2019 July Market Outlook

The markets essentially continue to trade in a trading range for the last two years. Despite the sideways movement, this year the market has spent more time on the upside than downside and it does not want to stay down (we try and explain why in the bullish section below). Also there are many diverging signals from different indexes and assets. I thought that the market would be volatile this year because of the mix of bearish and bullish news. The market seems to focus on good news and downplays negative news – for now.

The market has gone up on three basic reasons/assumptions: a healthy economy, the prospect for rate cut(s) and a trade agreement with China will be made by the end of this year. I wrote a Special Report on both interest rates and a China deal (click here to review the Special Report, the report is free if you sign up, if you don't sign up and would like the report email me at danhassey@yahoo.com). Briefly, I explain why rates went up and why a cut in rates would be a mistake and would not help. I also explain why a trade deal will take more time and create more uncertainty and is a drag on the global and U.S. economy and will get worse the longer it takes to come to an agreement assuming we do.

One of the major trends that has occurred this cycle is the shift from active to passive management. Passive investing is more about asset allocation and rebalancing versus active management that is about value investing and a focus on fundamentals (earnings growth, dividends, valuations, management, business models….). More about this in the Valuations, Price Targets section below.

Bullish Case

- The U.S. economy continues to exhibit growth and create jobs.

- Inflation is behaving, for now

- Interest rates have stopped going up and at least one Fed rate cut is expected

- Earnings estimates are out for 2020 and analysts see earnings growth in the low double digits. See valuation section

- Some analysts and economists believe the increased U.S., China tariffs will have a lesser impact than most people believe. This view point is being accepted by many investors.

- The market continues to react favorably to good news versus bad news, for example:

  The market was down about 6 points on 7/16 based on the President's comments "We have a long way to go as far as tariffs, where China is concerned, Mr. Trump warned Tuesday at a cabinet meeting."

"We have another $325 billion that we can put a tariff on if we want, Mr. Trump said, an approach that would put tariffs on almost everything China exports to the U.S."

7/18 U.S. stocks fell as the start of earnings season as weak earnings growth is expected

7/23 A U.S. delegation is expected to travel to China for trade talks the last week of July, according to the Trump administration. The market was up about 20 points on this news.

Again, on July 13th, the market was down about 6 points based on the President's comments that both China and the U.S. were far apart on a deal and more tariffs were being considered. A few days later, July 23, it's announced that a meeting will take place in China and the markets rallied about 20 points. More weight is given to good news versus bad news. In my Special Report, link above, this trade deal will take more time, unless the U.S. reduces its demand (it's possible, but the investment and business community will be let down).

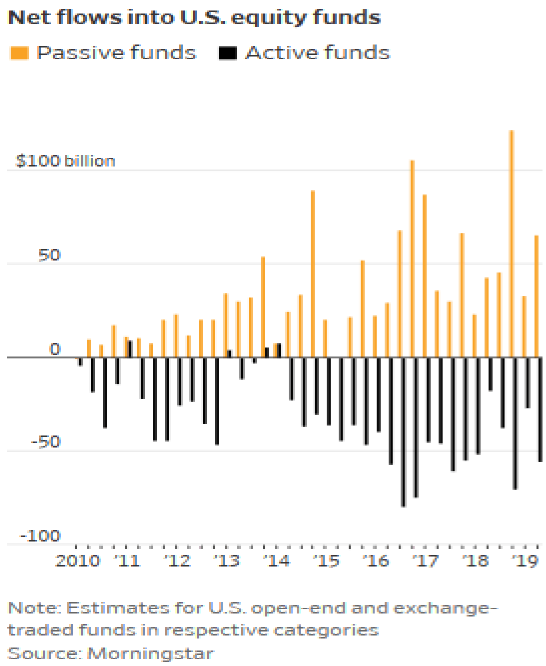
Also notice that almost all days the market rallies the last hour of the market. I've reported on this phenomenon in previous Outlooks.

