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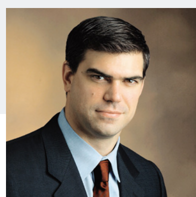

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U.S. Equities

U.S. EQUITIES FLASHING YELLOW AS CHALLENGES MOUNT

KEY POINTS

- The environment for U.S. equities should remain supportive but is likely to become more challenging over the next year.
- The rate of growth in corporate earnings should decelerate to about 8% to 10% from this year's stunning rise.
- Monetary tightening on a global basis may be a bigger concern than just the Federal Reserve raising rates.
- Equity valuations vary widely by sector, but overall price/earnings ratios will probably compress.
- Uncertainty over tariffs and protectionist trade policies pose a significant threat to economic growth and individual companies.

Some of the tailwinds that have thrust U.S. equity markets to record highs in 2018 could become headwinds over the next year or so. While the environment should remain supportive for investing, it could become more challenging.

CORPORATE EARNINGS MAY FALL, BUT FROM HIGH LEVELS

Corporate earnings have received a substantial boost from lower corporate tax rates, growing at a stunning 18% to 21% this year. However, the rate of growth is expected to decelerate next year, to perhaps 8% to 10%. That would still be favorable by historical standards, but this lower rate is probably not being priced into markets now. High profit margins are also likely to face headwinds from higher rates, wages, and input costs.

The U.S. economy, buoyed by tax reform and deregulation policies, is strong. Manufacturing has reached new highs, leading indicators are positive, consumer confidence is favorable, and small business optimism is at all-time highs. However, we are in the later stages of this economic cycle with less accommodative monetary policies, higher interest rates, and inflation and labor costs rising amid tighter labor markets. The uncertainty over tariffs and protectionist trade policies could also have an adverse impact on growth. And the stimulus from the tax cuts will have less impact next year. Recession risks are still moderate but rising.

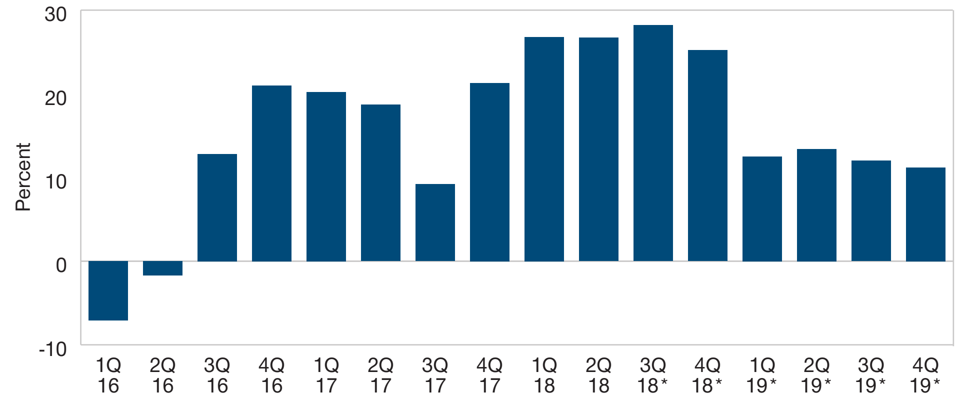
KEEP AN EYE ON THE FED... BUT OTHER CENTRAL BANKS AS WELL

The Federal Reserve is likely to continue pushing short-term interest rates higher while other central banks in Japan and Europe moderate their very stimulative quantitative easing programs. Monetary tightening on a global basis could be a bigger story for the markets than the Fed raising rates given that global liquidity has been such a huge support in recent years.

U.S. equity valuations, meanwhile, vary widely by sector but are generally above historical averages. As such, we anticipate seeing some compression in price/earnings multiples next year.

FIGURE 1: **S&P 500 Corporate Earnings Growth**

Quarterly operating earnings per share growth, year-over-year as of September 2018



