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Carousel of Concerns Transitions to Carousel of Catalysts

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Keith Lerner, CFA, CMT
Managing Director, Chief Market Strategist

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Carousel of Concerns Transitions to Carousel of Catalysts

The US stock market has decisively broken out to the upside from a 21-month trading range. Moreover, this is a global story, with emerging and developed international markets also performing well and economically sensitive areas leading.

Our Take

The Carousel of Concerns has transitioned to the Carousel of Catalysts. A key factor for us remaining positive over recent months is our work suggesting that investor fears were overdone. A fair amount of risks had already been priced into the market and investor expectations were low. Subsequently, a little good news has gone a long way as several concerns have receded, providing fuel for the market rally.

US policy uncertainty and recession fears have ebbed. The jobs market and consumer spending data have remained resilient while China-US tensions are easing. Moreover, the corporate earnings season has been better than feared. The global economy is also stabilizing. After a record 15 straight down months, there have been three consecutive monthly increases in global manufacturing surveys. The improvement is aided by an aggressive synchronized global monetary easing cycle, which is placing a large amount of liquidity into the economy and markets at a time when investors have not been positioned for an upside surprise.

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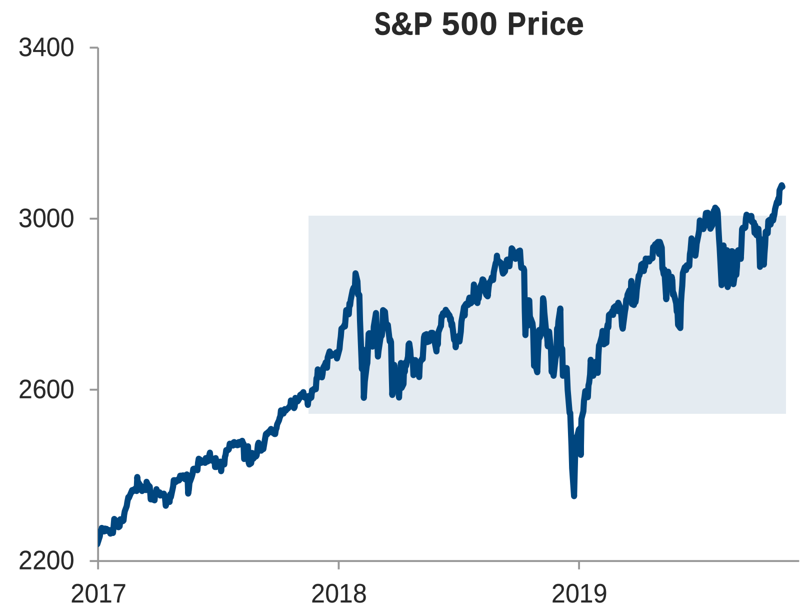

Data Source: SunTrust IAG, FactSet
Past performance does not guarantee future results.

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Indeed, over the past 12 months, we have seen the greatest amount of equity outflows (mutual funds and exchange-traded funds) from investors in more than 20 years.

Hedge fund exposure to the equity market on a net basis has also remained tepid. This high degree of investor angst is reflected in the equity risk premium (as measured by the earnings yield of stocks relative to bonds), which remains elevated. Similarly, up until recently the dividend yield on the S&P 500 remained well above that of the 10-year US Treasury yield. Many global equity markets still have dividend yields higher than their respective government bond yields.

Where to Next?

On a 12-month basis, we maintain a favorable view of equities given attractive relative valuations, supportive monetary policy, and a stabilizing global economy. That said, the short-term outlook is more mixed.

Stocks have used up a lot of fuel by rising about 6% over the past month, the S&P 500's forward price-to-earnings ratio is now 17.4x (the highest since early 2018) and our short-term investor sentiment indicators are showing a degree of excess optimism. If the market moves toward an 18x P/E near term, or 3150-3200 (vs. 3081 currently), that would only represent about 2% to 4% upside from those levels. Conversely, we could just as easily see the market pull back toward 3000.

