Boston Trust Commentary

March 31, 2019

FINANCIAL MARKETS

All major domestic stock indices registered double digit gains in the first quarter of 2019. The S&P 500 Index returned 13.6%, its biggest quarterly gain since the third quarter of 2009 when the market was only beginning to emerge from the depths of the financial crisis. Major international stock indices also posted strong returns, although most trailed their US counterparts. Bond indices were in positive territory, too, as still moderate inflation and concerns about the pace of global growth erased expectations of further Fed rate increases. The yield on the 10-year US Treasury fell by 0.28%, ending the quarter at 2.41%, continuing a steep decline from its recent high of 3.24% in early November of last year. Commodities also recovered significant portions of last year's fourth quarter losses. Crude oil prices rallied by over 30 percent to roughly $60/barrel. Despite the increase, oil prices remain well below recent highs.

Total Returns through March 31, 2019		
US Stocks	**1st Qtr**	**1 Year**
Standard & Poor's 500	13.6%	9.5%
Russell 2000®	14.6%	2.0%
International Stocks		
MSCI World Ex-USA	10.4%	-3.1%
MSCI Emerging Markets	9.9%	-7.3%
US Fixed Income		
Bloomberg Barclays Gov't/Credit	3.3%	4.5%
US Treasury Bill	0.6%	2.1%

INVESTMENT PERSPECTIVES

Economic Growth Continues

The type of sharp stock price movements we have had over the past year often signal substantive changes in the economic environment. That has not been the case in this instance. Economic reports have been consistent in pointing to a US economy that is continuing to expand – albeit slowly. Consumer spending and business investment are still increasing at a solid pace. Further, most forward-looking indicators, including consumer sentiment and business confidence surveys, suggest a continuation of the current trend.

Though the economy continues to grow, there is little room for further improvement in the labor market. The headline unemployment rate has steadied under 4 percent, its lowest level in almost 50 years. Average hourly wages are growing by better than 3 percent – ahead of primary inflation readings that remain shy of 2 percent. Full employment is a welcome aspect of a strong economy, but absent improvement in the labor participation rate, it likely rules out materially *faster* growth. Indeed, given the economy's long expansion, consensus expectations call for a downshift in domestic GDP growth to 2.1% this year. Given headwinds to the global economy, including unresolved US-China trade negotiations and an undetermined Brexit path, global growth expectations for 2019 have been reined in as well. The IMF recently cut its full-year growth forecast to 3.3% – further reducing expectations it had already lowered twice in the last six months.

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An Accommodative Fed

It was only six months ago that market prognosticators were worrying that economic growth would be choked off by the Fed's plan to steadily raise interest rates. By year end, however, it became clear that the Fed was considering a policy change. That change was made explicit in March. In its official statement following the March meeting at which it again held rates steady, the Fed was far more cautious than previously about the pace of economic growth while also noting that inflationary forces remained low. As a result, market participants no longer anticipate any rate increases this year.

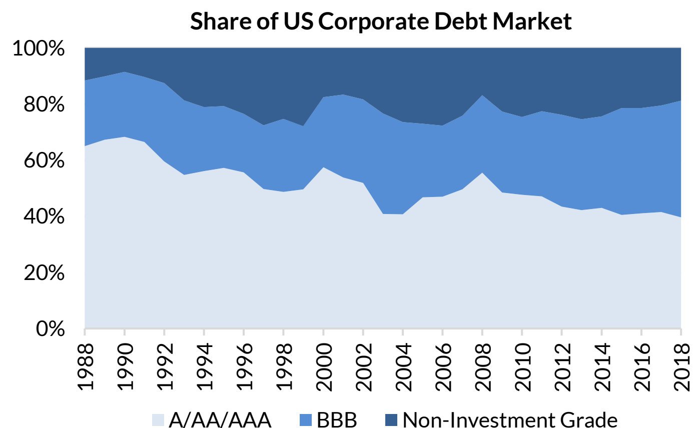
Beyond the revised policy regarding short term interest rates, the Fed also eased its stance regarding its massive bond portfolio. After purchasing close to $4 trillion of bonds from 2008 through 2014 in an unprecedented effort to push down longer-term rates and stimulate the economy (commonly referred to as quantitative easing), the Fed had set a course of paring those holdings. In March, the Fed announced it would end its unwinding much sooner than previously expected. This will leave the Fed with approximately $3.5 trillion of bonds on its balance sheet – over four times the $800 billion owned before the crisis – a relief to market participants who worried that aggressive Fed selling would drive long-term rates higher. Given the Fed's recent comments and a slower growth environment, we anticipate that lower bond yields will remain for some time.

Levered Corporate Profit Growth

US corporate profits, as measured by the constituents of the S&P 500 Index, surged by over 20 percent in 2018. Much of that outsized growth was due to the boost from the corporate tax cut, but corporations continued to benefit from the rising economic tide. With the fiscal stimulus behind us (and providing a tough comparison year) along with diminishing tailwinds from both the domestic and global economies, corporate profits are expected to grow a more modest 4 percent this year.

