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INVESTMENT MANAGEMENT

Andrew Slimmon Equity Market Commentary: Is Everyone On Board?

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AUTHOR

ANDREW SLIMMON
Managing Director and Senior Portfolio Manager, Applied Equity Advisors

This is going to be short. (Don't we all get too many long-winded pieces?)

Wednesday, March 6th we hosted a webcast chock full of new slides which I encourage you to review. If you have any thoughts, questions, or comments you would like to share, please email me at andrew.slimmon@morganstanley.com. I appreciate receiving the feedback and comments from those who follow us. Thank you.

Here are the salient conclusions from the webcast, followed by a couple of additional, more recent thoughts:

1. The US equity market's tremendous move would suggest some buying exhaustion especially since the biggest buyer (corporations) cannot participate for the next month.
2. A modest correction is a real possibility. We would expect it to be shallow as there remain two sources of liquidity:
   a. cash that was liquidated from mutual funds/ETFs in December and January.
   b. hedge fund positioning that remains under-exposed.

   Both of these should cushion any weakness.
3. The third year of a Presidential term is typically very good for equities, given the desire to have everything look good in preparation for the re-election campaign. We doubt this year will be different.
4. We believe the biggest risk is the potential for deteriorating earnings fundamentals. Given the high bar for year-over-year earnings growth set last year, an earnings recession remains a real possibility. (More on that below.)

5. In our opinion, even if we do have a market pullback this spring (possibly after more cash has been recommitted), the market would be very cheap versus 2020 consensus S&P 500 earnings per share estimates. Either the consensus earnings number needs to be reduced *significantly,* or the market is quite likely going to view 2020 earnings as a positive later this year. We believe the latter will happen.
6. As much as investors are focused on the China trade deal as the elixir for the Chinese markets, the Chinese government is employing monetary and fiscal stimulus to re-energize their economy. That level of stimulus is generally very bullish for equities.
7. Investors appear far too bearish on Europe at a time when some sort of resolution on Brexit is imminent. We expect the European markets to rally and catch many investors who may be underweight by surprise.
8. I am not a fan of equity opportunities in Japan relative to other places in the world. Therefore our global portfolios have zero to minimal allocations to the region.

Finally, here are two additional comments since the call:

1. In my opinion, the bears suffered a powerful one-two punch Friday, March 8th and Sunday, March 10th. Friday's employment report missed estimates. *Employment misses tend to lead more often to stronger equity markets than big employment beats*. Why? Because equities worry that too much strength means Fed tightening. While a big miss could lead to more sinister economic news, more often than not an employment miss simply suggests that the economy does not need any Fed intervention.

   The employment report was followed by an interview on Sunday night with Fed Chair Powell where he reassured investors that there was no sign of an economic recession, thereby defusing the more sinister implication of the weak number. He then implied that the Fed would remain on the sidelines, for the foreseeable future. Obviously the Fed's track record on economic predictions has some potholes, but for the time being:

   A slow and steady economy with a dovish Fed has typically been a very powerful combination to drive equities higher.

2. The argument by the bulls to remain optimistic even after this rally is mainly predicated on earnings and economic growth troughing in Q1 and strengthening from there. In essence, the bulls argue that we won't have negative earnings growth in Q2 and therefore we won't have an earnings recession.

   As I said earlier, I believe the odds of an earnings recession are better than 50/50. **But**, what nags at me is a powerful lesson Mr. Market has taught me over my many years in this business. If you think there is something out there that is bullish or bearish, yet the market keeps trading the other way even as that argument becomes more widely discussed, *it's not usually the market that is wrong…you are!* In essence, I am not espousing being a slave to "the tape", but the market needs to be respected. In other words, what does the market see that I don't?

   Do we need to recalibrate the earnings recession call? Could it be wrong?

   Time will tell, but I will say this: consensus Q2 earnings per share estimates went up last week, not down. If this continues, it would throw cold water on the earnings recession argument, suggesting that the Q1 trough thesis is correct.

   Andrew

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