However, unless something unravels on the trade front, we do not expect a deep market correction in the near term. Indeed, seasonal trends remain very strong: when the market has been up more than 20% heading into November, it has averaged a gain of about 6% in the final two months of the year. And even though short-term prices and sentiment are getting stretched, any near-term setback is likely to be met with buyers who were caught off guard by the rally and looking for an opportunity to play catch up into year end.

Bottom Line

The short-term risk-reward has become more mixed. However, for longer-term investors, our advice is to stick with the positive intermediate trend. Stocks still appear attractive relative to most other assets. For those investors who are underexposed to the market or have excess cash, we would consider averaging into the market over time, and if the S&P 500 pulls back toward the 3000-3025 area, we would view that as an opportunity for investors to become more aggressive in deploying cash near term.

Within our equity positioning, we still have a US bias, but emerging and developed markets, which are more value oriented, should also benefit from stabilizing global trends.

Similarly, the cyclical areas of the market are breaking out relative to defensive areas, a trend that will likely continue given the better global backdrop. Our favorite US sectors include financials, industrials, and technology, which should benefit from improved global trends. Conversely, we have a less favorable outlook on defensive areas of the market, such as utilities, which are trading at elevated valuations and are highly sensitive to interest rates.

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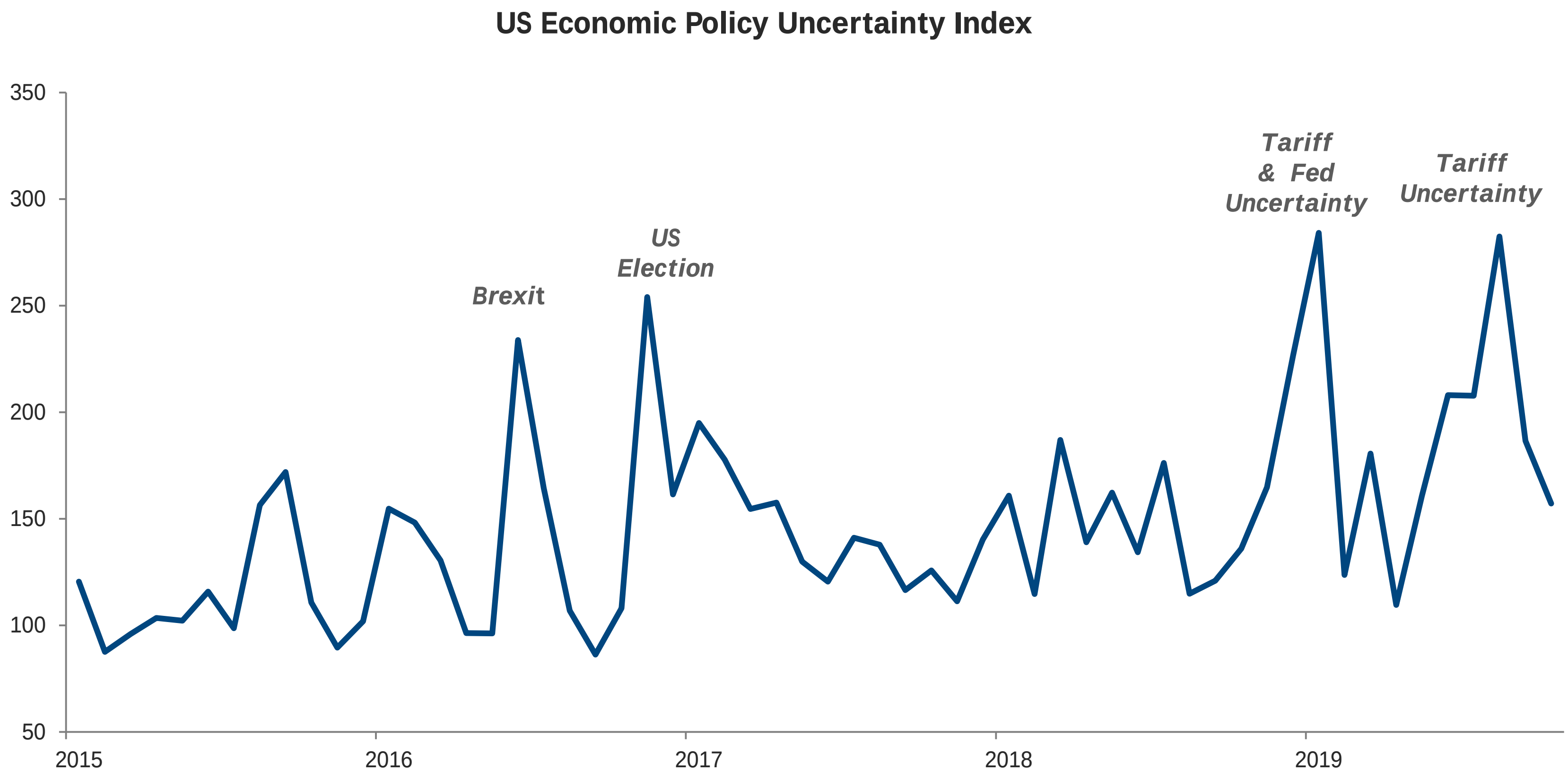
US Economic Policy Uncertainty Receding (For Now), Providing a Boost for Markets



