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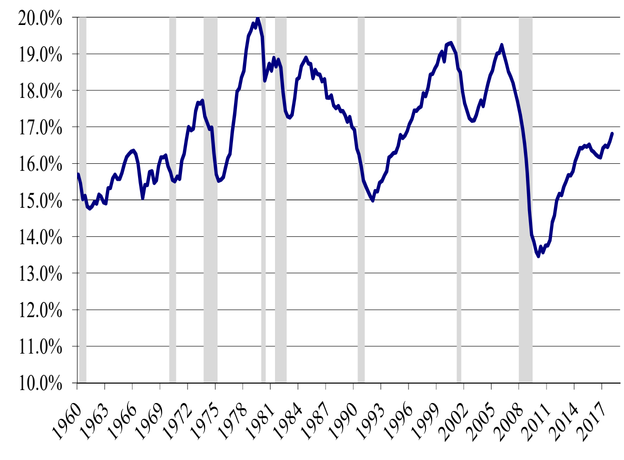
U.S. Fundamentals Improving, But Clouds Linger

The U.S. business expansion may be entering a phase of faster growth. For the 31 quarters from the end of the Great Recession in 2009 through the first quarter of 2017, real GDP growth averaged a meager 2.1%. In contrast, during the first 31 quarters after the recession that ended in 1982, growth averaged 4.3%, and in the same period after the recession that ended in 1991, growth averaged 3.7%. There is much debate in academic and business circles as to why this recovery has been comparatively slow. Some economists have pointed to slower population growth but there was no shortage of labor following the 2009 Great Recession. Other factors contributing to the slow recovery was an explosion of new regulations in recent years. Also, U.S. corporations were moving business out of the U.S. because of an uncompetitive corporate tax and capital investment has been below par. With many of these issues now addressed, real economic growth has picked up to a 2.9% rate over the past year through 1Q18. The consensus is that growth will now exceed 3.0% for all of 2018.

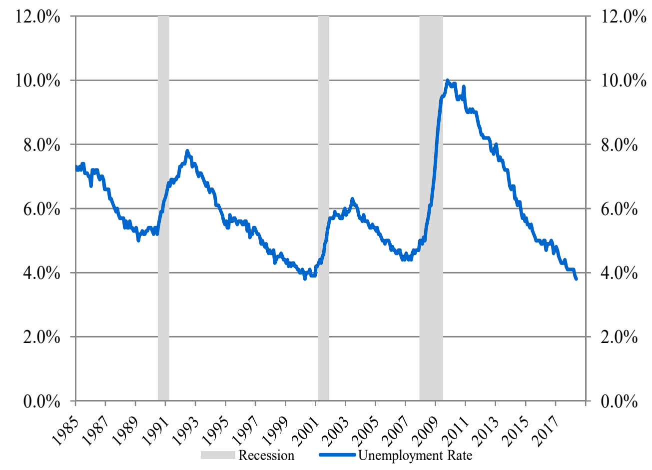
Expansion of the labor force is likely to be slow going forward and productivity will have to be the prime factor in faster economic growth. In our view, this is quite possible. Part of the recent tax legislation was to allow businesses to fully write off capital expenditures (excluding real estate) from their taxes instead of depreciating the costs over years. Already business investment has accelerated. During the first quarter of 2018, Private Nonresidential Fixed Investment was up 8.1%, year over year, versus up only 4.0% during the first quarter of 2017. Also, the reduction in that statutory tax rate from 35% to 21% itself should encourage domestic U.S. capital investment as opposed to capital moving to better opportunities overseas. A reacceleration in capital spending bodes well for productivity growth. Total Private fixed investment, which includes structures, was up 7.3% in the first quarter (see Chart 1).

