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April 11, 2019

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S&P 500

Table 1 S&P 500	2014	2015	2016	2017	2018	2019(e)	10 Apr 19
Price (Beginning of Year)	1,848.36	2,058.90	2,043.94	2,238.83	2,673.61	2,506.85	2,888.24
Earnings (forward)	113.01	100.45	106.26	124.51	151.60	154.81	157.53
P/E Ratio	16.4	20.5	19.2	18.0	17.6	16.2	18.3

Risks are Balanced: Investors Should Stay with Stocks

Don't fight the Fed is one of the oldest Wall Street maxims. In that context, stock investors can be happy. As we wrote in our report last October, the Chairman of the Fed triggered the 2018 correction in stock prices by suggesting a willingness to push short-term interest rates above the "neutral rate." However, since January, the Federal Reserve has changed its policy and is no longer expected to increase interest rates this year. Furthermore, the Fed has indicated plans to end its Quantitative Tightening program by September 2019 and allow its balance sheet to remain considerably larger than previously expected. The decision by the U.S. central bank to take its boot off the neck of the U.S. economy accounts for the substantial rebound in stock prices this year. With inflation remaining low, the Fed has considerable freedom to ease monetary policy if necessary. This factor alone should provide comfort to long-term stock investors. The time for serious concern is when inflation starts to spiral higher and central banks become obligated to tighten monetary policy sharply. That scenario is not on the horizon.

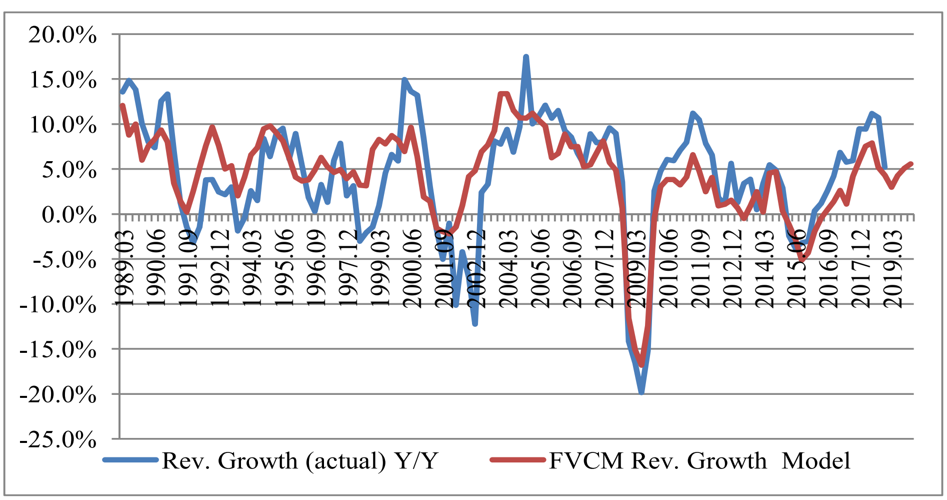
Tactically, stocks are beginning to look short-term overbought, but fundamentals still remain mostly bullish. The S&P 500 has risen 23% from the December 24th low and, now at 2878, is within striking distance of the old high of 2930 that was reached before the Fed triggered the Correction last October. It's been an almost perfect V with the Fed starting both the decline and recovery. Investors will now likely shift their attention back to business fundamentals, especially corporate profits. After such a rebound, a minor pullback in prices would be a common occurrence but as long as business conditions continue to expand, the trend in stock prices is likely to remain upward.

Growth has slowed and the yield curve is flashing yellow. While recent data in the U.S. indicates a cooling from the fast expansion of 2018, most signs suggest that growth in the economy and corporate profitability will continue in 2019. The one notable exception to that positive generalization is the U.S. treasury yield curve, which is the difference between short-term and long-term interest rates. An inverted yield curve, where short-term interest rates are higher than long-term rates, has historically been one of the best indicators of recession. Based on that one factor, the N.Y. Federal Reserve recently estimated the probability of a recession during the twelve months ahead at 27%. However, most other U.S. data, such as the Index of Leading Indicators and the Manufacturing Purchasing Managers Index remains positive. It is possible that U.S. long-term interest rates are being "artificially" depressed because of low and often negative yields in Europe and Asia. In that case, the risk of recession is likely less than 27%. Furthermore, the consensus estimate for U.S. 2019 real GDP growth has held remarkably steady at 2.4% over the past year.

