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MARKET COMMENTARY
October 2019

Earnings and Economic Growth Decelerating, Valuations Stretched - Markets Rising?

By Theresa Gusman

- US equities continue to hit new highs. After its best first half in 22 years, the S&P 500 posted a 1.7% gain in the third quarter.
- Global equity markets were mixed. Japanese, European and US equities rose in the third quarter, while non-Japan Asia and Emerging Markets declined, paring gains for the year.
- Volatility persisted during the quarter. Global equity markets advanced and declined along with trade tensions, Brexit news, and monetary easing amid slowing economic activity and continued low inflation.
- Despite the volatility, equity markets remain resilient, even as global growth slows, earnings growth decelerates sharply, and valuations are stretched.

Global Market Highlights

- Following an 18.5% increase in the first half, the S&P 500 rose 1.7% in the third quarter. In a reversal from the first half, value outperformed growth in the third quarter. As reported by Morningstar, among US Funds, large value (+1.52%), large blend (+1.45%) and mid-cap value (+0.41%) performed best in the quarter. Small growth - down 4.17% - was by far the worst performing US Fund category.
- Sector performance reflected the slower rate of economic growth and falling interest rates. Real Estate (+6.89%) and Utilities (+6.72%) were by far the top performers. Energy (-10.16%), Health (-6.34%) and Natural Resources (-5.45%) were the worst.
- International equity performance was mixed during the quarter, rising and falling with trade, Brexit and Middle East conflict news. Japan (+2.94%) was the only non-US market in the black. India (-5.07%), China (-4.22%) and Latin America (-3.37%) were the worst performers.
- Commodities (-1.84%) fell during quarter, with both Agricultural (-6.15%) and Energy (-4.53%) declining and Precious and Industrial Metals rising 5.28% and 2.44%, respectively.

Outlook - Climbing A Wall Of Worry…Until We Get To The Top

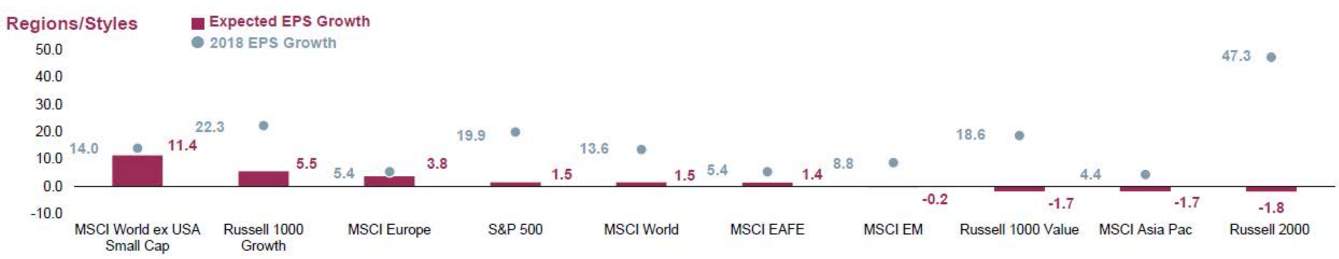
On the positive side, as of today, it appears that the UK and European Union have paved the way for an amicable Brexit, US-China trade talks are back on track, and US growth is decelerating but remains positive – despite the shenanigans in Washington. Of course, any or all of these could reverse tomorrow. On the negative side, the deceleration in economic growth outside the US is gathering steam. In fact, the International Monetary Fund (IMF) recently said the US-China trade war will cut global growth to the slowest pace since the 2008-2009 financial crisis. In addition, equity valuations are stretched, and more negative EPS pre-announcements were issued heading into the third quarter than in any quarter since FactSet began tracking the data in 2006.

All in all, the data points to a market decline. However, equity markets are telling us investors believe Central Banks have the wherewithal to save the day. In fact, according to FactSet, even after record closes, analysts still predict an 8% plus increase in the value for the S&P 500 over the next 12-months. Valuations generally are above (in some cases, well-above) the mid-point of their 10-year ranges. As a result, we believe allocation across sectors, industries, and individual stocks (also known as active management) will play a larger role in investment outcomes in the coming quarters. In the end, markets will continue to climb a "wall of worry", until we reach a-too-difficult-to-predict--tipping point. We anticipate modest equity returns amid higher volatility, to both the downside and the upside.

