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INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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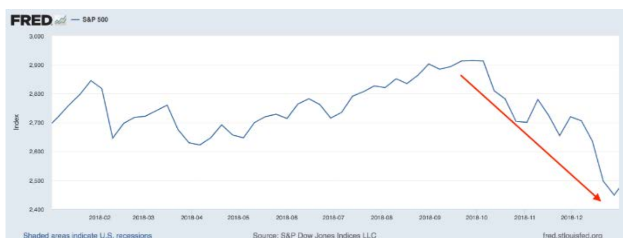
3 Reasons the Market Will End the Year Strong

Many of you remember the sudden and sharp S&P 500 declines around this time last year. Simply put, 2018's fourth quarter was harsh. From the S&P 500's highs in early October through Christmas Eve, the index dipped into bear market territory with a near perfect -20% decline.[1] Technical market watchers would rightfully label this decline a bear market, but throughout history, the dangerous bear markets have tended to be the ones known for size *and duration*. Since last year's Q4 'bear market' only lasted a day, it likely won't be remembered in the annals of stock market history.

The S&P 500 in 2018: A Sharp Q4 Correction



Source: Federal Reserve Bank of St. Louis[2]

In last year's fourth quarter, trade uncertainty was rising, global economic growth was positive but slightly decelerating, and the Federal Reserve was raising interest rates. In the current quarter (Q4 2019), global growth remains in the same middling decelerating pattern, but the Fed has lowered interest rates three times and "Phase 1" of a potential trade deal is driving some optimism in the markets. In other words, conditions are quite different in 2019 than they were in 2018, and the S&P 500 has been trending modestly higher.

The S&P 500 YTD 2019 Through October 31: A Smooth Start to Q4 (So Far)

Source: Federal Reserve Bank of St. Louis[3]

To be fair, however, we now have an environment where the global manufacturing sector is in recession, business investment is softening, and corporate earnings are on pace for their third straight quarter of declines. So, what has me convinced that the S&P 500 will finish

2019 in solidly positive territory? I'll give you three reasons.

Reason #1: Positive Signs are Being Ignored

Many of you are familiar with my view that markets love to climb the "wall of worry." The "wall of worry" forms when investors get so latched onto the recession narrative that pessimism pervades the airwaves, and people prefer to cling to negative news while ignoring positive developments.

We see this happening quite a bit today, with significant positive news being overlooked, such as:

• The yield curve turned positive with few people noticing
• Solid and consistent gains in the labor markets continue apace
• Consumer spending continues to grow at a healthy clip
• The all-important ISM non-manufacturing index continues posting readings in solidly expansionary territory
• And so on down the line

Instead of the narrative being that the U.S. economy is charting a modest, but healthy growth path in-line with a long-term trend of 2%, the narrative is instead focused on a matter of when, not if, the U.S. will enter a recession. This disconnect between sentiment and reality is bullish, in my view.

Reason #2: Recession Risks are Already Deeply Discounted in the Markets

In a recent *Barron's* poll, 27% of money managers said they had a bullish outlook on stocks, compared to a year ago when 56% of managers were bullish.[4] Many managers – and investors – have shifted into defensive positions over the past year, with historically defensive sectors like Utilities and Consumer Staples leading the charge of market gains in 2019. These sectors now look fairly expensive relative to cyclicals, in my view, which I believe creates an opening for mean reversion.

Reason #3: Trade Uncertainty Will Start to Lift, Bringing Sentiment with It

This week has brought with it several developments on the trade war front, with China and the U.S. appearing to agree that tariffs will be reduced or even phased out as part of "Phase 1" of the trade deal. Part of the reason business investment – and arguably manufacturing – have been softening is because of uncertainty surrounding the trade war. I believe that as we inch closer to clarity and the prospects of early innings of a deal, some of this uncertainty will lift and we could see a bounce-back in fixed investment and factory activity.

