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The month's advance brought this year's gains solidly into double-digits

Stocks expected to continue to post gains

By Daniel Wildermuth

The S&P 500 posted its fourth straight monthly gain in July. The month's advance brought this year's gains solidly into double-digits at 11.59% through July and the most recent 12-month gain to a whopping 16.04%. Although the index stumbled just a bit near the end of the month, July logged several new highs bringing this year's total new records to 29. Also in July, the tech-heavy Nasdaq Composite index marked 10 consecutive daily gains, its longest streak in more than two years.

This year's gains have been accompanied by remarkably little volatility, both here and abroad. The three major stock-market benchmarks for the U.S. (S&P 500), Europe (MSCI Europe) and Asia (MSCI Asia-Pacific ex-Japan) have all avoided declines greater than 5% from recent highs. Over the past 30 years, during good and bad years, these three indexes have always lost at least 5% during the year. Another volatility measure, the Chicago Board Options Exchange Volatility Index, commonly known as the VIX, hit its lowest level since 1993 on July 26th. So far in 2017, the Dow Jones Industrial Average has experienced only ten 100-point declines, the fewest through July since 1998. With the index now at nearly 22,000, a 100-point day means far less than it did in 1998 when the index finished at just over 9,000. The market has simply been incredibly strong and calm in 2017.

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Is all this warranted? Well, maybe. Very solid corporate earnings reports for the second quarter should give large U.S. companies two consecutive quarters of double-digit year-over-year growth for the first time since 2011, according to Thomson-Reuters. Although many companies have yet to report, consensus expectations for earnings growth is 11% and a four-quarter moving average growth rate should hit 18% before moderating next year.

Wages are also increasing. For the first time since the recession, weekly pay for full-time earners in the lowest decile of the wage scale rose at a faster rate last quarter year-over-year than for any other group measured by the U.S. Labor Department. The increase for low-income workers who make about $10.75 an hour, is a sign that a tightening labor market is finally driving up pay to workers who have mostly been bypassed by payroll gains since the recession ended eight years ago. Last quarter's gain marked the first time since late 2010 that the bottom decile's earning gains were the highest.

Various other measures also remain strong including consumer sentiment, the purchasing manager's index, inflation figures, the housing market, consumer debt markets, energy prices, and so on. While economic growth has never reached levels normally associated with post-recession recoveries, particularly the strong bounce back expected after a severe downturn, the steady expansion has now reached 97 months, shorter than only two other expansions since 1900.

Much has been written about the market's recent surge partly resulting from expectations regarding tax and regulatory changes promised by the Trump administration. The lack of significant progress to date on any key policy initiatives might suggest the market is ignoring reality. This certainly could be true, but investors are also reacting to another key change. While little has been accomplished on Capitol Hill, the number of new anti-business regulatory changes and policies has dropped to essentially zero. Policy stability is nearly always extremely

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U.S. valuations help international stocks appear more favorable

good for the American economy and equity markets. Historically, nearly all market gains accrue when Congress is not in session.

International news also remains fairly positive. China's official factory gauge recorded ongoing expansion in June, although government efforts to curb financial risks caused a slight pullback. Japan's industrial output also expanded in June. Most major Asian stock markets enjoyed a strong July and ended the month solidly as well.

European stocks as measured by the MSCI EAFE index have recovered most of their June losses, putting the broad index up about 17% on the year including dividends. In a sign of economic strength and growing confidence in the region's economic prospects, the euro climbed 2.8% in the month of July through the 28th. Eurozone unemployment, which has remained stubbornly high post financial crisis, dropped to 9.1% in June, its lowest level since February 2009. Unemployment remains under 5% in the traditional European economic engines of Germany, the UK, and the Netherlands, while typical laggards such as Spain and Greece have levels exceeding 17% and 22% respectively.

Amidst mostly good news, what can go wrong? While the answer is always "plenty", probably the easiest threat to identify today is current valuations which remain elevated. Equity valuations as measured by stock prices divided by earnings are above average for every traditional category

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whether measured by company size – small, mid or large – or investment style – value versus growth. Large companies are about 20% above their 15-year averages, and some sectors such as small cap growth are much higher, at around 35% above their 15-year norm. Of course, valuations can remain elevated for extended time periods and if the growth noted above continues, earnings increases can drive valuations back down, or spur more market gains.

Higher U.S. valuations have made less richly valued international stocks appear more favorable for some time, and the relatively stronger performance of international markets in 2017 support the idea that non-U.S. markets are more attractive today. Furthermore, the broadening and strengthening global economic expansion and recovery of global trade could further increase international equity momentum.

Looking forward, we expect stocks to continue to post gains over the next 12 months, but at a more modest pace. Recent market strength driven by improved domestic and global economic activity and corporate profits should continue. If major policy changes are enacted such as tax reform, we could see a greater upward market surge, while a failure to secure changes or concerns over the Federal Reserve's attempt to reduce its balance sheet may mute future gains or cause an overdue correction. Multiple favorable trends however, ranging from corporate earnings to cautious Fed policy to increasing global GDP growth seem likely to keep markets moving forward albeit probably at a more muted pace given current market valuations.