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TPWC Market and Economic Update

The Markets

As we have written before, it is October, the traditional month for market corrections. Investors did not apparently want to miss the opportunity, so they have given us one. The S&P 500 Stock Index (SPX) fell 3.94%, closing at 2658.57. Technically that does not amount to a correction as the decline from the high toward the end of September has been only about 9.3% but the Dow Jones Transportation Index and the NASDAQ Index are down more than 10% so we have at least part of the market clearly in "correction." That puts the SPX down about 0.56% year-to-date and only up about 3% from a year ago. It also is down from when the tax cut was announced last year, suggesting that the euphoria and economic boost from the $1.5 trillion in new government debt may be coming to an end.

SPX Index member companies have averaged a 22% year-over-year earnings growth this quarter. Unfortunately, analysts have been reported as saying that about 12 of those 22 points are a direct result of the tax cut rather than true economic growth. That means that even if we continue to see the exceptional real sales growth and profitability increases we have seen this year, the net in 2019 would drop to about 10%, which is about the long-term average for the Index. Another factor is that so far only about 57% of the SPX companies have exceeded their public estimates for earnings growth this quarter compared with about 75% last quarter. In short, earnings growth is normalizing and may have peaked for this expansion.

The reported general concern is that with new tariffs scheduled for the end of the year, employment expenses rising in an overheated economy along with interest rates to dampen rising inflation, corporate earnings growth in 2019 may be less than impressive. The good news is that the forward price-to-earnings ratio of the SPX is now down to about 15 or 16, which is significantly below its long-term average of about 17.5. Historically, bear markets develop from moments when the SPX P/E ratio is well above its long-term average while bull markets are driven upward when the P/E is below average.

There is another aspect of this correction that leads us to believe that it is not a bear market in the making. Across the market, value and growth indexes have dropped in unison. That means that the selling that is driving prices down is largely in S&P 500 index funds owned by amateur investors. When a real bear market has arrived historically, first the P/E ratio will have soared to unreasonable heights, then the professionals will be the first out the door. Historically, the amateurs in their index funds will keep on propping the market up to new heights before they, like Wile-E Coyote notice the economy has dropped out from below their feet. Again, all we have to work with here is history, but buying when the amateurs are selling and selling when the amateurs are exuberant has been a good idea for as long as we have records.

We had a conversation with an investor who has been at it for more than a few decades recently. He reminded us that election seasons are crazy, and we commonly see a market decline as election day approaches. He predicted that a rebound would take place as soon as the results are in, no matter who wins. We think that is a reasonable forecast.

The yield on the 10-year Treasury note dropped to 3.076% this week on those same market worries. U.S. Crude Oil dropped about 3% to $67.67, gold rose half a percent to $1,236, and the dollar rose about half a percent on the WSJ Index to 90.28.

The Economy

The big economic news this week revolves around the third quarter GDP growth report from the Commerce Department. The top line is that the first estimate (there will be three more) puts the annualized growth of the U.S. economy at 3.5% for the quarter. That sounds like an impressive number, but it represents a 17% decrease in growth from the 4.2% we saw in 2018's second quarter. A large part of the third quarter growth was an increase in government spending by 3.3%, including a 4.6% increase in defense spending. Over 2% of that 3.5% was from another suspect source, inventory building. Inventory building by businesses is, in essence, "borrowing" from future growth by spending on it today.

Car purchases were essentially flat while housing purchases fell at a 4% rate. Another yellow light came on as business investment growth was only 0.8% after rising to a nearly 9% rate last quarter. Spending on structures fell at about an 8% annualized rate, reinforcing the warning flag raised by declining home sales. Excluding defense, capital goods orders, the equipment that makes future growth possible, fell. On top of that, that the U.S. trade deficit hit a record in September having risen now for four months, and this GDP report indicated a quarterly 2.4% increase in imports and a 2.7% decrease in exports.

We have mentioned this before, but the tariffs imposed by the U.S. appear to be having effects quite different from those the administration intended. The dollar has risen about 7% against the Chinese Yuan, effectively making imports from China less expensive. At the same time, some of our major exporters, like the heavy equipment manufacturer Caterpillar (CAT), have become less competitive because of those tariffs. In its report this quarter, CAT stated that the import tariffs have cost it about $40 million this quarter alone.

It does appear that economic growth in the 4th quarter of this year is decreasing. Moody's estimate for the quarter is 3.2%, which would put the total year at about 3.0%. Most economists are then forecasting slower growth for 2019 as the tax cut stimulus wears off, the federal debt mushrooms, interest rates continue to rise, tariffs begin to bite into profits, and labor shortages slow things down. The possibility of a recession in or around 2020 remains high, if for no other reason than because the business cycle has been with us for centuries and good times are always followed by a recession.

The major positives today are that the economy is still running at nearly full steam, the stock market is trading at a price below its long-term historical averages, and there are no apparent bubbles anywhere in our economy. While our crystal ball is no clearer than yours, we would not be surprised to see a post-election rally in the markets. Meanwhile, we will be watching closely.

Until next week, we remain your faithful servants,

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