Bottom Line for Investors

Since 1926, the S&P 500 has entered the fourth quarter with double-digit gains on 42 occasions. In 35 of those years, the index continued its ascent through year-end, posting an average gain of +4.5%. In the post-World War II era, the S&P 500 has averaged a +3.8% return in the fourth quarter.[5]

These metrics are reassuring, and history can be useful in helping us assign probabilities to outcomes. But my real point in sharing those metrics is to demonstrate that last year's dreadful Q4 was an anomaly in history. At the end of the day, stocks have gone up more than they have gone down, and I've got three reasons to believe this year's Q4 will fit this historical pattern.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SP500, November 11, 2019.

[2] S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SP500, November 11, 2019.

[3] S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SP500, November 11, 2019.

[4] Barron's, October 26, 2019. https://www.barrons.com/topics/big-money-poll

[5] Silverlight Asset Management, LLC. October 2019. https://www.silverlightinvest.com/blog/sp-500-should-hang-there-through-fourth-quarter

IN FOCUS THIS WEEK

- Are the U.S. and China actually closer to a trade deal?
- Is soaring debt in the auto markets a problem?
- What is the SEC doing to protect everyday investors?

Tariffs Still a Central Obstacle to "Phase 1" of a Trade Deal?

Markets seemed relieved in the last week that the U.S. and China were nearing Phase 1 of a trade deal. The 'terms' of the trade deal appeared to be headway on agricultural purchases, technology transfer rules, and more opening of China's markets. But perhaps the greatest source of relief was the notion that tariffs would be reduced or eliminated, and that plans for future tariffs would be shelved. The reality on the ground, however, seems to be much different. Much like a majority of this trade dispute, there are plenty of signals that both sides are making headway – only to find after more details are fleshed out that the two sides actually remain far apart. In a speech this week at the New York Fed, President Trump suggested that he could even raise tariffs substantially if the two sides cannot reach an agreement. Then, late last week, China refrained from putting a number on purchases of U.S. agricultural products like soybeans and pork, whereas President Trump has stated the agreement is for $50 billion.[1] Our read on the situation is that the two sides are not any closer to reaching a deal.

Is Soaring Debt in the Auto Market a Problem?

Ten years ago, 19% of Americans who traded in cars for new ones did so with negative equity. In other words, they owed more on the car than it was worth at the time of trade-in. Five years ago, that number jumped to 28%. Today, it's up to 33%. The trend is clear that debt in the auto markets – which we would consider bad debt – is growing at a fairly rapid pace. While this may sound bad for only the consumers taking on bad debt, it's actually a potential negative for lenders and dealers. Lenders have a higher risk of defaults on loans while dealers are allowing some of the negative equity to be transferred to a new loan, worsening the problem. In some cases, consumer lawyers have reported seeing car loans where a person owes more than 130% the value of the car,[2] which feels like a reckoning waiting to happen.

The SEC Cracks Down on High-Fee Mutual Funds

In the past year, the Securities and Exchange Commission (SEC) brought 526 enforcement actions for all matters of financial fraud and wrongdoing. But a boost to this year's tally was due to the 95 enforcement actions brought on investment advisors for "inadequately disclosing their practice of selling more expensive funds to retail clients," according to the SEC. The shift in cases brought indicates that the SEC is more focused on protecting everyday investors, particularly those who may not be as sophisticated as higher net worth or institutional investors. Of the 10 biggest fines levied by the SEC, 55% of them went to individuals or shell companies that did not actually have real operations or proper licenses.[3] The frequency and size of these fines underscores how there is still work to be done in weeding out corruption in the financial markets, and it also underscores how investors should look for advisors that adhere to the fiduciary standard – meaning they are obligated by law to act in your best interests. We adhere to the fiduciary standard here at Zacks Investment Management.

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[1] The Wall Street Journal, November 12, 2019. https://www.wsj.com/articles/trump-says-u-s-china-close-on-phase-one-of-trade-deal-11573584025?mod=djem10point

[2] The Wall Street Journal, November 9, 2019. https://www.wsj.com/articles/a-45-000-loan-for-a-27-000-ride-more-borrowers-are-going-underwater-on-car-loans-11573295400

[3] The Wall Street Journal, November 6, 2019. https://www.wsj.com/articles/focus-on-sale-of-higher-fee-mutual-funds-fuels-30-year-high-for-sec-enforcement-actions-11573043400?mod=djem10point

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