- Most investors believe that the Fed will stop raising rates and the "Fed put" (if the economy or markets falter, the Fed will come to the rescue and lower rates) is back.

  The Fed has stated they will be accommodative to keep the current expansion going, especially to make sure that those that want a job will find a job. They do say, even though the economy is in better shape than the rest of the world, because global growth is slowing, they will be pre-emptive to keep the slower global growth from impacting the U.S. economy.

- There are a few market dynamics that have been bullish for this market and they include:

Most financial planners put money to work in passive ETFs when clients have investments to make. The chart below shows that investors, normally with the guidance from financial planners are investing in passive investments/ETFs and pulling money out of active funds/mutual funds. There are some negatives to this trend that I write about in the Psychology of the Markets section.

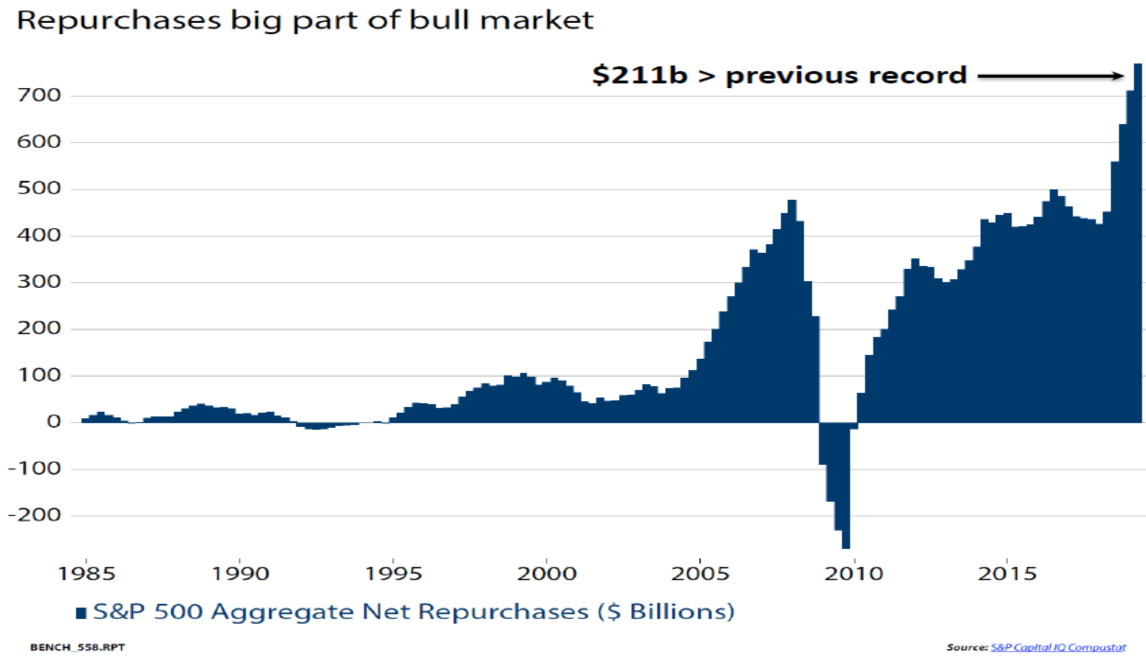


Source: Morningstar

The pitch by financial planners is diversification will help them minimize the impact of bear markets and that no one can time the market so it is best to stay invested. This could be true if you're younger. If you're close to retirement or in retirement you don't have the time to make up for losses in bear markets. Selling or hedging when stocks get to expensive is a course of action retirees should consider.

401K investors are providing automatic buying when they make their semi-monthly/monthly contributions. A lot of this retirement goes into target funds that invest in passive ETFs.

The tax cuts have increased the cash levels of many corporations and they're buying back their stocks at high prices and valuations.



Source: S & P Capital IQ Compustat

High frequency traders, speculators, trend followers, momentum players jump on trends, bullish or bearish. Since the markets, so far this year, are spending more time going up, high frequency traders jump on these trends exaggerating the trend.

