Investment Perspective

Risk premiums are shrinking, price earnings multiples are rising and confidence is improving

The U.S. stock markets are up 9% year-to-date, marching to the tune of solid fundamentals despite the noise in Washington. When the year began, there was confidence in a pro-growth agenda of lower taxes, less regulation and infrastructure spending. At the same time, there were worries about trade barriers, tighter immigration policies and Trump's mercurial behavior. Frankly, not much has happened in Washington on either front and investors seem accepting of gridlock. Not only are stock prices rising, but they are moving steadily higher without much volatility. In fact, this has been one of the least volatile periods in the last 50 years as defined by the number of days when the S&P 500 is up or down by 1% or more. In addition, the VIX volatility measure – the "fear gauge"– recently hit its lowest close in 24 years and the third lowest in its 30 year history. So why is the stock market calmly advancing to new highs? A few key reasons: economic growth is stable and balanced, employment growth is strong, capex is increasing, interest rates are low, inflation is subdued and corporate earnings are expected to grow approximately 10% annually over the next two years. In addition, risk premiums are shrinking, price earnings multiples are rising and confidence is improving. We expect the favorable environment to be sustained and look forward to more investment success ahead. A summary of index returns for the year-to-date ending June 30 is as follows:

Dow Jones Industrials	+9.4%	Russell 2500	+6.0%
MSCI EAFE	+13.8%	S&P 500	+9.3%
NASDAQ Composite	+14.7%	Wilshire 5000	+8.9%

GLOBAL ECONOMY

Europe is improving faster than expected and growth has been revised up to 1.9% for this year

World economic growth (ex. U.S.) should increase 3.8% in 2017, an acceleration from 3.4% last year. Europe is improving faster than expected and growth has been revised up to 1.9% for this year. Japan is sustaining a steady but positive 1.6% growth rate. Both regions are still battling the ill-effects of deflation and their central banks continue to stimulate aggressively. China is moderating to 6.5% growth as the country moves from infrastructure stimulus to a more diversified consumer-driven economy. China is also pushing reforms to reduce debt and mitigate the risks of an overheated real estate market. Geopolitical tensions and terrorism are risks to the global growth forecast.

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The ISM manufacturing survey and the Conference Board Consumer Confidence Index remain at robust levels indicative of broad strength

The U.S. economy is expected to grow 2.1% in 2017 after 1.6% last year. Growth accelerated in the second half of 2016, but recent economic conditions are mixed. First quarter growth was 1.4% – continuing a recent trend of weak first quarters – but the second quarter is forecast to rebound to 2.5-3.0%. Consumer spending also slowed in the first quarter due to a combination of weaker auto and retail sales, but should pick up to 3% in the next few quarters. In addition, nonresidential investment should strengthen and grow 4.5% reversing the lack of growth experienced in 2016. A national infrastructure policy would introduce upside to this projection. Residential investment is expected to grow at a healthy 5.3% pace – twice the pace for the whole economy. Other economic indicators such as the ISM manufacturing survey and the Conference Board Consumer Confidence Index remain at robust levels indicative of broad strength. The manufacturing survey was the strongest since June 2014 and the new orders component jumped to 63.5% – signaling a solid outlook. The employment situation remains healthy with private nonfarm payrolls growing consistently in the 2% range over the last several years. This has reduced the unemployment rate to a 17 year low and contributed to modest wage growth. This trend is likely to continue. Consumers are in the best financial shape in decades and the Conference Board Leading Economic Index (LEI) is hitting post-recession highs at levels above the 2005-2006 peak. Also, U.S. exports are recovering with leading indicators forecasting further improvement. These factors suggest consistent growth ahead in the 2-3% range.

INFLATION & MONETARY POLICY

We are in a "goldilocks" environment – not too hot, not too cold, but just right!

Monetary policy continues to transition from an extraordinarily accommodative stance toward a more neutral position. The Federal Reserve is gradually removing easy money, rather than tightening. The U.S. central bank has raised interest rates twice in 2017 and four times since December 2015. The federal funds rate is 1.25% and is likely to approach 2% in 2018. The tightening is justified by signs of full employment as the unemployment rate is 4.4%. More importantly, the Fed needs to normalize interest rate policy to restore its monetary policy tools and maintain credibility. The Fed intends to begin tapering its $4.3 trillion balance sheet in late 2017 in a measured way that will take years to normalize. This method insures an orderly wind down, but nevertheless removes a big buyer of bonds.

Most measures of U.S. inflation indicate stable trends in the near-term. We are in a "goldilocks" environment – not too hot, not too cold, but just right! Overall inflation is 1.6% and core CPI inflation (excluding food and energy) is 1.7%. The Fed's preferred inflation gauge, the core personal consumption expenditures (core PCE) price index, is up 1.5% and has been fluctuating between 1.3% and 2.1% since early 2012. The fear of U.S. deflation has subsided and a period of hyper-inflation is unlikely given lower commodity prices. For example, the market-based five-year forward inflation expectation is 1.80%. In general, subdued expectations for inflation and continued low interest rates overseas should help restrain any rise in longer-term U.S. interest rates.

