OmniStar FINANCIAL GROUP
Illuminating The Blind Spots

Market Perspectives

A Glance at How the World Affects You

February 12, 2019

Stocks closed mixed on Friday, but mostly recovered from early losses. The muted performance is attributable to fourth-quarter earnings, negotiations over a China trade deal and the insipid debt ceiling issues.

The 10-year Treasury yield closed Friday at 2.63%, down from 2.69% the prior week. Last week's economic reports, which included some catch-ups from prior weeks as government agencies re-opened following the partial shutdown, were generally soft. Motor vehicle sales were reported at 17.5 million in December and 16.6 million annualized in January, with the latter showing a significant drop in light truck sales. Factory orders for November fell 0.6%, hurt by oil's price drop late last year. The ISM non-manufacturing index for January was 56.7, down from the prior month and below the consensus, but still well into expansionary territory. The government shutdown has likely skewed some economic figures downward as both consumers and businesses paused their spending given uncertainty.

Earnings reports for the fourth-quarter are now hitting the home stretch, and the news has not been as bad as some feared, although lowered assumptions heading into earnings season helped. Of 333 S&P 500 companies reporting 4Q earnings through February 8, we believe that approximately 70% have exceeded the consensus estimate. This figure remains above the long-term average of 64%, but below the trailing four-quarter average of 78%. Looking at forward assumptions, updating 178 companies for recent earnings, were slightly biased toward the downside by lowering 2019 EPS estimates on 92 companies while raising estimates on 86 firms. We suspect forward earnings guidance by company managements has been more cautious than normal, given China trade and related supply chain uncertainties, the current reduced level of commodity prices and a stronger dollar.

In spite of some negative earnings surprises, the equity market generally reacted well throughout the fourth-quarter reporting season. Fears of higher interest rates have been allayed with the Federal Reserve setting expectations for no additional rate hikes in the near-term. Many investment analysts believe President Trump was right when he suggested rate hikes should be avoided near the end of 2018. Nevertheless, investor attention will likely shift focus in coming weeks and months; avoiding a second partial government shutdown (where efforts last week seemed to indicate a compromise was on track); China trade negotiations (where a new round of trade discussions is expected to begin this week), and the potential for a weak 1Q19 earnings season. On the latter, earnings for 1Q are now expected to be about flat with the prior year. We also expect some contribution from P/E multiple expansion following last year's contraction. Argus Research has set a target of 2,900 on the S&P 500 which implies an additional 7% rise for the year from current levels.

PEGY Ratios Point to Value

Hunting for stocks that balance long-term growth and value characteristics is a top priority. At present, Financial Services, Healthcare and Technology sectors are currently selling below the S&P 500's ratio of 1.5. The Energy and Materials sectors have among the lowest PEGY ratios, as they are in the early stages of a cyclical earnings recovery. To generate PEGY ratios, the P/E for each sector based on projected 2019 earnings is used as the numerator. For the denominator, average growth rates for the past three years, along with two years of forward estimates in order to achieve a less volatile earnings trend. The current dividend yield is then added to generate the approximate total return. The PEGY ratio is an improvised version of PEG, as it does not unfairly penalize slow-growth companies and rewards high-growth companies.

Beyond the U.S. borders, global stocks appear cheaper than domestic stocks on numerous valuation metrics. For example, yield on the S&P 500 is 2.0%, below the global average of 3.0% and well below the 4.3% average yield in Europe. A review of price/sales ratios tells a similar story. The U.S. ratio is 2.0, well above the global average of 1.2, while Japan and Europe are at 1.1 or below. The trailing P/E for the S&P 500 is 17.5, versus the global average of 14.7. Indeed, investors usually pay a premium for North American securities, largely due to transparency of the U.S. financial system. Moreover, global returns can be volatile across individual countries given currency, security and political risks; U.S. stocks are outperforming developed markets outside the U.S. and Canada so far in 2019. We continue to maintain a moderate allocation to international stocks.

Our Technical perspective remains optimistic; indicators are in positive territory. History tells us that a market rally can continue with only Technical or only Strategic indicators in positive territory, but the odds of sustainable gains are greater when both are positive. Technical indicators have fully recovered, driven by breadth. The NYSE Bullish Percentage is back near its early December high. Still, trading seems to have stalled in the last several weeks. Without a catalyst to push stocks through challenging levels of resistance, it is likely that a trading range develops in coming weeks.

This week's economic calendar is chock full of data. Tuesday brings the JOLTS report for December. On Wednesday the treasury budget for December and the Consumer Price Index for January will be released. Thursday brings business inventories for November, retail sales for December, and final demand for the producer price index for January. On Friday, import/export prices and industrial production for January, as well as the Empire State manufacturing survey and preliminary consumer sentiment for February, will be released.

Best Regards,
Phillip L. Clark, RFC
President & CEO