2019 Roundtable Contributors

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It is time for our annual Mid-Year Roundtable issue of the PCM Report. It is an interesting time as Q1 GDP was confirmed above 3% on Thursday and yet the equity markets have sold off sharply in May. We are privileged to have venerable economist Sam Stovall from CFRA as our guest participant. Sam is the Chief Investment Strategist at CFRA, a title he also held at S&P. Sam is one of the most widely read analysts in the industry and is a regular guest on CNBC and all other financial news outlets.

QUESTION: Q1 GDP surprised virtually everyone when it came in at 3.2%. Is 3%+ growth sustainable for the remainder of 2019?

BRIAN: No, I believe there were definitely some anomalies in the Q1 print that are not sustainable, especially as it relates to inventory and trade. I believe real growth will go back to trend around 2% for the remaining three quarters this year. There is a lot of debate among very smart analysts/economists as to whether the Fed has already tightened conditions too much or whether additional rate hikes are needed to limit a future rise in inflation. My best case scenario is for Goldilocks to continue in 2019.

SAM: Brian, yes, many were surprised by the strength of Q1, myself included. Let's face it, we had been warned by the Atlanta Fed that Q1 GDP growth would initially be below 1%, then growth was raised to above 1%, then eclipsing 2%. It ended up being an ascending moving target. The rest of the year should be good, but not as good as Q1, in our view. We see 1.8% growth for Q2 of 2019, followed by 2.3%-2.4% growth for the remaining quarters of the year.

CLINT: In reviewing the GDP report, it seems like there were some outliers that boosted the result, but that there was underlying weakness that suggested that GDP would gradually slow throughout the rest of the year. Net trade and inventory effects were a boost, but personal expenditures were weak. My guess is that a growth rate of 3% is somewhat optimistic, and we'll instead realize GDP of 2% to 2.5% by the end of the year.

- **Does this eliminate the risk of recession for the remainder of 2019?**

BRIAN: I don't think you can ever eliminate the risk of recession. At John Mauldin's recent Strategic Investment Conference there were notable economists who suggested the economy may already be in a recession. While the flatness or inversion of the yield curve is worrisome, the data right now on the Leading Economic Indicators and Small Business Confidence surveys suggest recession is unlikely over the next 7 months.

SAM: Yes, for 2019, but the jury is still out for 2020. Just as the bull market celebrated its 10th birthday in March, this economic expansion set a milestone next month. It is now the longest U.S. economic expansion in history. That said, history reminds us that every Republican president since Teddy Roosevelt had a recession start in their first term in office. We still have more than a year to go before we can say "except President Trump." That might end up being the case since, however, since we project a low but sustainable 2%+ growth trajectory for the U.S. economy through 2021.

CLINT: If a recession does come, it looks now to likely occur in 2020. Even if GDP comes in at 2% to 2.5% instead of 3% by the end of the year, we wouldn't necessarily meet the definition of a recession. But of course, we could always get shocks to the downside, so the risk of a recession can't be eliminated.

QUESTION: It appears that a Trade War with China is the largest risk to continued expansion. Can you quantify the risk to the global economy if the tariffs and retaliation continue?

CLINT: In a recent statement, Apple estimated that its EPS drops $0.15 for every 5% drop in sales in China. Remember, Apple is one of the largest companies in the world. Likewise, Nike, Adidas and Under Armour commented that a tariff on shoes imported from China would be "catastrophic" for American consumers. The retail sector in particular is coming under pressure and executives in the industry are increasingly pointing to the trade war with China as the reason why. So, you get the picture – if these tariffs continue it is ultimately going to flow through to bottom line EPS, which is obviously a headwind for continued expansion and higher equity prices.

BRIAN: Most would agree that the biggest risk of a recession occurring in 2019 and into 2020 would be an escalation of the trade/tariff spat. I would further suggest that a trade-related recession is only likely this year if it expands beyond China to Europe. Virtually everyone is in favor of "free trade," but the reality is that it has never existed. It has been well documented that China has not respected international law on intellectual property for decades, and the current Administration is the first to make this strong of a stand. If the end result is more "fair trade," the short term disruption will be worthwhile.

SAM: No, and I'm not sure many others can either. I think that is why the equity markets have been whipsawed so violently as analysts attempt to quantify the potential carnage. S&P Dow Jones Indices estimated that in 2017 about 44% of revenues for the S&P 500 came from overseas, in general, while 8.3% was from Asia in particular. On a sector level, energy, materials and tech saw more than 50% of revenues come from offshore. Besides China, a plethora of potentially upending geo-political issues linger, including Brexit, Iran, Venezuela and an escalating of trade tensions with Europe and Japan over autos. And with so many strategists continuing to say that a U.S./China agreement will be reached shortly, I'm reminded of a teenager who takes up smoking but quips "I'll quit before I get sick." I worry that should this trade dispute last significantly longer, it will metastasize itself to the global economy.