CAPITAL SPENDING

At this juncture, improving confidence, better earnings growth and higher stock prices are likely to promote a period of increased capital expenditures

The U.S. is approaching a positive inflection point for capital spending. Recently, business investment spending has been below expectations, but a variety of factors suggest a meaningful upturn ahead. Generally, the growth in major economies is suffering from slow labor force growth due to changing demographics. A potential answer to an aging population is greater productivity, which can be supported by increased capital spending. It is a matter of when the upturn occurs, not if. Business investment is rebounding from an extended period of weakness caused by over-investment during the "tech boom" in the late 1990s as well as the deflationary effects of the 2008 financial crisis (i.e. no need to invest with excess capacity.) At this juncture, improving confidence, better earnings growth and higher stock prices are likely to promote a period of increased capital expenditures. There are signs of an improving trend with fixed investment increasing in the past three quarters. In addition, pro-growth policies aimed at infrastructure spending, tax-incentivized capital spending and offshore capital repatriation would augment the underlying trends. We expect a renaissance in capital spending leading to greater productivity and improving economic growth over time.

INVESTMENT OUTLOOK

We currently enjoy a perfect combination of moderate economic growth, above-average corporate earnings increases, mild inflation and low interest rates

The favorable fundamentals supporting the outlook for equites are periodically called "goldilocks" or "nirvana." We currently enjoy a perfect combination of moderate economic growth, above-average corporate earnings increases, mild inflation and low interest rates. Consider this picture: 2% GDP growth, 10% earnings growth, 1.5% inflation and 10-year Treasury yields of 2.26%. This impressive combination supports an attractive outlook for capital appreciation without the harmful side-effects of accelerating inflation or higher interest rates. When combined with rising confidence, these factors explain the recent strength in equities. We see this favorable set of fundamentals persisting with a positive market impact.

Operating earnings for the S&P 500 are expected to increase 10% in 2017 to $131 per share, the first meaningful increase in three years. Revenue growth is reaccelerating to 5-7% from a sub-par pace in recent years and operating leverage plus stock buybacks will help produce 10% earnings growth. If the corporate tax rate is reduced in line with President Trump's proposals, S&P earnings could increase an additional $5-8 in 2018. Moreover, if tax changes favor the repatriation of cash trapped in foreign jurisdictions, that may accelerate capital expenditures, dividend increases and stock buybacks. The stock market is reasonably valued at 18.7x estimated operating earnings for this year, especially considering a 10-year Treasury yield of 2.26% and core inflation of 1.5%. This multiple compares to the long-term average of 16.6x, and 20.0x during periods of low inflation and interest rates. The positive outlook for corporate earnings growth remains a key element to the favorable outlook. In our opinion, we see possible upside to both multiple expansion and earnings growth.

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From a technical perspective, the leading market indicators are favorable. The overall secular bullish trend is clearly evident in breadth and price trend indicators with new 52 week highs in the S&P 500 and the small cap Russell 2000 index. In addition, the bull market has been confirmed with new highs in the industrials and transports. However, some technical indicators suggest the possibility of buyer exhaustion and early signs of a correction. A closer inspection notes some sector rotation – from tech stocks to banks – and waning momentum. Some technicians are concerned about a distributive or topping process, but this is normal after a strong advance. At this juncture, a 5-7% correction would be healthy and help cleanse any built up excesses. However, after an average first half return in bull market years, such as in 2017, second-half returns average 9.03% and increase 85% of the time. We like those odds.

Investor confidence is rising and there is optimism that "buying the dip" is a profitable strategy. It was not long ago that the world's major central banks embarked on huge rounds of quantitative easing with the objective of pushing investors to accept more risk. At that time, a vicious cycle was gripping psychology and negativity pervaded. We are now witnessing the cycle of hope and pursuit of opportunities. The lengthening of the investment horizon and willingness to take risks is a sign of progress. We believe U.S. equities, particularly small and medium-sized growth companies, remain attractive. The resumption of above-average earnings growth with some multiple expansion should support appreciation consistent with historic trends. We believe the odds favor higher equity prices, although we may experience some unexpected turbulence. The investment risks primarily relate to complacency and valuation rather than growth.

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The key risks to the outlook include: Fed tightening during global economic weakness, a Chinese hard landing, military conflict, political dysfunction, "taper tantrum", terrorism and unexpected inflation. Additionally, the lack of action on Trump's pro-growth agenda presents a risk to business sentiment and the stock market may correct if the president's agenda lacks support.