Chart 1 Nonresidential Fixed Investment (as % of GDP)



Source: Federal Reserve, FVCM

Chart 2 Unemployment Rate

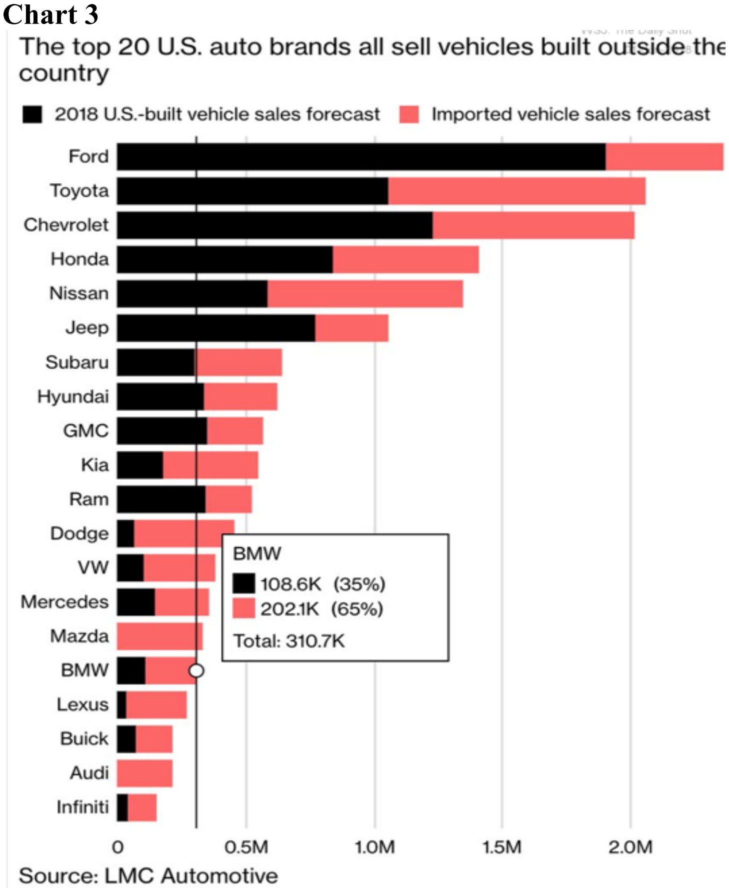


Source: Federal Reserve, FVCM

Most of Trump's economic policies have been positive, but his trade positions create a cloud over business. The ultimate effects of Trump's plan to put a general 10% tariff on aluminum, 25% on steel and at least $50 million in tariffs on various Chinese imports, is not known. Near term, this trade action could reduce U.S. GDP growth by a minimal amount--perhaps a tenth of a percentage point. But Trump is also making threats about a 25% tariff on auto imports. This makes even less sense to us. The auto industry has become so globalized that most companies build near their end markets. For example, BMW is forecasted to produce 35% of its U.S. sales within the U.S. Toyota, the second largest car seller in the U.S., makes about half of those cars in the U.S. Furthermore, if you look at imports by country, the majority come from Canada and Mexico where U.S. companies produce autos. The supply chains are even more interlinked.