Index based on monthly searches of newspaper for terms related to economic and policy uncertainty.
Data Source: "Measuring Economic Policy Uncertainty" by Scott R. Baker, Nicholas Bloom and Steven J. Davis, SunTrust IAG

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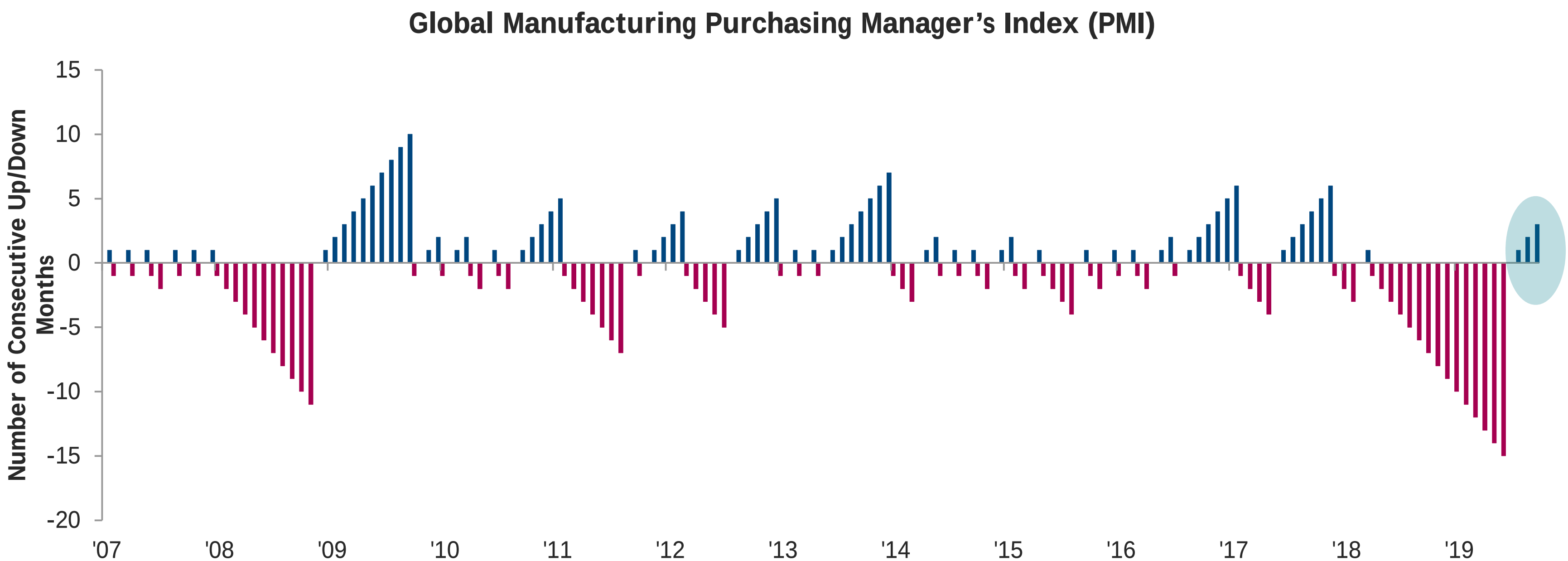
Stabilizing Global Economic Trends Aiding Stocks