- A few high profile Wall Street analyst believe the market should be between 2900 to 3100, based mostly on using a higher P/E multiple.

- Participants seem unwilling to leave the market, in other words they are not selling.

- Participants are buying any type of pullback, for now

Bearish Case

- The markets are expensive. At the beginning of the year the P/E was almost 15, they are 18 and change now. Earnings are expected to grow about 2% to 4%, but the market is up about 20%. The rise of the markets and the high P/E are not justified in light of the trade war with China and the potential for slower U.S. and global growth and rising geopolitical risks. See valuation and other bearish case points made below

- Part of the bull case is the earnings yield (the opposite of the P/E, E/P). The earnings yield is (167 S & P 2019 earnings estimate divided by 3019 current S & P price) = 5.3%. The earnings yield is then compared to the 10-year treasury yield that's about 2.05%. What this is saying is that new money coming into the market should go into the market with an earnings yield of 5.3% versus the 10-year treasury that is yielding about 2.05%.

Interest rates have not acted normally since the Great Recession and don't reflect inflation plus the normal time premium. The 10-year treasury should reflect inflation (1.9%) plus a time premium normally about 2 to 4%. This means the 10-year should yield at least 4.9% (1.9% inflation plus time premium average 3%), very close to the earnings yield of 5.3%. Considering the many risks this market faces the earnings yield comparison is not the bargain some experts are claiming.

Also, the earnings yield is normally about 6.25% and is not a bargain compared to today's 5.3% yield.

- The markets have gone up too far and too fast. A sign of speculation. See Technical Analysis section

- Leadership keeps changing (risk off to risk on, technology to dividend payers, financials to energy).

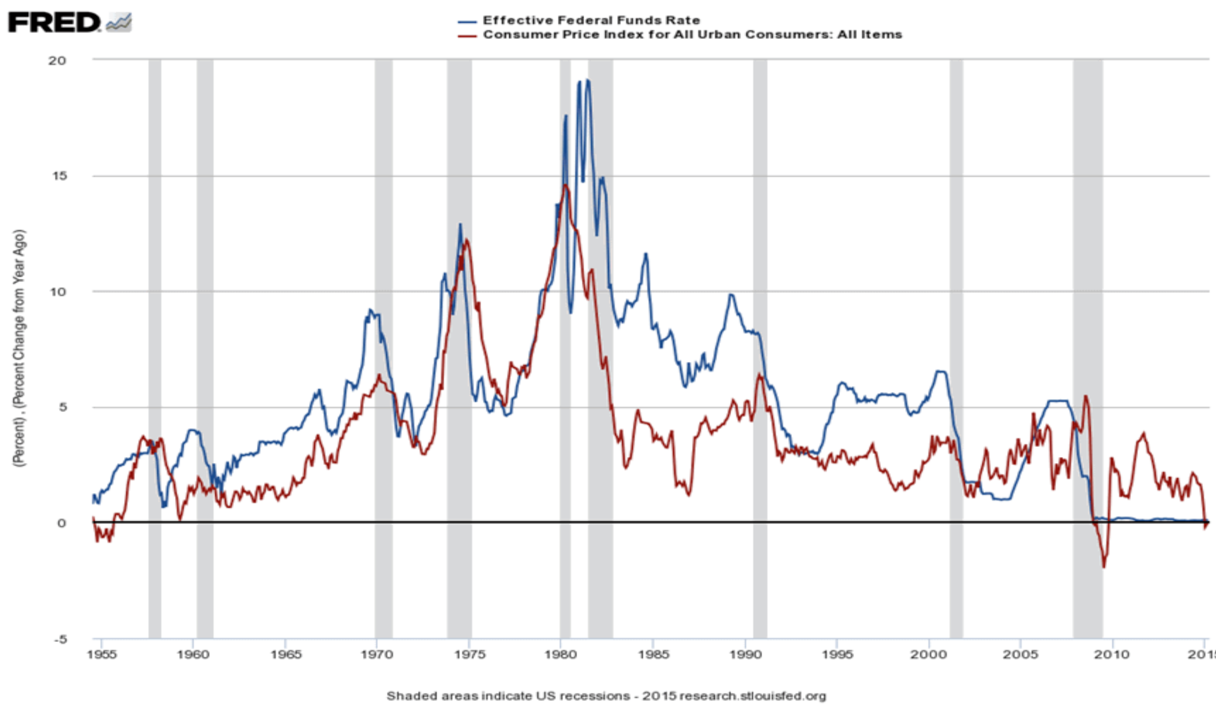
- Most analysts, and economists agree we are in the late stages of this economic and market cycle. Many analysts bring up the topic of recession. Most believe we won't have one, but the fact that recessions are constantly brought up means it is a concern. Also most analysts and economists would agree that predicting recessions is extremely difficult. Can anyone really predict the future? This is why I invest when stocks are undervalued not fairly or overvalued, in other words, buy low, sell or hedge when prices are high, overvalued.