Corporate Growth Continues

We expect sales for the S&P 500 (SPX) to rise 3.0% in the 2019 first quarter, year-over-year, and 4.5% for the full year, down from an astounding 9% growth rate in 2018. Corporate sales are highly levered to the U.S. economy—nominal GDP. In other words, if nominal GDP growth was zero, SPX sales would decline about 6%. However, for every 1% percentage point of economic growth, S&P 500 revenues get a boost of more than 2%. Things really start to take off when nominal economic growth exceeds 5% (it was 5.2% in 2018 and we expect similar in 2019). Another big factor is the U.S. dollar foreign exchange rate because almost 40% of sales are overseas. The dollar was weakening in late 2017 and into 2018 and provided a considerable boost to sales growth last year. However, the dollar has been strengthening since about March of 2018 and is now providing a headwind to sales growth. The dollar's strength is the main reason we see sales only growing 4.5% this year even though nominal GDP growth should surpass 5% again. Our model shown in Chart 1 below estimates revenue growth for the S&P 500 using nominal GDP growth, which is expected to stay just north of 5%, and foreign exchange rates, which we assume will stabilize going forward.

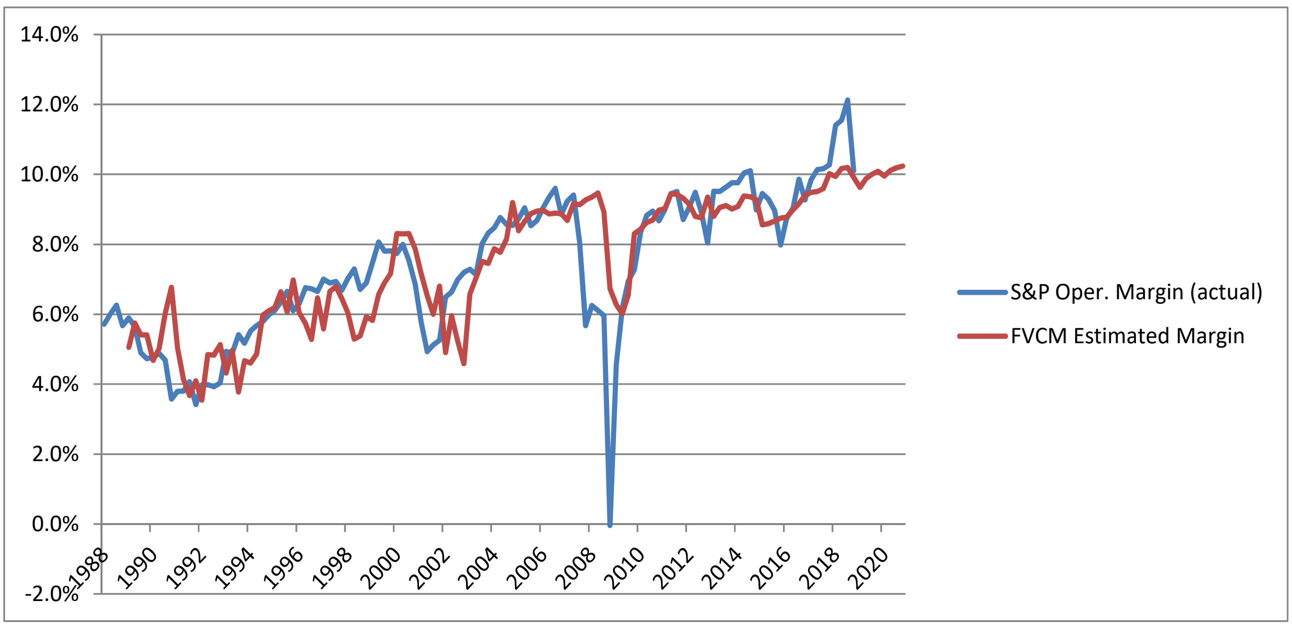
Chart 1 S&P 500 Revenue Growth vs. FVCM Revenue Growth Model



Source: Standard & Poor's Corp., Federal Reserve, FVCM

There has been speculation for years now that profit margins would start "to revert to the mean," but we remain skeptical. We think margins will remain about flat this year and in 2020. Firstly, the expansion in profit margins over the past 20 years has been almost entirely, by some estimates, due to the growth in the U.S. technology sector, which is notoriously fast growing and profitable. Secondly, one of the biggest factors affecting profit margins is labor costs. For starters, overall wages have been growing at a modest rate of about 3% per annum. And, after accounting for productivity, which has been accelerating and was up 1.9%, year over year, in the 2018 fourth quarter, unit labor costs are growing slower than many measures of inflation. Another large factor impacting profit margins is interest costs. Yet, despite some predictions, interest costs are showing no signs of rising. Lastly, corporate margins got a big boost in 2019 thanks to the Trump tax cuts, which brought effective tax rates down to about 19% from 25%. That's not changing anytime soon either. With the growth in sales, we expect the net profit margin to be 11.0% in 2019 and resulting in operating earnings of 154.81, versus a margin of 11.3% in 2018 and earnings of 151.6. In 2020 we're estimating earnings of 166 based on 5.6% revenue growth and an 11.2% profit margin.