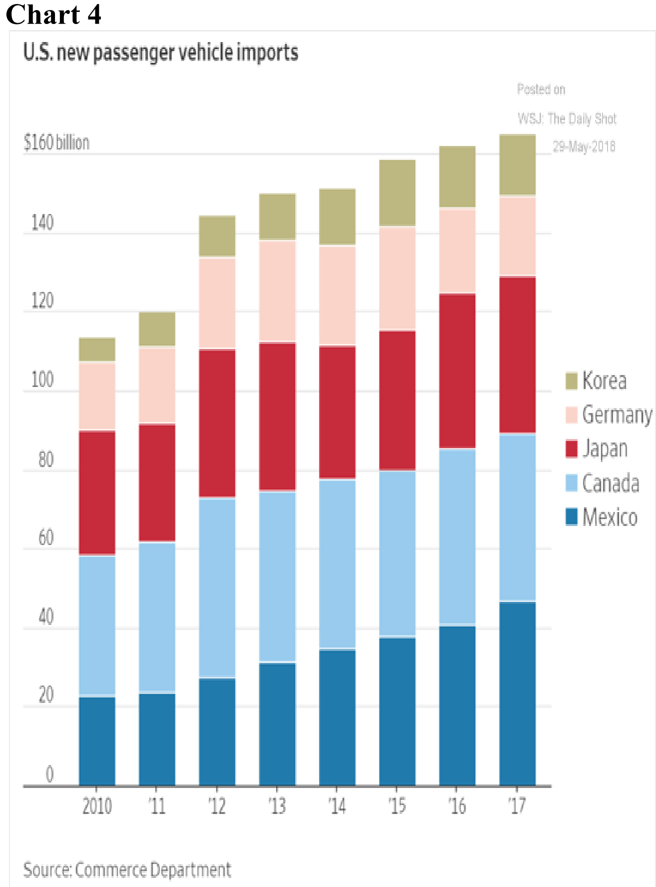
As unfortunate as these trade policies are, it is not time to hit the panic button. Trump feels secure in his threats because U.S. exports are only about 12% of GDP while the trade deficit is 3%. This is about politics. Trump ran for election promising to help "the forgotten man" who was put out of his factory job by globalization, particularly since China entered the WTO. But many here in the U.S. have pointed out that while some 150,000 people work in the steel and aluminum industries and their suppliers, more than six million people work in manufacturing industries like auto and aircraft manufacturing that use steel and aluminum. It is hoped, therefore, that the math eventually convinces the Trump team that trade is best when left as open as possible. And, whereas the trade rhetoric initially had a significant impact on volatility, the stock market lately seems to be reacting less to every turn in the trade saga. It is now virtually certain that the tariffs on aluminum and steel will hit friends and foe alike but investors seem to be expecting compromises to take place before serious damage is done.

Chart 3



Source: Wall Street Journal

Chart 4

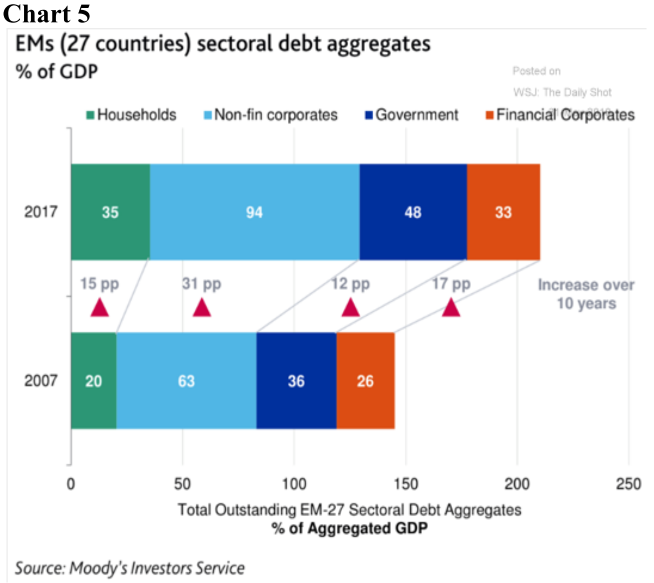


Source: Wall Street Journal

Clouds Looming from Overseas

Faster U.S. growth is, ironically, contributing to stresses in emerging markets and could create stock volatility. Because of the low 3.8% level of U.S. unemployment (Chart 2) that has come with the improvement in growth, the Federal Reserve has been tightening monetary policy by raising short term interest rates and allowing fixed income securities on its balance sheet to runoff as they mature (quantitative tightening). The Fed sees this as necessary to prevent the excesses that may lead to inflation down the road.

