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March Madness? The stock market's Cinderella story

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Summary

Much like last year's underdog, the stock markets faced some obstacles going into 2019—plenty that would give them reason to extend their end-of-2018 slide. But also like the Cinderella team, stock markets overcame adversity and rallied last month, continuing to build on their impressive gains since the start of the year.

With US men's basketball NCAA March Madness underway, I'm reminded of an historic moment from last year's tournament, where the University of Maryland, Baltimore County (UMBC) pulled off a stunning upset victory over the University of Virginia (UVA). It was the very first time in tournament history that a team with the lowest-ranking seed (no. 16) beat a highest-ranking seed (no. 1)—a true Cinderella story by all accounts.

Going into the historic game, it was clear UMBC had the odds stacked against them. UVA was a better team on all measurable fronts, boasting a nearly undefeated record and a notably strong defense. UMBC was a little-known school that had only made the tournament by the skin of their teeth, ranked 63 out of a field of 68 teams. But in a situation where defeat was all but a foregone conclusion, UMBC emerged from the game victorious by a wide margin, out-strategizing UVA's defense with speed and agility.

Much like UMBC last year, the stock markets faced some obstacles going into 2019—plenty that would give them reason to extend their end-of-2018 slide. But also like the Cinderella team, stock markets overcame adversity and rallied last month, continuing to build on their impressive gains since the start of the year.

If the face of adversity for UMBC was a stronger, more accomplished team, what did the face of adversity for the stock markets look like? If I had to put it in one word, it would be this: earnings.

A company's earnings don't necessarily tell the whole story of financial health (or lack thereof), but they give the market something to react to—and the recent news hasn't been encouraging. Earnings surprises—the degree by which earnings beat estimates—came in considerably lower than the last two years, and also below the historical median.

And that's just a look in the rearview—the look ahead also painted a dreary picture. Analyst expectations for earnings growth have more than halved since September, and less-than-stellar sales are at least in part to blame.

Increased risk of earnings recession in the US

In the last four months, earnings growth estimates have precipitously declined.

Source: Bloomberg. Data as at March 2019.

You might be thinking this gloomy news can't possibly bode well for the stock markets, and if earnings were the only factor in play you'd be right. But we've watched two other trends unfold over the past couple of months, both of which you might have heard a few things about.

First, as tensions over the US/China trade deal continued to ease, renewed investor optimism gave stocks a boost. And the second boon for the stock market came from the Federal Reserve (the "Fed")—that entity holding the reigns of monetary policy—which had previously been on a (potentially stock market-crushing) track to continue its interest rate hikes. The Fed instead declared a more patient stance on raising rates, bolstering overall confidence in markets.

If we again reflect on UMBC's tournament run, we can try to glean some future learning. Just two days after their historic first round victory, UMBC lost steam and fell to Kansas State, putting an end to their historic March Madness run. If this turn of events tells us anything, it's that past performance is truly not indicative of future results, and there's a chance the same could also ring true for stock markets—particularly if earnings headwinds persist.

While consensus among analysts implies that we'll see earnings growth pick up again in the second half of the year, we think this may still be lofty and maintain a neutral view on US stocks. We'll continue to keep an eye on earnings expectations for later in the year, and see whether stocks can again make like UMBC—prevailing in the face of earnings adversity.

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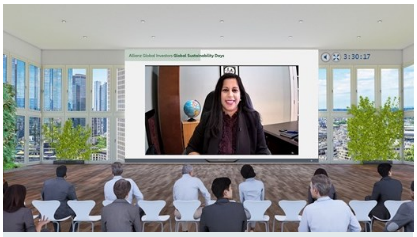

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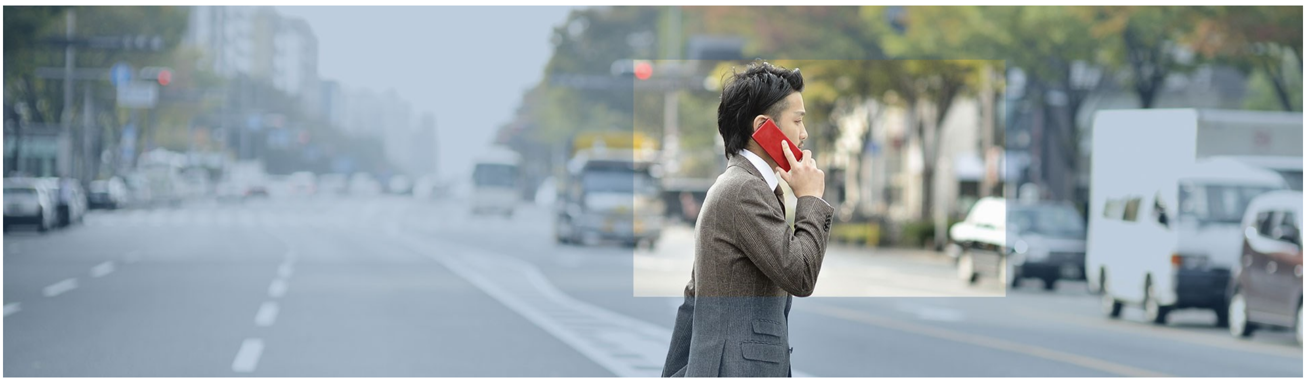

Summary

Investment income provides many benefits – including guarding against inflation – but today's "safe" bonds may offer no or ultra-low returns. We suggest investors hunt for income among "riskier" income generators like corporate bonds, emerging-market debt and dividend-paying stocks.

Key takeaways

- Inflation is an overlooked risk that can feel higher than official inflation numbers – but even 2% annual inflation can reduce purchasing power by almost 20% over 10 years
- Slow economic growth and low interest rates mean market returns – beta – may also be low; this underscores the importance of taking enough risk to earn a sufficient return
- Many "safe" bonds offer zero or ultra-low returns – and now that most central banks have stopped raising rates, easy and attractive cash returns are hard to find
- Investors who "hunt for income" using riskier asset classes may be able to fight off inflation, stabilise returns and reduce overall portfolio volatility
- An active approach to income investing can help investors search for opportunities and manage a broad range of risks

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