Chart 2 **S&P 500 Operating Profit Margin vs. FVCM Profit Margin Estimate**

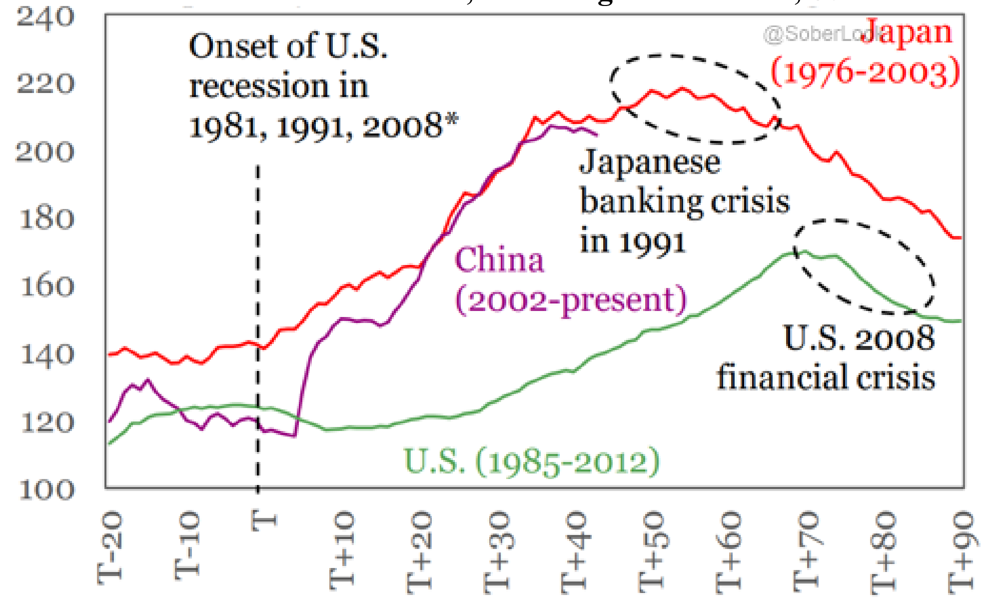


Source: Standard & Poor's Corp., FVCM

Risks Always Exist, Valuations are Fair

The greatest risk to global and U.S. growth, in our opinion, is the extreme increase in debt in China, most of which has accumulated since the 2008 financial crisis (see Chart 3). The central planners in Beijing have used debt to prevent a decline in the economy through massive infrastructure projects, massive real estate projects, and indirect and direct subsidies to unprofitable state owned firms. It is impossible to know how long this can go on, but such rapid accumulations of debt rarely ends happily, especially when the debt has been generated because of political purposes. Japan in the 1980s, like China now, was seen as the new, up and coming economic superpower that would eclipse the U.S. Yet Japan is still withering under the debt accumulated in the 1980s during a period of extreme real estate speculation and debt expansion. We would point out the 1990s was a period of growth and prosperity for the U.S. despite the implosion that began in Japan ("the lost decade," etc.). When China enters a crisis, the U.S. will not be immune to the negative effects. However, each nation makes its own way and pays its own price for its policies. The U.S. should continue to prosper following this scenario.

