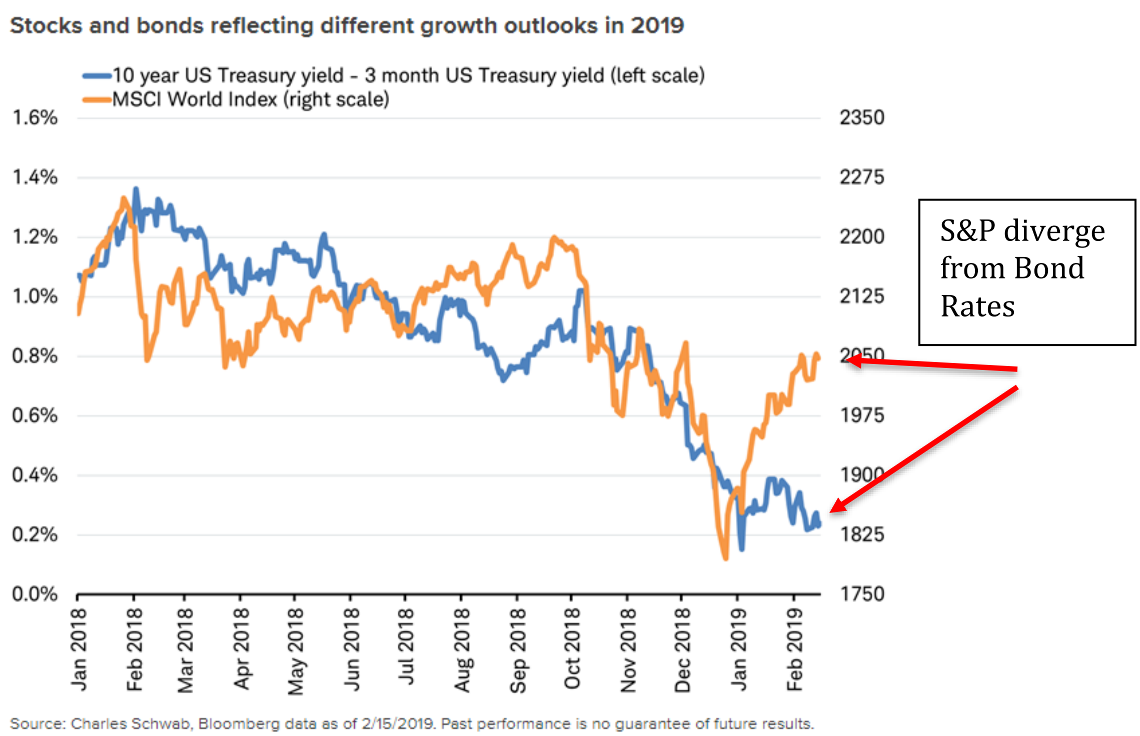
Bond Market Signaling a Slowdown: It has been said the stock market is a good leading indicator of the direction of the economy. However, an even better indicator of future growth is the level of interest rates and the spread difference between short term and long-term bond rates, otherwise referred to as the slope of the yield curve. The Fed only controls short term rates, but the market (investors) determine the level of long rates. Thus, when the yield spread between short and long-term rates narrows (curve flattens), investors believe growth will slow; and when the gap widens, investors are expecting stronger growth and inflationary pressures.

Since February of 2018, the curve has been flattening, from 135bpts to barely 20bpts by December. This can be seen by the blue line on chart below (ignore the orange line for this part of the discussion). From January through September, the spread narrowed (flatten) because the Fed was raising short term rates faster than the market was raising long term rates. But even during this time, ALL rates were still rising, and thus signaling growth ahead. Then, in October, everything changed. Though the Fed was still raising short term rates, long term rates started to fall and caused the gap to narrow even further (curve flatten) and signaling slowing growth ahead. Today, the spread remains at its narrowest point and gives a reasonable caution signal future economic growth.

