January 15, 2018

Q4 2017 Commentary: …and the beat goes on…and the beat goes on…

It was a remarkable year for financial markets in 2017. The stock market traded persistently higher with practically no volatility. We could run through a litany of impressive market statistics but suffice it to say that stock market returns were very good, and the investment environment was as stable any other one-year period in the last hundred. We have now gone an unprecedented 300 plus days without the stock market retreating by even 3.0%. The S&P 500 gained 6.6% in the fourth quarter, rising in each of the three months in the quarter. In fact, the S&P 500 posted gains in every month of the year, the first time that has ever happened going back to the large cap index's inception in the 1920's. Bond returns suffered in the quarter from rising interest rates, yet the Barclays Aggregate Bond Market index still managed a 0.4% return.

It was a simple formula that led to the 2017 returns. The resumption of earnings growth and a stable interest rate environment fueled the stock market. After more than a year of stagnant earnings, going back to 2015, growth resumed in 2017. The S&P 500 companies increased their cumulative earnings by more than 10% for the year and fourth quarter earnings, being reported now, are on track for another quarter of double digit growth. The US economy has been growing at a rate above 3.0% for that last few quarters. In addition, the global economy is growing across the board. In 2017 every member country of the Organization of Economic Co-operation and Development (OECD) will have growing economies, the first time they all have grown in unison in ten years. More importantly, global economic growth estimates are ratcheting higher for 2018.

With economic growth increasing around the world and the US economy growing at a solid pace, we are confident US corporate earnings growth will be sustained through the year. The corporate tax cut and repatriation of corporate cash held outside the US will also provide a boost to economic activity. The tax cut is already having a major impact on stock prices in January and should continue to be beneficial through the year. Therefore, from an earnings perspective, we have every reason to be positive about the stock market in the year ahead.

How successful corporations are at growing earnings is only half of the equation for our stock market outlook. Of equal importance is how much investors are willing to pay for earnings. At this time, the S&P 500 is trading around 18x this year's expected earnings which is historically on the high side. Trading at higher multiples of earnings is justified in the low interest rate environment which has existed since 2008. However, higher interest rates may be coming, and they are probably the greatest threat to stock prices. We will be watching carefully for higher rates and factors that may lead to higher rates. One factor we will have our eye on is inflation.

Persistently low inflation has allowed the Federal Reserve to maintain a zero-rate policy that pulled the economy through the financial crisis. However, change may be coming. Commodity prices are creeping higher. Oil prices have moved above $60 per barrel. In addition, we are approaching full employment in the US and the potential for wage inflation is rising. One example of rising wages is WalMart raised wages to employees in the aftermath of the corporate tax cut. Finally, the weaker dollar will raise the cost of imported goods. Thus far, inflation has been well under the Fed's 2.0% target rate. Until inflation increases and significantly impacts interest rates, the investment environment remains positive and a major correction unlikely.