Bull and bear in front of the Frankfurt Stock Exchange

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U.S. MARKETS
OCTOBER VOLATILITY

KEY TAKEAWAYS

1. September and October are historically the months of greatest volatility in the U.S.
2. Some investors seem concerned that earnings have already peaked.
3. Corporate fundamentals are still strong and do not support this view.
4. Macroeconomic forecasts remain strong, especially in the U.S.
5. From a valuation perspective, the market now offers even better opportunities.

September and October tend to be the most volatile months for stocks. October of 2018 has been no exception to this trend, with the S&P having lost 8.9% month-to-date as of 10/24. The reason behind this loss is less clear. The relevant question is whether the recent volatility and large stock-market losses can be justified from the standpoint of changes in corporate fundamentals, or at least explained by changes in macroeconomic conditions. In this paper we argue that both the fundamentals and the macroeconomic conditions have not changed in any substantive way, such that they would explain the recent sell-off. Moreover, we strongly believe adding at current valuations is an attractive opportunity.

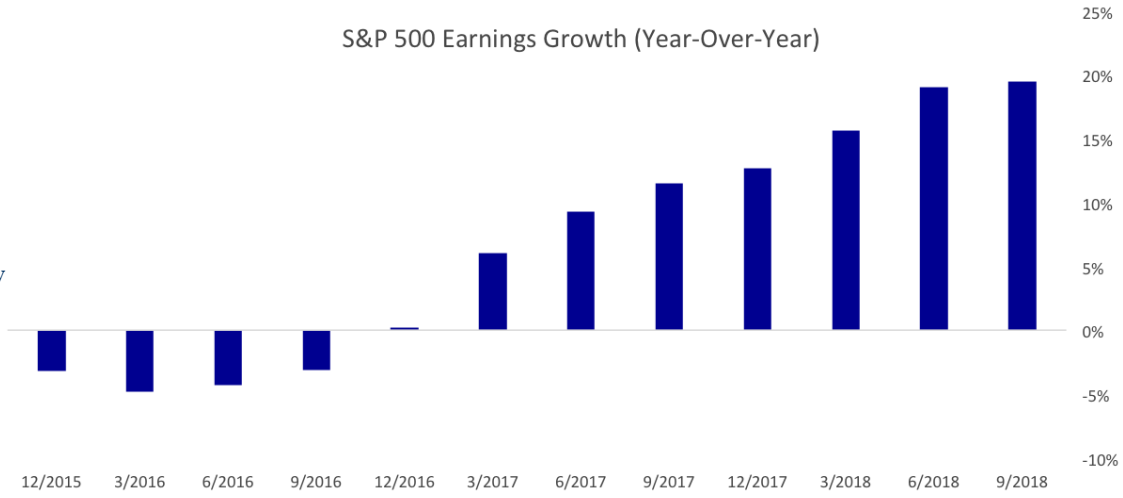
The Fundamentals

What the U.S. markets experienced yesterday (10/24) —the S&P 500 shaving off 3.1% and the Nasdaq losing 4.4%— came mainly from the fear that growth, and particularly earnings, have already peaked. However, the data are far from supportive of this negative outlook. So far, we are almost halfway through the earnings season, with 101 out of 160 companies having beaten revenue estimates. According to Factset, the Q3 2018 blended earnings growth rate for the S&P 500 is 19.5%, while the expectations for the earnings growth rate, as of September 30th, was 19.3%. So earnings are actually growing as expected, if not slightly faster.

Figure 1

EARNINGS GROWTH HAS BEEN ACCELERATING FOR STOCKS IN THE S&P 500.

Source: Innealta Capital using quarterly data from Bloomberg.

