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Bull Market Continues Despite Rich Valuation

By Daniel Wildermuth

> *...Bull market that started in March of 2009 will become the longest in history if it continues into August of this year.*

Global equity markets have launched strongly in 2018 up nearly 6% through January 30, despite a pullback in late in the month. All 45 of the top economies continue to expand, purchasing managers' indexes continue to improve, and seemingly most of the world's economic measures, outside of China, continue to accelerate.

Within the U.S., growth for the fourth quarter of 2017 slowed a bit to 2.6%, but many of the most important numbers were excellent and improved over the previous quarter. Consumer spending was up 3.8%, business investment was up 6.8%, housing was up nearly 12%, and even government spending, largely driven by states, was up 3%. A key measure of domestic demand jumped at a 4.6% rate, the quickest increase since the third quarter of 2014. Early indications for 2018 look strong with expectations for longer term GDP to average around 3%. For context, the U.S. economy has yet to hit this level of sustained growth after the 2008 recession, and it is highly unusual for growth to increase this late in an expansion cycle.

As the expansion continues, corporate capital spending should increase driven by chronic underinvestment, a reduction in regulations and a lack of new ones, strong and growing corporate profitability, and rising confidence among corporate CEOs. The recent tax cuts should further drive growth through allowing repatriation of foreign profits and immediate expensing of capital spending.

Adding to the chorus of good news coming from the corporate sector, consumer sentiment remains near post-recession highs and spending is picking up. As people experience the reality of tax cuts rather than the negative press rhetoric, the bill's popularity and spending will both likely jump.

Another driver for consumer sentiment is clearly low and decreasing unemployment which could fall to its lowest level in 50 years. As unemployment continues down, wages should continue to rise, likely at an accelerating pace. Historically, unemployment below 5% boosts wage growth up to around 4%, which has not happened yet. This is an indicator that likely bears watching. If wages start rising at accelerated rates corporate profits could be hit and with them, equity prices.

Looking at U.S. equity markets, the current bull market that started in March of 2009 will become the longest in history if it continues into August of this year. The expansion has also been very broad, especially when compared to past bull markets. More than three-quarters of stocks have rallied in the current bull market versus about half during the two previous bulls.

In addition, the market has also been incredibly calm, particularly in the more recent past. In 2017, the VIX (the Chicago Board Options Exchange Volatility Index) lodged over half of its historical lows since its introduction in 1993. It has also been well over a year since the S&P 500 declined five or even three percent, a rare phenomenon that seems unlikely to continue. Goldman Sachs warned that their risk measurement is predicting a drop of 10% to 20% in equity prices during the coming months.

Yet, even as Goldman Sachs warns of a pullback, they also advise that a pullback would present a buying opportunity because the risk of a bear market remains very low given strong, synchronized global growth. The bank's guidance on future economic growth and likely market reactions seems accurate given past history. Bull markets do not die of old age, but rather, something usually kills them.

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The most common cause of U.S. recessions in the postwar era, which trigger bear markets, has been monetary tightening by the Federal Reserve. Today, it seems very unlikely that the Fed will end the current expansion as they have been extremely sensitive to disrupting the economy. Other recessions such as the 1973 and 1979 recessions have been caused by "oil shocks" resulting from the oil embargo that rapidly drove up oil prices, and hurt businesses and consumers. This could happen again as shocks are generally unpredictable, but growing U.S. energy independence also makes this unlikely. Given today's economy, a shock, if it were to occur, would most likely result from a geopolitical event such as North Korea behaving badly.

Against this backdrop, stocks seem likely to outperform bonds again in 2018. Stocks are already up sharply on the year while bonds are firmly in negative territory down nearly 1% through January 30th. Since rates will likely rise in 2018, further pain for bond markets can be expected, while the outlook for stocks appears favorable. Assuming the pattern remains or at least does not reverse, it will mark the seventh year in a row of equity outperformance, which has not happened in nearly a century.

Internationally, the European Union's statistics agency Tuesday reported that GDP produced by the eurozone's 19 member countries was 2.5% higher in 2017 than in 2016, recording its fastest growth rate since 2007. Surprisingly, France, not Germany is leading the recent charge. Businesses are warming to French President Emmanuel Macron and his actions to make the French economy more competitive. Recent data revealed that the economy accelerated in 2017, growing 1.9% and recording its strongest year since 2011. A return to growth potentially signals an end to half a decade of French inertia that has kept unemployment close to 10% and held back the broader European recovery. Growth was powered by the largest increase in business investment in a decade which also bodes well for future growth.

Beyond France, Spain grew by 3.1% in 2017, and Italy, which has grown more slowly than the rest of the eurozone in recent years, is also showing signs of revival. The International Monetary Fund recently forecasted an increase in growth of 1.6% for Italy in 2017, up from 0.9% in 2016.

Looking forward, predicting market returns for 2018 appears to be fool's game. A preponderance of good news could push stocks even higher. Few threats to the U.S. economy seem to exist and accelerating global growth suggests continued tailwinds. Yet, current valuations, which already seem to incorporate much of the good news, suggest that markets may have already assumed that too many positive expectations will come to fruition. Today, equity markets continue to appear attractive, but investors also need to remain aware that lofty valuations present investors unique risks and future return challenges.

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