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MARKET COMMENTARY

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Good News Continues, but Concerns Over Future Growth Increase

By Daniel Wildermuth

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Investors appear caught between a seemingly continuous stream of positive economic news and concerns that opposing forces such as the Federal Reserve and resource constraints will thwart ongoing economic expansion. The combination of ongoing good news and fears of future bad news have resulted in a more volatile and generally directionless market. Compared to the first three months of the year, April's market moves have been fairly muted, with the market edging up a bit near month end to put returns in positive territory.

Good news continues. The US Federal Reserve revised domestic economic growth upwards to 2.7% in 2018 from their previous 2.5% forecast. The Fed also raised 2019 GDP growth projections up to 2.4% to 2.1%. The US has been helped by a booming global economy growing at its fastest pace since 2010. According to OECD Economic Outlook, global GDP is projected to hit 3.5% in 2017 and strengthen further to 3.75% in 2018 (reported in November 2017).

In the US, robust business spending helped the economy grow moderately with weak consumer spending acting as a bit of a drag. Yet, slightly weaker consumer spending appears unlikely to continue. After hitting an 18 year high in March, consumer confidence dipped a bit in early April before rebounding quickly later in the month as reported by the Conference Board on April 24th. Consumer confidence has climbed steadily since the recession, repeatedly reaching highs over the past year. Factors driving the increase include strong job growth, a rising stock market, low interest rates, modest inflation and rising property values. Higher take-home pay resulting from the tax-cut package passed by Congress late last year has also helped.

Americans not only feel better about current economic conditions and their expectations for future growth, their confidence is usually personal. The share of Americans expecting their incomes to decline over the next six months fell to 6%, the lowest level since December 2000.

A strong economy combined with the recent market pullback has driven valuations as measured by the prices to earnings ratio (PE ratio) down sharply. After January's market run-up, recent volatility has driven prices down a bit. Yet, the bigger impact on the PE ratio results from dramatic earnings growth which is set to continue.

Even without the boost from the Trump tax cut, S&P 500 companies earnings per share are expected to rise 18% over the past year, according to Howard Silverblatt at S&P Dow Jones Indices. Historically, US corporate earnings have risen as far and as fast as they have this year only one other time. The rolling forecast for forward 12-month adjusted earnings has risen more than 11% in 2018, an acceleration surpassed only during the rebound from recession in 2009. Sales are also predicted to rise 7%, the fastest pace since 2011.

The combination of falling prices and rising earnings has driven the 12-month forward PE ratio of the S&P 500 down to 16.4 as of the market close on April 17th, off from its 16-year high of 18.6 times adjusted earnings in January. According to Thomson Reuters IBES, this puts the PE ratio back to its 2014 level, although it's still above its average since 1985. The combination of falling prices and rapidly rising earnings rarely occurs outside times of crisis such as country collapses (Greece) or major market events (Lehman Brothers collapse, Long-Term Capital Management meltdown, and the 1987 stock market crash).

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Yet, despite Wall Street's favorite valuation measure appearing to create a much more favorable investment climate, investors have hardly reacted, and the market has moved down from April's high reached on the 18th.

Investors appear to be reacting to several potential future issues. Trade wars have rattled markets and the outcome of various trade initiatives remain uncertain even if little has resulted from past Trump administration rows. Potential or threatened government action against technology companies hit the headlines several times in recent weeks. While North and South Korean leaders are hopefully negotiating peace, the prospects for real wars remain elevated.

The synchronized global recovery referenced early also appears to be hitting some rough spots. After the Eurozone output expanded by 2.3% in 2017, the strongest growth in a decade, signs of potential weakness are showing. German exports of goods were down 3.2% in February versus January, and their industrial production also fell by 1.5%. Italian industrial production decreased by 0.5% in February compared with the previous month, while manufacturing output fell in France for the second consecutive month. While a couple of weaker months, particularly during a colder than normal winter, may signify little, investors are more nervous than they have been.

Possibly most concerning for the US economy, increasing labor shortages, inflation concerns and Fed rate increase call into question our ability to continue to generate strong growth. The unemployment rate is already at a 17-year low, and it's projected to go markedly lower from today's 4.1% rate down to 3.8% by year-end 2018 and 3.6% by year-end 2019. These numbers are great for the American workforce, but can restrict future growth and profits as companies must pay more to attract talent and replace workers more willing to job-hop. Rising wages contribute to inflation which rose 2.1% on an annualized basis in January, versus expectations of 1.9%.

Incredibly low unemployment combined with rising inflation appears likely to drive the Fed to more quickly raise rates. The combination of factors have driven the CBOE Volatility Index, often referred to a Wall Street's "fear gauge", up 85% on the year and have driven investors to doubt the sustainability of the fantastic rise in earnings. Speculation is growing that analysts will lower future earnings growth projections.

Weighing all these factors, the market's pullback despite record earnings appears quite rational. Most investors seem to believe we are reaching the later stages of the current expansion, but guessing how long it will continue is always challenging. The odds of a recession in the next couple of years remains very low, which is highly relevant because recessions are the most common cause of major market declines. A lower market PE ratio likely offers investors a more attractive equity market, or at least one that should be a bit less vulnerable to severe pullbacks. This year's equity markets likely present investors a much more normal year of ups and downs along with ongoing uncertainty – and this may be calmer part of the year as November's mid-term elections should add to uncertainty.

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