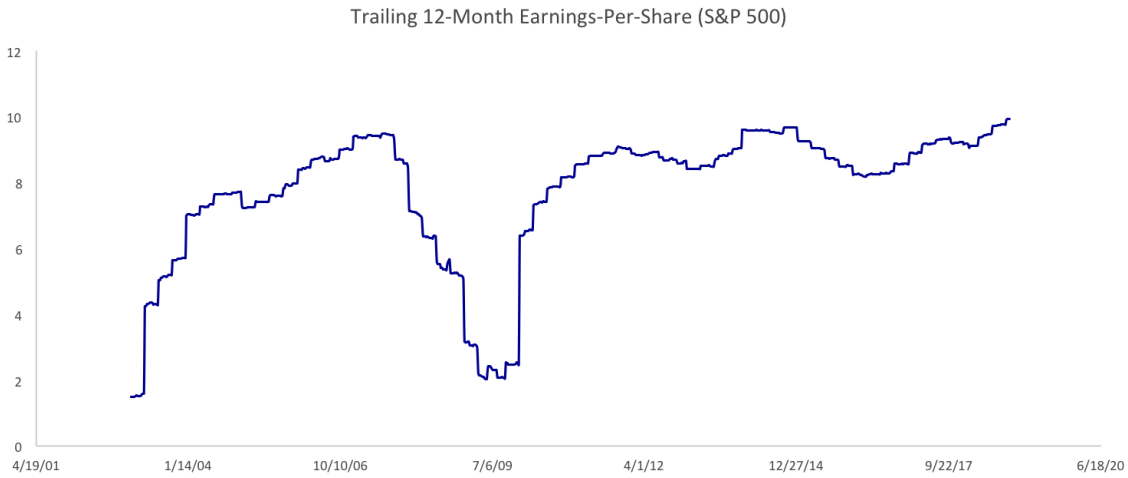


Over the past three years, earnings growth has accelerated. Fiscal events, like the recent tax cut, have helped, but more fundamentally U.S. corporations have also increased their operating margins. From June 2016 to today, S&P 500 profit margins increased from 8.23% to 9.93%, and profit margins from Q3 data show another increase —not a decrease— in profit margins.

Figure 2

TRAILING 12-MONTH EPS FOR S&P 500 STOCKS.

Source: Innealta Capital using data from Bloomberg.



Finally, we can examine the projected price-to-earnings ratio for the S&P 500. This valuation ratio can be interpreted as a measure of how long it takes to recover an initial investment. For example, if the price-to-earnings ratio of the S&P 500 is 10, and we assume that the earnings growth rate will be zero in the future, and that the company will distribute all earnings as dividends, then we would recover our initial investment in ten years. At the beginning of 2018, the price-to-earnings ratio using expected earnings was approximately 18. Today that same metric is 15.5, meaning we should recover our investment two-and-a-half years earlier. If we convert the time into an approximation yield, the earnings yield increased from 5.6% (i.e., 1/18) to 6.5% (i.e., 1/15.5).

Figure 3

FORWARD 12-MONTH PRICE-TO-EARNINGS RATIO FOR S&P 500 STOCKS.

Source: Innealta Capital using data from Bloomberg.

Monetary Policy

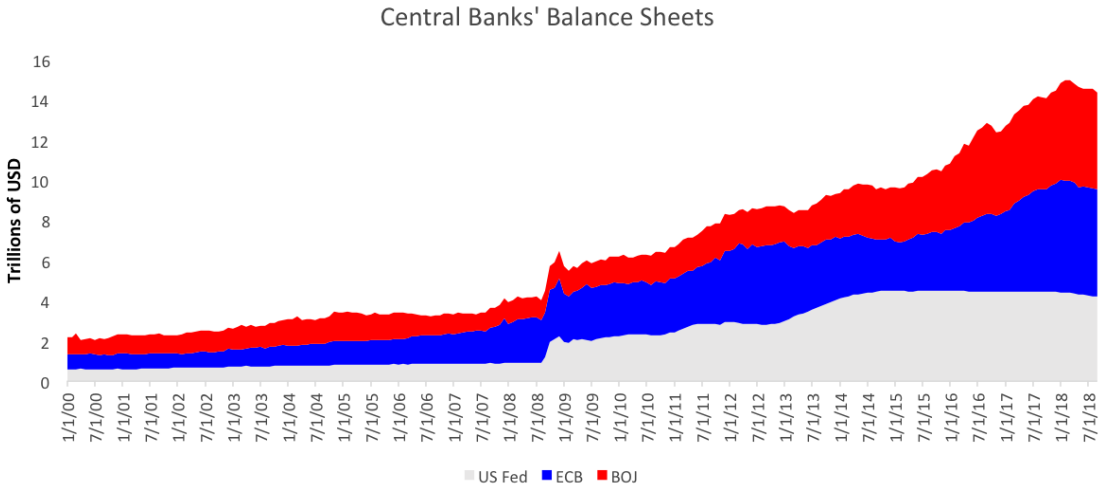
There are two important ideas that one should retain about current monetary policy. The first is that monetary policy is becoming less supportive of growth. This is just an inevitable part of the return towards more normal conditions, after the extraordinary measures taken by the Fed and other central banks in light of the financial crisis. The new conditions are evidenced, on one hand, by a steady increase in interest rates, and, on the other, by a decrease in the amounts of assets purchased or held by central banks.

