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Q2 2017 Commentary: Slow and steady is winning the race…

In 2009, the large bond investment manager, Pimco, dubbed the post great recession environment as the "new normal." The new normal was an environment in which the massive buildup of global debt over many years would restrain economic growth well into the future. It is now eight years later and the new normal has become the old normal. The US has experienced a long period of growth, but it has been slow growth, exactly as Pimco predicted. Only the hyper stimulative efforts of monetary authorities around the world have kept economies and financial assets growing. The cost of these policies is even more debt and the likelihood that long-term real growth exceeding 3.0% in the US will be very difficult to achieve.

Economic and financial conditions have been so steady that one almost has to feel pity for the financial media. It must be difficult to attract viewers when there are so few panic inducing headlines to blast us with. Since the Brexit vote more than a year ago, there has been precious little financial market volatility. In fact, the S&P 500 has not corrected by 5% since that vote last Summer. According to LPL Financial's senior market strategist, Ryan Detrick, there have only been six other periods of this length without a 5% correction since 1950. The most recent was all the way back in 1995. Though we marvel at how calm the markets have been, it is not completely baffling when we take a step back and realize how stable the economic environment has been. Economic growth has been very steady around two percent. Some quarters have been a little faster and others a little slower. Inflation has been low. With the investment backdrop being so stable, it is little wonder financial markets have been as calm as they have been.

The only real events that have roiled the market at all, is talk of monetary tightening around the world. In Europe, Mario Draghi hinted that the European Union may begin to curtail its bond buying program like the US did when it ended its quantitative easing four years ago. In the US, speculation that the Federal Reserve would begin to reduce the leverage on its balance sheet also raised investor concern. Any action that might slow down economic growth would be unfavorable for earnings growth and put pressure on stock prices. However, slow and steady has been a winning combination for the stock market. The second quarter saw the S&P 500 rise 3.1%, adding to gains in the first quarter. Long term interest rates fell modestly, despite the Federal Reserve raising short-term rates. The 10-year US Treasury note's yield fell from 2.40% to 2.30% sending the aggregate bond market index 1.4% higher for the quarter.

We are not particularly concerned that Federal Reserve policy will derail the stock market. It is abundantly clear that Janet Yellen and the Fed will move very, very slowly and deliberately toward normalizing Fed monetary policy. As long as inflation remains subdued, the Fed will be under no pressure to accelerate its timetable and disrupt the economy.

As we have expressed recently, further earnings growth will be required to take stocks higher. In 2017, so far so good. In the first quarter, the S&P 500 earnings greatly surpassed expectations growing by 15%. Second quarter earnings are expected to grow by 7%. Analysts are forecasting 8% to 12% growth in the second half of the year. The second half estimates may be aggressive unless tax cut legislation is passed. Still, growth is expected without a tax cut. We find ourselves locked into the winning combination of a steady economy, low inflation and earnings growth. Under these conditions, me maintain our favorable investment outlook.