ClearBridge Investments

The Long View

Jeffrey Schulze, CFA
Director, Investment Strategist

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." - William Arthur Ward

Key Takeaways

- Heightening trade tensions top the list of risks that could sidetrack investors who pay too much attention to what we see as short-term noise.
- History suggests markets should rally after the midterm elections and that recession risks will remain low into President Trump's third year in office.
- Corporations are delivering some of the best organic growth since the financial crisis, which bodes well for second-half results.

Since 1950, the market has not seen a negative return in the 12 months following midterm elections.

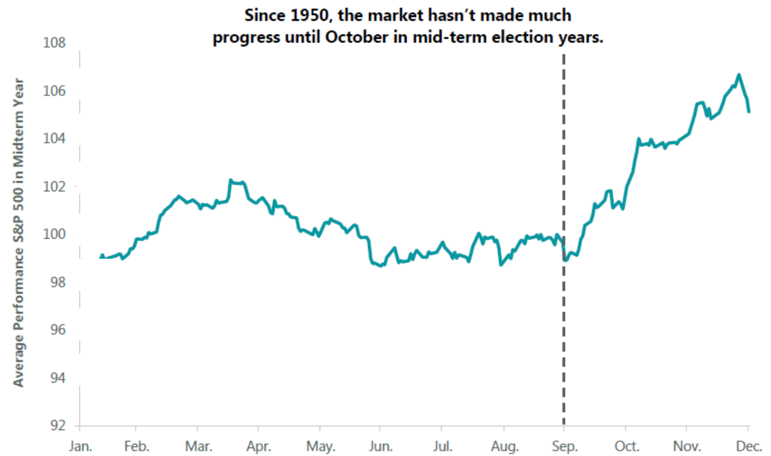
Wall of Worry Obscures Solid Fundamentals

As tax reform euphoria faded in the second quarter, the market's wall of worry continued to grow. Against this backdrop of rising uncertainty and market angst, the observations of William Arthur Ward should serve as a helpful guide for investors. Even seasoned professionals sometimes succumb to the fears (and hopes) of the day, rather than adjusting their sails to the new reality and market environment. The second quarter saw many bricks added to the ever-expanding wall of worry, with issues such as peak earnings, trade wars, rising inflation, yield curve flattening, tighter policy from both the Federal Reserve and European Central Bank, a stronger dollar, a potential EM currency crisis, "Quitaly," corporate debt and rising U.S. federal deficits dominating the headlines.

This anxiety is a far cry from the exuberance when the markets peaked in late January following the passage of tax reform. However, as outlined in our last commentary, corrections typically take several months to play out. Arguably, the most important change needed for a durable bottom to materialize was sentiment. Growing investor concern, largely driven by increased fear of a trade war, has shifted the dialogue from optimism toward pessimism. While the market may see near-term pressure as the most recent escalation of rhetoric is digested, these midterm election year corrections are not out of the ordinary. In fact, the market has historically traded sideways up until September during an election year, only to turn higher as the

election draws closer and policy uncertainty diminishes, as shown in Exhibit 1.

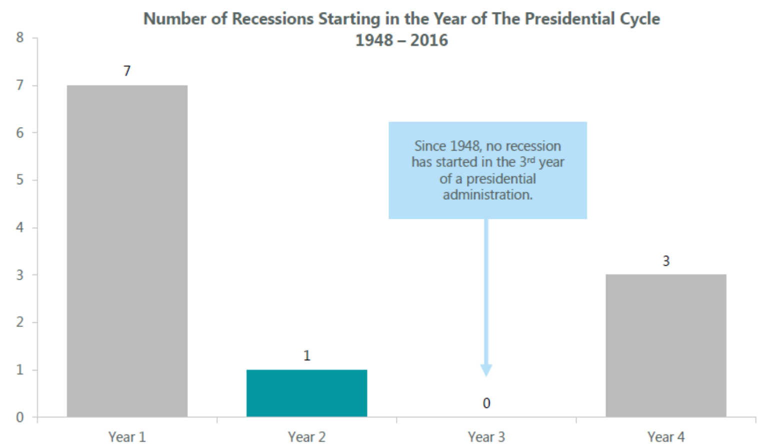
Exhibit 1: Midterm Elections Since 1950



Data as of June 1, 2018. Source: Strategas.