After a record 15 straight down months, we have now seen three consecutive monthly increases in global manufacturing surveys.



Data Source: SunTrust IAG, Haver

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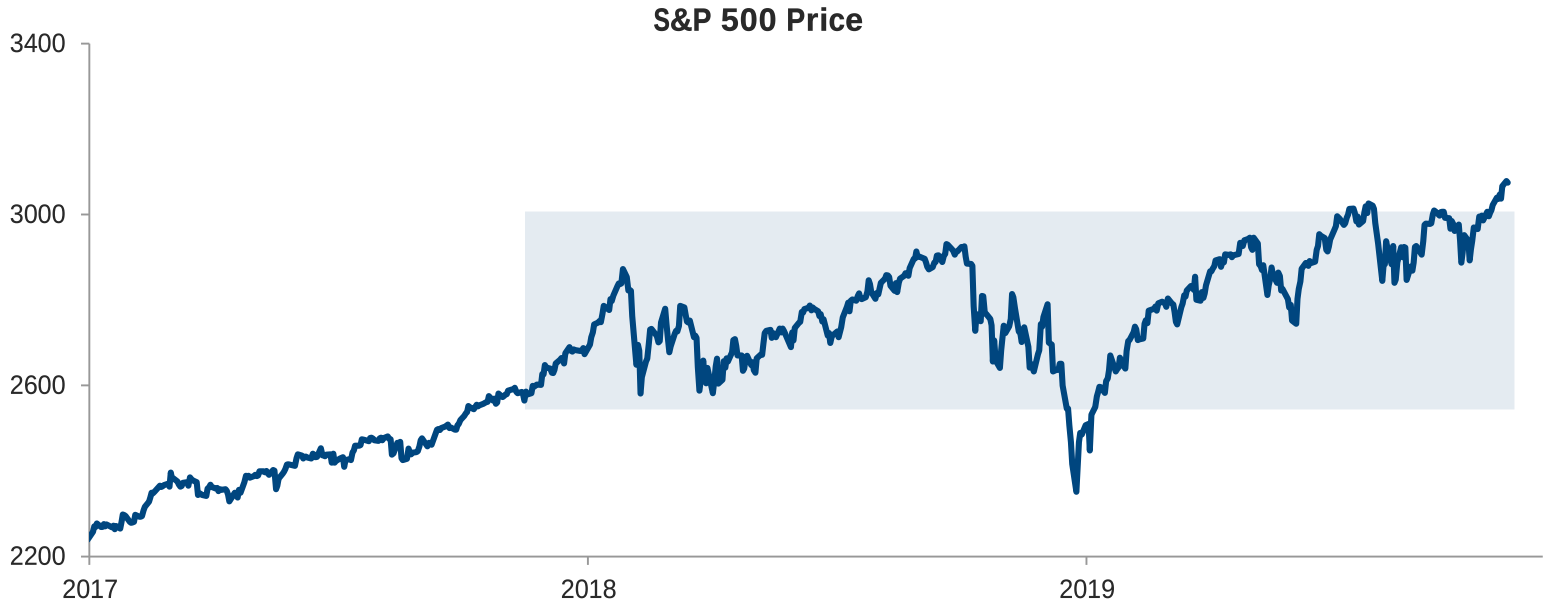
S&P 500: Breaking Out of 21-Month Trading Range

The S&P 500 has broken to the upside of a 21-month trading range, a positive longer-term technical development. We see short-term support for the market around the 3000-3025 (currently 3080), the level which had previously acted as a ceiling for stocks.



