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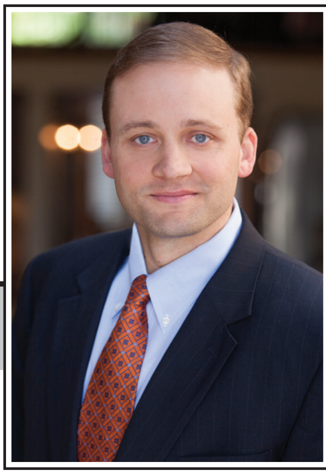
THE MARKET MATTERS



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The Path to 3,000

On July 9, 2011, I sat in right-center at Yankee Stadium in the Bronx along with my wife and a longtime friend of ours. As luck would have it, it would be the day that Derek Jeter would go 5-for-5 against the Tampa Bay Rays and reach 3,000 career hits. It just so happened that his 3,000th hit would be a bullet off a breaking ball that soared over the left field fence. As a lifelong Atlanta Braves fan, I felt little disloyal as I enthusiastically hailed the Yankee milestone alongside the pinstriped faithful. But I was helplessly swept up in the moment all the same. Greatness is greatness – and it is worth celebrating. I am grateful we were there to witness such an iconic performance.

But Jeter didn't reach 3,000 hits overnight. That journey began 16 years prior with a routine single against the Seattle Mariners on May 30, 1995. But every journey begins with a single step. Today, the S&P 500 Index sits within whisper of its all-time high of 2,933.68 set on April 23. It too can see the 3,000 mark within reach. In the time between Jeter's first MLB hit and this writing, the S&P 500 Index is up 465%, or 7.50% per annum (Bloomberg). In that span, the S&P 500 has thrived through 4 U.S. Presidents, 2 recessions, the worst terror attack in U.S. history, multi-front military conflicts, unprecedented technological innovation, and light-speed economic globalization. The S&P 500's approach toward 3,000 – and the U.S. equity market's journey as a whole – is an incredible odyssey indeed.

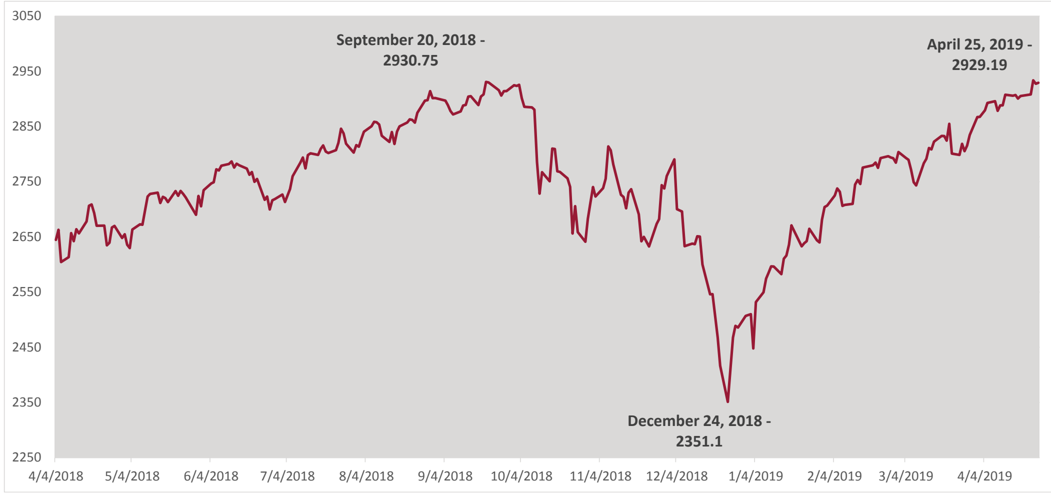

Chart 1. The S&P 500 Index's performance over the past 12 months — Source: Bloomberg

