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Consumers leverage against the 2008 recession ...

Household debt lowest in 40 years

Progress in regulatory areas could launch the U.S. into much stronger growth.

By Daniel Wildermuth

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In the last few days of April, strong earnings reports from multiple companies drove stocks back up to late February highs after a mild pullback in March and April. The recent bounce up in U.S. equities came in spite of weak first quarter growth that averaged just 0.7 percent annualized, the weakest quarterly expansion since early 2014. Mixed economic signals and President Trump's challenges in moving his agenda forward have checked the market run-up for now. Against this backdrop, market and economic fundamentals will more likely return to the forefront in driving market levels both here and abroad.

Over the past several weeks, I have had the good fortune to attend a couple of large industry conferences focused on pension funds, large college endowments, and ultra-high net worth individuals. In addition to the general sessions, the event enabled me to interview around 30 different management companies across various investment sectors and specializations. Many of the comments below draw from their various insights.

First, the bad news. By nearly any measure, U.S. equity market valuations easily place in the top quartile historically, making stocks somewhat expensive. Today's valuations suggest a total market return over the next decade of only around six percent. Investor sentiment has also turned fairly positive. While this would seem to be great for markets, it is nearly always the opposite, because less money is sitting on the sidelines. When investor sentiment is this high, the ensuing 12-month market returns tend to average somewhere around one percent.

Government debt has reached about 80 percent of GDP and continues to grow. Debt levels have only been higher during WWII, when we were a much younger nation facing fewer liabilities tied to entitlement programs. As interest rates rise our interest payments on debt will also increase eating a larger share of the budget.

Our tax structure is archaic, burdening corporate America with the highest tax rate in the developed world. The 2017 Heritage Index of Economic Freedom dropped the U.S. again this year to a ranking of 17 behind not only obvious leaders such as Hong Kong, Singapore and Switzerland, but also behind seemingly less developed nations such as Estonia, Taiwan, Chile, Georgia, and Lithuania. We have dropped over 10 spots in the last eight years, largely due to increased regulation.

But, much good news and potential remain. Falling economic freedom is a failure of government, and as messy as our is, the U.S. has demonstrated it can make positive changes when motivated. Progress in tax and regulatory areas could launch the U.S. into much stronger growth, and hopes for progress in these areas have been the primary driver of post-election market returns.

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As global economies pick up, China remains the strong growth story

Household debt is the lowest it has been in 40 years. As consumers have been deleveraging since the 2008 recession, their lack of spending has been a consistent drag on growth. The reduction in gas prices has been repeatedly projected to increase spending, but instead, consumers saved their cash, resulting in a much healthier consumer which will eventually benefit the economy.

Housing is stable across the country and homes are selling quickly, enabling the U.S. population to return to its more mobile tendencies.

Unemployment is low, and long-term unemployed are finally returning to the workforce. In addition, the Millennials (*born between 1982 - 2004*) are coming of age, and they represent the largest generation in U.S. history. They will spend and start to more significantly offset the retiring of the Baby Boomers (*born between 1946 - 1964*).

Continued oil and gas development provides the U.S. an incredible economic advantage. Most countries have either economic development or carbon resources, with the really poor countries possessing neither. The U.S. has both, providing us an ongoing economic tailwind. The U.S. is also the largest free market energy producer, which results in much greater innovation and ensuing benefits.

Recession indicators remain positive. While numerous issues can warn of recessions, historically, recessions actually occur when manufacturing and goods inventory expectations tilt out of balance. There is no indication this is happening and manufacturing remains stable and steady.

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Bond markets also provide another relative plus for equity markets. Since investment-grade bond returns are generally expected to average around zero during the next decade, equity markets still likely present a more desirable opportunity, even if expectations are relatively low.

Opportunities may be better outside the U.S. In Europe and many emerging equity-market economies, the post-2008 recovery has been much more muted. In the last decade, emerging market stock returns have been near zero, and foreign developed markets as a whole have delivered only very small single digit returns. As a result, equity valuations remain lower than in the U.S.

A significant contributor to poor returns for international markets has been the strengthening U.S. dollar. Emerging markets in particularly have struggled as their currencies moved from about 50 percent overvalued a decade ago to about 50 percent undervalued today. Currencies, and markets, generally revert back to their averages offering the potential for stronger relative returns.

Global growth is picking up. Lending is rising in Europe, which normally translates into growing demand, and unemployment is moving down. China remains the strong global growth story. Their economy is transitioning rapidly out of a debt-driven, low-cost manufacturing, high-export economy to a modern economy tied to consumers and financial services. The transition is going quite well, and should have a long way to run. Asia Pacific growth is also returning which will further spur Chinese growth and the international recovery.

Lastly, central banks around the world are starting to move independently, which should cause a lessening of the high degree of correlation in equity markets that we've seen over the past several years.

Against this backdrop, the amount of return available for a given level of risk is likely lower today than it was five years ago. A portfolio strategy that recognizes the unique challenges and opportunities of today could help investors achieve better returns for a given level of risk. And foreign markets could present unique opportunities relative to U.S. stocks and bonds. Both for currencies and equity markets, regression to the mean is very powerful and very persistent. U.S. stocks still offer upside, but investors likely need to temper expectations.