- Serious risks are rising outside our borders: Venezuela, North Korea, Iran, Yemen, China, trade wars. There is a recent report from BusinessWeek that ISIS is forming alliances with Islamic groups in Africa and the potential for global terrorist attacks from these groups are possible.

- The global economy is slowing. China, Germany, France, Italy, Japan, South Korea are all showing signs of slowing. Brexit has been kicked down the road. The latest extension is to October and Britain will probably go into a recession if Britain leaves without a better deal from the EU.

- Earnings estimates have been falling, see valuations section below

- Lowering rates now would be risky:



Source: FRED (Federal Reserve Economic Data)

I've used this chart many times. It shows the relationship between inflation, interest rates and recessions.

Notice most of the time rates start to fall either slightly before or when the economy is in a recession. The Fed is now talking about being pre-emptive by lowering rates now to keep the expansion alive and more importantly help more people get jobs. If we use the above history, and we start lowering rates, a recession is imminent.

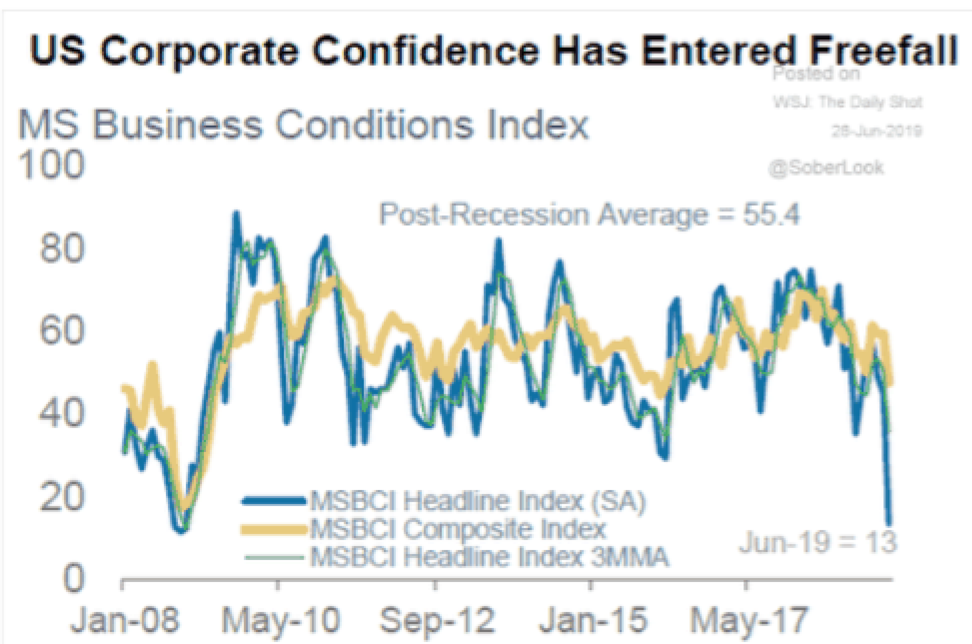
Also notice that when Fed lowers rates, there is normally a significant drop in the rates when there is a recession. The only time that rates were lowered much earlier before a recession started was 1987. There was a market meltdown in October 1987. The market was in a bear market, but there was no recession. The market meltdown was a market event only. The economy eventually entered a recession in early 1990s because of Gulf War I and shock and awe.

