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CAPITAL MANAGEMENT

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Investment Perspective

NOISY CALM

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The tweets and turmoil have continued, leading to some churning by stocks, but prices have still moved higher this year. In fact, the S&P 500 return over the past six months was about equal in magnitude to its historical average over a full year. So why the seeming disconnect between the noisy macro environment and calm equity markets? Have investors become too complacent, setting themselves up for a fall?

Fiscal flatline

The Trump administration's agenda is under threat, sidelined by a lack of focus as well as internecine feuding among Republicans. The president came into office with majorities in both chambers of Congress and a bold promise to jump-start the economy and get Americans back to work. Through tax reform, infrastructure spending, deregulation, and fairer terms of trade, growth would accelerate after a sub-par pace of recovery.

But six months after the inauguration, Republicans can point to few meaningful policy achievements. A major impediment seems to have been the decision to put health care reform at the top of the list. The GOP has gotten bogged down in its longstanding quest to repeal-replace Obamacare. Dissension in the ranks, a razor-thin majority in the Senate, as well as pushback by some constituents have turned this issue into a battleground.

House Speaker Paul Ryan first tacked towards health care to simplify the math for tax reform. Primarily by reducing Medicaid expenditures, the Republican health care plan(s) would lower future budget deficits, freeing up room to cut taxes.

Originally, party leaders envisioned an overhaul of the tax code by late summer. But comprehensive reform, while very desirable, may prove even more daunting than health care reform. Behind every deduction and credit within our overly complex tax code stands an ardent constituency willing to fight that provision's repeal. Tax reform has been relegated to the back burner, potentially pushed into 2018.

Build it and they will come

Meanwhile, the administration's $1 trillion, 10-year infrastructure program remains undefined and underfunded. The President did earmark $200 billion for infrastructure spending in his 2018 budget. But the balance of the outlays will presumably need to come from the private sector, incented by tax credits to invest in highways, bridges, and shipyards. Many observers are skeptical that private companies could (or would) shoulder that much of the load. And Democrats would prefer that the federal government take the lead role.

Our aging infrastructure represents an increasingly large unfunded liability — not unlike Medicare, Social Security, and many municipal and corporate pension plans. Few dispute the critical need to channel society's resources nor the positive return on that investment. But in the decades-long, toxic political climate in which the country has resided, the challenge will be to agree on an effective plan.

Containing uncertainty

With the ongoing gridlock in Washington, some elements of the "Trump Trade" seem to have been reversed. For instance, long-term interest rates and the dollar both initially surged after Election Day, ostensibly on an outlook for a big uptick in debt-financed economic growth. The 10-year Treasury yield jumped from 1.88% on November 8th to 2.62% in mid-March; by late June it had dropped back to 2.14%. Meanwhile, over the same period, the trade-weighted dollar wiped out all of its earlier appreciation.

Clearly, uncertainty about government policies has caused some financial market participants to reconsider their previous assumptions. The greater risk is that this sentiment harms the broad economy. *The Economic Policy Uncertainty Index,* a gauge based in part on news article text searches, is fairly elevated at the moment. A number of academic studies have demonstrated that the small business sector, a key driver of growth, tends to moderate hiring and expansion plans during such periods.

The great unwind

Monetary policy represents another question mark as the Federal Reserve sails into unchartered waters. Many investors seem to be focused on the maneuvering by the administration and Congress. In our view, upcoming central bank moves will potentially be more impactful to stock prices and interest rates than fiscal policy.

Facing the 2008 financial crisis, the Federal Reserve embarked on an unprecedented course to prop up the economy and salvage the banking system. Short-term interest rates were held near zero for years. In addition, the Fed significantly expanded its balance sheet, purchasing trillions of dollars of bonds (vastly increasing the money supply) to hold down longer-term rates and encourage risk-taking.

With the U.S. economy moving back towards full potential, the Fed has gradually changed course. The federal funds rate target was first increased ¼ of 1% in December 2015 and then again twelve months later. That pace has accelerated with two more rate increases this year. And since 2014, the Fed has reinvested the proceeds of its maturing bonds but not added net new exposure. However, the central bank has now indicated that it will slowly stop replacing bonds as they mature.

So monetary stimulus is being removed, albeit slowly. The target range for the overnight lending rate currently stands at 1.00%-1.25%, still a very low level. Importantly, Janet Yellen testified recently that Fed policymakers believe the longer-run "neutral" level of the federal funds rate will likely reset below levels that existed in past decades. Perhaps a new normal for short-term interest rates.

Profits not politics

In general, stocks have obviously shrugged off most of the political noise. This backdrop reminds us that while political events may interfere with equity markets, they are typically not game changers. Rather, stock prices ultimately reflect underlying fundamentals, particularly the profit cycle.

And though it has been tempting to focus on all the clamor from inside the Beltway, corporate earnings have indeed been staging a comeback. Moreover, the trend has gone global, beyond the shores of the United States. The International Monetary Fund expects each of the top twenty economies to expand this year, something that last occurred in 2010. Although proceeding at a modest pace, the global economic recovery has become more synchronized.

The period from early 2015 to mid-2016 had marked a rough patch for many larger companies. S&P 500 earnings dropped five consecutive quarters on a year-over-year basis. An imploding energy sector and strong dollar accounted for much of this weakness. Those headwinds have dissipated.

First quarter 2017, S&P 500 earnings surged by 15%, the fastest pace in six years. Excluding the snapback in energy, growth was still strong at 11%.

For each of the last three quarters, actual S&P 500 earnings have come in higher than forecasted. And in the most recent quarter, three-fourths of companies reported positive earnings surprises. Ned Davis Research has noted the same trend for companies in the broader MSCI All Country World Index (ACWI). Earnings strength has been broadening and in many cases improving.

How much is too much?

The profit outlook is positive so the key question is whether the good news is already baked into stock prices. By most valuation measures, U.S. stocks currently trade above their historical averages; in some cases, well above. However, considering the current environment of low inflation and interest rates, stock prices seem much more reasonably valued.

And some argue that the post-financial crisis world is one with structurally lower inflation and interest rates. Forces such as demographics (aging populations), technology, and global competition will serve to keep a lid on inflation, supporting higher multiples. Central banks may then be more accommodative than they might otherwise be.

Reversion to a new mean?

Even Jeremy Grantham, a well-regarded and disciplined "value" investor, has begun whistling a slightly different tune. The foundation of his investment philosophy involves *mean reversion,* the notion that "important financial ratios always went back to their old trend." So profit margins and price-earnings ratios that have been crushed generally recover, thus offering a buying opportunity. In contrast, high ratios are likely to come back to earth so such investments are to be avoided in Grantham's world.

But Grantham has observed that corporate profit margins seemed to reset around a higher average after 1997. He attributes this step-up to lower real interest rates and increased monopoly, political, and brand power. Price-earnings ratios have also reset around a higher average. He declines to label these new levels permanent but posits that they could persist for years.

In any event, current valuations can be sustained in the near-term with solid earnings growth. So the trend in corporate earnings will be a key driver of stock prices.

— Christopher J. Singleton, CFA, Managing Director

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