GAMBLE JONES | CAPITAL MANAGEMENT
A Division of Gamble Jones Investment Counsel

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The road to nowhere has been paved with uncertainty. While the stock market continues to be resilient and is hovering near all-time highs, it has made little progress since January 2018. Given the market's distaste for uncertainty, it is not surprising that a lack of clarity on the U.S.-China trade war, the economy, and corporate earnings growth has played a key role in this relative stagnation.

The trade war between the U.S. and China has served as a major headwind for the market since early 2018. Prospects for a resolution have deteriorated since late May, when negotiators were believed to be close to a deal. Since then, the dispute has escalated, with each side implementing additional tariffs and scheduling further rounds of tariffs for later this year. Though there continues to be dialogue between the two countries, including a meeting scheduled for next week in Washington D.C., both sides seem fairly well dug in at this point, and we do not expect there to be a quick resolution.

Uncertainty over trade policy has led to growing economic uncertainty. The effects of the trade war, including slowing trade flows and business investment, have weighed on the global economy. Global GDP growth is expected to decelerate this year to its slowest pace since 2009, with China cooling off significantly and Europe nearing a recession. The U.S., which relies less on exports than most countries, has fared a little better than much of the world so far. However, it hasn't been entirely immune to the effects of the trade dispute, as evidenced by the recent contraction in the manufacturing sector as well as the significant cooling in business spending. Federal Reserve economists recently estimated that uncertainty over trade policy will reduce U.S. GDP by more than 1% through early 2020. Still, consumer spending, which makes up nearly 70% of the U.S. economy, has held up well, fueled by an unemployment rate that continues to sit near a 50-year low. So while economic growth has undoubtedly moderated, we don't anticipate a recession in the U.S. in the near future. However, the potential for a significant escalation in the trade dispute certainly poses a risk to that expectation.

As is usually the case, corporate earnings growth has followed the lead of the economy. The more uncertain economic outlook has also made it more difficult to forecast the pace of earnings growth. At the beginning of the year, the consensus estimate among analysts was that S&P 500 profits would rise by about 8% this year. Due in part to the strain that the trade dispute has placed on the economy and business sentiment, that estimate has now fallen to 1%. While analysts currently expect S&P 500 earnings growth of 11% next year, we think that forecast is likely a bit too optimistic given our expectations for moderate economic growth. There is also the potential for earnings to contract should the trade war intensify.

Even amid this backdrop of uncertainty, historically-low interest rates continue to bolster the stock market. Interest rates have fallen sharply this year as the Federal Reserve and central banks around the world have cut rates in an effort to combat a slowdown in economic growth caused in part by the trade

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dispute. The Fed cut its short-term benchmark interest rate in July for the first time since 2008 and followed up with a second cut in September. Longer-term yields have followed suit, declining sharply in anticipation of additional Fed easing. Yields have also been dragged down by the gravitational pull of the more than $15 trillion of foreign sovereign debt now trading at negative yields. As a result, the 10-year U.S. Treasury yield has declined from 3.2% in November to 1.7% today and the 30-year Treasury yield recently dipped briefly below 2% for the first time in history. While we continue to have concerns about the potential long-term side effects from such an extended dose of loose monetary policy (see our 2nd quarter newsletter), low rates have played a key role in this record bull market and continue to support stocks even in the face of trade volatility and slowing economic and earnings growth.

In the short term, the stock market's path appears somewhat tethered to developments in the U.S.-China trade war and its ripple effects on economic and corporate earnings growth. Though the market has fundamentally been treading water since early last year, it has still had an impressive run during the current 10 ½ year bull market, the longest on record. During that span, the market has benefited significantly from the expansion of its price-to-earnings ratio, with the forward P/E of the S&P 500 rising from a multiple of 9 to a multiple of 17 today. While today's valuation is not exorbitant, particularly in the context of a supportive low-rate environment, it is above its long-term average of 15. Without much room left for further P/E multiple expansion, the market will need to rely mostly on earnings growth to drive it higher. As a result, we think it is unlikely that the market's returns over the next few years will be as robust as they have been over the past decade. Though we still expect the market to be higher a few years from now, we think it is prudent for investors to expect moderating gains.

We thank you for the confidence you have placed in us to help guide you on your financial journey. If a trusted colleague, friend, or family member needs objective guidance or advice, please do not hesitate to share our information with them.

Sincerely,

Alison Gamble, President
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