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The Four Horsemen of 2019

In the wake of a peak to trough sell-off of nearly 20% in the S&P 500 and then a 10% retracement back higher which began in the new year, the stage appears to be set for some sort of follow-on performance which may help further explain what this market drama was all about. Earnings, leverage, rates and the dollar are the Four Horsemen that will get us through to the end of the "play."

We can observe right now that Eurozone growth forecasts have projected down by 60bps from a previous 1.9% to 1.3% by the European Commission. In Asia, Chinese and South Korean industrial cycles show current activity contracting as indicated by each country's Purchasing Manager's Index registering below 50. These are slowing situations in significant global economies indicating a global condition which may begin to inject more negative feedback into the United States as time goes on.

Lest we get too downtrodden, it helps to look at current projections for U.S. growth. The long run trend growth rate for the United States is currently considered by the Fed to be 1.9% based on demographics and other factors. Fed projections presently estimate 2019 full year growth at 2.3% which is "above trend" with contained inflation. Looking at the Four Horsemen in turn, we can deduct where possible catalysts positive and/or negative lie.

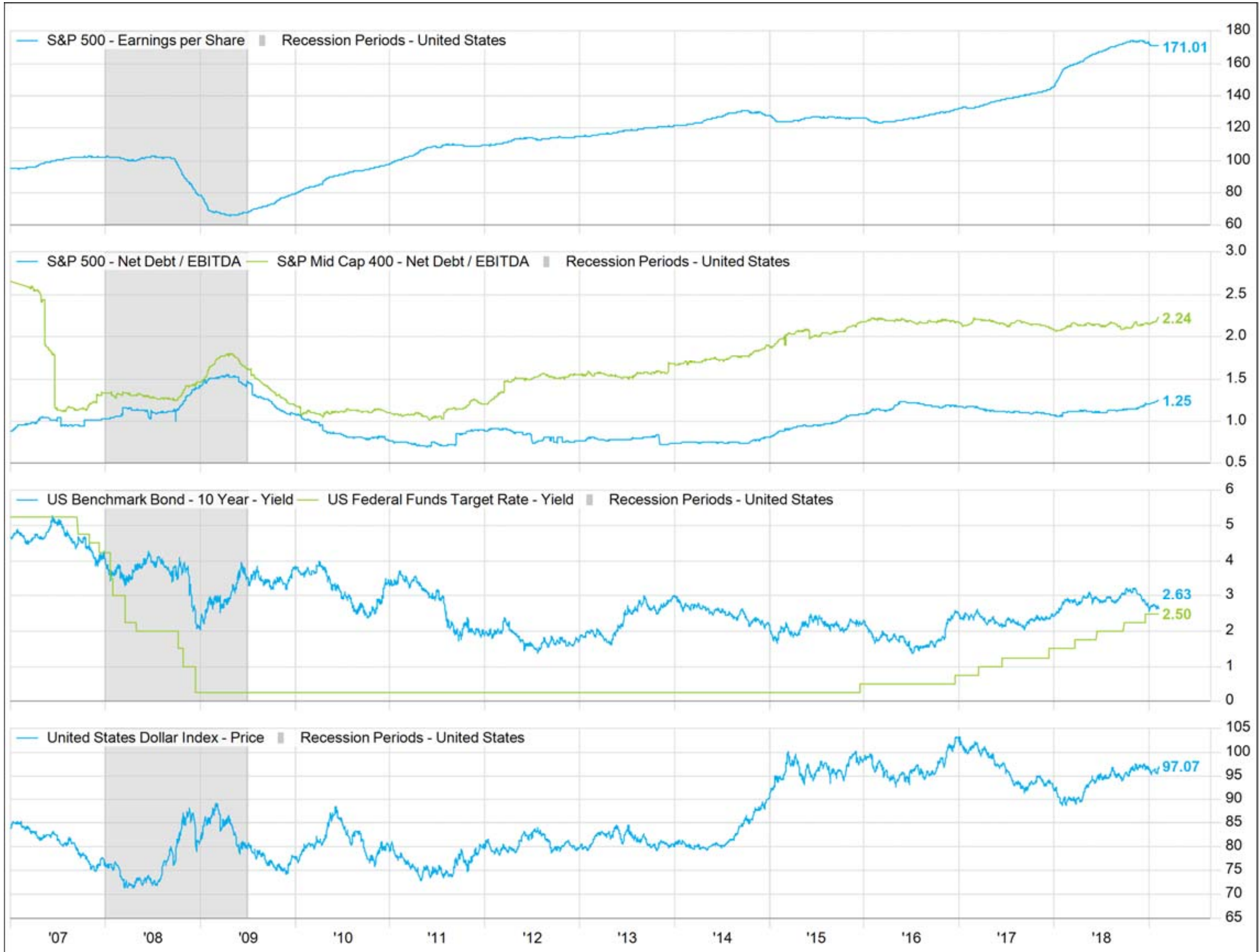
The quality of earnings and corporate cash flows for global multinationals will be mostly impacted by the global economy, relative to companies listed in the U.S. whose revenues are largely derived in the U.S. and North America. As per FactSet, the estimate for FY 2019 earnings growth for companies with greater than 50% of revenues in the U.S. is currently at 6.7% while companies with less than 50% of revenues in the U.S. are currently expected to see only 1.9% growth. Additionally, with the Energy sector being less import driven nowadays, weakness in global commodities and oil prices, should they occur, could bring more weakness to bottom lines and employment statistics as opposed to cost input relief for the economy more broadly.

Corporate leverage is a concern because companies have taken advantage of lower interest rates and borrowing costs by increasing debt. Net debt to EBITDA (earnings before interest, taxes, depreciation and amortization) measures for the S&P 500 and S&P Mid Cap 400 companies are 1.25x and 2.24x respectively. These are not alarming levels and they still indicate long-term funding ability and strength, though we are in a hiking cycle, and should earnings outlooks move lower, then it decreases the credit profile. Rising interest rates and possibly deteriorating credit equals financial tightening hastening even more of a slowdown. Again, this result is not a foregone conclusion but a concern.

Short-term interest rates have been raised nine times since the end of 2015. While the transition to longer term interest rates has not been automatic, there has been a lifting in the long end of the curve as well. The Fed has paused a bit in its hiking cycle, seemingly to allow policymakers to see further incoming data and assess from there, but it is noticeable that the reflation has stalled for now. Interest rate sensitive industries such as Autos and Housing have slowed to a degree and we will have to see how consumers react over time.

Of course, the U.S. dollar intermediates a lot of business globally. It funds enterprise and material inputs outside our borders and there is a demand for dollars across the globe just through the course of normal global activity. We have been able to lift interest rates faster than other economic zones and the U.S. economy is achieving a reasonably strong relative performance while growth outside is being assessed lower. Interest rate and growth differentials can drive the dollar higher in terms of other currencies. While the dollar has been in a stable range since 2015 with oscillating periods of strength and weakness, it is a breakout to the upside which could indicate further deterioration in the outside world, as that would be an indication of capital flows accelerating towards strength from weakness. It would be a disinflationary signal at best, deflationary at worst and all those weakening offshore earnings for U.S. companies would then get translated back into U.S. dollars at an even costlier rate.

Companies and governments will maneuver through this period and outcomes will vary. The Four Horsemen and, of course, a multitude of other variables provide clues as to where the many risks and rewards may be. It most definitely is not an apocalypse but rather a world of some constraints.



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