US Private Wealth Management
U.S. Bank

Market and economic update

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Current economic events

The mood across global markets continues to shift away from the pervasive recession fears that paralyzed markets just a few months ago. November's global investor sentiment survey from Sentix posted its largest one-month rise since August 2009, with forward expectations and the perceived current situation both rising by the most since 2012. October purchasing manager's indexes (PMIs) told a more mixed story; the global composite reading fell to its lowest level since February 2016, a tick off lows since 2012. A third consecutive pickup in manufacturing PMI was offset by a decrease in the service sector, while global private sector employment contracted for the first time since February 2010. The improvement in manufacturing, which tends to lead the business cycle, is encouraging. However, a softening in employment brings into question the sustainability of strong consumer spending. Our proprietary global "Health Check" is still hovering around seven-year lows, although the indicator appears on the cusp of some improvement.

The U.S. labor market showed signs of slowing last week that were not evident in October's blockbuster employment report. U.S. Markit PMIs showed employment contracting at the fastest rate in a decade, while surveys from the Institute of Supply Management (ISM) showed employment ticking higher in October, though still among the worst readings since 2010. The Job Openings and Labor Turnover Survey (JOLTs) showed job openings contracting at the fastest rate since February 2010 and September layoffs registering the highest reading since May 2012. Unit labor costs from the Bureau of Labor Statistics increased at the fastest pace since March 2014 — that's a positive for consumer spending, but a negative for corporate profits. Moving on from labor, September factory orders contracted at the fastest rate in more than three years and core capital expenditures fell at the quickest pace in nearly three years. While improvement in ISM and Markit manufacturing PMIs, as well as a jump in Sentix expectations, were more encouraging data than we've seen in a while, overall economic health has continued to trend down in the United States. Our U.S. Health Check sits just off a three-and-a-half-year low.

European data came in cautiously optimistic in general last week, with PMIs improving across the board. The composite PMI rose off nearly stagnant levels in September to depict a slightly faster economic expansion. Employment was a weakness in the report, with growth falling to a four-year low. The manufacturing sector remained in a relatively sharp contraction, though it fell at a slower rate in October. Retail sales growth rose to the best level since November 2017 as consumer strength held up and supported growth in the eurozone. Eurozone purchaser prices continued to deflate in September; the eurozone is one of the only major economies not showing signs of inflation downtrends subsiding. German manufacturing orders continue to contract, but the pace of the decline has subsided somewhat. Revised October PMIs in Japan confirmed the negative impacts of the October 1 consumption tax hike and Typhoon Hagibis. The manufacturing sector, service sector and composite activity all fell into contraction for the first time in more than three years, though inflationary pressures rose. Our Health Check shows the foreign developed economies trending downward to the lowest level since October 2013.

Equity markets

U.S. equities continue to drift higher, with the S&P 500 ending last week at an all-time high of 3,093. On balance, equities continue to show broad-based strength, consistent with a Goldilocks-like not too hot, not too cold environment. Third quarter earnings reports are modestly exceeding expectations and valuations are elevated, yet short of extremes. Our year-end 2019 price target for the S&P 500 is 3,135, roughly 1 percent above the November 8 close. Our preliminary year-end 2020 price target is 3,325, approximately 7.5 percent above the current level.

The broad-based index and sector strength we're seeing is typically indicative of a favorable backdrop and a market that is poised to trend still higher. All 11 S&P 500 sectors are up for the year, nine of which are up more than 16 percent. Information Technology is leading sector performance, advancing 38.7 percent, bolstered by the software industry group. Energy continues to lag, up a less sanguine 5.2 percent, reflecting soft global growth.

The third quarter earnings reporting season is nearing an end, with 89 percent of S&P 500 companies having released results as of Friday's close. Results are modestly exceeding expectations, but guidance is muted and few companies are referencing a pickup in outside-of-U.S. activity. Heading into third quarter releases, sales were estimated to increase 2.8 percent while earnings were projected to decline 4.3 percent, according to FactSet Research Systems. With 89 percent of companies reporting, sales are trending up 3.7 percent over year-ago levels, with earnings declining a more modest 1.0 percent, according to Bloomberg. Here's what to watch within individual sectors:

- Energy, Materials, Consumer Discretionary and Information Technology are the four sectors posting negative year-over-year results. Languishing results from Energy and Materials sectors are as expected, consistent with the slow pace of global growth. However, conclusions from the Consumer Discretionary will be better made over the next couple of weeks, since only 38 percent of retailers have released third quarter results. So far, the retailing industry group is posting negative year-over-year results, which is inconsistent with favorable sentiment associated with equities at all-time highs and low unemployment levels. Also, dire conclusions from the Information Technology sector are potentially misguided. Technology hardware and equipment and semiconductors are posting negative year-over-year trends, which are largely as expected due to sluggish capital expenditure levels, slow pace of global growth and the negative effects of tariffs. In contrast, earnings for the software and services industry group, which is associated with artificial intelligence and machine learning — and comprises roughly half of the companies in the sector — are up more than 11 percent year-over-year.
- Healthcare is the second-worst-performing S&P 500 sector in terms of market returns year to date. However, it is posting the highest year-over-year earnings growth rate among all 11 sectors, advancing 8.9 percent so far. Valuations continue to be squeezed for many healthcare companies over lingering cost pressures.

Overall, we believe valuations are elevated but short of extremes, warranting still-higher stock prices. The S&P 500 currently trades at 19.8 times forward 12-month estimates, higher than the 30-year average price-earnings ratio of 17.1, according to Bloomberg. Multiples on forward estimates above 20 times are generally regarded as extreme. By this metric, equities are trading at the high side of fair. While valuation is often regarded as a poor timing tool, elevated valuation levels support the notion that equities are largely priced-to-perfection with a narrow margin of error.

Fixed income markets

Improved investor sentiment boosted Treasury yields last week. Foreign sovereign yields also increased as worries of a global economic downturn dissipated. Expectations for further monetary stimulus have justifiably pulled back, with the pace of rate cuts by global central banks appearing to have peaked last quarter. The market is currently pricing in only 50 percent odds of another rate cut by the Federal Reserve (Fed) by end of next year. Fed messaging has emphasized a bias toward holding rates steady for now. We continue to suggest that investors hold portfolios with slightly below-benchmark duration, because long-term bonds offer little incremental yield over shorter-term options.

Corporate bond spreads (the incremental yield received over comparable duration U.S. Treasuries) continued to decline last week. Despite higher leverage across the space, earnings this quarter have been better than expected and indicate marginal improvements in companies' abilities to service their debts. Strong fund flows and investor sentiment have pushed investment-grade and high yield spreads below their long-term median levels. While valuations are somewhat expensive, they are not unreasonable, considering monetary policy is accommodative and companies have had little trouble servicing their debts. We continue to see value in mortgage-backed securities due to their attractive yields, link to U.S. consumers and real estate markets and diversification from corporate credit risk. We recommend investors maintain exposure to primarily high-quality debt within their bond holdings to diversify equity-like risk.

Real assets

Defensive sectors underperformed last week, with the recent shift to a "risk-on" (more aggressive) market environment continuing. The recent sell-off has shifted all defensive sectors to underperformance compared to the S&P 500 for 2019. Among real estate companies, third quarter same-store net operating income (NOI) growth was only 2.5 percent, 0.8 percent below the long-term average and the slowest since 2010. With valuations in the defensive sectors stretched, coupled with slowing fundamentals, these stocks will have difficulties in an extended risk-on market with higher interest rates.

Crude oil prices, as represented by West Texas Intermediate, rose 1.8 percent last week and are now up 26 percent for the year. Domestic fundamentals were negative for prices, with a large increase in domestic crude inventories and production levels at an all-time high. However, increased hopes of a trade deal and a potential reflation trade boosted prices. Energy complex stocks slowed last week, with flat performance. However, after serious underperformance of the sector over the past few years, energy stocks have started to come to life in the past month. While it is still early, a generally risk-on market environment coupled with a shift to a more reflationary economy could result in outperformance for these stocks.

The gold market was down 3.2 percent last week but is still up 15 percent for the year. Gold prices have eased recently as interest rates moved higher and the volume of negatively yielding debt declined. However, central banks re-engaging in balance sheet expansion policies have historically been a catalyst for higher gold prices. With more than $12 trillion in negative-yielding fixed income securities across the globe, precious metals may have a valuation advantage to much of the bond market. Prices can remain supported in a higher rate environment as global central banks fire up their bond buying programs.

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