Chemung Canal Trust Company,
and Capital Bank (a division of Chemung Canal Trust Company)

Investment Outlook – January / February 2020

The U.S. stock market has overcome one obstacle after another over these last fourteen months, soaring to new highs as this is being written. The euro-zone crisis, fears over slowing growth in China, the Federal Reserve's botched tightening cycle, on-again-off-again trade wars with most of our major trading partners, and negative earnings comparisons, all have failed to discourage investors from adding risk to their portfolios. Then, just when it appeared that the global economy was in the early stages of an upturn, we learned that a patron of an exotic meat market in Wuhan, China, had unleashed a new virus on the world, adding a new brick in the wall of worry that all bull markets must climb.

The coronavirus has reshaped the global economic outlook for at least the next couple of quarters. The Chinese economy, the second largest in the world, has virtually shut down, and the ripple effect will no doubt impact global economic data until the factories restart and travel returns to normal. Consensus estimates are that global GDP will actually contract through the first quarter, at least. The U.S. economy is likely to be adversely affected as well, but not by enough to trigger another round of recession fears. The consensus is that the spreading virus might slow our growth rate by 0.25% in Q1, and the ongoing production woes at Boeing might reduce growth by another 0.25%. But even those twin hits are unlikely to drag growth below 2%, using the Federal Reserve's most conservative estimates. Still, economic data is going to be messy until the virus concerns dissipate.

It is easy to become unduly anxious about circumstances that are beyond our understanding or ability to analyze, but epidemics have not historically been associated with market declines. Stock prices rose during the SARS virus, the Avian and Swine Flu outbreaks, and the Ebola virus, all of which occurred in the last seventeen years. There are conflicting reports about the rate at which this virus is spreading, and reports from within China should be viewed with more than a little skepticism, but so far no responsible authority has indicated that a worst case scenario is a possibility. And there is good news for those of you who are still inclined to don your face masks and board a cruise ship – itineraries are booking for as much as 75% off this week.

As has been the case with past outbreaks, the U.S. stock market has remained unconcerned with the coronavirus, focusing instead on financial conditions that could hardly be more favorable for equities. Recession risks have diminished following three Fed rate cuts last year, and global monetary policy remains accommodative. Cash levels are at their highest level since the Great Recession, so there is plenty of fuel for further advances. Risk free rates remain at historically low levels, which increased the attractiveness of "risk assets" like equities, and dividend yields are competitive with bond yields, making stocks attractive to income investors. And lower interest rates globally will likely continue to exert downward pressure on U.S. rates.

The most recent economic reports are encouraging, with both the ISM Manufacturing and the Service data coming in better than expected, and reinforcing the expectation that the economy is in the early stages of another upturn, however modest it may be. But as noted earlier, the ripple effects of the coronavirus may dampen the reported numbers for a quarter or two.

The jobs market remains strong, with jobless claims declining slightly and non-farm payroll reports coming in better than expected. Despite the fact that the unemployment rate remains at a 50-year low, wage gains continue to be modest, but steady, and inflation continues to be a non-issue. The Goldilocks economy remains intact, neither too hot nor too cold.

Elsewhere, the euro-zone appears to be putting Brexit in the rear view mirror, though negotiations remain on a host of economic and security issues. More significantly, the Phase 1 Trade Agreement with China has served to reduce tensions, at least temporarily, but this remains a serious concern longer term. The U.S. accounts for 21% of the world's GDP, but has only 4% of the world's population. Our economy has reaped enormous benefits from globalization over the last several decades, and continued access to foreign markets is vital for continued growth and the creation of high paying jobs.

All in all, we begin 2020 in a much better place than a year ago, coronavirus concerns aside. The major concern is that all of these expectations are already discounted in today's valuations. The S&P 500 Index rose nearly 29% last year, not including dividends, while earnings remained essentially flat from the prior year. This means that the market's entire gain resulted from higher valuations, not from any improvement in fundamentals. In other words, investors' expectations rose, even if earnings did not. Stock prices may well continue to rise simply because the world is awash in liquidity and competing assets (bonds, commodities) are unappealing, but economic and earnings reports will have to be watched closely for evidence that current expectations may not be met.

The foregoing, however, is a short term concern. Longer term, we would argue that changes that have occurred in our economy are resulting in periods of expansion that are far longer than has been the case historically, even if the rate of growth is more muted than in the past. We would also argue that equities should be more highly valued if the question is no longer how fast can the economy grow, but how long. We are now 128 months into the longest economic expansion in our history, surpassing the 1991-2001 expansion by almost a year. It is also noteworthy that the last two recessions did not occur as the inevitable end of the traditional boom-and-bust economic cycle, but from external shocks (9/11) or asset bubbles (dot.com collapse, real estate). We cannot forecast an external event, of course, but there are no financial bubbles to concern us, and no end of cycle concerns that would historically send equity investors to the safe harbors of bonds or cash.

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