Several prominent economists have talked about the problem when we do go into a recession we won't have the normal tools of lowering rates and government spending and cutting taxes. Rates are too low and we've already cut taxes and increased spending so monetary and fiscal efforts may not be available/effective. This could cause the next recession to last longer because lowering rates and fiscal policy were used before a recession leaving less tools to deal with a recession. Lowering rates now is risky.

Another risk is if a China Trade deal is made, a deal could stimulate the economy and with lower rates the risk of an overheating economy and inflation could be a problem

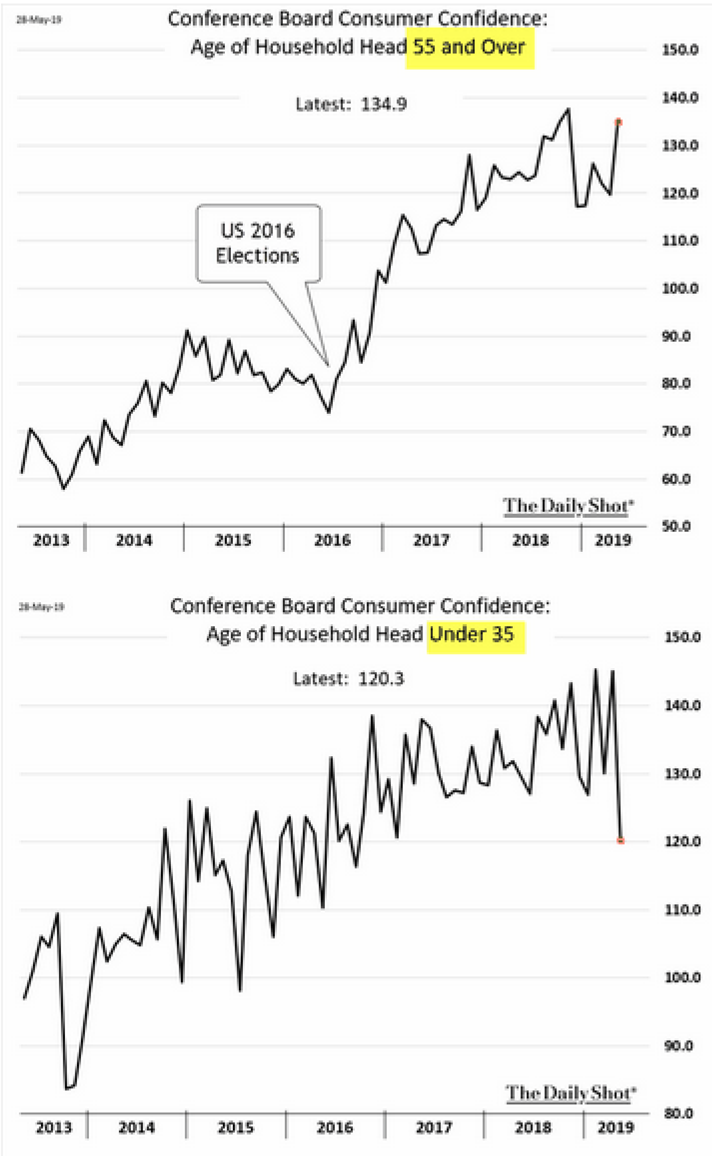
Investors and traders have got to ask themselves, will a ¼ point cut keep the expansion going and if a ½ point is taken, what happens when we go into a recession? Rates will be too low to be an effective economic stimulus.