Earnings Growth Continues to Decelerate

Against the backdrop of a slowing US economy, the fading benefits of the US corporate tax cut, and continuing sluggishness internationally, we anticipate a significant deceleration in the pace of US earnings growth over the next several quarters. In fact, FactSet's tabulation of bottom-up earnings projections points toward a dramatic decline in the rate of S&P 500 earnings growth to 1.5% (down from a 2.6% forecast in the second quarter) in 2019 from 19.9% in 2018. Even Europe -- which saw comparatively sluggish 5.4% earnings growth in 2018 – will see a deceleration in earnings growth in 2019 (see Figure 1).

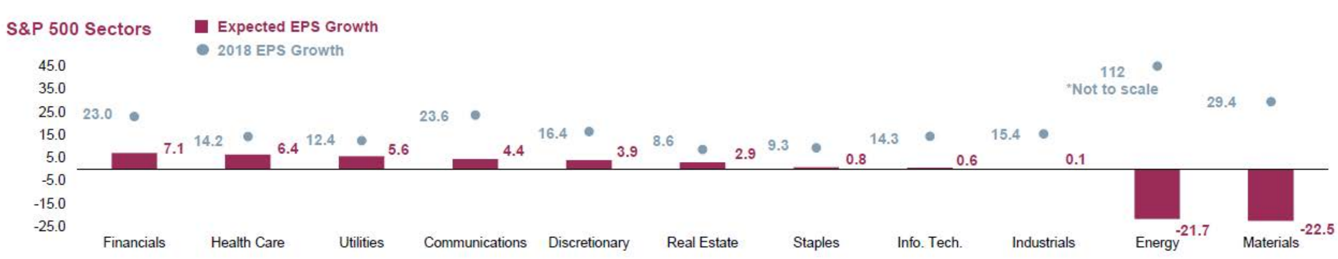
Figure 1. Corporate Earnings Growth, Regions/Styles (9/30/19)



Source: FactSet as of 9/30/19. Expected EPS Growth is the % change in EPS growth from the beginning of the current calendar year through the end of the calendar year. 2018 EPS Growth is the % change in EPS from the beginning of the year through the end of the year.

In the US, corporate earnings growth is expected to fall sharply across all S&P 500 sectors (see Figure 2) in 2019. Earnings declines of 22.5% and 21.7% are forecast for the Materials and Energy sectors, respectively, and the high-flying Information Technology sector is poised for a paltry 0.6% earnings gain. The Financials (+7.1%), Health Care (+5.7%) and Utilities (5.6%) sectors are set for the largest earnings increases in 2019.

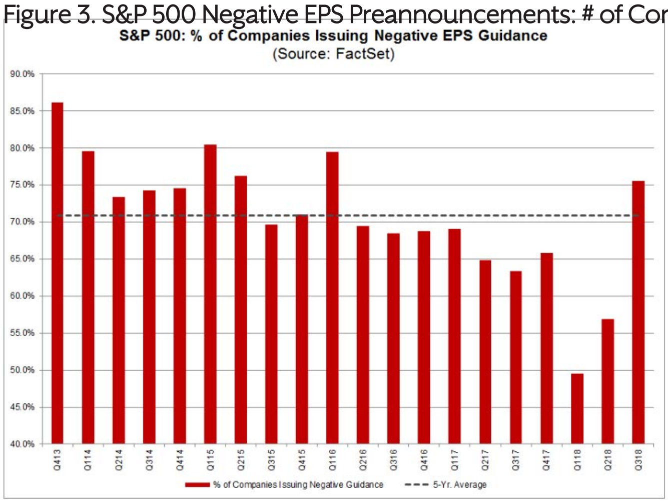
Figure 2. Corporate Earnings Growth, S&P 500 Sectors (9/30/19)



Source: FactSet as of 9/30/19. Expected EPS Growth is the % change in EPS growth from the beginning of the current calendar year through the end of the calendar year. 2018 EPS Growth is the % change in EPS from the beginning of the year through the end of the year.