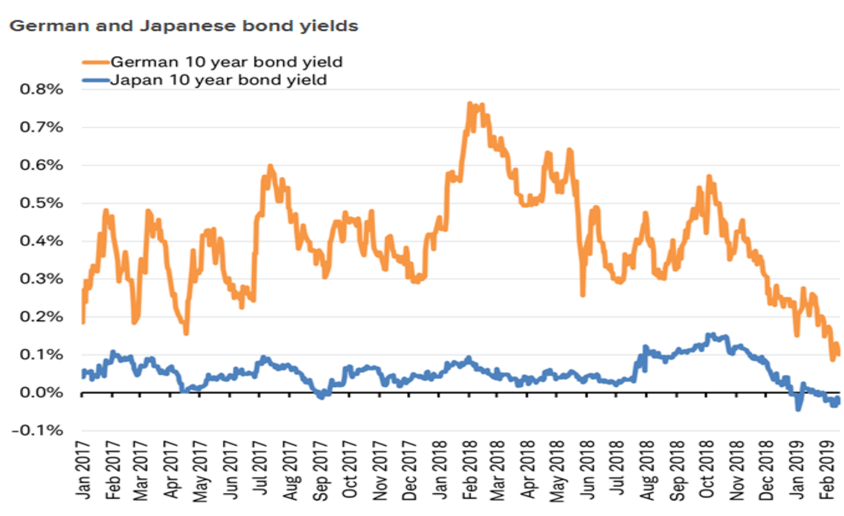


Source: Charles Schwab, Bloomberg data as of 2/15/2019. Past performance is no guarantee of future results.

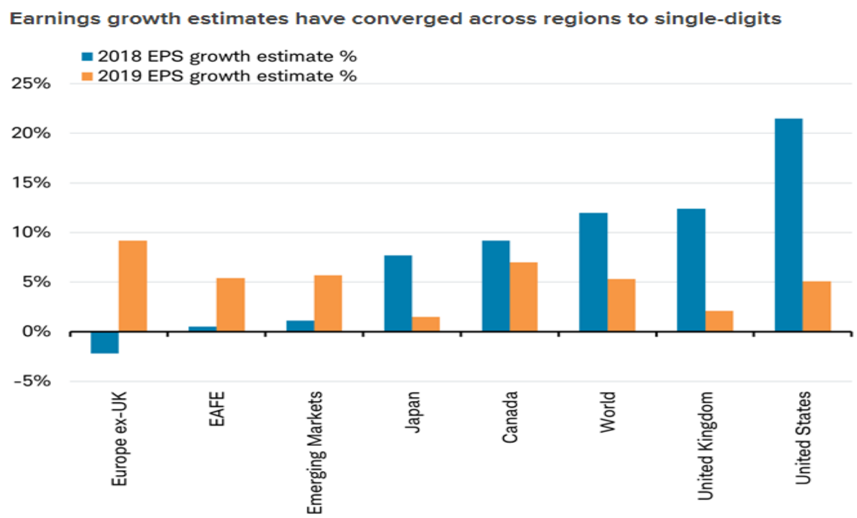
Stock and Interest Rates Diverge: Another noteworthy change is the divergence in the direction of interest rates and stock prices. Typically, long term rates and stock prices move in the same direction. That is, when rates are rising, so are stock prices, and vice versa. This positive correlation held true through all of 2018; however, this year has been a very different story where stocks and bond rates have moved in opposite directions. The chart below (same as above) shows the S&P 500 (orange line) and the spread between the US 10yr Treasury and the 3mo US Treasury (blue line). Notice how they tracked together through July, then diverged until October when Bonds lead the sharp decline. Since December however, once again the two markets have diverged. This divergence is unsettling, because history has shown that eventually these two markets will sync up (correct), and when they do it usually occurs quite quickly.



