Much to our surprise, the S&P 500 Index has recovered almost 2/3rds of its losses incurred during the collapse in last year's fourth quarter, and now stands more than 16% above the Christmas Eve low. Part of this rapid rebound has been purely technical, as the market had become severely oversold during the December decline. But there also seems to be a palpable sense of relief among investors over the more recent indications from the Federal Reserve that a pause in its series of rate hikes is at hand. Fear over the possibility of the Fed continuing to increase rates into 2019 had almost certainly contributed to the market turbulence of late 2018.

While investor sentiment has improved dramatically in the new year, the earnings outlook has worsened, at least for the near term. To date, nearly half of the companies in the S&P 500 have reported actual earnings for the fourth quarter, and the results so far appear to be strong, at least on the surface. Almost 70% of those earnings reports have exceeded estimates, but that number, impressive as it may appear, is actually below the average of the last 5 years. The average rate by which companies are exceeding estimates is 3.5%, which also falls below the five-year average.

More worrisome is the increasing frequency by which companies are lowering guidance for the rest of 2019, at the same time as they are reporting strong current results. At last count, 106 of the companies that comprise the S&P 500 Index had pre-announced future guidance, and 72 of those had lowered their earnings forecast for 2019, while only 34 guided estimates higher. A case in point would be Microsoft Corporation, a company that is both widely held and closely watched. The company lowered expectations for 2019 at the same time as it reported fourth quarter earnings that were slightly above estimates, and were 15% higher than the same quarter last year. The stock fell nearly 2% on the lower guidance, despite the impressive gains over the prior year.

It is now expected that the year-over-year earnings growth for the fourth quarter will be 12.4%, once all companies have reported. If so, it will mark the first time the S&P 500 has not reported quarterly earnings growth in excess of 20% since Q4 2017, which is also the last quarter for which earnings comparisons were not positively impacted by lower corporate tax rates. Consensus estimates for 2019 are for earnings growth in the 5%-6% range for the entire year, and weaker in the first half of the year. Three months ago, the consensus was that 2019 earnings growth would be in the range of 9%-10%.

The good news is that the deceleration in earnings growth is now almost surely factored into the market at these levels. Even after the market's strong January rally, the market's forward price/earnings ratio is still only 16 times which, while not compelling, is nevertheless reasonable in light of a less hawkish Fed and lower long term interest rates. It is worth noting that bonds rallied strongly during the stock market's recent correction, with the 10-Year Treasury yield falling from above 3.2% to 2.7% currently.

In summary, the market appears to have undergone a period of adjusting to lower expectations going forward. A more challenging earnings environment in 2019 would have resulted in a market correction of some magnitude in any case, but the process was made worse by investor fears of a recession caused by an overzealous Fed continuing to raise rates into a slowing economy. That the market has recovered at the same time as the Fed has signaled a more patient course is not merely coincidental. In our view, the market's rise from the December lows has been a case of "too much too soon," and we would not be surprised if stocks traded lower from here for a while. But the downside is certainly more tolerable now than it was three months ago, and we would look for the market environment to improve as the year goes on.

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