X-Factors

January 28, 2019

The S&P 500 had its best start to a year in at least 30 years (+6.2%) through January 25. The Dow and Nasdaq have been up five weeks in a row and the S&P 500 has been up four weeks in a row. Volatility (as measured by the VIX) has been cut in half since the December 24 lows. However, this upcoming week provides a myriad of x-factors, ranging from the Federal Reserve meeting, to trade, to earnings. The uncertainty surrounding each of these factors has caused some volatility today. Hopefully, the outcome of these events will provide more clarity, and assuming our base case, should continue to support higher equity prices.

U.S. ECONOMIC UPDATE

Scott Brown, *Ph.D.,* *Chief Economist*

The partial government shutdown is expected to have subtracted a few tenths of a percentage point from first quarter growth. Data from the Bureau of Census and the Bureau of Economic Analysis have been delayed, but we should see reports released over the coming days and weeks.

TRADE POLICY AND ECONOMIC INDICATORS

Trade policy had an uncertain impact on the trade balance and inventory growth in 4Q18 (we only have preliminary data for October), but both are expected to have subtracted from GDP growth. Underlying domestic demand appears to have been mixed into early 2020. The household sector is in good shape. Consumer spending remains supported by strong job growth and wage gains, while the drop in gasoline prices has added to consumer purchasing power. Business fixed investment appears to have been a little soft, restrained partly by a weaker global outlook, trade policy uncertainty, and fears of slower growth (and possible recession). The housing sector has slumped, reflecting the lagged impact of higher mortgage rates and affordability issues, but mortgage rates have declined and the strong job market remains supportive.

At the mid-December policy meeting, Federal Reserve (Fed) officials indicated that the central bank could be “patient” in raising short-term interest rates in 2019. On January 4, Fed Chairman Powell said that the Fed will be “flexible,” and would move “quickly and flexibly” if needed. Powell also said that the Fed could adjust its drawdown path for the Fed’s balance sheet if it was “somehow interfering” with the Fed’s goals (implicitly, he doesn’t think it is). All of this goes without saying, but investors took encouragement from Powell’s comments. However, some financial market participants have likely gotten ahead of themselves in thinking that the Fed might cut interest rates or halt the unwinding of its balance sheet in the near term.

In July, the current expansion will become the longest on record. The economy does not appear to be close to entering a recession, and the odds favor a continued expansion through this year and next. However, risks to the growth outlook are tilted to the downside.

INTERNATIONAL UPDATE

Chris Bailey, *European Strategist, Raymond James Euro Equities**

2019, to date, has seen further indications of a slowdown in the global economy outside of the United States. Economic indicators such as the purchasing managers' indices have indicated that a number of export-intensive economies such as South Korea and Germany came close to stalling in the last few months of 2018. Meanwhile in China, official economic statistics have also shown a slowdown but, so far, not to levels which have put the Chinese

*Affiliate of Raymond James & Associates and Raymond James Financial Services government's targets at risk. This may be due to the increased use of stimulus measures by the Chinese authorities, including extra government spending and monetary policy loosening. Similarly in Europe, authorised looser fiscal policy in countries including Italy, France and Germany are being enacted in 2019 as a response to slower growth conditions and rising electorate dissatisfaction.

LOOSER FISCAL POLICY ABROAD

The Italian budget standoff between the populist government and the European Commission ended in late December with an agreed expansion of the allowed budget deficit which should make a contribution in keeping Italy out of recession in 2019. At the same time, President Macron of France authorised a series of measures - which will temporarily push the French budget deficit to over 3% of GDP - to try to placate high profile 'yellow vest' protesters. This has not stopped the protests but it has seen their intensity reduce. Finally, German budget spending plans have been raised for 2019 in an attempt to boost the popularity of the ruling government, with an eye on boosting the electoral chances of Angela Merkel's successors at the next general election in a couple of years. However, the ever prudent Germans are still running a budget surplus despite this extra expenditure.

Just last week the European Central Bank - which formally stopped their quantitative easing expansion policy at the end of last year - signalled to the financial markets that its policy positioning will remain very loose for the foreseeable future.

BREXIT UPDATE

In the UK, the Brexit question continues to dominate local political and economic debates. Despite an historically material defeat for her preferred Brexit plan, the UK Prime Minister has continued to try to find a workable deal that will please both the European Union and the British Parliament, which has opened the floodgates for other proposals and solutions. With around two months to go until the date for the UK to leave the European Union, precise clarity on what will happen currently does not exist. However, rising agitation from the business community, particularly regarding the costs of a 'no-deal' Brexit appear to be having an impact. Certainly, the upward performance of the British Pound during 2019 suggests saner heads are starting to prevail.

