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MARKETCOMMENTARY

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Market Appears Reasonably Positioned Despite Valuation and Challenging Politics

U.S. Companies optimistic on sales growth and capital investment value

By Daniel Wildermuth

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IT ppears that the month of March will deliver negative returns for the S&P 500 for the first time since President Trump's election victory. Disappointment over the failed Obamacare repeal combined with growing nervousness that President Trump may be unable to deliver on his economic promises, such as tax reform, caused markets to pause.

Even before the collapse of the House GOP health bill, a quarterly survey from the National Association of Business Economics, conducted in early March, showed that 70 percent of respondents believe the market has overpriced future policy developments. As always, investors can also find various reasons for concern ranging from higher than average valuations to an abnormally calm market to investor sentiment that might be a bit too optimistic.

So, how concerned should equity investors be? In the Wall Street Journal on March 29, Steven Russolillo offered an insightful analysis – of analysts. The gist is simple. Toward the end of most bull markets, investors and analysts often become overly optimistic. Confidence climbs or remains too high, forecasts are too rosy, and potential problems are ignored. The result is often very poor returns as markets correct. Fortunately for equity investors, according to this measure, comparisons to past analyst and market behavior show that this is not happening in spite of the market's enthusiasm for Trump's potential policy changes.

Earnings for the S&P 500 companies during first quarter are projected to have increased 9.1 percent over the same period from last year, according to FactSet. The numbers are impressive, returning the best performance since 2011 and the third consecutive quarter of growth. Yet, while the growth is welcome and a good sign by itself, analyst projections are potentially more interesting because they remain a solid but not overly optimistic 7.8 percent, according to data provided by Ned Davis Research Inc.

Since 1985, when the median analyst estimate remains between 3 and 14 percent, the S&P 500 has risen at an impressive 9.7 percent annualized pace, slightly exceeding its 8.6 percent annualized gain over the same time-frame. According to the same Ned Davis data, when analyst expected growth exceeds 14 percent, the S&P 500 has dropped at an ugly 2.4 percent annualized rate. Conversely, when analysts' median earnings estimates fall below 3.4 percent, the S&P 500 has averaged a whopping 14 percent annual gain. While these numbers only identify patterns, the current 7.8 percent earnings growth projection suggests a reasonable basis to believe this long-running bull market still has some life left.

Fortunately for investors, fundamental data suggests the same thing. Leaders of the largest U.S. companies continue to grow more optimistic about various measures including expected sales growth and value of capital investment and hiring, driving the Business Roundtable CEO Economic Outlook index up by the most since the fourth quarter of 2009, the be-

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U.S. Companies: Lean and Mobile Competitors

ginning of the U.S.'s emergence from recession. The recent reading of 93.3, well above a 50 which indicates economic expansion, also revealed not just a positive change, but a high level of confidence.

CEOs are not alone in their enthusiasm. U.S. consumer confidence surged to a 16-year high in March, driven by strong job gains and homes sales. Respondents to various polls continue to express their approval of President Trump's focus on helping workers in the private economy rather than focusing on social issues such as income inequality, entitlement expansion, climate stability, and environmental justice.

Much additional data supports the optimism. Increasing homebuilding, rising home sales, falling unemployment, difficulties finding qualified workers, more Americans rushing into the labor market given expanding opportunities, and climbing factory orders all signal a mostly positive direction for the economy. The goods trade deficit narrowed sharply in February, which is believed to indicate that the economy is regaining momentum after a slight misstep at the start of the year. The National Federation of Independent Business's Small Business Optimism Index rose to its highest level since 2004, although it receded slightly in February.

Looking longer-term, oil and natural gas production in America should contribute significantly to the U.S. economy, and the staunch in bloodshed as the industry has adjusted to dramatically lower oil prices has already helped corporate earnings and jobs numbers.

Around the year 2000, I attended a presentation on the potential for shale and hydraulic fracturing in the U.S., which seemed optimistic beyond belief, and yet industry development has been unfolding largely as predicted (although somewhat delayed), resulting in the fastest and largest increase in hydrocarbon production in history.

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The U.S. brings a very unique combination of entrepreneurial bravado, smaller nimbler companies, sophisticated capital markets, and innovative new technologies. The lack of stifling state control is also extremely notable given the energy sector's international domination by slow, monopolistic, politicized bureaucracies.

The recent difficult downsizing has cost the industry and countries billions in revenue and profits. Many countries have struggled horribly such as Venezuela and Nigeria. Yet, while U.S. companies have shrunk, they have also become very lean and mobile competitors, improving productivity per shale rig by more than 20 percent per year. Now, the cost to produce shale oil continues to drop rapidly and hundreds of experienced small to midsize companies respond smartly and quickly to small price changes.

While the U.S. remains a net importer of oil, net imports have declined by half, and America now exports natural gas as the world's largest natural-gas producer. Oil exports are also at the highest level in American history, twice the previous crude export peak of 1958.

The Energy Information Administration and the International Energy Agency both forecast hydrocarbon demand rising for decades regardless of alternative energy developments. A huge and growing market, ready capital, new technology, entrepreneurial opportunity, and a friendly administration should propel the U.S. energy industry into becoming a far bigger oil exporter, and possibly one of the world's largest. The industry is likely to provide a tailwind of profitability to U.S. corporate earnings while also holding down the cost of domestic energy – both highly positive longer-term trends.

More near-term, despite a small recent pullback in U.S. stocks and higher than average valuations, cautious optimism combined with seemingly reasonable expectations imply that the bull market can continue. Most of the indicators remain positive, and negative news is harder to find. The result has been a market that has not only generally moved higher, it has done so with remarkably little volatility. Problems, challenges and surprises will obviously arise, but current indicators and trends suggest that the market remains reasonably well positioned to reward investors.