QUESTION: Coming into 2019 the biggest concern was the Fed over-tightening conditions leading to recession. Has the Fed found the Goldilocks balance between accommodation and contraction of the Money Supply?

SAM: The Fed likely ended its rate tightening cycle when the Goldilocks economy started taking on the characteristics of Mama Bear (leaning softer and colder). I think the flat 10-year/2-year Treasury yield curve signals that the Fed has finished tightening rates, but the narrow differential between rates and inflation (Fed funds rate vs. the year-over-year change in Core PCE) implies that the Fed won't start cutting rates anytime soon. Over the past 50 years, the average difference prior to a new easing cycle was 600 basis points, with the low water mark at 330 bps. Today the difference is 70 bps.

BRIAN: I view the Fed in the same way I view referees in an NBA playoff game; if both sides are frustrated at the end of the game they probably did a good job and did not factor in the outcome. I think the Fed has found that place for now. Those in the Administration, and equity bulls, want a rate cut to stimulate higher growth and create more liquidity. Other economists believe the Fed should still be moving towards normalization of rates and reducing financial repression. This suggests to me they have found the right balance today.

CLINT: Perhaps, but what I find interesting is how quickly the Fed seemed to change its stance on interest rate policy in the face of declining asset prices last year (the so-called Fed "pivot"). The central bank was set on a policy of gradual interest rate hikes, given the relative strength of the overall economy. Asset price declines accelerated late last year, president Trump publicly ridiculed the Fed, and voila, the central bank began talking about a possible rate cut. This led some to wonder if the Fed was more focused on short-term equity prices than its dual mandate. So, does Goldilocks mean propping up the stock market or actually following through on what seemed like a reasonable interest rate policy?

QUESTION: Investment firm GMO has a widely followed 7-year asset class forecast that suggests Domestic Stocks will generate negative annual returns while International equities average less than 1.5%. Only Emerging Markets are forecasted to beat inflation. Do you agree or is GMO overly bearish?

BRIAN: I would start by saying you ignore GMO's forecast at your own peril as they have historically been pretty accurate. You can quibble over disputes between the markets being up 5% or 7%, but when they forecast negative 7-year returns on stocks it is worth taking note. I am a firm believer that future returns are determined by starting valuations, and that valuations, by some measures, are extremely high today. The problem is that there are other valuation metrics that suggests stocks are reasonably valued today. What seems certain is that a recession, possibly two, will occur over the next 7 years and the 30-40% drawdown of equity benchmarks will limit investor returns over that period.

CLINT: It's interesting to look at the work GMO does. Historically, there's a fair amount of forecasting error between what GMO predicts and what actually transpires. Given that their methodology is based on a mean reversion framework, what they are basically saying is be prepared for lower-than-average returns from the equity markets because in the recent past, returns have been above average. Of course, mean reversion doesn't always follow a well-behaved path, so don't necessarily avoid equities because of the GMO report.

SAM: I agree that forward price appreciation for the S&P 500 should slow in the years ahead because of how well it has done in the past decade. From February 2009 through February 2019, the 10-year price CAGR was 14.1%, well above the one standard deviation level of 11.2% since 1918. Prior similar peaks occurred in 2000, 1959 and 1929. That said, I think most investment strategists are like nighttime drivers who only use their low beams. As a result, they are comfortable making forecasts 12-18 months out. The "Rule of 20" acknowledges that the sum of inflation and valuations (the y/y change in CPI plus the P/E ratio for the S&P 500) has averaged 20 whether using GAAP EPS since 1948 or operating EPS since 1988. Based on forecasts for both, the Rule of 20 implies that the S&P 500 has the potential to post a near 10% increase in price over the coming 12 months.

- **Is there a sector or region that is largely being ignored that will surprise investors?**

CLINT: Emerging markets haven't gotten much love from investors for some time, with the asset class still below levels reached prior to the 2008 recession. This is likely why the GMO's forecast favors emerging markets over the next 7 years, given their mean reversion methodology.