Continuing a lackluster year, third quarter earnings are set to decline by 3.7% year over year. Just as forecasts lagged reality on the upside, we anticipate continuing "negative earnings surprises" as companies and analysts scurry to catch up with deteriorating momentum over the next several quarters. This trend became apparent heading into the end of the third quarter. The number of S&P 500 companies issuing negative EPS guidance through mid-September totaled 98, which – if it is the final number for the third quarter – will be the highest number of companies issuing negative EPS guidance since FactSet began tracking this data in 2006 (see Figure 3).

Figure 3. S&P 500 Negative EPS Preannouncements: # of Companies, (9/30/19)

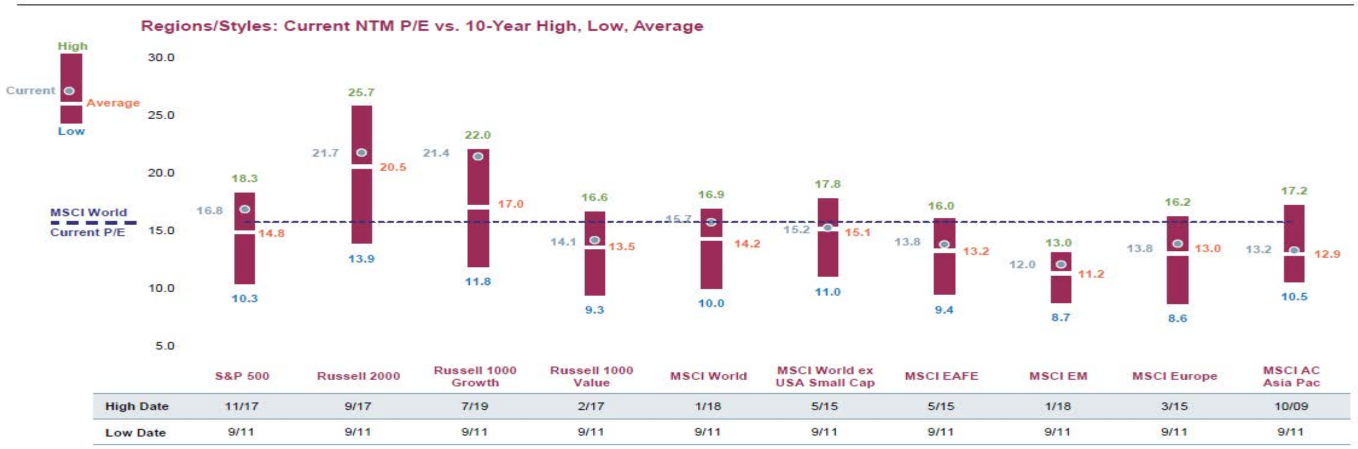


Source: FactSet, September 30, 2019

Valuations at or Above Historic Averages

The year to date surge in equities leaves valuations at or above historic averages. The valuation of the Russell 1000 Growth index is most stretched, with a Next-Twelve-Month (NTM) Price/Earnings Ratio (P/E) of 21.4, just below the historic high of 22.0. The S&P 500, MSCI World, MSCI Emerging Markets, and MSCI Europe indices are also above their historic averages. The Russell 1000 Value, MSCI World Ex-USA Small Cap, and MSCI EAFE are in line with their history averages. Importantly, none of the indices are below their historic averages (see Figure 4).