The S&P 500 now sits just 3% below the 3,000 threshold – a number that seemed fantastical from the shadows of the financial crisis. The more recent journey has not been without its own drama. In Q4 2018, the S&P 500 endured a painful -20% correction as a result of the U.S. Federal Reserve's overly tight monetary policy (that aggressively flattened the U.S. yield curve), rising U.S.-China trade tensions, and weakening global economic data that sent growth and inflation expectations spiraling downward. Then came Q1 2019's recovery. In last month's The Market Matters, we discussed "When Threats Become Opportunities." Over the past few months, these threats to global stability evolved into more supportive roles – and risk market performance roared back to life. Specifically, the Fed pivoted its monetary policy plans in dramatic fashion. No longer did the Fed predict two rate hikes in 2019 or that its balance sheet reductions were stuck on "autopilot." Instead, the Fed now pledges to keep the Fed funds rate on hold for 2019 and to stop its balance sheet reductions this coming September. That is the monetary policy equivalent of a 180-degree turn. Simultaneously, the mood around the year-long trade negotiations between the U.S. and China has improved dramatically. Both sides are now touting significant progress and signaling that the end of the trade standoff may be nearing. Lastly, economic data has improved in recent weeks. China's stimulus efforts to combat its slowing manufacturing activity and deteriorating GDP appear to be bearing fruit. Major European economies are still struggling with Brexit and geopolitical unrest, but April's agreement to push a Brexit decision off to October 31 has provided short-term relief. The European Union needs to move beyond the monumental economic drag that is the Brexit process, but kicking that can down the road suggests a disorderly U.K. exit may still be avoided. Some of 2018's biggest fears have recently become sources of optimism. That ignited the V-shaped rebound in U.S. equities throughout the first 4 months of 2019 that erased Q4 2018's losses.

That's not to suggest 2019 has been without concerning developments. Most notably, the six-day-long inversion of the 3 Month-to-10 Year U.S. yield curve suggests the probability of economic malaise within the next 24 months has increased (if history is to be believed, which we believe it should be). And despite improving economic data, growth expectations among global central bankers, the IMF, and financial strategists continue to deteriorate. Also, as U.S. equity markets rally higher – especially in this case as they rallied to all-time highs – one would expect yields to move higher in sympathy. Typically when money flows towards equities and away from fixed income, bond prices decrease and bond yields rise. That has not been the case. In fact, U.S. yields have actually fallen since the start of the year despite the S&P 500's 17% year-to-date returns. That suggests that the current rate environment is more of a reason for 2019's U.S. equity strength, as opposed to a byproduct. The Fed and stubbornly low inflation can be thanked for that.

One other trend worth noting: it appears that the enthusiastic reactions to positive headlines surrounding the Fed's newfound dovishness, U.S.-China trade progress, or better-than-expected global economic data have fallen in both frequency and magnitude. To us, that suggests some fairly optimistic outcomes on these fronts are already priced into domestic equity markets. That could spell two things: 1) any downside surprises (i.e., a less-than-substantive trade agreement; a quick downturn in data; an abrupt change in Fed guidance) opens U.S. equities up a more powerful negative reaction and higher volatility; and 2) U.S. equities will need to find new sources of fuel to extend its rally. So, where might the S&P 500 discover such sustenance to reach its own 3,000 milestone?

Many are hoping the Q1 2019 U.S. corporate earnings season (which is currently underway) could provide a reason for more risk-taking and further gains. Thus far, about 40% of the S&P 500's constituents have reported sales and earnings results. More than 75% of those that have reported beat earnings expectations, some by significant margins. Those "beats" are fairly evenly distributed between sectors other than among energy and real estate companies. That number of upside surprises coupled with their breadth are encouraging signs that although long-term economic concerns are rising, near-term prospects remain bright. If equity bulls can no longer focus on the Fed, trade, or data to validate their rosy outlooks, this earnings season is likely where they will turn their attention. We expect these positive results to continue and; therefore, expect the broadly risk-on mindset to persist. Secondly, the late-March 3 Month/10 Year U.S. yield curve inversion has evaporated. That should help ease near-term fears that a slowdown is imminent and free up more risk-taking. A patient Fed should help nurture that sentiment into the summer months and could allow the S&P 500 extend its winning streak. Also, the relationship between low U.S. bond yields and S&P 500 earnings yields (near 5% and rising) creates an argument that stocks are still reasonably priced relative to other asset classes. However, we must not forget January and October 2018 when U.S. yields moved higher and pressured equity dividend yields, which sparked a powerful rotation out of then-expensive stocks and into then-cheap bonds. If 10 Year U.S. Treasury (UST 10) yields drift toward 3.00%, it could threaten this relationship once again and force more rotational behavior which would come at the expense of equity performance. However, this is not a likely threat in the weeks ahead. Despite some hurdles, the path to 3,000 is open.

Everyday there are threats – both seen and unseen – to economic stability. But over the long-term U.S. equity markets have proven themselves resilient to major disruptions. Like Jeter, to achieve the 3,000 mark requires patience, discipline, and following a long-term vision. Is it possible for the S&P 500 to reach the 3,000 threshold? Yes – but it will have to depend upon a new set of motivators to get there.