SAM: If you are a believer in "reversion to the mean," then you have to think internationally. Both the S&P Developed and Emerging BMI (Broad Market Index) are trading at relative P/Es (to the S&P 500) that are more than one standard deviation below their long-term averages. Also, their relative 5-year CAGRs are also at these low extremes. So if you are NOT someone who is so impatient that they get upset if they miss a slot in a revolving door, you might want to take a second look at foreign equity opportunities, or at least don't bail out of them if you are currently a holder.

BRIAN: I think many investors are still cautious about emerging market stocks because of the volatility over the last couple of years. Valuations there are truly compelling and if the U.S. dollar is about to enter a declining period, as many have forecasted, I believe emerging markets will be the safest equity markets in which to be long.

QUESTION: We have been in a repressive interest rate regime for more than a decade now and it is impacting many retirees needing income. What is your advice for investors approaching retirement?

CLINT: First, don't reach for yield. That strategy can lead you into some bad investment decisions. For example, retirees might be tempted into investing in certain asset classes such as high yield corporate bonds without fully understanding the risks to their principal. Second, consider a diversified portfolio strategy with a risk management overlay. This allows you to allocate across various income-producing asset classes while addressing market drawdowns. You can reasonably achieve a sustainable level of income with full liquidity. Perhaps the best advice is to set a reasonable level of income (i.e. a 7% interest rate in a 3% rate environment is going to be difficult) and work into a diversified portfolio that meets that requirement with an eye on risk management.

BRIAN: That is a difficult question because the standard answer is that you have to utilize different asset classes like high yield, preferreds, or real estate to earn a reasonable yield. The problem is that you move significantly out on the risk curve when you do this compared to Treasuries or investment grade bonds. This trade has worked well the last couple of years but my fear is that many conservative investors have waded into these more volatile asset classes, and when a recession happens and these assets correct there will be some panic selling as investors find their portfolios do not match their tolerance for risk. My suggestion would be to be as conservative in your withdrawal rates as possible and employ some level of tactical decision making in your portfolio to mitigate risk.

SAM: First, income-oriented investors need to remind themselves that the reason rates are currently so low is that inflation is too. Don't wish for mid-teens interest rates, like in the early 1980s, since inflation would have to be excessive as well. Today, we think investors should combine quality with yield when searching for an income opportunity. Stock investors should focus on issues with S&P Earnings & Dividend Quality Rankings of A+, A, or A-, since they have demonstrated an above-average consistency of raising EPS and dividends over a 10-year period. Add to that a sub-100% payout ratio and a favorable investment outlook by a trusted investment research firm, such as CFRA. When investing in ETFs, consider CFRA's investment ratings, since they incorporate the investment outlooks and quality rankings of the underlying holdings, rather than just a trailing relative price performance.

QUESTION: The popular idea that interest rates only had one direction to move, higher, has been largely dispelled. Where do you see yields over the next 2-3 years and how will that impact the markets?

CLINT: Predicting the future level of interest rates is just as difficult as predicting the level of the S&P 500 Index. But over the near term, it seems like there's a greater probability of a global economic slowdown that might keep longer-term rates lower than a global expansion that might send rates meaningfully higher from here. While the U.S. economy is doing quite well, other economies around the world are not on the same footing. You could argue that there are deflationary pressures that will be a wet blanket on longer-term rates in the near term. That means a 10-year yield, currently around 2.5%, could remain bounded by the 3% to 3.25% range.

BRIAN: I do not believe we have seen the bottom in yields for this cycle. The Fed, and all Central Banks, demonstrated that they are willing to take extreme policy action to increase aggregate demand, even if the policies are unproven with unintended consequences. There are still Trillions in sovereign debt trading at negative yields today so there is a lot of room for yields in the U.S. to fall. I believe the 10-year U.S. Treasuries will trade at 1% or less in the next 2-3 years.

SAM: The 10-year yield, which averaged 2.90% in 2018, is expected to slip to an average 2.60% in 2019 but inch up to an average around 2.75% in both 2020 and 2021. Stocks should not be tripped up by these expected rates, in our opinion, especially since they are well below the median 10-year yield of 5.7% over the past 60 years. What's more, the average P/E whenever the 10-year yield was between 2.40% and 2.70% was 17.3x, implying fair value for the S&P 500 to be around 3035 by June 2020.

QUESTION: Inflation may be the greatest future risk investors are facing. What green shoots are you looking for to gauge if inflation will become a problem?