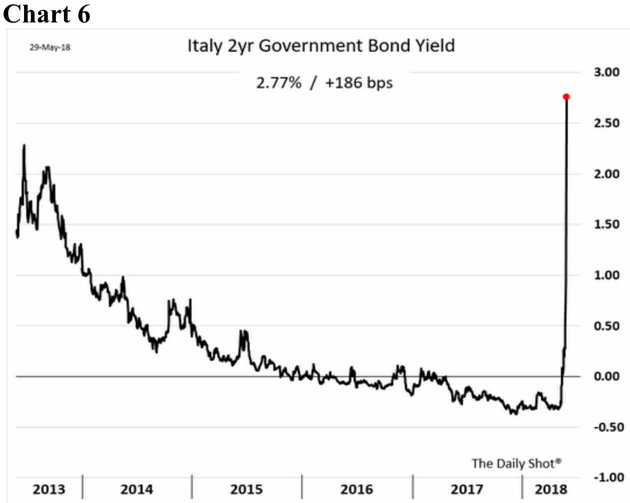
Chart 5



To a large extent, the recent spike in emerging market bond yields and declining currencies reflects indebtedness. As seen in Chart 5, Moody's has calculated that since the end of the last business cycle in 2007, debt among 27 EM countries has expanded to its current level in excess of 200% of GDP. The rise in debt has been in all sectors. What may prove to be especially problematic is that many EM countries, including China, have issued dollar denominated debt. With their currencies weakening, paying back debt issued in dollars becomes even more difficult.

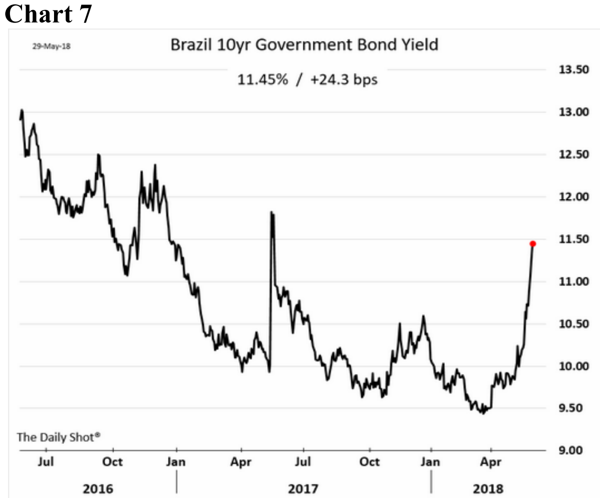
Signs of financial market stress have recently been in evidence in many places. The changed political situation in Italy has caused concern about that country seeking debt relief from the ECB or even reconsider its commitment to the Euro. While no earth shaking event is imminent, the Italian two year bond yield had its greatest one day increase in years (see chart 6). The price of credit default swaps, which operate like insurance in case of default, rose not only on Italian sovereign debt, but also Spanish, Portuguese and even German debt. And there are similar troubling patterns taking place in other places as well. The Brazilian currency has been falling and bond yields rising (Chart 7), Turkish interest rates have been rising and the currency falling (Chart 8), and almost no need to mention the collapse in the Venezuelan currency (Chart 9) as that country has entered hyper-inflation and economic catastrophe.

