Where's the Beef?

The stock market rally that sprung from the election of Donald Trump as our 45th President continued through the first quarter of '17 as the Dow Jones Industrial Average, S&P 500 and NASDAQ Composite respectively rose by 4.56%, 5.53% and 9.82%.

In our January 2017 Market Outlook, we established 2,500 as a reasonable year-end target for the S&P 500. By March 1st, this bellwether index had already reached 2,395, just 4% shy of our full year prediction! Having accelerated so close to our target in such a short period, bargain opportunities are much harder to find and we are more hopeful for an inevitable corrective pause that might refresh this persistent advance. Since reaching the 2,395 plateau, stocks have drifted only marginally lower as investors continue to opportunistically buy on even the slightest pullback.

With the market exhibiting such strength thus far into 2017, it begs the question whether improving fundamentals warrant such strength or whether an overly optimistic market may be getting ahead of itself. Before exploring potential signs of emerging euphoria, let's examine the extent to which fundamentals may have changed.

After raising rates in March for only the third time since the Great Recession by 0.25% to a range between 0.75% and 1.00% , the Fed remains on course for two additional quarter-point hikes this year. While the "reflation" argument that accompanied the "Trump Rally" led many analysts to predict a faster pace of rate hikes from a more hawkish Fed, the March dissent from Minneapolis Fed President Neal Kashkari served as a noticeable reminder of the Fed's more dovish DNA.

The Kashkari justification for the dissent is that labor markets still show signs of slack and inflation has only recently reached the Fed's 2% target. Indeed, with 30,000 brick-and-mortar retail jobs lost in March on the heels of 30,900 lost in February, the addition of only 98,000 total new jobs in March was the slowest pace in over a year. Further, Kashkari would prefer that the Fed clearly signal its intentions for the potential unwinding of its massive $4.5 trillion balance sheet before commencing with more traditional federal fund rate policy tools. Kashkari's dissent notwithstanding, Fed Chair Janet Yellen very recently told an audience at the University of Michigan that the Fed's benchmark short-term interest rate will continue to gradually move closer to long-term averages. Yellen's remarks implied that the days of easy monetary policy to stimulate economic "oomph" are passing and Fed policy is on track to achieve economic cruise control, a pace that allows the economy to "coast and remain on an even keel".

In spite of (or perhaps because of) the Fed's clearly telegraphed "dot plot", investors are acquiring record sums of newly issued bonds. Investment grade U.S. companies issued a new quarterly high $414.5 billion of debt during the first quarter. Emerging market companies and governments similarly sold a record $178.5 billion of dollar-denominated debt in the first three months of 2017. Meanwhile, the $79.6 billion of newly issued junk bonds doubled the level from last year's first quarter. And while the knee-jerk reflation Trump trade coincided with an immediate $40 billion exodus from bond funds, investors have returned to the market en masse with more than $112 billion of bond fund inflows from the end of December through the beginning of April.

After twice reaching the 2.60% threshold since the election of Trump, the yield on the 10-year Treasury is again testing the recent low end of the recent range at 2.30%. In the wake of the Fed's March move to increase rates as intermediate and long-term yields again move lower, a potential flattening of the yield curve bears watching. A sharp move back below the 2.30% floor would leave market participants wondering whether the bond market may be hinting at potential recession ahead. While the most recent economic data does not appear consistent with any imminent recession, we are always humbled by what the market may be trying to tell us.

In light of the Trump administration's inability to *immediately* deliver on its promises to replace Obamacare and reform the tax code, the downshift in interest rates may simply signal growing resignation to the fading potential for any immediate economic boost from fiscal reform. In any case, the move back to the low end of the range for the benchmark 10-year Treasury yield is indicative of how difficult it will be for bond yields to move materially higher in a world where U.S. economic growth will be challenged by unfavorable demographics and the burdens of our staggering federal debt. In addition, as referenced above, strong global demand for yield continues to keep a tight lid on higher rates. (Please read our recent white paper for a detailed analysis.)

While interest rates have remained range bound for the first few months of 2017 and essentially followed script, Trump's much ballyhooed tax reform has thus far failed to materialize, leaving investors to ponder whether the Trump rally can continue without enactment of the Trump policies that catalyzed the rally in the first place. With a recent CNBC survey showcasing a disappointing 39% approval rating for President Trump, how long can the Trump rally chug along without Trump? Today's Trump rally reminds us of the infamous 1984 Wendy's hamburger ad campaign…"where's the beef?"

Consensus forecast for 1st quarter GDP at 1.9% is actually below the 2.1% GDP observed during the final quarter of President Obama's administration. Meanwhile, the consensus S&P earnings estimate for 2017 has also come down, albeit slightly, from $132.61 to $130.86. To arrive at this annual consensus from the $29.44 first quarter base, earnings are expected to grow 5% quarter-over-quarter, arriving at $35.43 in the fourth quarter for an annualized quarterly growth rate of 20%. This may prove a tall order to fill with Fed policy less accommodative, GDP stagnant, and Trump fiscal initiatives in limbo.

At first blush, with the S&P 500 presently trading at 2,345, today's full year forward PE multiple at 18x does not appear overly extended. That said, there are pockets of emerging exuberance that warrant attention. Consider the following:

- The same CNBC survey referenced above reveals that a record 40% of respondents expect the economy to improve in the coming year; 67% of the 40% believe the economy will improve specifically because of Trump's policies; and 47% say that now is a good time to invest in stocks, representing the most bullish sentiment for this survey since 2007.

- Tesla just surpassed Ford as the second largest U.S. automaker as measured by market cap. At approximately $47 billion, Tesla now ranks $2 billion ahead of Ford and only $4 billion behind General Motors. Ford posted 2016 annual revenue of $151.8 billion compared to $7 billion for Tesla. Ford trades at a forward PE ratio of 8x and offers an approximate 5% yield; Tesla trades a forward PE of 128 and pays no dividend.

- Margin debt climbed to $528.2 billion in February, a new all-time high. Margin debt as a percentage of GDP also hit a new all-time high.

- Market analysts are abuzz about the race between Apple, Google and Amazon to become the first company to obtain an incredible $1 trillion market cap. While Apple is the clear leader with a current market cap approximating $750 billion, analysts are rapidly raising estimates and price targets for the faster growing Amazon juggernaut. Amazon trades at a forward PE of 72x.

- The Conference Board Consumer Confidence Survey spiked in March to its highest level since 2000.
- The number of NASDAQ 100 companies making a new record high has reached a new all-time high.

With the market short of concrete improvements in fundamentals and increasingly long on budding enthusiasm, we believe the odds have increased for a pullback in equity prices. We remain optimistic that tax reform will eventually come to fruition and expect the economy to continue growing at a moderate pace for the balance of the year. Especially if bond yields remain subdued, we expect a buy-the-dip mentality to prevail and any corrective phase to be relatively short-lived. We maintain our 2,500 year-end target and welcome the opportunity any such correction might provide.