BRIAN: I am worried long term about inflation and what I would characterize as reckless monetary policy being implemented around the world. There is too much confidence in my opinion that a re-visit of 1970's-style inflation cannot happen. I closely monitored real growth in wages as a sign the Fed could be getting behind the curve as a sharp increase in wages would lead businesses to raise prices as they try to protect margins. The same could be said of commodity prices, but I do not expect commodities to be a reliable inflation indicator in this cycle as global deflationary pressure remains high due to excessive levels of debt. I expect inflation to be more of a country-specific or regional problem than a global issue.

SAM: Instead of the "green shoots" analogy, I would call them "red flags." We aren't calling for any red flags just yet. The unemployment rate used to be a reliable indicator of potential wage pressures, but with so many baby boomers remaining in the workforce (and not demanding pay increases), we forecast Core CPI to average only 2.1% in 2019 and 2.3% in both 2020 and 2021. We project unemployment to average 3.7% this year and 3.5% in each of the next two years. However, we do see hourly earnings creeping higher from the 3.0% recorded in 2018 to 3.5% by 2021.

CLINT: We've heard recently about the potential impact the tariffs might have on inflation. The thought is that the businesses that are directly impacted will pass along the higher costs to the end consumer, which in turn would put upward pressure on inflation. However, I think consumers could change their spending habits (i.e. purchase goods that aren't impacted by the tariffs), so the ultimate impact could be marginal at best. In the past we've mentioned the recent uptick in wages as we enter the later stages of the expansion, but there doesn't seem to be any meaningful passthrough to underlying inflation.

QUESTION: We would all agree that politics will influence the markets heading into 2020. Do you expect any surprises from either the Democratic primary or the general election in 2020?

SAM: The market will let us know in advance should there be any big surprises ahead. Since 1948, a declining market in the three months prior to the general election signaled the replacement of the incumbent party about 90% of the time (and was correct in 2016). The Democrats will have to get their act together, or the economy will need to start to unravel, in order for the current administration to fail to be reelected.

BRIAN: I do expect surprises, which by their very definition make them had to predict. Political commentators like to point to prior periods where the country was extremely divided and even when politicians tried to protect their honor with duels. The sophistication of technology today is different than we have previously experienced. Each side of the political aisle or issue creates content that makes its adherents even more solidified in their beliefs. The mainstream media is not trusted, but what is published by social media is often more fiction than fact (on both sides). I think a candidate like Pete Buttigieg could gain traction and end up being the Democrat to face off against Trump, although the likelihood is still small.

CLINT: Well, it doesn't seem like any idea, no matter how extraordinary, is off the table. We've seen proposals from Sen. Warren for a tax on wealth over $50 million (which I'm not sure would be constitutional), the adoption of modern monetary theory from Rep. Ocasio-Cortez (i.e. let's pay for a Green New Deal by just printing money), and free (i.e. government controlled) healthcare and education for everyone from Sen. Sanders. At the end of the day I think the market dismisses most of this as political banter and policies that have little to no chance of passing through Congress and signed into law. However, if there's a surprise on election night, and Democrats control both houses of Congress and the White House, then market volatility might hit levels we haven't seen since 2008.

- **Almost every Democratic candidate has called for Medicare-for-All. If this became a reality how would it impact the markets?**

CLINT: It would likely impact the healthcare sector, and service providers in particular, to a greater degree than any other segment of the market. Year-to-date, the healthcare sector has underperformed the broader market, perhaps in part due to the potential for healthcare reform.

SAM: We have already seen the health care sector admitted to intensive care when the Medicare-for-all discussion started being discussed. Even the imposition of pharmaceutical price caps has pressured share prices. Yet despite this imposing rhetoric, the S&P 500 health care sector is forecast to record EPS growth of nearly 6% in 2019 and more than 10% in 2020. And on a sub-industry level, such groups as health care supplies, life sciences & tools and managed care are all projected to record double-digit EPS growth in 2019.

BRIAN: It would be disastrous. Healthcare will soon be almost 20% of our economy and this plan would quickly eliminate virtually all private sector healthcare. It simply would not be possible for private companies to compete with the U.S. government except for the very wealthy. It is not as if this model is unknown, it is delivered in most Western economies. It is also the reason why Canadians, Brits, and Aussies who have the resources necessary come to the U.S. for treatment do so. I hold out the slightest hope that a system could be designed where the U.S. expands the VA network and makes it available for those with pre-existing conditions or who cannot afford private health insurance and a private system of insurance, like what existed before the Affordable Care Act, returns.

QUESTION: What is the best and worst investing idea you can leave with our readers?

CLINT: The best idea is to follow a well-defined investment strategy. The worst idea is to throw darts at a board. If there's one takeaway from this roundtable discussion, it is that there is much uncertainty on the horizon – tariffs, Fed policy, elections, etc. It's important to stay invested, stay diversified, and have a plan of action when markets become volatile.

