Q4 2019 | Equity Outlook

A market of mixed messages

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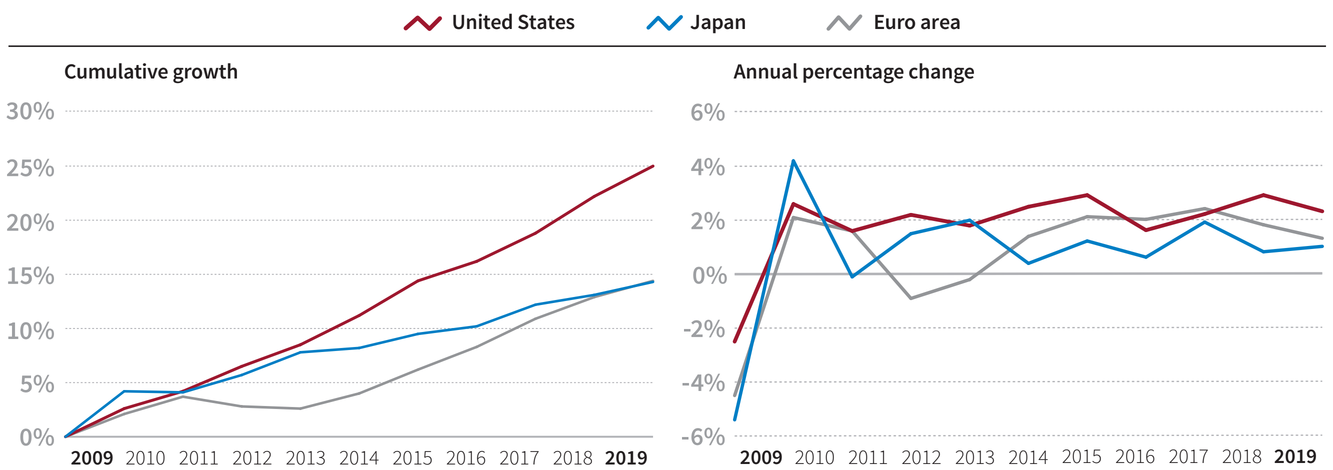
We enter the final quarter of the year with a somewhat puzzling backdrop for equity investors. GDP growth across global markets remains in the positive range of the past decade. However, trends that typically signal pullbacks, slowing growth, or even recession have been intermixed with positive economic data and signs of strong consumer confidence.

Are equity investors bullish or nervous, and what is the likelihood of recession in the year ahead? We take a look at positive and negative trends — from the surprising drop in Treasury yields to the impressive financial results from many businesses in the consumer sector. We also analyze the U.S. housing market and the potential effects of the U.S. presidential election on health-care stocks.

GDP growth has been positive, in a narrow range over most of the decade

Real GDP growth, 2009–2019



Source: IMF, 2019.

Making sense of the market's rise

Shep Perkins, CFA
Chief Investment Officer, Equities

Near the start of the fourth quarter, global equity markets were enjoying solid year-to-date gains. The S&P 500 Index, although flat year over year, was up strongly year to date and near an all-time high. GDP growth was also healthy across global markets. In the United States, economic growth has slowed since the first quarter, but remains in the positive range of the past decade. Likewise, GDP growth in Japan and Europe is also steady, albeit low. Over the past two years, growth has been higher than the 10-year average.

The U.S. consumer sector was a bright spot, especially at the low end. Comparable store sales growth for a number of businesses revealed underlying core strength in the most recent quarter. A number of fast-food chains and fast-casual restaurants, for example, reported a solid jump in same-restaurant sales. Also, retail stores focused on low-income customers delivered impressive growth. The same cannot be said at the higher end, however, where luxury retailers and premium cosmetics businesses saw revenues decline.

> “Sales growth for a number of U.S. businesses revealed underlying core strength.”

While the consumer sector has been an area of strength, we have seen a modest slowdown in the U.S. housing and automobile industries despite lower interest rates. This could suggest that consumer confidence may be weakening. In fact, surveys show that confidence has pulled back from highs. However, the combination of record low unemployment, increasing wages, and very low interest rates has provided a favorable backdrop for the consumer. In our view, these positive trends could continue through the final quarter of 2019 and 2020.