Chart 6



Source: Wall Street Journal

Chart 7



Source: Wall Street Journal

Chart 8 US Dollar – Turkish Lira Exchange Rate

Source: Wall Street Journal

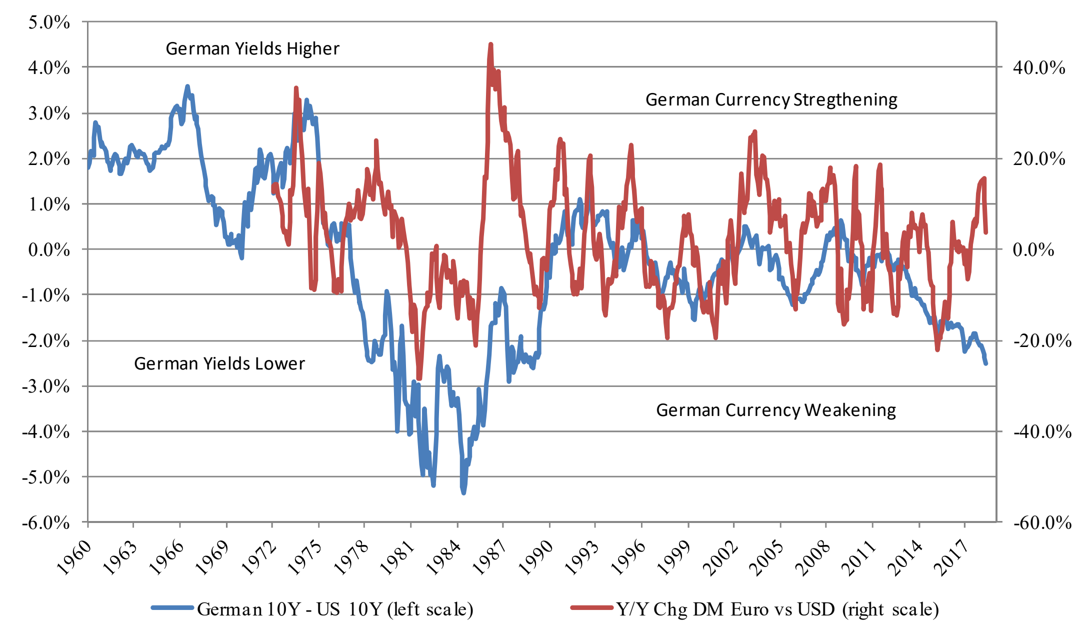
Chart 9 USD – Venezuelan Bolivar Exchange Rate

Source: Wall Street Journal

Dollar Strength Likely to Continue

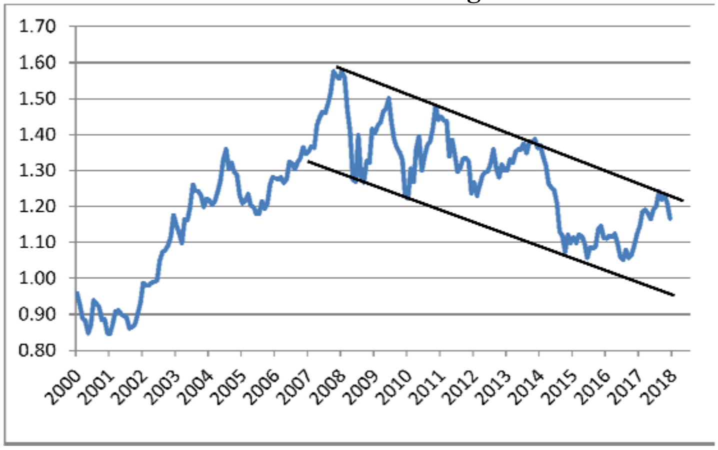
For sure the above examples reflect economic conditions specific to each country, but they also reflect fiscal and monetary policies in the U.S. which are putting upward pressure on interest rates and the dollar's foreign exchange value. We updated Chart 10 from our report in February. Since then the 10 year U.S. Treasury bond yield has been fairly stable while the yield on the 10 year German bund has fallen further. The bund is now yielding 2.5% less than the US T bond (see the blue line in the chart). But with the Euro falling to about 1.16, it is now up only about 4%, year-to-year (see the red line). Looking ahead, the relationship between the yield spread and changes in the currencies suggest that either the spread between the German bund and the U.S. bond starts to narrow, or the dollar will strengthen against the Euro because of capital flows.