Once the election passes, investors typically move past any trepidations and adjust to the new market reality. The period after a midterm election tends to be quite positive for equities, with the S&P 500 up 15%, on average, in the 12 months following midterm elections since 1950. Most importantly, none of these periods have seen negative overall returns. One reason for this is the strong linkage between the presidential and economic cycles. Over the past 70 years, the U.S. economy has never seen a recession in the third year of a presidential term (Exhibit 2).

Exhibit 2: Recession Unlikely in Third Year of Presidency



Source: Strategas.

We believe this is largely due to the pattern of fiscal stimulus that typically accompanies a presidential election. The first year of a presidency, particularly a new presidency, is dominated by the appointment of key cabinet members, congressional approvals, and perhaps most importantly, the development and often the passage of a new "plan" the candidate ran on. These plans usually include comprehensive fiscal spending, which helps boost the economy. Because this uplift often occurs in the second and third year of a presidency, it is unsurprising that recessions are rare during these middle years of a presidential term. The fiscal stimulus from the just enacted tax reform is still in the early stages of entering the economy. Policy lags are notoriously long, and most people have only started to see higher paychecks in the last few months. To that end, the consensus expectation for second-quarter GDP is 3.4%, a meaningful uptick from the 2.2% experienced in the first quarter.

This positive economic backdrop is consistent with the ClearBridge Recession Dashboard (Exhibit 3), which currently signals little risk of recession over the next 12 months. At present, only one of the 12 indicators is flashing any type of warning sign. Historically, market crashes like 2000 or 2008 have coincided with broader economic downturns. History assures us that an economic pullback is inevitable. However, until that day of reckoning, the markets should rebound from any rough patches and refocus on underlying fundamentals. Right now, stronger earnings and an improving economy should combine to ultimately drive equities higher by year-end.

Exhibit 3: ClearBridge Recession Risk Dashboard

		First Quarter 2018	Fourth Quarter 2017
Financial	Yield Curve	Expansion	Expansion
	Credit Spreads	Expansion	Expansion
	Money Supply	Expansion	Expansion
Inflation	Wage Growth	Expansion	Expansion
	Commodities	Expansion	Expansion
Consumer	Housing Permits	Expansion	Expansion
	Jobless Claims	Expansion	Expansion
	Retail Sales	Expansion	Expansion
	Job Sentiment	Expansion	Expansion
Business Activity	ISM New Orders	Expansion	Expansion
	Profit Margins	Caution	Caution
	Truck Shipments	Expansion	Expansion
	Overall Signal	Expansion	Expansion

Expansion Caution Recession

Source: ClearBridge Investments.

A common fallacy exists today that blockbuster first-quarter earnings were entirely a function of tax reform. S&P 500 earnings were up 26% on a year-over-year (YoY) basis. However, removing the one-time benefits from tax reform, earnings grew at a still impressive 18%. Perhaps even more impressive, in our view, is the 7.5% YoY revenue growth. This is among the highest levels achieved since the 2008 global financial crisis and demonstrates that U.S. companies are truly growing. After several years of "lower-quality" earnings driven largely by cost-cutting and share repurchases, stronger organic growth on both top and bottom lines is a very positive sign for the market heading into the second half of the year.

Trade Tensions Escalating

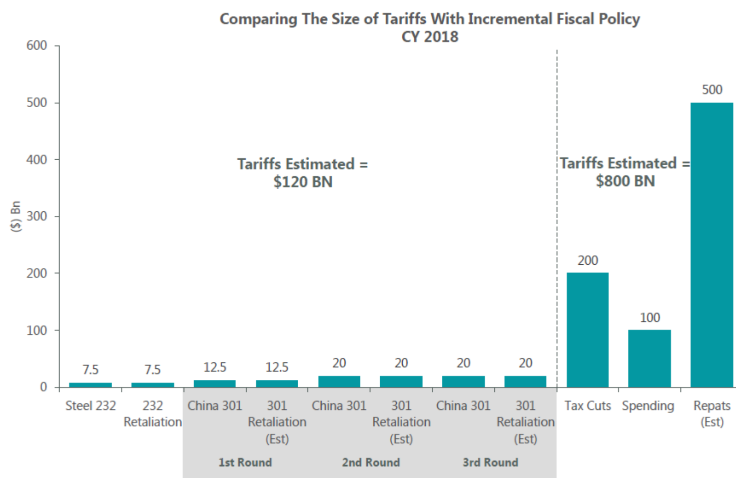
An escalation of trade issues and the prospect of a trade war became likely given the agenda outlined by President Trump on the election trail. While investors are understandably concerned about the impacts of rising tensions between the U.S. and our largest trading partners, we believe the end result will be a trade skirmish rather than an outright war. Relations between the U.S. and China appear to be perhaps the most vulnerable to disruption given the size of the tariffs currently being discussed, the interconnectedness of modern supply chains, U.S. export exposure and the potential for China to make it tougher for U.S. companies to do business locally via additional "red tape" or other measures. If the current escalation continues, pain will be felt much more acutely in some areas than others. For example, GM sold more cars in China than they did in the U.S. in 2017, while Apple has 310 million active iPhone users in China, more than double the number in the U.S.