Worrisome undercurrents

Despite these positive forces, the market is sending cautionary signals. The most notable may be the collapse in 10-year Treasury bond yields. The magnitude of the decline was sharper than almost any bullish bond investor would have expected at the start of the year. The 10-year yield hit its lowest level since July 2016. Declining yields are often a sign of an oncoming economic slowdown. Also, the yield of 10-year U.S. Treasury notes fell below the yield of two-year notes briefly in August for the first time since 2007. This inversion of the yield curve has often signaled a looming recession. Moreover, a midsummer move higher in the price of gold suggested a heightened level of anxiousness about risky assets.

The valuation spread — the difference between the most expensive and the cheapest stocks — remains near one of its widest points in history. When P/Es are grouped by quintiles, the highest price/earnings multiples in today's market are extremely elevated relative to the market's lowest quintile P/Es. This confidence in only a narrow range of companies may be an indication of worry as well. Other periods of time when the growth/value spread has been at these extremes were 1991, 1999, and 2008 — all of which were amid or shortly followed by recessions.

So, what's wrong? Looking at a key growth driver

Investors are naturally wondering what is behind the market's mixed signals. In my view, the main cause of concern is China, a key driver of global growth over the past decade. Of course, we've had daily headlines about the U.S.–China trade conflict and worries over the impact of tariffs. However, I believe those issues are masking a broader problem — that China's age of infrastructure build has peaked and is at risk of contracting.

China's buildout has been extreme. One commonly cited statistic was that China consumed more cement between 2011 and 2013 than the United States did in the entire 20th century. And this trend has continued. Just since the global financial crisis a decade ago, China has consumed three times the amount of cement that the United States has consumed over its entire history. China's yearly cement use could drop by 50% or more, and it would still be consuming a lot. The same is true for other infrastructure-related building materials.

There are clear signs that this building boom, and China's growth overall, is subsiding. GDP growth in China recently slowed to its lowest level since 1992. Auto sales offer additional evidence of a slowdown. In 2009, 10 million cars were sold in China. By 2017, annual sales soared to 25 million. That dramatic increase had a significant impact on demand for a wide range of materials, from steel to semiconductors. Auto sales have now been in decline for 18 months. They were down close to 20% at the close of 2018, and are expected to be even lower for 2019.

> "Despite a number of positive forces, the market is sending cautionary signals."

Is a recession looming?

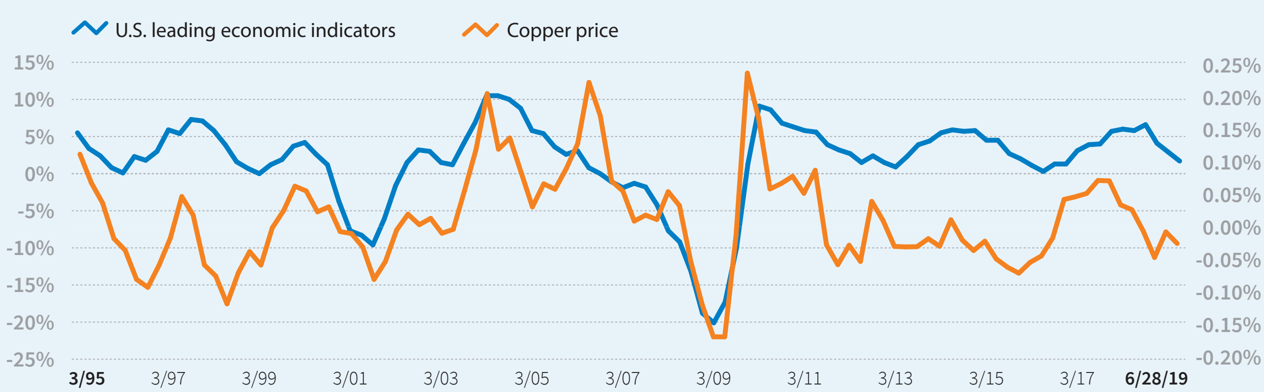
I believe the likelihood is low for a U.S. recession between now and the end of 2020 given the underlying strength of the consumer sector combined with low interest rates. However, we are keeping a close eye on China. The trade war is exacerbating the country's underlying structural issues, and serious economic problems in China could lead to significant ramifications for the global economy. On the other hand, China is implementing stimulus measures, and we could see a resolution for some aspects of the U.S.–China tariff conflict. This could provide stabilization, or even a reacceleration of growth in China and globally in the months ahead.

Doctor Copper and cotton: Is economic health weakening?

The term "Doctor Copper" refers to the notion that copper could have a Ph.D. in economics because of its ability to determine the health of the global economy. Copper prices have pulled back 15% since the spring and hit a two-year low in early September. Copper supply is also lower, which normally would push prices higher, so the current price decline may indicate falling demand.

