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U.S. companies experience fastest growth in six years ...

Corporate earnings remain well-positioned and solid

By Daniel Wildermuth

Bull market potentially set to extend its already long run.

While the market experienced pullbacks in March, April, and May, the recoveries have been a bit stronger propelling the market to several all-time highs in late May. Much has been made of President Trump's ability to implement his agenda, and recent market strength appears to result more from corporate earnings, which are more traditional key fundamental drivers of equity returns.

During the first quarter, U.S. companies grew at their fastest pace in nearly six years, further extending the stock market rally that has stretched into its ninth year. With nearly all companies in the S&P 500 having reported results, aggregate earnings for the first quarter are up around 13.6 percent over last year's results on revenue gains of 7.7 percent, according to FactSet.

Analysts polled by FactSet also estimate the broad index will post earnings growth of 6.8 percent for the second quarter and 11 percent for the full year. The gains were not only strong, but also broad, coming from various industries including technology, heavy equipment, banking, consumer goods, and social networking.

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The strength and quality of earnings provides investors a welcome contrast with past years in which it appeared that stock gains were resulting more from corporate share buybacks and ultralow interest rates rather than business growth. In fact, share repurchases by S&P 500 companies declined 24 percent over the past year, according to S&P Dow Jones Indices using early-reported data from about a third of S&P 500 companies.

Not surprisingly against the uptick in earnings, the U.S. economy slowed less than initially thought in the first quarter delivering a 1.2 percent annual growth rate instead of the 0.7 percent level reported last month, according to the Commerce Department. Although GDP growth in first quarter was the worst in a year, U.S. consumer spending recorded its biggest increase in four months in April contributing to a rebound in inflation and signaling stronger U.S. demand.

In a separate report released May 30, the Conference Board said its consumer confidence declined slightly to 117.9 in May from 119.4 in April. While the index has slipped a bit from its March 16 -year high of 124.9, the current measure remains at the 88th percentile of all the monthly data points since June, 1977, down only slightly from the 90th percentile the previous month. High levels of consumer confidence combined with debt levels not seen since the early 1980s likely provide more reason for optimism regarding future U.S. economic strength.

A strong labor market is helping to

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European recovery set to pick up speed as credit demand increases

boost consumer confidence levels. Hiring increased in April helping drive unemployment to 4.4 percent, its lowest level since May, 2007 shortly before the housing bubble burst. Yet to date, falling unemployment has resulted in surprisingly low wage pressure and instead seems to be luring sidelined workers back into the labor force. Eventually, this trend should change as businesses compete for fewer workers. The Conference Board's survey also recorded the strongest reading since 2001 regarding respondents' perception of the ease of finding a job - both trends should start driving wages higher.

The strength of various indicators will likely be used by the Federal Reserve as justification to raise rates again later this year after a brief pause to be sure economic softness was temporary. Most expect the second short-term interest rates hike this year at the Fed's next policy meeting in June, and then likely another increase in September. Still, the Fed's projections continue to place the U.S. on its ongoing weak expansion path of about two percent, resulting in a less aggressive longer-term strategy regarding short-term rates than past periods with similarly low unemployment.

Looking beyond U.S. borders, growth appears to be picking up internationally, meaning the U.S. may receive a bit of a boost from beyond its borders. The Global Purchasers Managers Index for manufacturing has improved markedly in the last two years and recorded steady gains throughout 2017. The overwhelming majority of countries are enjoying an acceleration with the notable exceptions of Greece and scandal-ridden Brazil. Europe is also enjoying continued strong credit demand. After the plunge in demand in 2008 - 2009 and then another dip almost as large in 2012 - 2013, growth has now been strong since early 2015, providing good reasons to believe the European recovery will not only last, but pick up speed.

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President Trump's recent visit generated a fair amount of concern over disagreements between the countries. Yet, from an economic perspective, the news has been inconsequential. While Europe may complain about the U.S. potentially pulling out of the Paris Climate Deal, the U.S. is the only signing country that has actually honored its commitments, mostly because of the U.S.'s market-driven rapid switch to natural gas from coal.

However, more encouragingly, issues regarding trade friction have been completely absent. Germany's economy continues to ramp up which bodes well for the continent given their historical role as the region's engine. President Trump's posturing on trade has raised concerns that future conflict could hurt both the German and U.S. economies. Germany's historical manufacturing and economic strength combined with the weakened euro have added to Germany's trade surplus with the U.S. that was already far larger than China's. And the German surplus is generally more consequential for America's economy. While low wages in China impact U.S. workers to some degree, most of their labor is unskilled. By contrast, Germany's industries and exports are much more similar to the U.S. and workers between the two countries are more natural competitors.

The lack of attention to a key issue that President Trump had threatened to pursue serves both the U.S. and Europe's best economic interests through avoiding a potential costly and damaging trade spat. European equity markets remain fairly inexpensive, and likely offer investors interesting potential, particularly if the euro continues to recover some of its lost value.

Overall, U.S. corporate earnings and the underlying economy remain solid and well-positioned to potentially extend the already long-lived bull market run. Yet, while much news continues to be positive, current equity valuations remain in or near the upper quartile, historically. Good news may continue propelling stocks ever higher, but with high expectations already built into U.S. equity prices, investors are likely wise to temper expectations regarding future market strength.