The second big idea is that all of this has been known for a while. Nothing has changed recently. No moves by the Fed, the European Central Bank (ECB), or the Bank of Japan (BOJ) have surprised analysts. These banks have carefully laid out their plans precisely to avoid creating any turbulence; and they have stuck to them. The last three chairmen of the Fed have basically toed the same line. The ECB's president, Mario Draghi, has held the post since 2011. And the BOJ has targeted reflation for decades now, amassing more assets, as a percentage of GDP, than any other major central bank.

Figure 4

THE BALANCE SHEETS OF THE MAIN CENTRAL BANKS ARE STILL HUGE WHEN COMPARED TO PRE-CRISIS LEVELS, BUT THEY ARE BEING SLOWLY REDUCED.

Source: Innealta Capital using data from Bloomberg.



The recent rate hikes by the Fed had already been priced in by the markets. Given the all-but-certain outcome of the last FOMC meeting in September, analysts were actually more interested in Jerome Powell's press conference. At least two more increases of 25 basis points each are already priced in, with the next one expected for December of this year. Furthermore, the downsizing of the Fed's balance sheet has been slow and very transparent. In Europe, Mario Draghi had announced a long time ago that his goal was to end the purchase of bonds in December of this year, while continuing with the low-interest policy until inflation showed signs of picking up. The news after the bank's meeting on October 25th just confirmed this, with rates expected at their current levels —zero for financing, and negative for deposits— at least until the summer of 2019.

Of course, the actions of central banks would be different if economic conditions were to change. And there lies one of our key arguments. Macroeconomic conditions and prospects have not materially changed recently. Jerome Powell, after the Fed's September meeting, was very clear: the economic outlook is strong, with solid growth, low

unemployment, and controlled inflation. In terms of forecasts, the Fed is estimating a GDP expansion of 3.1% for 2018, 30 basis points higher than the previous estimate. For next year, projected growth is 2.5%. Inflation is not expected to surpass 2.1% per year during the next few years. Mr. Powell said the central bank did not see inflation rising unexpectedly. Unemployment is estimated to be 3.7% this year, dropping to 3.5% in 2019. In Europe, Draghi stated his confidence in the euro area's "broad-based economic expansion."

Finally, it should be noted that the return to a more neutral monetary policy has a big upside. With historically low interest rates and large asset purchases, the central banks had very little ammo to shore up the economy in case of a downturn. Central banks are thus beginning to recover their most valuable tools in case intervention is needed again.

Conclusion

Looking at data on corporate fundamentals, we find that earnings have been growing steadily for a long period of time. Additionally, each dollar of earnings has become cheaper from a valuation perspective, as indicated by the price-to-earnings ratio. Moreover, earnings growth remains strong. As monetary policy recedes from its supportive role, corporate fundamentals and macroeconomic conditions will become more relevant. As we have argued, both offer a positive outlook. On the macroeconomic side, recent data seem supportive of further growth, with central bankers being very clear about their optimistic outlook. In the U.S., GDP is expected to continue growing strongly, the labor market is projected to remain tight, inflation under control, and wages growing. On top of everything, we have the tax cuts. Of course, there are some worrying signs on the horizon. The starkest one is probably the tension surrounding trade between the U.S. and the rest of the world. However, the fact that the Fed is more rapidly steering policy into pre-2008 territory relative to its European and Japanese counterparts, should be construed as yet another sign of strong growth prospects in the U.S.

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