OPPORTUNITIES AHEAD?

World trade discussions and specific regional matters (such as Brexit) continue to have the potential to significantly influence global financial markets outside of the United States. Most of these markets are currently trading on lower multiples offering higher dividend yields to investors, so greater clarity may have opportunities for U.S. investors to internationally diversify further, especially if the dollar continues to fade against currencies such as the Chinese yuan, Japanese yen, euro and British Pound.

WASHINGTON POLICY

Ed Mills, *Managing Director and Washington Policy Analyst*

TRADE POLICY

The China/U.S. meetings this week on trade should continue to progress as both sides appear to have increasing macroeconomic incentive to continue a positive dialogue. While it is overly optimistic to expect a formalized trade deal to result from the discussions this week, we would expect, at a minimum, signals from both sides as to the direction talks are trending with a looming March 1 deadline.

SHUTDOWN REDUX?

A compromise is by no means assured given the underlying political factors of the debate have not changed post-shutdown, but the odds of a second government shutdown over border wall funding should remain low. If the special bipartisan committee tasked with finding a solution cannot agree on a plan, President Trump would have a clearer case to take executive action in the form of a declaration of a national emergency that taps into military funding for construction of a border barrier.

U.S. EQUITY
Joey Madere, CFA, *Senior Portfolio Strategist*

MARKET THOUGHTS
The S&P 500 has rallied sharply (+12%) from its Christmas Eve lows over the past month. There have been some positive signals over the past month on U.S./China trade negotiations, but there remains a long way to go for both sides to reach a potential trade deal. Up next, Chinese officials are scheduled to come to D.C. this week (1/30-1/31) to continue talks, and investors will be watching very closely to gauge the likelihood of a deal coming into place by March.

The market rebound has brought the S&P 500 P/E multiple up to 16.4x, in line with the 65-year average valuation. We continue to view the risk/reward as favorable over the next 12 months at these levels. Our base case fair value estimate for the S&P 500 over the next 12 months is 2922 (+11% from current levels), using $167 in S&P 500 earnings (~2.5% below consensus EPS at $171.45) and a 17.5x P/E multiple.

However, we would be cautious in the very short term following the sharp market rise and numerous headwinds still at play. Oftentimes, sharp draw-downs are followed by snap-back rallies and then a consolidation period. The S&P 500 has gone straight through numerous technical resistance levels during its advance (positively), but short-term internals are now ticking lower from overbought levels with the S&P 500 price near technical resistance in the ~2650 area. We believe a consolidation period is likely, and a retest of the December lows is probable. However if this were to play out, we would use it as a buying opportunity. A market-convincing trade deal could remove the need for a retest.

EARNINGS UPDATE
4Q earnings season is in full swing, and 22% of S&P 500 companies have reported results thus far. 72% of these S&P 500 companies have beaten on the bottom line for an aggregate earnings surprise of 1.45%, and 57% of these companies have beaten on the top line for an aggregate sales surprise of -0.13% so far. Earnings are now expected to grow by 12.1% for the full quarter on sales growth of 6.3%. These estimates are up from 11.5% and 6.1%, respectively, when earnings season began, but still downwardly revised since the end of Q3. Price reactions on earnings announcements have been positive, albeit in a market that has moved higher over the past couple weeks. Nevertheless, the average S&P 500 company has moved 1.45% higher on its earnings report. At the sector level, the best price reactions have come from Consumer Discretionary (+3.78%), Financials (+2.28%), Energy (+2.16%), and Technology (+1.39%). The worst price reactions so far have come from Consumer Staples (-4.29%), Health Care (-1.91%), and Materials (-1.85%).

Forward earnings estimates had been trending lower since the market peaked in late September, primarily due to lower margin assumptions, but have stabilized during earnings season. Investors will get plenty more data on earnings and company guidance in the next couple weeks- 121 S&P 500 companies report this week, followed by 89 the following week.

The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market.
VIX is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. It is a widely used measure of market risk.
The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market.
The NASDAQ 100 Index is an unmanaged index of 100 of the largest non-financial domestic companies listed on the NASDAQ Stock Market's National Market.
The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

RAYMOND JAMES

INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER
880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // TOLL-FREE: 800.248.8863 // RAYMONDJAMES.COM