BRIAN: Compliance guidelines make giving specific investment advice difficult in this type of format so I will stay at a high level. The best advice for investors today would be to look closely at your portfolio to see if your tolerance for risk is well-matched with your portfolio. Consider the fourth quarter of last year as a "shot across the bow" of what may be coming. The recovery so far in 2019 is an opportunity to make sure your portfolio is positioned to weather a storm. Stocks could certainly go higher, but it may prove to be like picking up nickels in front of a steamroller. I do think utilities are well-positioned to benefit from lower yields, making them an attractive sector, along with small allocations to emerging market debt and equities. The biggest mistake investors can make today is remaining confident that cap-weighted passive investing is going to generate attractive results. There is likely to be more pain than gain for these investors.

SAM: The best investment advice I ever got came from Clint Eastwood, when he played Dirty Harry in the movie "Magnum Force." He kept mumbling through gritted teeth "A man's got to know his limitations!" Many investors are emotional, impatient, and indecisive. As a result, I think the best thing these investors can do for themselves and their portfolios is uncover a rules-based strategy that will encourage them to buy when the market is advancing, but not bail when it's declining. Whether it's a monthly momentum, a semi-annual seasonal rotation, or a static, reduced-volatility strategy, only they can decide which will help them reach their financial goal while also allowing them to sleep well at night. The worst investment idea is the one that attempts to time the market, especially if the signal is based on a gut feeling. In that case, they will just end up playing a very frustrating version of "whack-a-mole."

I want to extend a special thanks to Sam for participating and sharing his insights and wisdom for our monthly readers of the PCM Report.

Roundtable Contributor Bios

Sam Stovall, CFP®

As Chief Investment Strategist, Sam Stovall serves as analyst, publisher and communicator of CFRA's outlooks for the economy, market, and sectors. He is the Chairman of the CFRA Investment Policy Committee, where he focuses on market history and valuations, as well as industry momentum strategies. Sam is the author of The Seven Rules of Wall Street, and writes weekly "Sector Watch" and "Investment Policy Committee meeting notes" on CFRA's MarketScope Advisor platform. His work is also found in CFRA's flagship weekly newsletter The Outlook.

Prior to joining CFRA, Sam was Managing Director and Chief Investment Strategist at S&P Global for more than 27 years, and served as Editor In Chief at Argus Research, an independent investment research firm in New York City. He received an M.B.A. in Finance from New York University and a B.A. in History/Education from Muhlenberg College, in Allentown, Pa. Sam is also a Certified Financial Planner.

Sam's volunteer efforts center on financial literacy. He is a board member of W!SE (Working in Support of Education), an educational not-for-profit that aims to improve the lives of young people through programs that develop financial literacy and readiness for college and careers. He is also a Trustee of Muhlenberg College.

Brian Lockhart, CFP®

Brian Lockhart is the founder and Chief Investment Officer of Peak Capital Management, LLC (PCM). With over 20 years of portfolio management experience, he serves as the co-portfolio manager of PCM's suite of strategies. Brian directs the company's dynamic allocation of PCM's unique ETF investment strategies implemented on behalf of high net worth and institutional clients like Mauldin Solutions Core and Cavalier Funds Dynamic Growth. Brian has been featured in multiple media outlets including Barron's, Forbes, Fortune and Business Week. An active conference speaker, Brian communicates on topics ranging from portfolio and risk management to alternative investments. A graduate of Polytechnic State University in San Luis Obispo, California, Brian received his Bachelor of Science degree in Business Administration with a concentration in Financial Management. Brian is also an alumni of Harvard, having completed an Executive Education course in Investment Decisions and Behavioral Finance at Harvard's John F. Kennedy School of Government in 2017. He and his wife, Cindy, have been married for over 25 years and love living in Colorado where they raised their two children, Caleb and Jennifer.

Clint Pekrul, CFA

Clint Pekrul, CFA is Head of Research at Peak Capital Management (PCM), and is responsible for the development and implementation of the firm's quantitatively driven strategies. Clint has over 16 years of industry experience. Prior to joining PCM, Clint worked in the asset management group at Curian Capital, a registered investment advisor, where he managed $2BB in managed risk strategies. Clint is often heralded as a pioneer in creating and managing portfolios using ETF's. Clint holds a B.S. in business administration from the University of Oklahoma, and is a Chartered Financial Analyst. Clint resides in Denver where he enjoys fly fishing when he is not managing portfolios.

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