Lower expectations notwithstanding, corporations will undoubtedly still seek to increase their profits. Over the course of this slow but steady economic expansion, corporate executives have looked beyond revenue growth to produce higher earnings per share. Among their primary tools have been mergers and acquisitions and share buybacks. In the case of the former, management (and their bankers) often cite operational synergies to justify the premium paid for an acquisition target. And, to be sure, corporate tie-ups can be quite effective if well-executed and based on a sound business plan. Often, however, anticipated synergies fail to materialize. Share buybacks, on the other hand, can directly reward shareholders, though they may also indicate management's assessment that opportunities for organic growth are meager.

In many cases, share buybacks and mergers are funded with accumulated cash flows. However, in an era of historically low interest rates, companies have also borrowed aggressively. Indeed, even cash-rich corporations like Apple and Microsoft have taken advantage of low borrowing costs. Of some concern, however, is the aggressive borrowing of many lower-rated companies. Companies rated BBB or worse now comprise 60 percent of corporate bonds outstanding – their highest share in a generation – almost doubling their share of the market.

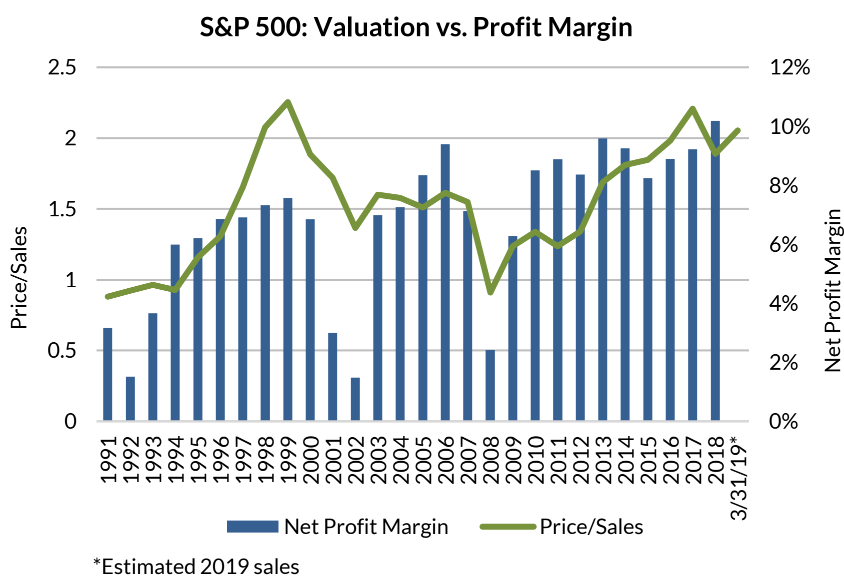


For financially strong companies, taking advantage of cheap and abundant credit can make good sense. Such companies have adequate cash flows to cover current interest expenses and can also support higher ones if rates rise. However, many lower-rated companies with less robust cash flows might be squeezed financially if economic conditions deteriorate, or if rates are higher when their debt obligations come due. We suspect that this risk is unappreciated by some investors given the long period of low rates; it remains high on our radar when evaluating the long-term sustainability of business models and balance sheets.

Peak Valuation?

The market gains of the first quarter have led a few pundits to raise questions about excessive valuation. Judged by the usual metrics, we do not agree that stocks are too expensive. For example, as a multiple of forward earnings, the S&P 500 ended the quarter at 17x, or just above its long-term average. On a price-to-sales basis, stocks are indeed trading above 2x – close to the levels reached before last year's price drop as well as the highs of the late 1990s. These references may raise concern, but in the context of current profit margins (and in turn, profits), we believe aggregate market valuations are appropriate.

As shown in the chart, price-to-sales tends to move in tandem with profit margins. Given the current level of margins, the sales multiple, like the P/E ratio, is at a reasonable level.



*Estimated 2019 sales

Courtesy of lower labor costs, more operational efficiency, lower commodity prices, and of course, the recent corporate tax cut, net profit margins have steadily increased over the past few decades (recessions excluded). In fact, margins for the S&P 500 are now over two percentage points higher than their levels in the late 1990s. Should the benign economic and low interest rate environment continue as we expect, we anticipate that current profit margins will be sustained.

Outlook

The US economy remains on sound footing with a strong labor market and the implicit support of a responsive Fed, but domestic GDP growth is likely to slow in the year ahead. Combined with decelerating global growth, smaller increases in corporate profits are expected. Despite the slower growth environment, current stock valuation and profit margins are supported by low interest rates and remain at sustainable levels. Within the context of individual client guidelines, equities remain favored over low-yielding fixed income alternatives. As always, we remain steadfast in focusing investments in financially strong companies with sustainable business models.

Data Sources: Bloomberg, FactSet.

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