Chart 10



Source: ECB, Federal Reserve, FVCM

Chart 11 Dollar – Euro Exchange Rate

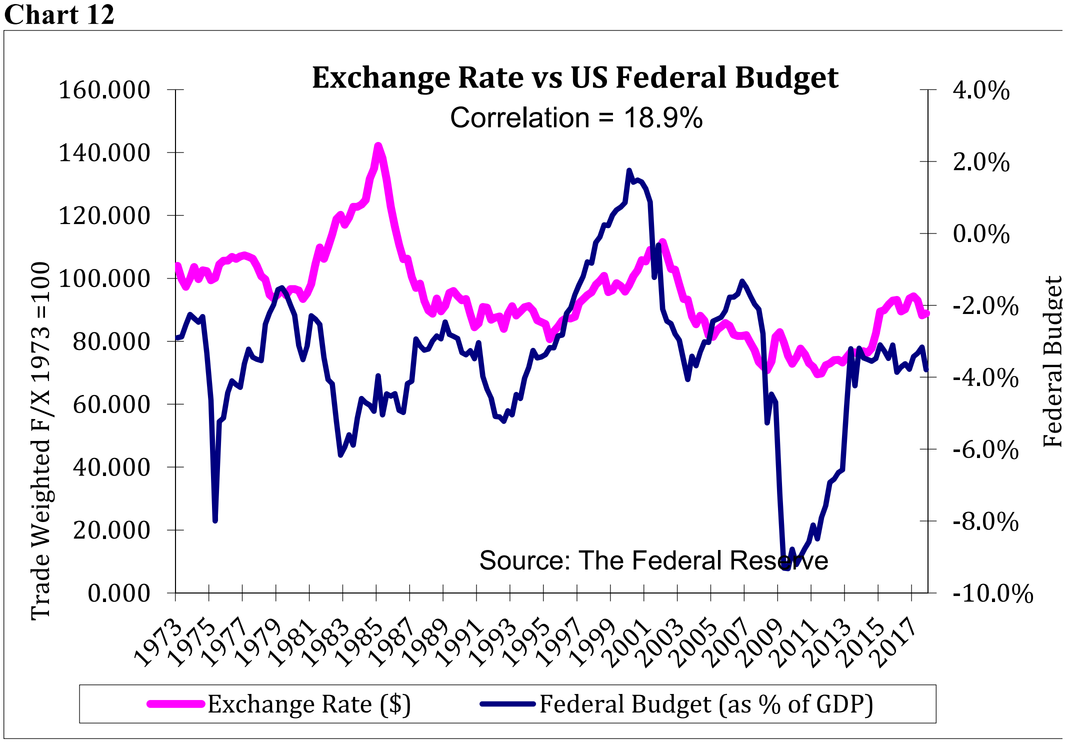


Source: Federal Reserve, WSJ, FVCM

The Euro has been in a downward trend against the dollar since 2008 and recently bounced off the top end of that channel (see Chart 11). Currencies are notoriously difficult to forecast, but given the interest rate differentials and the negative technical trend for the Euro, we would not be willing to encourage investors to wait for a stronger Euro anytime soon. The near term outlook remains negative.

One major European bank had been forecasting a weaker dollar because of wider U.S. budget deficits. We're skeptical. Firstly, the relationship between budget deficits and the dollar's F/X value is very weak with only an 18.9% correlation (see Chart 12). Second, notice that in the early 1980s, the U.S. budget deficit was nearly 6% of GDP partly due to Reagan's tax cuts and increases in defense spending. But rather than cause the dollar to weaken, the dollar strengthened as the U.S. attracted foreign capital due to high interest rates and improved growth prospects. The dollar's strength in the early '80s only ended with ***the Plaza Accord*** in 1985 when France, West Germany, Japan, the U.K. and the U.S. agreed to coordinated intervention to bring the dollar's foreign exchange value down. Those Reagan policies in the early '80s--tax cuts, more defense spending, budget deficits and reduced regulations--are being echoed today.