- Oil prices are up about 30% from last December's low. Higher oil prices are similar to a tax on consumers and many businesses.
- Economists are stating that the stimulus from tax cuts is waning.
- The dollar remains strong and is hurting earnings and trade.
- Growing deficits will probably get worse and may be headwinds going forward
- Crowded index funds may cause problems for investors if they all try to head for the exits as the economy and earnings slow. Too much money is going into index ETFs, passive funds. See passive funds chart in Bullish section above.
- President has too many balls in the air (China, North Korea, Russia, Iran, Venezuela, U.S. economy, immigration, healthcare…) and the mishandling of these important issues is possible.
- Black or grey swans (wars, oil supply disruptions, weather related disasters, cyber attacks….)
- Consumer, business, confidence are starting to decline



Source: Morgan Stanley, @jsblokland

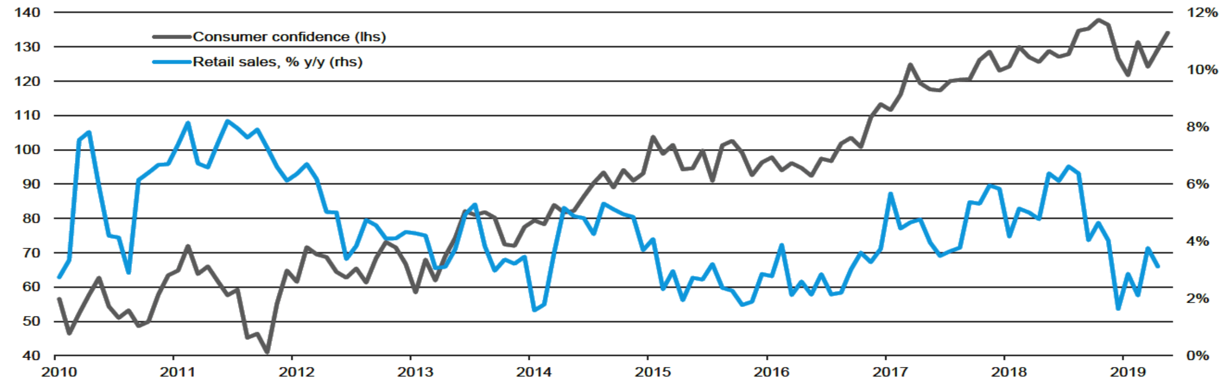
There is a divergence of confidence between older and younger consumers' confidence:



Source: Daily Shot WSJ

The divergence between younger and older consumers could be the reason why there is a divergence between confidence and retail sales:

Consumer sentiment outpacing activity



Source: U.S. Census, Conference Board

The chart does show consumer confidence rising, but not at the same rate as retail sales. Retail sales did pick up last quarter. I will explain in my 3rd Quarter Economic Update that should be out toward the end of August.

Valuations, Market Price Targets

I've mentioned many times regarding earings estimates, they tend to be too optimitic at the start of a year and have to be adjusted downward. This is true this year. Below is a table that shows the downward revision of earings estimates for 2019 and 2020.

	2019.00	2020.00
10/29/18	1720.33	
4/8/19	1656.32	1823.80
4/15/19	1623.95	1823.80
4/22/01	1632.19	1832.30
4/29/19	1623.15	1832.98
5/6/19	1616.95	1809.21
5/13/19	1614.62	1806.06
5/20/19	1614.35	1806.87
5/27/19	1614.97	1807.24
6/10/19	1614.48	1806.12
6/17/19	1610.90	1802.92
6/24/19	1609.60	1800.90
7/1/19	1605.83	1798.72
7/8/19	1601.52	1797.37
7/15/19	1595.01	1798.60
7/22/19	1590.62	1792.79
EST. FALL FROM PEAK		
2019 .	**7.54%**	
2020 .	**1.70%**	

Source: Barron's, Thomson Reuters, Dan Hassey database

Back in October 2018, the earnings estimates for the Dow30 for 2019 were 1720.33 and have declined to 1590.62, a fall of 7.54%. The earnings estimates for 2020 came out in early April and have so far declined 1.70%, and it's still early.