Chart 3 **Non-Financial Sector Debt, excluding Government, % of GDP**

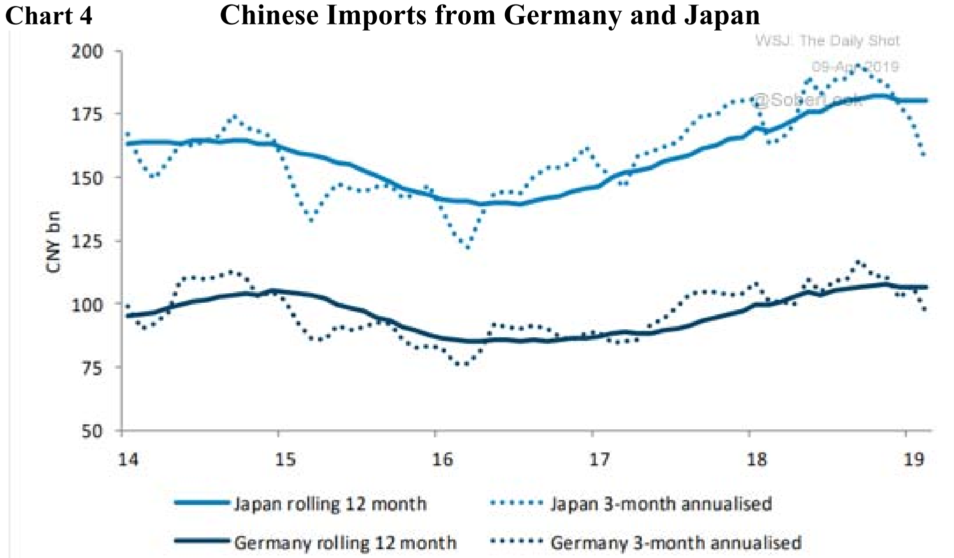


Source: Wall Street Journal-Daily Shot, BIS, IIF

Note: In Chart 3 above, the T shown in the horizontal axis indicates the beginning of each period mentioned for each country. The numbers represent quarters, so T+40, for example, is 10 years after T.

Europe, because of its large size and importance, also represents a material risk to the U.S. Germany, the largest European economy is showing notable stress in its manufacturing sector, much of which is traceable to China. Exports from Germany to China, like those from Japan, have been declining. However, concerns here should be reduced as current Chinese policies are expected to again stimulate its economy. Furthermore, there are signs that China and Europe are making progress on trade peace. Other factors well known to Europeans are the great uncertainty related to Brexit and the rather unstable political and banking situation in Italy.

Chart 4 **Chinese Imports from Germany and Japan**

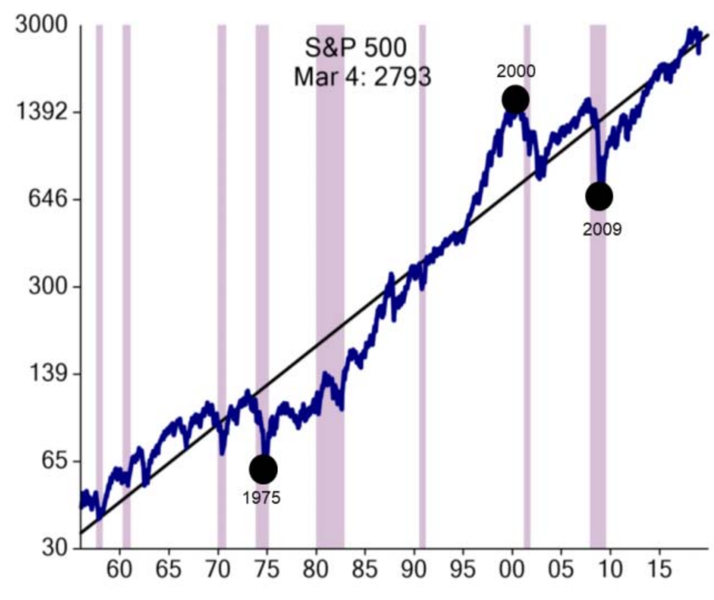


Source: Wall Street Journal-Daily Shot, Bloomberg, ANZ Research

It seems to us that these risks from overseas are the primary factors now leading to the flat or inverted yield curve noted at the beginning of this report, and continued bullishness is warranted. A steady flight of capital from China, as well as the deteriorating condition in Europe—and the resultant low interest rates, are the factors putting downward pressure on U.S. bond yields. We don't think the low U.S. yields reflect domestic weakness. If the yield curve turns deeply negative for an extended period, we will have to concede the probability of an oncoming recession. When that time comes, we will reduce equities. But for now, the S&P 500 is trading at 18 times earnings, which is a reasonable level for a low inflation, positive growth environment. We also would point out that Information Technology is more than 20% of the S&P 500, versus about 5% in Europe. That high tech weighting probably justifies a higher P/E ratio since it now seems likely that the tech revolution may resemble the industrial revolution of the 19th century in terms of importance. Furthermore, the U.S. manufacturing sector is benefitting from rapid growth in U.S. energy production and energy costs below global levels. The bottom line is that investors will probably be best served by suppressing nervous fears about the risks outlined herein, as well as many others, and focus on the long-term opportunities for equity investing.

We conclude with the Chart below from the analysts at Evercore ISI, who have pointed out that over the past 50 years the S&P 500 has compounded at a 7.2% annual rate and 10.6% including dividends. The greatest accumulators of capital in America have been those who have held steady and reaped those rewards.

Chart 5



Source: Evercore ISI

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