Chart 12



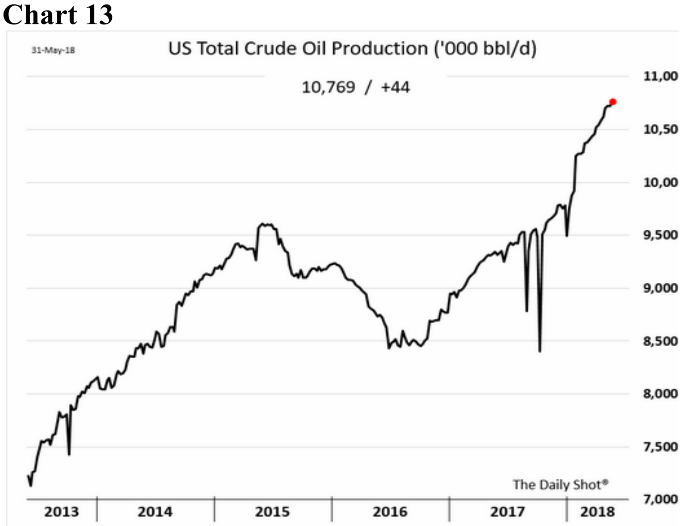
Source: Federal Reserve, FVCM

Oil Prices Rising Despite Dollar Strength

Somewhat oddly, the increasing strength in the dollar is coming at the same time that oil prices are rising. We say odd because often in the past oil prices rose in dollar term precisely because the dollar was depreciating against other major currencies. This time around, however, the rise in oil prices reflects fundamental factors specific to that commodity and not general financial/USD conditions. OPEC and Russia have reduced oil sales and there has been a decline in non-OPEC production with the notable exception of the U.S.

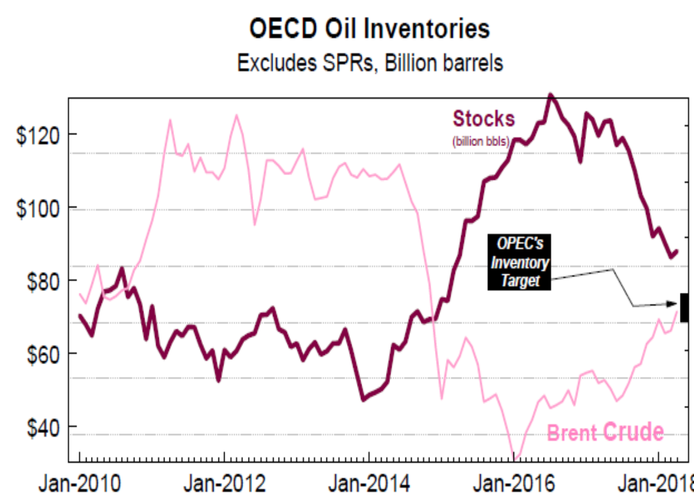
The story of surging U.S. oil production is well known, but other factors have more than offset that new supply and prices are poised to rise further. U.S. drillers have continued to find new ways of engineering their wells to increase production at lower prices. U.S. oil production is now well north of 10 million barrels per day (see Chart 13) and rivals Saudi Arabia and the states of the former Soviet Union. However, Mike Rothman at Cornerstone Analytics has pointed out that the rising U.S. production has been more than offset by growing demand, reductions in output by OPEC, and lower production by certain non-OPEC countries. As a result, inventories have been falling rapidly and crude prices, which are inversely correlated with inventories, have been rising. Just based on current supply and demand trends, it looks like inventories will continue to decline and prices will rise in the months ahead regardless of the dollar's strength. Furthermore, any type of further supply disruption, such as continued declines in Venezuelan production or an event in the Middle East, could cause an upward spike in prices.