Below are my price targets for the markets:

2019 FORECAST					
	EARNINGS ESTIMATES	P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1590.62	15	**23,859.30**	27,192.00	-13.97%
SPX	167	16	**2,672.00**	3,025.86	-13.24%
2020 FORECAST					
	EARNINGS ESTIMATES	P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1792.00	15	**26,880.00**	27,192.00	-1.16%
SPX	184	16	**2,944.00**	3,025.86	-2.78%

Source: Barron's, Thomson Reuters, Dan Hassey

Using a moderate P/E the markets are overvalued for 2019 and are looking slighly overvalued for 2019.

Here is what Barron's said of the market on the weekend of July 27, "the S & P is up 20% on almost no earnings growth." What I've noticed about the market after decades of observation is that in the short-run the markets can be inefficient in terms of valuing the market(such as now), but in the longrun the market tends to get valuations right. I've written in the past that I've noticed that this market does not seem to care about valuations. This happens occasionally and this is why I've focued on the charts/price anallysis.

Why are valuations taking a back seat, here are my thoughts on why:

- The chart on page 3 shows more money is going into passive ETFs versus managed mutal funds. Passive investors/financial planners normally don't pay attention to valuations compared to the portfolio managers of mutual funds.

- Much of 401K money goes automatically into target funds and target funds invest much of their money in ETFs. Again valuations are not part of the decision making in these 401K investments.

- Company stock buybacks are more interested in deploying excess cash, lowering the amount of outstanding shares than company stock valuations.

- Trend followers, momentuem players and high frequency traders are more interested in price/analysis versus valuations. See technical section below.

Why should investors use valuations and fundamentals versus price analysis, momentuem or asset allocation? If you wanted to sell your company the only tools you would use to determine a price/valuation is using fundamentals and valuation models (discounted/dividend cash flow models, sum of the parts, multiple time a forecasted earnings).

Psychology of the Markets

The bullish case for the markets dominate investors and traders psychology and this includes:

- The Fed has the economy and investors back and a cut in rates is expected to keep the expansion going.

If the Fed cuts too much, we could be in real trouble if we do have a recession or financial crisis. Rate cuts are the best tool we have to stimulate the economy and asset prices.

- A trade deal will happen

Investors have been disappointed many times regarding trade progress announcements.

- The consumer is in good shape

Consumer sentiment can be tenuous

- The trade war is impacting capital spending and manufacturing, but not the consumer.

  The consumer is the largest part of our economy.

- Very few analysts are forecasting a recession.

  Recessions are hard to predict. Predicting the future accurately and consistently is very, very difficult.

The market takes bad news and spins it to bullish news. I gave a few examples above. A recent example is the latest GDP announcement. GDP growth was 3.1% in the first quarter. Growth was expecting to slow to 2% for the 2nd quarter. Growth was reported at 2.1% and the news was GDP growth exceeded expectations versus the economy slowed from 3.1% to 2.1%. The market rallied on the spin.

This is also happening with earnings. Company earnings will have little growth but as long as earnings beat estimates the stock will probably rally. Investors, traders should not be buying because they beat estimates, they should be investing because of earnings, profit margins, cash flow and dividend growth…

Investors need to ask themselves: what if we don’t get a trade deal before election season starts? What if a quarter point cut in rates doesn’t continue the expansion?

Price and Technical Analysis

Below is a current chart of the S & P:

Source:www.erlangerchartroom.com

The market has been stuck in a range, but it looks like it may break out, even though there is very little earnings growth, the global and U.S. economy are slowing and geopolitical risks are growing in number and concern.

The market has major resistance at the 2950 area and it has rallied above that. Normally, when prices break above major resistance prices have a chance to continue to make new highs because the sellers/resistance at the 2950 area have been taken out and resistance is now minimal. The market could continue to make new highs. Last year at this time the market made new highs, but could not sustain its rally of new highs. If the market moves to new highs without good fundamental news, the upward trend would be easy to reverse, similar to last year.

