July 2018

Economic Comment and Market Outlook

While the S&P 500's total return of 2.7% for the first six months of 2018 sounds fairly pedestrian, the first half of the year witnessed a sudden return of market volatility that had remained dormant throughout 2017. After a stellar January saw the market index rise to record highs, stocks retreated in February and March when the possibility of faster-than-expected inflation and higher interest rates triggered a spike in volatility. The S&P 500 experienced one of the quickest 10% declines from an all-time high on record, a move that was exacerbated by the unraveling of trading strategies betting on low equity volatility. The second quarter brought threats of tariffs, trade wars, and strained international relations; however, the S&P 500 generally rebounded through the end of June, supported by superb corporate profits and persistent economic growth. With profits and cash returns to shareholders continuing to increase smartly in this period of stagnant stock prices, the broad market and our investment portfolios enter the second half of the year with improved valuation metrics and a solid foundation for a further advance.

Heightened concerns about rising inflation and interest rates set off the market's rapid correction in February, but the Federal Reserve continues to move at a very gradual pace in returning monetary policy to a neutral stance. A miniscule upside surprise in a government report on wage growth and a bipartisan budget deal that raised government spending combined to fuel speculation that the Federal Reserve might need to lift interest rates more quickly than previously forecast. Those concerns over potential inflationary pressures caused the yield on the 10-year US Treasury note to increase by 70 basis points, from 2.41% at the beginning of the year to 3.11% on May 17. However, additional economic data points and the Fed's consistent messages calmed the fixed income markets through the remainder of the first half, enabling the 10-year yield to return to 2.86% by the end of June. As such, the interest rate curve continued to shift up in a measured manner, with the Fed increasing short-term interest rates by 50 basis points, and the yield on the 10-year Treasury note rising 45 basis points during the first half of 2018. These higher rates across the yield curve represented a headwind for fixed income instruments and contributed to a 1.6% decline for the Barclay's US Aggregate Index over the period.

Outside of the United States, slowing economic momentum and declining liquidity conditions created additional difficulties for international equity markets and the value of many foreign currencies. Having surprised on the upside in 2017, the European Union and Japan both experienced a decline in their rate of GDP growth in the first quarter. Many emerging markets also displayed signs of cooling momentum, with currency values under pressure in countries such as Argentina, Brazil, India, Russia, South Africa, and Turkey. Meanwhile, stronger growth in the US economy and in the profits of its corporate sector contributed to an appreciation of the US dollar relative to most foreign currencies. These developments resulted in a small decline for most international equity markets in their local currencies and a (2.4%) and (6.5%) total decline in dollars for the MSCI EAFE Index and MSCI Emerging Markets Index, respectively, over the first half of the year. At this point in the cycle, the US appears to enjoy the lead in global growth while also serving as a safe haven for global funds in times of market uncertainty.

While markets exhibited greater volatility in the first half, the corporate sector continued to perform exceptionally well, leading to valuation compression for the equity market. The S&P 500 reported a 23.3% year-on-year gain in operating earnings per share (EPS) in the first quarter, with almost 80% of companies beating revenue and profit estimates. Even though second quarter earnings reports are only partly complete, consensus estimates are pointing to another quarter of better than 20% growth in EPS. The energy sector continues to be a significant growth driver, aided by a substantial increase in oil prices and easy year-over-year comparisons; however, eight of the eleven sectors are projected to report double-digit earnings growth for the second quarter. Using estimates from David Bianco at Deutsche Bank, full year EPS growth for the S&P 500 is now projected at 20% for 2018, from a level of approximately $133 in 2017 to $160 per share in 2018. We expect a typical Sarofim portfolio to see earnings growth greater than 25% over the same period. Strong revenue growth, margin expansion, lower tax rates, and generous share buybacks are all contributing to these results for the broader market and for our portfolio companies. Importantly, we also expect 2019 to be another positive year for profit growth. As a result, while the decline in the market's price-earnings multiple indicates some concerns about rising economic or financial risks, we believe that the market is now in a much better position to rise as companies report growing profits.

Fueled by record profitability and a newfound ability to repatriate foreign cash balances, cash-rich businesses are returning copious amounts of money to investors. In March, U.S. corporations set a record for share buybacks in a quarter at $189.1 billion as the one-year rolling sum of total returns to shareholders via dividends and buybacks topped $1 trillion for the first time in history. The technology sector is seeing particularly strong buyback trends, with Apple embarking on a remarkable $100 billion increase to its buyback program. America's biggest companies have now paid out over $4.8 trillion in buybacks and dividends since the beginning of 2013, a figure that exceeds the size of the Federal Reserve's entire post-crisis quantitative easing program. Separately, the value of global merger and acquisition activity rose to $2.5 trillion in the first half of 2018, up 64% compared to the same period in 2017, breaking an all-time record for the period. AT&T's court victory in its $80 billion acquisition of Time Warner Inc. helped to boost worldwide deal volumes; that decision was widely viewed as opening the door to more deal-making, increasing the odds of a record-breaking year for M&A.

While inflation, interest rates and geopolitical concerns continue to impact market sentiment, the US economy and underlying corporate fundamentals remain quite healthy. We believe the foundation for a continued market advance – earnings growth – is still strong, and equity valuations have become more attractive as profit growth has accelerated in the face of a flat market this year. While our primary focus remains on our companies' prospects for continued earnings growth, we remain alert to signs of accelerating inflation, trade tensions and the stresses of generally tighter financial conditions. We believe the strength of our portfolio companies' balance sheets and cash flows provide financial strength and flexibility to weather the volatile periods surrounding these concerns. Furthermore, Fayez Sarofim & Co.'s portfolio companies are benefiting from record cash flows, which are being redeployed for the shareholder's benefit into dividend increases and share buybacks. Given the financial strength, earnings outlook and return of capital of our portfolio companies, we remain confident in the long-term outlook for portfolio returns. We encourage you to contact us if you have any questions, and we thank you for your continued trust and confidence in Fayez Sarofim & Co.