Data Source: SunTrust IAG, FactSet

Stocks Also Breaking Out Relative to Bonds

As stocks have risen and bonds sold off, the relative price momentum has shifted back toward stocks.

S&P 500 Price Relative to Bonds*

*Measures S&P 500 price relative to the 10-Year US Treasury Bond
Data Source: SunTrust IAG, FactSet

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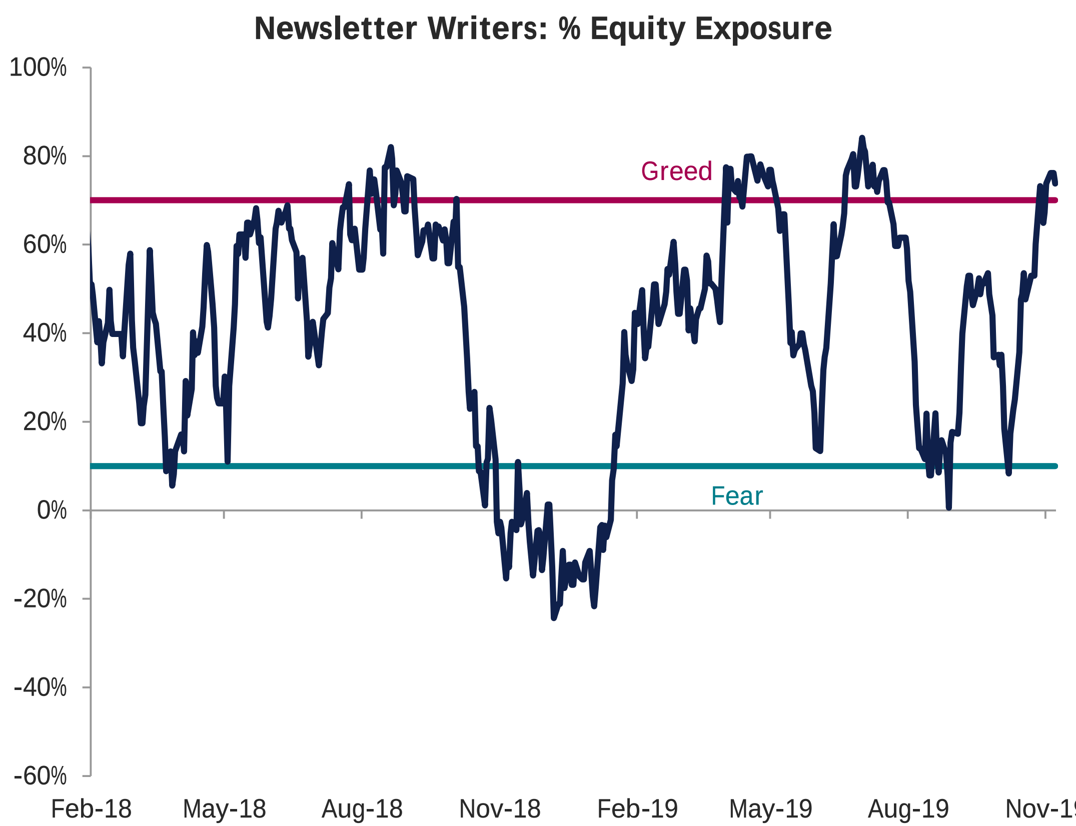
Investor Sentiment Becoming a Shorter-Term Negative From a Contrarian Standpoint

Although price trends are positive, sentiment measures are showing some signs of froth. The average newsletter writer is now recommending over 70% equity exposure versus 8% in early October.