Internationally, the decline in government bond yields is even more extreme in places like Japan and Germany where yields are back below zero or near it again, reflecting a pessimistic outlook. Japan's 10 year government bond yield is negative again at -0.03% and the 10 year German bond yield is down to 0.10%, as you can see in the chart below.

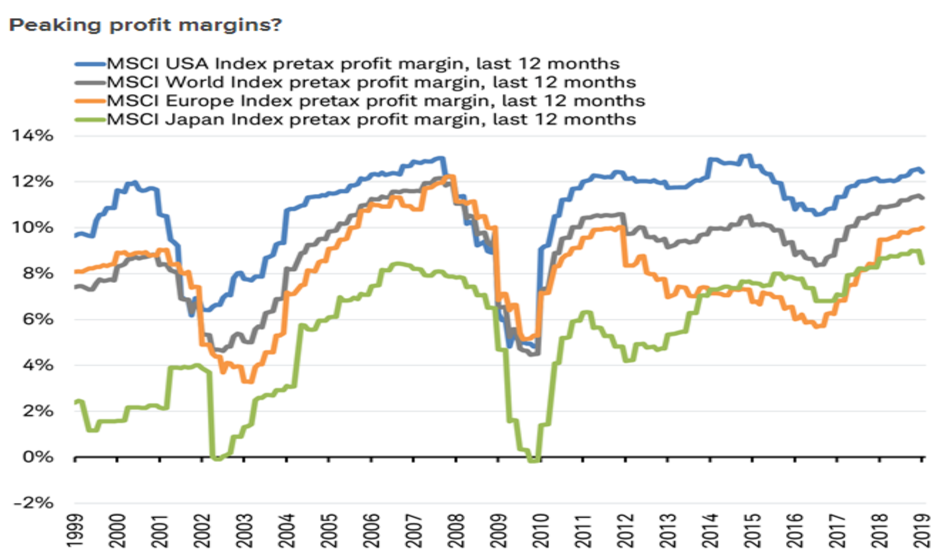


Global Earnings Growth Slowing significantly. The stock market has enjoyed seven quarters of double-digit earnings growth which justifies the tremendous rally in stock prices from late 2016 through mid-2018. Now however, US growth is expected to be flat to negative the first two quarters of 2019 and only 5% for the entire 2019. And earnings growth is slowing not just in the US, but globally. The chart below compares year-over-year earnings growth in the major world economies. Interestingly, the countries with the fastest earnings growth in 2018, such as the United States and United Kingdom, are expected to see the largest decline in growth in 2019. Meanwhile, some of last years' slower growers are expected to see higher expected growth (primarily Europe).



Source: Charles Schwab, MSCI data via Factset as of 2/15/2019.

Profit Margins to Decline. First since 2016. In addition to earnings declining, net profit margins are expected to decline, marking the first year-over-year decline in the profit margins for the index since Q4 2016. It will also mark the lowest net profit margin reported by the index since Q4 2017. The main contributor to the decline in margins is rising wage cost. The chart below shows profit margins across the globe with a downtick in most areas accept Europe. Notice the blue line, which represents the US, shows margins, never achieved the previous peak. Contracting profit margins are typical late in the economic cycle and are a sign growth is losing steam.



Source: Charles Schwab, Factset, MSCI data as of 2/28/2019.

In sum, Global stock prices have rallied this year, a sign that stock market investors anticipate growth. Yet, bond prices have rallied also, pushing down yields, a sign that bond market participants are bracing for weakness. This divergence in the assessment of the outlook will be reconciled over the next several quarters as the reality of earnings growth becomes apparent. At this point there is no clear path ahead and risks seem balanced between stocks correcting lower or rates moving higher. Perhaps they meet somewhere in the middle. Time will tell.

Investment Strategy is "Neutral". There has been no change in the risk positions. Both stock and bond exposure remain in the neutral zone. The positive price momentum in stocks is balanced against a weakening forecast from the bond market.

These are my thoughts. As always, please contact me with any questions or concerns.

Best Regards,
Barbara

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