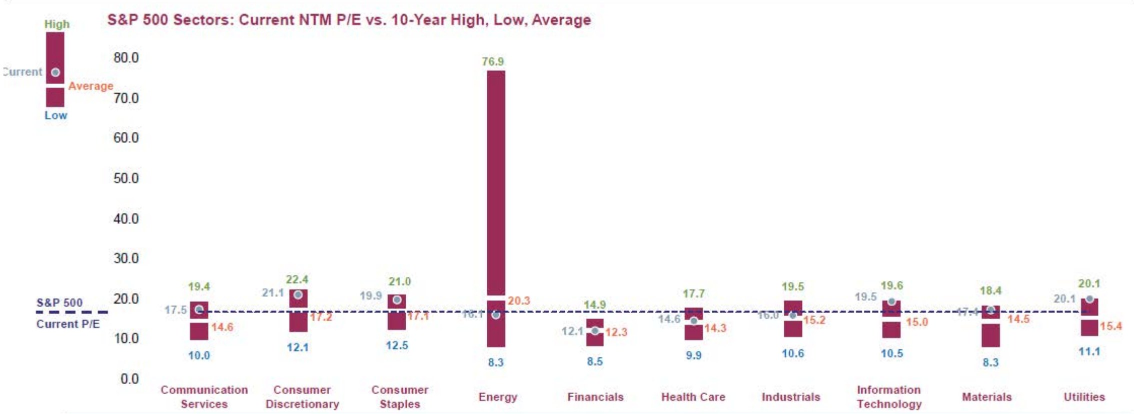
Figure 4. Equity Valuation Analysis, Regions/Styles, 9/30/19



Source: FactSet as of 9/30/19. NTM P/E is market price per share divided by expected earnings per share over the next twelve months.

Looking at the sector perspective, Consumer Discretionary, Information Technology, and Utilities are most over-stretched from a valuation perspective. Only the Energy sector, which will show an earnings decline in 2019, is trading below its 10-year average NTM P/E (see Figure 5).

Figure 5. Equity Valuation Analysis, S&P 500 Sectors, 9/30/19



	Communication Services	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Information Technology	Materials	Utilities
High Date	7/12	3/17	6/16	4/16	11/17	2/15	12/17	1/18	10/17	9/19
Low Date	5/18	9/11	6/10	9/11	9/11	8/10	9/11	9/11	9/11	6/10

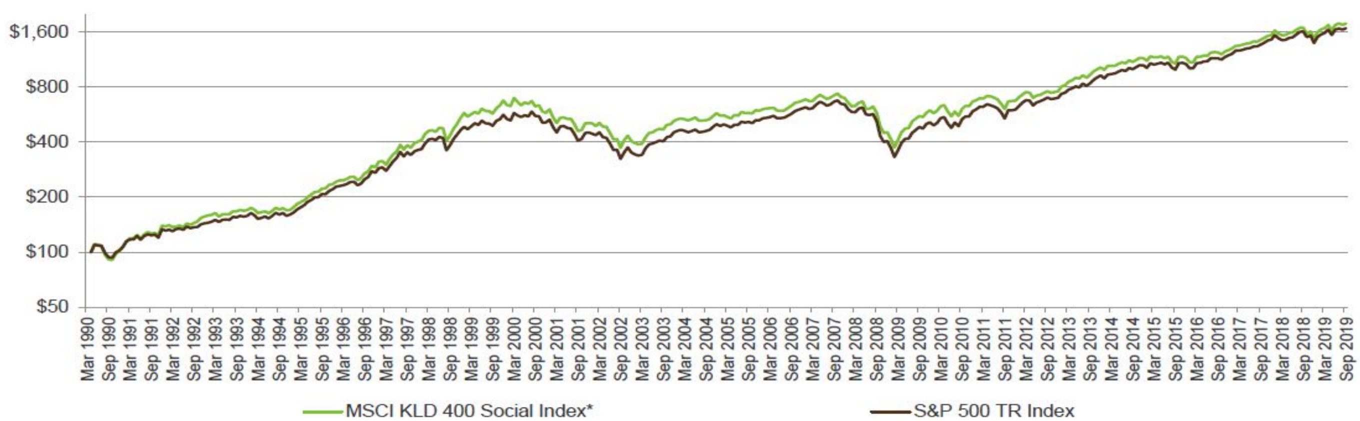
Source: FactSet as of 9/30/19. NTM P/E is market price per share divided by expected earnings per share over the next twelve months.

We anticipate continued volatility and mixed, choppy returns across stocks, sectors and geographies amid the reality of stretched valuations and reduced earnings expectations in the coming months. However, barring an economic recession, we are looking for modest overall gains in equity markets through 2019.