Data Source: SunTrust IAG, Hulbert Ratings Sentiment

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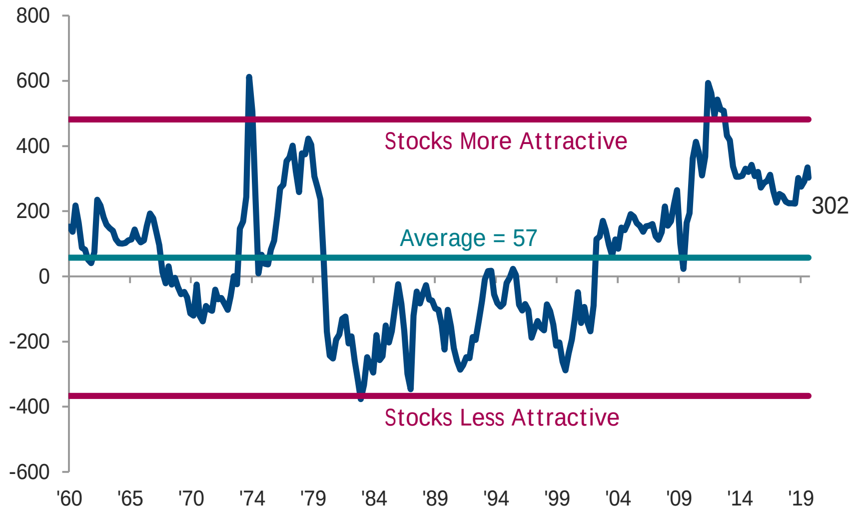
Valuations Now the Highest Since Early 2018

Data Source: SunTrust IAG, FactSet

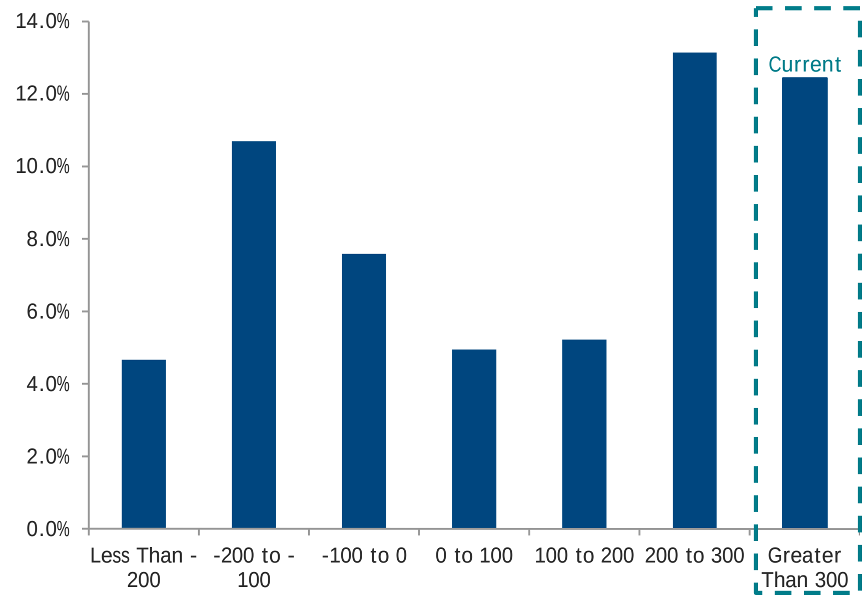
Relative Valuations Still Favor Stocks to Bonds

While the absolute valuations of stocks are slightly above average, the equity risk premium, which compares the earnings yield of stocks relative to bond yields, remains at a level which has historically been associated with average 12-month forward market returns of about 12%.

S&P 500: Equity Risk Premium: Earnings Yield Minus 10-Year Treasury Yield



Average 12-Month Forward Return by ERP Tranche (1960-Current)



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Source: Strategas, SunTrust IAG

Equity risk premium is quantified in basis points (bps). One basis point = 0.01%

Economically Sensitive Sector Breaking out Relative to Defensive Areas

MSCI Cyclical Sectors—Defensive Sectors Spread

*Cyclical sectors include sectors such as industrials, materials, technology and consumer discretionary; defensive sectors include sectors such as staples, healthcare and telecom.

Data Source: SunTrust IAG, Bloomberg

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