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Market Commentary

WEEKLY PERSPECTIVE ON CURRENT MARKET SENTIMENT

Stocks and Geopolitics

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Last Week's S&P 500 Index:
-0.2%

Key takeaways

» *Geopolitical tensions come and go but those that have the most effect on the stock market have the potential to cause economic headwinds and, as a result, impair earnings growth.*

» *Consumer spending has driven this expansion. Higher gasoline prices would give consumers less money to spend on discretionary items.*

Let's make the main point of this commentary right up front: The vast majority of the time, the stock market doesn't worry about geopolitics, and rightfully so. Spats between the U.S. and any number of countries around the world occur all of the time, no matter what party controls Congress or who is president. The only geopolitical confrontations most equity investors care about (or should care about) are the ones that could potentially affect the economy and, therefore, eventually, the ability of companies to generate earnings.

This brings us to our most recent geopolitical conflict between the United States and Iran. Granted, there has been geopolitical conflict on a virtually 24/7 basis between our two countries since 1979 (that's 41 years for those keeping track). But the drone missile strike last Friday and the attack on the U.S. embassy in Baghdad on New Year's Eve have brought this ongoing conflict back from the backburner to the front burner, at least for the time being.

The S&P 500, at least so far, doesn't reflect an atmosphere of panic, or anything close to it, as the index at the time of this writing is trading only 0.7% below the all-time record high set just last Thursday. The price of oil has climbed higher since early December and jumped on the embassy attack but continues to trade within our $55-$65 year-end 2020 target range. Not surprisingly, the Energy sector has been an outperformer since the price of oil began to rise last month. Note that this sector dramatically underperformed the overall market in 2019, trailing the performance of the S&P 500 Index by more than 21% (+7.6% versus +28.9%).

We currently hold a neutral recommendation on the Energy sector. But some of the underlying fundamentals don't look bad in our opinion. For instance, for the sector as a whole, the trailing 12-month price-to-earnings (P/E) ratio is the lowest relative to the other 11 sectors while price-to-free cash flow (P/FCF) ranks in the top three. However, as is almost always the case with any sector, macro issues continue to dominate, if not drive, the outlook.

The Energy sector is typically a late-cycle outperformer. You might ask why then Energy is not outperforming given where we believe we are in the current cycle. In a "typical" cycle (this one is not typical), late cycle usually means the global economy is advancing and oil supply/demand dynamics tighten. In this cycle, supply has been plentiful relative to demand and global growth has not synchronized at anything close to a robust pace.

While any U.S./Iran confrontation could have far-reaching effects, for the stock market in the near term, it will likely come down to what happens with the price of oil. If gasoline prices jump, consumers will have fewer dollars in their pockets to spend on discretionary items. For many corporations, expenses also would increase with rising fuel prices. It has been the U.S. consumer who has driven this expansion, and any headwinds that would crimp spending would be taken as a negative.

Stocks and geopolitics can be linked when potential economic and earnings growth are at risk.

Risks Considerations

Forecasts are based on certain assumptions and on views of market and economic conditions which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions.

Definitions

An index is unmanaged and not available for direct investment.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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