Achieving Long-Term Investment and Impact Objectives

As shown in Figure 6, the MSCI KLD 400 index continues to track the S&P 500 index. The sustained, consistent relative performance of this standard SRI benchmark supports our view that sustainable, responsible, and impact investing and mainstream financial returns are not mutually exclusive.

Figure 6. MSCI KLD 400 vs S&P 500 Indices, September 30, 2019



	MSCI KLD 400 Social Index*	S&P 500 TR Index
Annualized Return Since 5/1/90:	10.27%	10.05%

Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indexes are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indexes but may purchase mutual funds or other investment products designed to track the performance of various indices.

As always, everything we do at First Affirmative is driven by our dedication to enabling advisors to deliver financial results to clients and belief in the power of capital to bring about lasting environmental and social change. Our three Sustainable Investment Solutions – Custom, Multi-Manager, and Managed Mutual Fund – are built to enable clients to achieve their financial goals over the long term, along with their individual environmental, social, governance, ethical, and values-based objectives. Each portfolio is carefully constructed to be well diversified across assets, sectors, geographies, securities, and management styles — and designed to weather periods of uncertainty and volatility.

Quarterly Bond Market Overview

Provided by Wasmer Schroeder

Could It Happen Here??

By: Tom Richmond, Chief Investment Officer

It was a busy third quarter in the bond markets, although not as volatile when taken as a whole, as the constant social-media-driven shifts in investor sentiment would lead one to believe. As the global economy continued to slow, especially outside the US, rates fell around the world in lock step. The world's Central Banks continued to dish out copious amounts of monetary policy accommodation, although the US Federal Reserve was perhaps a bit less aggressive than their foreign colleagues and market expectations, leading to a somewhat flatter yield curve in the US. As the economic data continued to generally be good in the US, and seemed to moderate somewhat abroad, rates began to rebound in September; this should leave these same Central Bankers with some more interesting decisions ahead. All in all, however, when looking at this dynamic, and noting slightly higher stock prices and largely unchanged risk spreads in our markets, the quarter will be remembered best as unremarkable, from our perspective.

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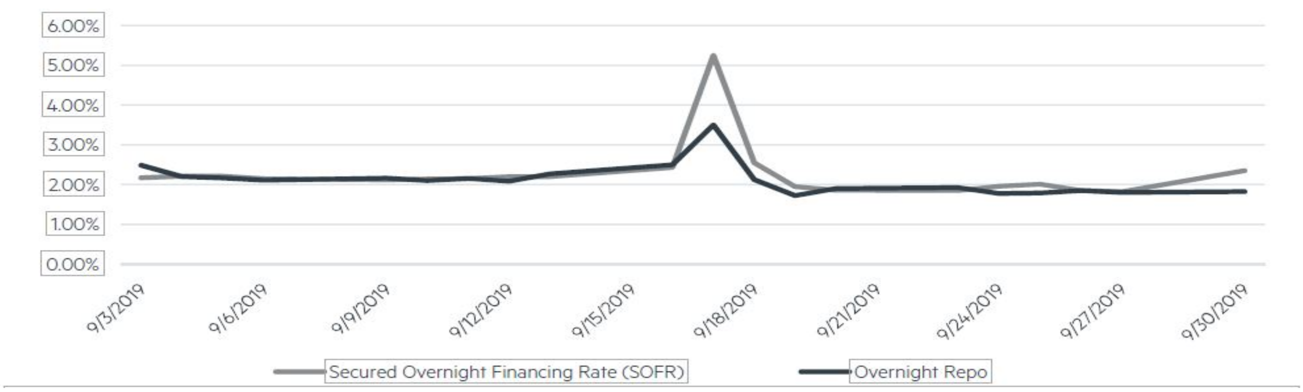
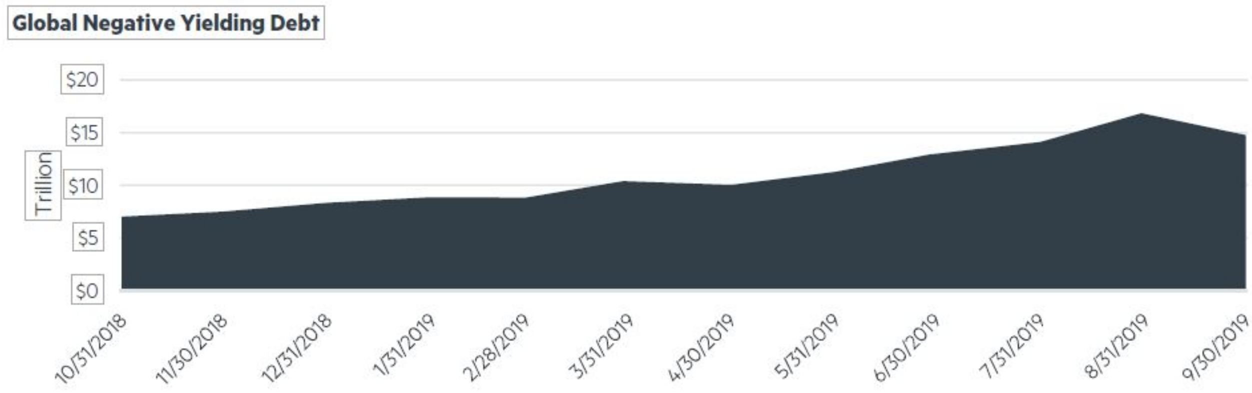


