INVESTMENT COMMENTARY & OUTLOOK

January 29, 2019

The stock market has been "re-liquefied" in January and is off to one of the strongest starts in decades, especially for small capitalization stocks that have "melted up." The other good news is that unlike the third-quarter announcement season where the stock market was worried about non-earnings-related macro issues, like the Fed interest rate increases and the China trade dispute, so far in 2019, stocks are largely responding positively to their quarterly announcements and guidance.

Furthermore, earnings surprises are bigger than normal. It appears that the analyst community was way too cautious with their fourth-quarter earnings estimates, since many companies are providing positive guidance above analyst consensus estimates. It is important to remind all investors that the good earnings announcements tend to come out early, so later on, the fourth-quarter announcements (by mid-February) may not be that strong. As a result, we expect the stock market to get increasingly "bumpy" in the upcoming weeks.

Now that the S&P 500 has resurged more than 10% from its Christmas Eve lows, a "retest" of those lows is becoming less likely. Ironically, the stock market largely ignored the federal government shutdown and the ongoing Brexit chaos. First-quarter GDP is now expected to be flat due to the federal government shutdown and especially severe winter weather in the Midwest and Northeast. No one really wants to be the British Prime Minister leading up to the implementation of Brexit on March 29th, so ironically Prime Minister May survived a "no confidence" vote after a humiliating Brexit defeat in the House of Commons by a resounding vote of 432 to 202.

Interestingly, in addition to Brexit undermining the British pound, the euro has also been hurt by the Brexit mess. Furthermore, the ongoing "yellow vest" protests in France are also hindering the euro. Of all the reserve currencies in the world, the U.S. dollar remains king and this international capital flight is helping to suppress Treasury yields due to more international buyers.

The inflation data is giving the Fed a lot of wiggle room to pause rate hikes. The Labor Department recently announced that its Consumer Price Index (CPI) declined 0.1% in December, which is the first decline in nine months. The Labor Department also announced that Producer Price Index (PPI) declined 0.2% in December, which the biggest monthly decline in more than two years and was a bit more than economists' expectations of a 0.1% decline.

I should add that thanks to the boom in shale oil production, the U.S. is now producing more crude oil at 11.8 million barrels per day than Russia and Saudi Arabia. Furthermore, U.S. crude oil production is expected to expand by another 1.1 million barrels per day in 2019, so by the end of the year, domestic crude oil production will be near 13 billion barrels per day and significantly higher than Saudi Arabia ever produced (its maximum is 12 billion barrels per day).

This domestic energy boom essentially means that the U.S. is displacing Saudi Arabia as the swing producer of crude oil and will increasingly dictate crude oil prices worldwide. This is a major development, since higher crude oil prices have traditionally hurt growth in emerging markets and other major economies. So thanks to the domestic shale oil boom, the U.S. is now expected to help boost overall global GDP growth in the upcoming years.

In March, the U.S. is scheduled to increase it tariffs on China from 10% to 25% if a new trade agreement is not achieved. Interestingly, China recently offered to go on a six-year buying spree to ramp up imports from the U.S., which effectively signaled that the ongoing trade talks are going well.

In the upcoming quarters, earnings momentum is expected to decelerate due largely to more difficult year-over-year comparisons. In this decelerating earnings environment, we expect that the breadth and power of the overall stock market will become increasingly narrow in the upcoming months. This narrow market environment that we are anticipating is actually very good news for our dividend growth and conservative growth stocks, since the money flowing into the stock market will likely become increasingly narrow and more focused. As a result, we expect that many of our dividend growth and conservative growth stocks will continue to benefit from their quarterly results and positive guidance.

ETF & VOLATILITY OBSERVATIONS

Despite a positive tone to the stock market this year, volatility persists and we have been carefully monitoring ETF spreads to see if the stock market is finally becoming "normalized." We are happy to report that the abnormally wide ETF spreads in the fourth quarter that complicated the correction, have tightened up, which is important for investor confidence. Unfortunately, ETF spreads still remain elevated. As an example, on January 23rd, an hour after the market opening, DVY was trading at a 19 cent spread (0.2%), while SPY was trading at a $1.08 spread (0.4%) according to Morningstar's Intraday Indicative Value. DVY and SPY are two of the biggest and most liquid ETFs traded and their spreads should eventually diminish to 1 to 3 cents before we can confidently say that the volatility has fully diminished.

According to our friends at Bespoke, SPY rose 13.1% in 2018 "after hours" when the stock market was closed, but declined 17.2% during "regular trading" hours in 2018. Clearly, this 30.3% performance dispersion during 2018 in the most liquid, largest, and oldest ETF is very disturbing and undermines investor confidence. In our managed ETF portfolios, we remain invested in two Treasury ETFs, since the bid/ask spreads on most stock ETFs remain cost prohibitive.

I should add that Wall Street's new invention of "no transaction fee ETF trading" does not eliminate the ETF spread, just merely the brokerage commission. Essentially, no transaction fee ETF trading is just how selected ETF firms pay TD Ameritrade and other brokerage firms for order flow and there are all too often extra charges if an investor sells ETFs a bit too quickly.

The ETF spread dilemma is thoroughly discussed in Jason Bodner's new white paper, *ETF-DOOM Sharks*. Furthermore, this white paper thoroughly discusses how the growth in both algorithmic trading and ETFs has made the stock market much more volatile, which essentially triggered the recent stock market correction. Jason is a former institutional ETF trader and has unique insights into ETF trading that all serious investors must read … see link:

https://navellier.com/etf-doom-sharks

SUMMARY

Overall, Wall Street likes to climb a wall of worry, but the U.S. remains as oasis around the world. The saying that "as January goes, the year goes" bodes well for the overall stock market. The January "melt up" means that a "retest" of the Christmas Eve lows is now increasingly less likely.

In the fourth quarter, the major fears for the stock market were rising interest rates and the trade war with China. Still, after the Fed's Federal Open Market Committee (FOMC) statement in mid-December, Treasury yields have collapsed and effectively discouraged any further key interest rate hikes. Also, the China trade negotiations are apparently going well, since China announced that they plan to substantially boost U.S. imports over the next six years. In other words, the financial media tried unnecessarily to scare investors in the fourth quarter.

In the upcoming months, the sales and earnings growth for the S&P 500 are expected to decelerate, due largely to more difficult year-over-year comparisons. Since our conservative growth stocks are characterized by much stronger sales and earnings growth than the S&P 500, we expect that many of our stocks will continue to exhibit relative strength and benefit from persistent institutional buying pressure. In our opinion, an investor's best defense remains a strong offense of fundamentally superior dividend growth and conservative growth stocks.

LOUIS G. NAVELLIER
CEO/Chief Investment Officer

MICHAEL J. BORGEN
Senior Portfolio Manager

MICHAEL GARAVENTA
Portfolio Manager

TIM HOPE
Portfolio Manager

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1 East Liberty Suite 504 Reno Nevada 89501

800-365-8471 • 775-785-2300 • www.navellier.com