Also, the price of cotton has declined more than 25% in the past 12 months, making it the worst performer in the Bloomberg Commodity Index. In August, it approached a three-year low after being at a near-decade high just one year ago. While the trade war hasn't helped, the reduced demand could be due to the economic slowdown in China, one of the world's top importers of cotton.

Copper prices have often signaled economic downturns



Source: Bloomberg; Copper price represented by 12-month rolling average percentage change.

The case for U.S. housing

Walter D. Scully, CPA
Portfolio Manager

Despite a sometimes turbulent ride for global equity markets in 2019, there is still a lot to like about the U.S. consumer sector. Many retail stores and restaurants, particularly at the low end of the market, have experienced impressive sales growth this year. In August, the Commerce Department reported a sixth straight month of positive growth for retail sales. Unemployment is at an all-time low, and wages have increased. And after a brief downturn, the housing market continues to be a positive force for equity investors, in our view.

A bump in the road for housing

In many respects, the U.S. housing market is still recovering from one of its greatest busts in history. Following the peak of the housing bubble in 2006 and the subsequent market collapse, U.S. home prices declined for six years. In 2012, housing began a remarkable recovery, and it has largely been a pillar of strength for the U.S. economy in the years since.

Housing hit a rough patch late in the third quarter of last year due to a significant increase in interest rates. For September 2018, there was a 9% year-over-year drop in sales of single-family existing homes and an 8% year-over-year decline in new home sales. We would describe it as a housing recession that lasted approximately eight months. In July 2019, year-over-year U.S. home sales rose more than expected due to lower mortgage rates and the healthy labor market.

The good news: Inventory is tight

The U.S. economy has continued to grow in 2019, and demand for homes remains steady. In our view, we are not building enough new homes. According to recent data, the current inventory of U.S. homes available for sale is well below the long-term average. This can be good news for consumers as it helps to drive up home prices and boost aggregate housing wealth. Also, although their prices have been increasing, homes are still affordable, helped by rising household income.

When housing wealth grows, even homeowners who choose to stay put tend to invest more in home improvement. The solid demand from homeowners for products, services, and supplies bodes well for many stocks in the consumer sector, particularly home improvement retailers and their suppliers.

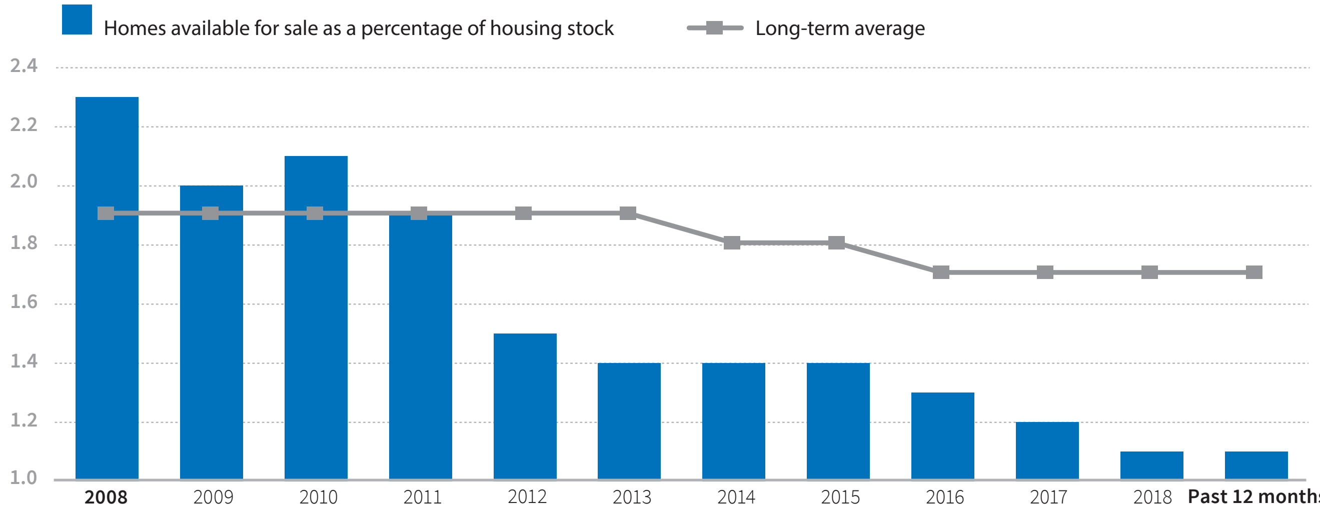
Despite rising prices, housing remains affordable

National Association of Realtors affordability index

Source: National Association of Realtors, as of 6/30/19.