9/3/2019 – 9/30/2019; Source: Bloomberg

What was remarkable for me, personally, during the quarter was the number of opportunities I had to speak with clients when compared to quarters past. As is usual, many of these calls were simply to discuss current market conditions, our outlook, and our current thinking on positioning. Two topics, however, were recurring themes. For about ten days in the middle of September, I fielded several calls looking for both an explanation of the problems that emerged in the short-term funding (aka repo) markets, and for some assurance that these problems were not signaling the same types of stresses that revealed themselves at the onset of the financial crisis (spoiler alert: they were not). The other theme was more interesting I think, both in that it was framed in several different ways, but also in that I hadn't really been queried about it before: Will we ever see negative interest rates in the US that permeate so much of the rest of the world? Great question.



10/31/2018 – 9/30/2019; Source: Bloomberg

Mathematically, of course, we certainly could. Some Treasury Inflation Protected securities (TIPs) traded at negative yields in late August (hope everyone's systems were ready for that one), but other than these 'real' yields we have not seen the same phenomenon now plaguing roughly $15 billion of foreign sovereign debt. Beyond this observation, you must dig a little deeper and parse the market into smaller bites. Could nominal US Treasury yields go negative? This would probably be the sector most likely to do so, but only if things actually deteriorate much further from here, and the Federal Open Market Committee (FOMC) lowers its policy rate to the Zero Lower Bound or below. This is also the case because certain groups of investors are mandated for various reasons to have allocations to USTs, and as a result have to pay the going rate regardless of what it is, the same dynamic that has caused overseas investors to continue to buy, say, 10-year German Bunds below -0.70%. Do we think this will happen here? Never say never, I guess, but I can say with some confidence that it certainly won't before I write again after the holiday season. Hopefully, and most importantly because savers should never have to pay someone for the right to lend them money, this will never be the case.

The happier news for our clients is that the road to negative rates in the sectors in which we invest is a lot harder to see. Absent some sort of Quantitative-Easing-on-Steroids by our Fed, corporate bonds should be exempt, as the economic conditions that could lead USTs down would probably widen risk spreads to some extent, helping them remain above water. The logic that could lead tax-exempt municipals to such levels is even harder to see. Given that tax-frees are held to a much greater extent by individuals either outright or through mutual funds or ETFs, we believe that, even were these yields simply to approach zero, selling would be brisk, as most folks would rather sit in cash than buy investments for their personal accounts doomed to lose money over time unless the next buyer was willing to lose even more. That all said, this is obviously a crucial issue, especially for those of us who make our livings managing bond portfolios, and one that we will continue to discuss often. With any luck, Santa will bring us all an improving global economy when he comes around in a couple of months, and the concept will be much further removed from our day-to-day thinking.