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MARKETCOMMENTARY

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Market Continues Up on Strong Domestic and International Growth

By Daniel Wildermuth

> *An economy running at full potential is using its resources efficiently.*

The long running US equity rally has notched record highs more than 180 times so far in 2017 (includes intraday highs), taking the S&P 500 up just short of 20% through late November. Very few expected the S&P 500 to reach 2600 in 2017, and amazingly, 2700 is already within reach. In mid-November, Goldman Sachs Group raised its year-end S&P 500 target to 2850, claiming that its "rational exuberance" reflects numerous positive trends and developments including expected tax reform. Various other banks and forecasters have raised their forecasts for next year including UBS Group AG and BMO Capital.

Yet, despite recent record prices, elevated forecasts for 2017 and rich current stock valuations, money managers attending Reuters Investment Outlook summit in mid-November predicted more records in 2018.

Their reasoning is straightforward and reasonably compelling. US company earnings continue to enjoy double-digits annual increases, rates rarely seen over the past five years. Gains also should be stable as they result from diverse factors including global growth, US consumer spending and increased capital spending.

Views of the money managers were further supported by updated economic numbers. On November 29th, the Congressional Budget Office reported that the US economy was running at its full potential for the first time since fourth quarter 2007. This measure compares the economy's total economic output to its potential to produce goods and services. An economy running at full potential is using its resources efficiently. By comparison, in mid-2009 at the bottom of the recession, GDP was running 6% below its maximum. GDP was also revised up for third quarter to 3.3%, its strongest annual rate in three years. Unemployment was also reported at its lowest level in 17 years.

Within the US, share values remain rich, but many argue that they are not overly high against recent economic reports and ongoing expectations for domestic and global growth. Federal Reserve governor Jerome Powell signaled in late November his intentions to follow the same monetary-policy course as his predecessor, Janet Yellin, if he is confirmed as the central bank's next leader. Short-term interest rates will likely increase in December followed by gradual raises over the next two years. Investors were also cheered by his comments that he believes current rules governing Wall Street are tough enough and focus should now shift to making the rules more efficient and less burdensome.

Globally, central banks are maintaining policies that also favor equities. Of the 45 major global economies commonly tracked, ALL 45 are growing. Expansion across the entire set of economies measured is rare, and in addition, nearly all the economies are also enjoying accelerating growth. Global economic growth has reached its strongest level since the 2008 recession, and it looks set to further strengthen.

Contributing to global growth, emerging markets earnings and profitability have notched significant recoveries over the past 18 months. Before the recent bounce back, earnings of companies within MSCI EM Index had declined 7% a year since 2011, partly because of currency devaluations versus the dollar. Yet, even with the MSCI EM valuations reaching their highest levels since 2010, they remain over 20% below developed markets valuations. Over-investment largely focused in the resource sectors combined with capacity expansion dragged down profitability from 2011 to 2015. More recently, companies have slowed investment driving increases in return on equity. Past investments combined with reduced expansion should continue to support further increases in returns on equity.

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Looking forward, emerging markets should continue to fair well. Structural reforms should boost profitability as the ease of doing business improves. Two of the largest markets, India and China are both pursuing aggressive reforms, and they have much company in other countries such as Indonesia and several Latin America countries. Synchronized global growth continues to fuel demand for products stimulating further growth given the dependence on trade by most emerging market economies. Stimulative fiscal and monetary policies should also fuel ongoing expansion.

Additional factors could also bolster markets. Globally, there is a growing "savings glut" driven by the expanding global economy. In the US and abroad, investors with capital are searching for opportunity, with seemingly more money available than great ideas. Against a growing demand for investments, fixed income offers poor prospects resulting in more dollars chasing other investments. At the same time, share buybacks and slow IPO activity has resulted in limited new supply of equities. Recent combinations of rising wealth and limited new investment opportunities has likely contributed to price gains, and the dynamic seems likely to continue.

The recent stock run-up has also seen a smaller segment of the market drive much of the advance. Through mid-November, S&P 500 growth companies, those with higher-than-average rates of earnings or sales growth, were up 23% on the year, compared with just 7.8% for so-called value stocks that post below-market valuations. The phenomenon is not uncommon during stronger economic expansions, and pricing tends to revert back to averages as growth slows, which could offer an opportunity sometime in 2018 assuming trends normalize.

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After all this positive news driven by very attractive fundamentals, a couple notes of caution seem appropriate. At least some of the recent rise in equity markets have been driven by tax reform expectations. If this initiative stumbles, markets will likely react adversely. President Trump also seems to be pursuing his war on trade and has formed an unlikely alliance with Ohio Democratic Senator, Sherrod Brown, an avowed trade opponent. If Trump's protectionist policies were to advance significantly, profits here and abroad will be impacted, likely pushing down stock prices.

Another potential problem results from investor confidence or exuberance which becomes more dangerous as it grows. Three of the largest losses since the creation of the S&P in 1957 were primarily driven by a reversal of exuberant markets without a specific trigger. Markets lost about a third in October 1987 and drops of 21% and 28% occurred respectively in 1966 and 1962. While many justify today's valuations, they remain elevated by nearly every measure. Pullbacks are simply more likely at these valuation levels because it takes less to scare investors into selling.

Still, numerous improving fundamentals here and abroad suggest that markets could continue upward. Critically, a recession is nowhere on the horizon. Since recessions serve as the usual trigger that ends a bull market, the combination of positive and improving fundamentals combined with a lack of concern regarding a significant slowdown suggest that equity markets continue to offer attractive potential in spite of their elevated prices.

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