The National Association of Realtors affordability index measures whether or not a typical family could qualify for a mortgage loan on a typical home. An index value above 100 signifies that a family earning the median income has more than enough income to qualify for a mortgage loan on a median-priced home, assuming a 20% down payment.

Inventory is tight, boosting housing wealth



Sources: U.S. Census Bureau; National Association of Realtors, as of 7/31/19.

Who benefits from housing wealth?

Home improvement retailers in the United States should continue to benefit from the growth in housing wealth. Many of these stocks are attractively priced, and the businesses are generating solid free cash flow and strategically allocating their capital.

Unlike many retailers, home improvement businesses are somewhat insulated from the "Amazon effect" — the pressure placed on traditional businesses from online competition. This is due to the specialized nature of their products and services, many of which are not conducive to online shopping. The same can be said for manufacturers of paint and residential building products.

2020 campaign changes health sector valuations

Jacquelyne J. Cavanaugh
Portfolio Manager

Michael J. Maguire, CFA
Portfolio Manager

Jackie: The anticipation of a U.S. presidential election can have an impact on many sectors of the economy. Once again this year, issues related to health care are capturing the attention of candidates, the media, and voters. Political parties are advocating changes to address insurance coverage and drug costs, and the headlines they generate can be very disruptive to health-care stocks.

Mike: Election season and the "noise" it creates can take a toll on the price multiples that investors are willing to pay for health-care stocks. It is easy for candidates to ask provocative questions but difficult for businesses to provide quick and simple answers because the issues are so complex. We try to look past the noise and take advantage of price declines that result from short-term disruptions.

Managed care in the spotlight

Jackie: In April, Democratic candidate Bernie Sanders introduced a "Medicare for All" bill that would create a government-run system to provide health insurance for all Americans. Stocks of managed care companies plummeted in response. The reaction was based on the assumption that private insurers would have no role in such a system. We believe "Medicare for All" is not even a remote possibility, and all but a few candidates have recognized that it is unrealistic and fraught with problems. It is a headwind for the managed care sector, but we believe the "Medicare for All" risk the market is assigning to these stocks is far too high.

A positive force amid the noise: Medicare Advantage

Mike: It is difficult to find areas where politicians from both sides of the aisle are in agreement. Medicare Advantage, the privatized version of Medicare coverage, has been a resounding success in the view of Republicans and Democrats. Because of this and our aging population, we believe many managed care companies are well-positioned for growth, regardless of the election outcome.

Jackie: Another tailwind for managed care could be the proposal to lower the eligibility age for Medicare. The "Medicare at 55 Act" would expand the addressable market for private insurers, bringing in new customers who are likely to have fewer health issues than older Medicare patients.

Drugs: Yea to innovation, nay to higher prices

Mike: We also find bipartisan support when it comes to medical innovation. From gene therapies to next-generation targeted oncology, highly innovative assets tend to be viewed favorably from a legislative and regulatory perspective. Although these treatments are extremely expensive, politicians are generally committed to finding payment models that work.

On the other hand, drug pricing is a significant problem. Drugs are getting more expensive, and the co-pay structure is poorly designed. Politicians are pressuring retail pharmacies, drug manufacturers, wholesalers, and pharmacy benefit managers. It is an incredibly complex challenge, and will continue to be long after the election.

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Investing since 1993
Joined Putnam in 2011

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In the investment industry since 2008
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MSCI EAFE Growth Index (ND) is an unmanaged index that measures the performance in 20 countries within Europe, Australasia and the Far East with a greater-than-average growth orientation.

MSCI EAFE Value Index (ND) is an unmanaged index which measures the performance of equity securities representing the value style in countries within Europe, Australasia, and the Far East.

Russell 1000 Growth Index is an unmanaged index of those companies in the large-cap Russell 1000 Index chosen for their growth orientation.

The S&P 500 Index is an unmanaged index of common stock performance.

The Bloomberg Commodity Index is a broadly diversified index that measures the prices of commodities.

The views and opinions expressed are those of the authors: Shep Perkins, CFA; Walter D. Scully, CPA; Jacquelyne J. Cavanaugh; and Michael J. Maguire, CFA, as of August 31, 2019, are subject to change with market conditions, and are not meant as investment advice.

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