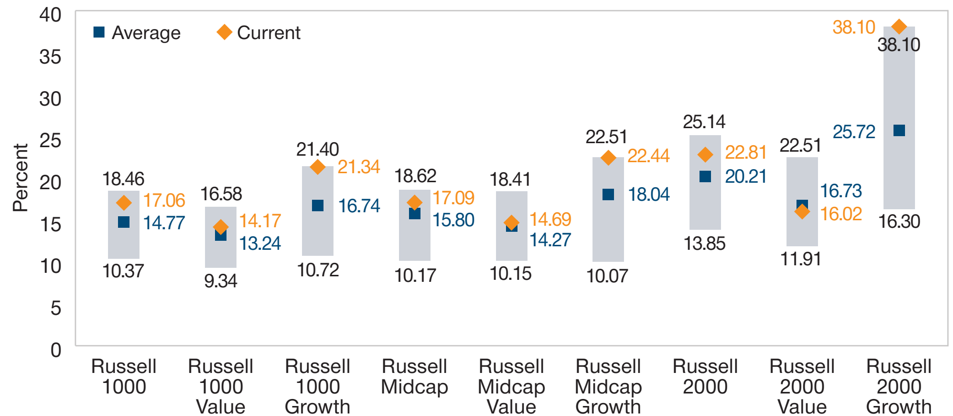
Past performance is not a reliable indicator of future performance.

*Denotes consensus estimated earnings.

Source: S&P Dow Jones.

FIGURE 2: **Forward Price-to-Earnings (P/E) Ratios**

September 2003 through August 2018



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Further, with longer-term interest rates fairly stable, the yield curve has been flattening and we could see it invert early next year, with short-term rates exceeding longer-term rates. That's typically been a harbinger for a slower economy and weaker markets. Another concern is that tax reform has not led to the boom in capital spending (capex) that many expected. Instead, many companies have deployed revenue growth into significant dividend increases and enormous share buyback activity. A stronger capex cycle would be beneficial for earnings.

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DON'T UNDERESTIMATE THE (DISRUPTIVE) IMPACT OF TRADE TARIFFS

Perhaps the biggest threat facing investors is the uncertainty over trade and the tariffs imposed or threatened by the Trump administration as it seeks more favorable trade agreements with other countries. The heavy tariffs imposed on China could end up being very disruptive to the U.S. economy and individual companies. As companies incur higher costs in their global supply chains, that leads to margin pressure on goods they manufacture or sell.

From a portfolio perspective, this is particularly relevant given the fund has typically maintained an overweight position in medical technology, for example. This area has performed well recently, but we have trimmed our position because the companies are susceptible to retaliatory tariffs imposed by China on their exports. More broadly, we remain optimistic on health care because, in our view, it provides the best combination of solid fundamentals and acceptable valuations and is secularly driven by the aging population. And health care is becoming increasingly global. Developing countries are buying more health care from the U.S. than ever before. We recently began investing in pharmaceutical companies such as Johnson & Johnson and Pfizer, because the sector has materially underperformed and now valuations are extremely attractive.

LOOKING FOR LONG-TERM, SECULAR GROWTH DRIVERS

One of the fund's largest sector allocations, in absolute terms, is in information technology. The technology sector has been dominated by a handful of fast-growing, mega-cap companies able to leverage dominant Internet platforms, such as Apple, Alphabet, Microsoft, and Amazon. Given the limited competitive risks, we expect these companies to remain powerful and continue to grow. However, we have been trimming technology holdings this year based on valuation and the regulatory risk stemming from data breaches. As a result, technology is currently our biggest underweight position, accounting for about 22% of the portfolio compared with 26% for the S&P 500 Stock Index.

The fund also has a large weighting within financials. We own some of the higher quality banks such as JP Morgan Chase, U.S. Bancorp, and more recently PNC, which should benefit from rising rates. We are also overweight insurance brokers such as Marsh & McLennan and Willis Towers Watson which have attractive business models, modest pricing power, and highly recurring revenue streams.

Considering the late stage of the economic cycle, we have also been investing in utilities. These companies are typically less volatile than the market, while benefitting from some attractive secular themes, such as the huge growth in renewable energy in the U.S.

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With the number of possible headwinds rising, the outlook for 2019 is potentially more modest than in recent years. However, with solid fundamental support, U.S. equities could continue to perform well, particularly if there is resolution on trade-related disputes. We maintain our more cautious view of the market overall, but stock selection will be the primary driver of longer-term performance.

As of June 30, 2018 the U.S. Large-Cap Core Fund had 22.3% of assets invested in the stocks mentioned in this article, but the fund did not own PNC at that time.

Stocks with growth characteristics can have sharp price declines as a result of earnings disappointments. Stocks with value characteristics carry the risk that the market will not recognize their intrinsic value for a long time or that are appropriately priced. The fund's fairly concentrated portfolio means poor performance by several fund holdings could affect the fund more than a fund holding a larger number of companies.

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