The choppiness indicator (bottom pane) does suggest that a new trend may develop, but it does not indicate up or down. Breaking above resistance does indicate new highs could continue. The ascent of the trend (almost 90 degrees) is a sign of speculators and not investors. Again, once the trend reverses those speculators will probably sell and sell short accelerating the downward trend, similar to last year.

Here is an example, Starbucks, where speculators and not investors have taken over some stocks and indexes:

Source:www.erlangerchartroom.com

Starbucks has a bullish pattern of rising tops and bottoms trendline that started in January. The trend has accelerated since June.

The stock is up over 50% but earnings are expected to be up around 15% for 2019:

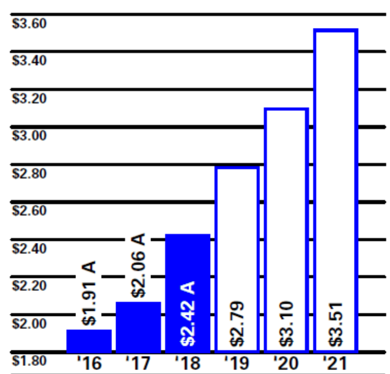
Annual EPS Consensus Expectations

	FY '19	FY '20	FY '21
Mean as of 07/24/19	$2.79	$3.10	$3.51
Previous Mean	$2.78	$3.08	$3.47
# of Brokers	33	33	13
Range (low/high)	$2.70/2.88	$3.00/3.22	$3.39/3.70
Stnd. Deviation	$0.03	$0.05	$0.08
Announce Date	10/30		
Year Ago EPS	$2.42 A		

Change Over Previous Year

Calendar Year	'19	'20	'21
Starbucks Corp	15.1%	11.2%	13.4%
Industry	NA	NA	NA
Sector	NA	NA	NA
Market	2.3%	11.1%	10.1%

Annual EPS Trend



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The earnings growth versus the stock growth would not attract the value investor, but the bullish trend of rising tops and bottoms would attract the trend follower, momentum player, speculator and high frequency trader and some hedge funds. It is hard to justify a stock being up 50%, and earnings are expected to be up 15%.

There are many other examples where this market jumps on bullish trends where there is a rising tops and bottoms trendline. Below is a chart of Beyond Meat, a recent IPO:

Source:www.erlangerchartroom.com

It is hard to justify this stock being up about 500% on a fundamental basis. Participants are paying $13 billion for a $155 million business with no profits. From a technical/price action perspective, traders/speculators like the rising tops, bottoms bullish trendline.

There are many assets and indexes that are diverging from the S & P and technology indexes. I analyzed these trends in last month's Market Outlook. Click here to review the Outlook, the Price and Technical Analysis section. You can also email me and I can email you the PDF.

Summary and Conclusion

- It's hard to justify on a fundamental basis that the market is up around 20% with little earnings growth

- The performance has to do with several market dynamics: financial planners focus on asset allocation, rebalancing and not on fundamentals; 401K investing mostly invests in ETFs, target funds; corporate stock buybacks.

- Also, the bullish trends are exaggerated by traders, speculators, trend followers, momentum players, and some high frequency traders and hedge funds who jump on bullish trends.

- Also helping the markets is participants focus on good news and spins bad news into good news. There is also hope that the Fed put is back and there will be a China trade deal. A China trade deal with compromises is priced into the markets. A great China deal is not in prices but the prospects are remote. No deal is not in the markets. Some analysts believe nothing will happen on both sides because of the upcoming U.S. elections.

- There are many risks the market is not discounting: slowing global and U.S. growth, lack of earnings growth, growing geopolitical concerns (Iran, North Korea, Venezuela, Russia), the President's many legal and political problems

- Trade wars with Canada, Mexico, Europe, Japan, China as well as sanctions against Russia, Venezuela, North Korea, and Iran are slowing the global and U.S. economy.

Next month, August, I will do my 3rd Quarter Economic Outlook. The President and his supporters keep stating that the economy is "booming". I will answer the question, is the economy "booming"?

If you need help with your portfolio, especially with your retirement portfolio that should be focused on safety and income, contact me at danhassey@yahoo.com.