Daniel Wildermuth's
MARKETCOMMENTARY

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Bull Market Reaches Record Length on Heels of Strong GDP Growth

On August 22nd, the S&P 500's ongoing bull market, born out of the 2008 financial meltdown, became the longest running bull-market in history at 3,453 days old. As if to flaunt its success, the market went on to set a new high a few days later, which some market watchers claim must occur for the record to fully count. With the market up over 320% on its record-setting run starting on March 9, 2009, we are now in unchartered territory.

The market's recent run-up has been powered by continued good news in multiple areas. U.S. corporate profits again ratcheted up sharply in the second quarter as tax cuts and strong economic growth drove GDP forward at 4.2% annualized rate. In late August, the Commerce Department reported that its broadest measure of U.S. after-tax profits rose at the sizzling pace of 16.1% in the second quarter versus the same period last year. The gain was the fastest in six years.

Optimism abounds that the party can continue. Many pundits attribute the improving economy to better economic policies that are just starting to make real impact. Beyond the new tax policy, many other changes are cited including a partial rollback of the burdensome Dodd-Frank financial bill, numerous regulatory rollbacks (more than during the Reagan years), friendlier leadership in the Department of Labor with an emphasis on compliance rather than punitive enforcement, and new leadership in the Consumer Financial Protection Bureau. While

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nearly all of corporate America has been helped, small companies in particular have benefited through lower compliance and record-keeping costs.

Unemployment also keeps hitting new lows, dropping to 3.9% at the end of July. The pace of factory hiring has more than doubled since last year, and recent job growth has been wonderfully inclusive with nearly all demographic groups enjoying very strong gains. Over this past summer, the jobless rate for Americans age 16 to 24 hit a 50-year low. In May, the black unemployment rate declined to 5.9%, the lowest level ever recorded by the Bureau of Labor Statistics. Job satisfaction has also increased markedly as people enjoy greater freedom to leave current jobs in search of better opportunities.

Feeding the trend, optimism among small-business owners is at levels last seen in July of 1983 according to the National Federation of Independent Business. Small company sentiment is particularly important to future growth as small companies not only employ nearly half of the nation's private sector workforce, but they also create the majority of new jobs.

Internationally, many of the world's most important markets are thriving. Germany's economic growth accelerated in the second quarter to 1.8% annualized, ensuring the eurozone in aggregate avoided a slowdown. The European Union's statistics agency raised its growth estimate for second quarter to 1.5%. The Bank of England raised its central bank policy rate to 0.75%, its highest level since 2009, illustrating increased confidence in future growth. Partially driving the rate increase is the desire to keep up with solid if uneven growth that drove global inflation to a healthy four-year high in June. The only notably negatives were the ongoing global trade tensions and Turkey's currency crisis

With the market and the economy seemingly moving from strength to strength, it could seem reasonable to assume the market will simply keeping trending higher. Yet, historically, economies and markets often look their best shortly before sharp reversals, and caution signs

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remain.

The lower tax rate reduced U.S. company tax bills last quarter by a whopping 33% from a year earlier. While the savings are very big and very real, the jump in earnings is a one-time event that some investors appear to be incorrectly pricing into future earnings expectations as on repeatable event. Corporate America understands the one-time nature of the increase as firms have actually decreased dividends and share buybacks rather than raising them, possibly revealing a lack of confidence in future profit gains.

In addition, predicting an end to the economic fun has been challenging historically. A study by the International Monetary Fund concluded that economists failed to predict 148 out of 153 of recessions (97%) that occurred across the globe, a record the average first grader can almost certainly best.

Moreover, economic numbers are often the strongest right before the storm. Notably, unemployment is often the lowest just before an expansion stumbles. A recent Bloomberg article cited a study that found that the average time between the low in the unemployment rate and the start of a recession was just 3.8 months in the ten recessions since 1950.

Inflation is also ticking up, accelerating at its fastest annual clip since 2012, driven by strong consumer spending and business price increases. Currently, the closely watched Federal Reserve number, which excludes volatile food and energy prices, is up around 2% from last year, right at the Federal Reserve's target to warrant a future rate increase.

In addition, despite recent increases in earnings that have reduced the market's price-to-earnings ratio a bit closer to historical averages, by many other measures, the market remains quite richly valued. The median price-to-sales ratio reduces the influence of giant companies like Apple and Exxon by focusing on the middle of the index. According to the Leuthold Group, the index now sits at 2.63 compared with 1.23 in February 2000, the level right before the dot-com crash. Leuthold's chief investment officer, Doug Ramsey, claims that overvaluation in the late 1990 bubble years was highly concentrated on tech giants, where now, everything is expensive. While this more arcane measure might prove to be meaningless, it's also not very comforting. Not surprisingly, history suggests that the more overvalued the market is at the start of a recession, the more it declines during the recession.

Given much ongoing good news, the market may continue moving up for some time. However, increasing warning signs suggest that a correction could be nearer, and if, or really when, it does come, it is likely to arrive quickly without much warning. Yet, if you can weather at least a 20% to 40% drop in your equity portfolio, it is probably wise to leave your equities alone as timing markets has proven nearly impossible for all investors. Finally, we believe that regardless of what happens to the economy and the stock market in the near-term, eventually the market recovers and reaches even higher highs.

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