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MACROSCOPE the market bulletin from Luft Financial

No.18 04-January-2019

Market prognosis and experts' prognostications for 2019

Investors will doubtless be glad to see the back of 2018, a year when nothing seemed to work – stocks, bonds, commodities, preferred shares. Almost every asset class finished in the red for the year, in sharp contrast to 2017, when most investments generated sizeable returns amid record-low volatility.

In fact, if the stock market had a persona, one could say that it morphed from a swaggering, overconfident entity in 2017 to a "Nervous Nellie" in the fourth quarter of 2018. In other words, while the market successfully overcame a plethora of risk factors to continue its ascent in 2017, it was weighed down by most of those same risks in Q4 of 2018, resulting in the worst performance for equities in a decade.

Market swings were particularly dramatic last month, exacerbated by thin trading volumes during the holiday season. The S&P 500 and Dow Jones recorded their worst December performances since 1931, despite a rebound in the last week of the year that was marked by the biggest one-day gain since 2009 for U.S. indices on December 26. The S&P 500's 9.2% plunge last month resulted in it losing almost 14% in Q4 and ending the year down 6.2%, its worst return since the Great Recession of 2008. The TSX Composite fell 11.6% in 2018, also its worst performance since 2008 (Figure 1).

Where do we go from here? Most of the issues that hindered risk appetite in Q4 continue to loom over the markets. A potential full-fledged trade war between the world's two biggest economies is one of the major risks; the trade spat may already be having an impact, judging by Apple's lowered revenue forecast on January 2 due to weak sales in China. Global growth also seems to be decelerating, based on recent economic indicators. On January 1, China reported that its factory activity contracted for the first time in 19 months. On January 3, the ISM Manufacturing purchasing managers' index for the U.S. showed its biggest one-month drop since October 2008. Apple's gloomy forecast and the ISM data combined to push U.S. indices down between 2.5% and 3% on January 3, getting 2019 off to a rocky start.

Softer economic data, the recent swoon in global equities and commodities, and recessionary signals from the U.S. yield curve, has some economists forecasting a possible U.S. recession in 2020. But market strategists on both sides of the border apparently did not get that bearish memo, because index forecasts for end-2019 continue to be unabashedly optimistic.

For the TSX Composite, the average year-end estimate of eight strategists polled by Bloomberg in a recent survey is 16,644, a 16.2% gain from its end-2018 level; combined with an expected 3.5% dividend yield, that estimate implies total returns of almost 20%. For the S&P 500, the median year-end target compiled by FactSet from strategists' estimates is 3,117, a 24% surge from its end-2018 level.

Those ambitious index targets are predicated on fairly lofty earnings estimates for Canadian and U.S. companies. According to earnings estimates compiled by FactSet, EPS for the TSX is forecast to grow 10.9% this year to $1,155. Based on the index's Jan.3 closing level of 14,212, that gives the TSX a forward Price/Earnings multiple of 12.3. For the S&P 500, EPS growth is forecast to slow down to 7.6% this year, compared with 22% growth in 2018 that was largely attributable to U.S. tax cuts. However, forecast 2019 EPS of $173.35 (estimates compiled by FactSet) would set a new record for the S&P 500 and give the index a forward P/E – based on its 2,448 Jan.3 closing level – of 14.1.

These are admittedly attractive valuations but should be taken with a grain of salt because revenues and earnings estimates may not be reliable in another challenging year and could be subject to sharp downward revision. For proof, look no further than Apple, which surpassed $1 trillion in market value last year but has plunged 39% over the past three months as it missed overly optimistic estimates. In fact, the five stocks that go by the overused acronym FAANG (Facebook, Apple, Amazon, Netflix and Google), which contributed disproportionately to the S&P 500's advance in recent years, are down 32% on average from their highs reached in the second half of 2018. This loss of leadership may make it harder for the index to make sustainable gains – an old market axiom says that an army cannot advance if its generals are missing.

In this publication about a year ago, we had opined that 2018 could be a year of enhanced volatility with limited market upside and had recommended that investors focus on strategies that preserved wealth rather than aggressive, "shoot the lights out" investments at this late stage of the economic cycle. Given the deterioration in the economic and market outlook over the past year, we see little reason to change our viewpoint. While we expect our client portfolios to participate in most of the market upside if the TSX rebounds – as it did after similar declines in 2011 and 2015 (Figure 1) – we will continue to focus on downside risk mitigation in our diversified portfolios by holding fixed-income securities and assets with inverse or low correlation to stocks, while maintaining an adequate level of US dollar exposure.

Figure 1: The TSX posted its worst annual performance in a decade in 2018 (Source: Bloomberg)

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