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Record Highs With A Chance of Volatility

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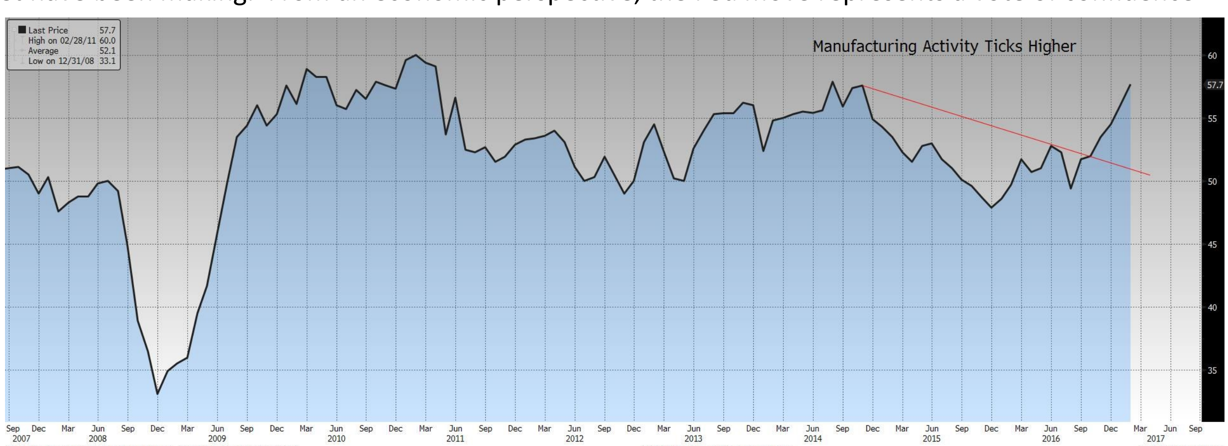
Upon initial inspection, the environment looks very similar to a year ago with the economy growing modestly, the Fed expected to raise rates a few times this year and the S&P 500 priced at around 18x calendar 2017 earnings. Let's hope not because 2016 was filled with an assortment of potholes and detours that made the journey longer and bumpier than most prognosticators expected at this time last year. Concerns about Chinese growth, the Brexit vote around midyear, and later Deutsche Bank's credit problems all weighed on global markets at various times throughout 2016. While the economy continued to perform within reason, the stock market muddled along. Lo and behold, the Fed didn't end up raising rates until December. Everyone went home happy though as the market caught some wind at its back after the election that has pushed us into the first quarter with record highs amidst still waters that haven't offered even a smidgeon of volatility.

Some have referred to the market's buoyancy as the Trump effect driven by the prospects of fiscal stimulus, tax relief and a laissez faire regulatory environment which should all have a positive impact on corporate earnings in the months ahead. These factors are powerful in and of themselves, but we think that sophisticated investors have picked up on something that the mainstream media has overlooked in part. That is a noticeable increase in global purchasing managers activity (PMI) that began in the Fall and has extended into the new year. This suggests to us that global demand is on an upswing for the moment and helps to account for the staying power of the rally in stocks. While we are still lean on many of the legislative specifics of the new administration, the underlying economic fundamentals have continued to improve. The good news for investors has not gone unnoticed by the Federal Reserve as they pushed rates higher again this month in recognition of the progress that both the economy and the market have been making. From an economic perspective, the Fed move represents a vote of confidence as inflation has nudged higher toward the Fed's 2% target rate. The rate hike also provides the Fed a bit of a hedge so that they will not get too far behind the curve on inflation should the Trump spending plan prove to be $1 trillion as advertised. While the Fed's mandate is inflation focused, it has been hard to ignore the impact of rising asset prices amidst unusually low volatility. Echoes of former Fed Chair Alan Greenspan alluding to the "irrational exuberance" of markets are not lost on the current Fed members who have to be a little concerned by the relative calm exhibited in recent months.



With that said, the market does not present the signs of speculative excess that we expect to see at major tops. Valuations are modestly above historical averages but are not excessive, leverage doesn't present significant risk as corporate managers have been more conservative than usual in their capital spending budgets, and the Fed has done a good job of nurturing the economy to grow without overheating. While we don't see the recipe for a sustained bear market on the immediate horizon, it is possible that the near term upside is becoming more limited for several reasons. First, the market has lost the tailwind of falling interest rates. As good as the last four months have been for stocks, they have not been so good for bonds as investors have revised their inflation expectations and interest rates have pushed higher. Second, near term sentiment has gotten too optimistic in part based on lofty expectations for the new administration. As these expectations are reconciled with the practical implications of shaping a legislative agenda, it would not be surprising to see some profit-taking creep back into the market. Finally, it has been almost five months since we have seen a correction in excess of 5%. This is not overly concerning to our long term projections as volatility should be low during periods when the economy is performing well, but it is unusual in terms of its duration as experience teaches us that there is no market utopia and volatility will ultimately find a catalyst to resurface. In light of the recent rally, some consolidation might increase opportunity for the rest of the year as it would foster a healthier landscape that was less vulnerable to external shocks.

Taking a longer term perspective, this is a market that can continue to grow to the degree that corporate profits do. The staying power of the bull market will hinge on two factors, the pace at which the Fed continues to move rates higher over the course of the year and the degree to which global demand can continue to gain traction. These factors will be crucial to how earnings estimates are revised as we go through the year. We have become accustomed to Fed tightening cycles where rate hikes occur in rapid succession as central bankers are determined to choke off inflation until they in fact choke off growth and trigger a market decline. In contrast, this Fed has been more measured in raising rates as inflation pressures have presented less urgency and history suggests that this is a market friendlier recipe. A resurgence in global demand is also a key ingredient in the equation. This could lead to proportionately higher interest rates across international boundaries which would keep the dollar in check and American exports more competitive. With interest rates in the 2% range, the flow of funds continues to be a powerful dynamic for stocks where you can pick up a 2% dividend and factor in some growth to get a reasonable return. This will remain true so long as the present economic momentum can be maintained. In this climate, there is room for the market to move higher, though not likely at the same pace as we have seen over the last few months, and not without the occasional interruption.