Any trade-induced impediments to normal operations could have a disproportionate impact on the bottom line of exposed companies. The idiosyncratic nature of these developments should provide a fertile environment for active managers who are aware of the potential pitfalls. However, this is much more of a micro issue than a macro one. Although some areas of the market will experience a displacement from trade escalation, others may benefit and the broader economy and market should ultimately look past these issues.

To put it in perspective, let's examine a worst-case scenario. If every tariff that has been discussed were implemented, and then every country impacted were to retaliate against the U.S. with an equivalent tariff, the total amount levied would be $138 billion (Exhibit 4). While a large number, it is dwarfed by the amount of fiscal stimulus added to the economy recently. Corporate and individual tax breaks, higher government spending and corporate repatriation of profits held overseas amount to an approximately

$800 billion boost to the economy. In our view, this would likely overwhelm the negative effects from any tariffs.

Exhibit 4: Fiscal Stimulus > Trade Concerns



Data as of June 18, 2018. Source: Strategas.

However, history suggests that an agreement will ultimately be forged. Of the eight Section 301 investigations that have been launched into Japan and China since the 1980s, only one resulted in implementation of tariffs. While the first round of 301 tariffs may go into effect (July 6 deadline), these penalties amount to just $36 billion and we remain optimistic that the foundation for a trade deal can be laid before the next $200 billion tranche comes into play.

Economic Fundamentals Remain Robust

Despite the tariffs, U.S. small business expansion plans are continuing to surge. CEO and consumer confidence remain elevated despite the constant barrage of trade concerns over the last six months. While these surveys could fall in the coming month, we suspect they will remain at generally positive levels. Manufacturing PMI New Orders, a gauge of the business cycle, has had readings higher than 60 for 13 consecutive months. This is the longest stretch since the early 1970s and continues to affirm a sustained uptrend in economic activity. Loan delinquencies (Commercial & Industrial) are in decline and lending standards are easing. While this behavior is more typically associated with the earlier days of an economic cycle than the middle portion, it shows that credit conditions remain loose despite central bank tightening. To that end, capital spending trends appear quite healthy and should be an important driver for equities in the second half of the year.

Capital spending trends appear quite healthy and should be an important driver for equities in the second half of the year.

It isn't just business activity that looks healthy. The labor market, the plow horse of this recovery, continues to tighten. The

unemployment rate of 3.8% is near its lowest level in 20 years and could approach the lowest levels in 50 years by 2019. For the first time on record, there are more job openings than unemployed persons. Initial jobless claims as a percent of total employment are at their lowest level ever. Against this backdrop, compensation continues to trend upward. Wages increased 2.7% and total hours were up 2.1% in May, making annual earnings rise by 4.8% over the last year. This is more than enough to keep consumer spending trends healthy for the foreseeable future.

These developments, along with the ClearBridge Recession Dashboard, point to an economy and a market that grinds higher in the back half of 2018 and into early 2019. If history is any guide, expect near-term volatility to remain elevated due to the approaching midterm elections and trade war anxieties. However, as Ward suggests, it is important for investors to focus on the fundamentals of robust organic earnings and a strengthening economy rather than the noise emanating from the wall of worry. In fact, it just might be time to adjust your sails to capitalize on these tailwinds.

Past performance is no guarantee of future results. Copyright © 2018 ClearBridge Investments. All opinions and data included in this document are as of the commentary date and are subject to change. The opinions and views expressed herein are of the author(s) and may differ from other managers, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. This information should not be used as the sole basis to make any investment decision. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed. Neither ClearBridge Investments nor its information providers are responsible for any damages or losses arising from any use of this information.