Chart 13



Source: Wall Street Journal

Chart 14

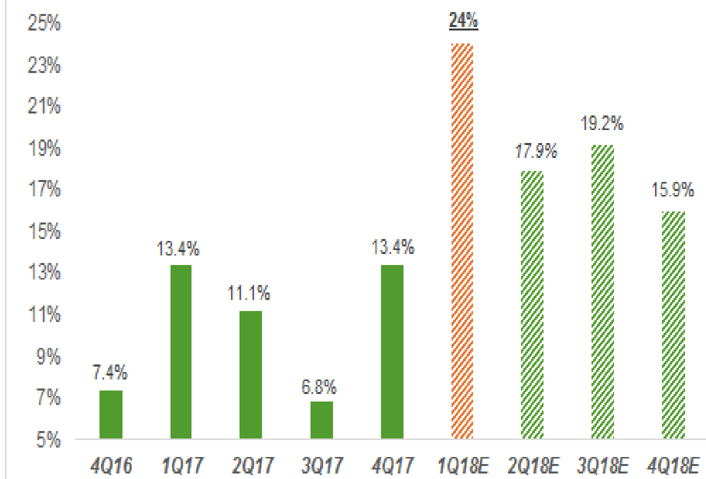


Source: Cornerstone Analytics

Equities Remain Attractive

U.S. stocks should continue to perform well in the year ahead, despite the problems noted above, because of good earnings momentum. Corporate profitability has been sharply rising and looks like it will continue expanding past 2019. Earnings for the S&P 500 were up an amazing 24% in the 2018 first quarter (see Chart 15) and further large gains are expected for the remainder of the year. Corporate profits are being boosted by the reduction in corporate tax rates, the rebound in energy earnings—up 75% from depressed levels, and a 29% increase in earnings for the technology sector. The direct impact of the corporate tax cuts will wash out in 2019, but further strong gains in profits are likely to continue thanks to the improvement in general economic growth. Our 2018 S&P 500 earnings forecast of 150.4 is 21% higher than in 2017, and we expect earnings to rise another 7% in 2019 to about 160. Our estimates may be conservative. Credit Suisse, for example, is estimating S&P 500 earnings of 158 and 170, respectively.

Chart 15 S&P 500 Earnings Growth (Year-to-Year)



Source: Zacks Investment Research

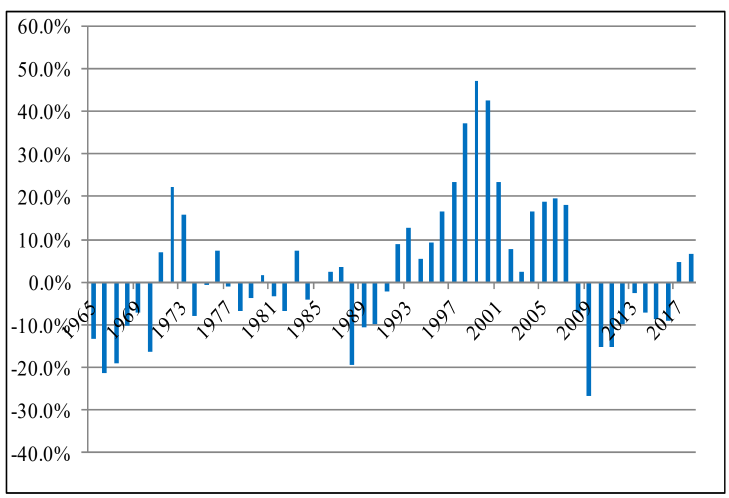
The S&P 500 is trading at 18.1 times estimated 2018 operating earnings, which is slightly above our model's fair value (see Table 1). While the valuation for the S&P 500 is full, we still expect stock prices to move higher during the year ahead. First, keep in mind that valuation is a poor predictor of near and intermediate term stock performance. For example, stocks were moderately overvalued in the mid-1990s but stock prices and valuations continued to rise sharply up until March 2000 (see Chart 16). Furthermore, even if valuations remain stable, stock prices would continue to rise as long as earnings continue to increase. And stock returns for the remainder of 2018 and 2019 may reaccelerate if valuations expand upward as they did in pervious Bull Markets. The primary driver of cyclically adjusted valuations is inflation. The recent rise in oil prices has put some upward pressure on consumer prices, but there are no signs that general inflation is about to become a significant problem. So, valuations should remain high and a big upward move in stock prices, beyond only earnings growth, is possible, especially if some of the recent clouds like trade and emerging market stresses dissipate.

Table 1 S&P 500 Valuation

Trailing 6 Year Earnings (2018)	104.80
Trailing 6 Year Inflation (%)	1.6
Actual P/E on Trailing 6 Yr. Earnings	26.0
Fair P/E on Trailing 6 Yr. Earnings	24.4
Actual S&P 500 May 25'18	**2,721**
Fair S&P500	**2,555**
% above/(below) fair value	**6.5%**
Earnings GAAP 2018(e)	135.3
Earnings Operating 2018(e)	150.4
P/E 2018 GAAP Earnings	20.1
P/E 2018 Operating Earnings	18.1

Source: FVCM

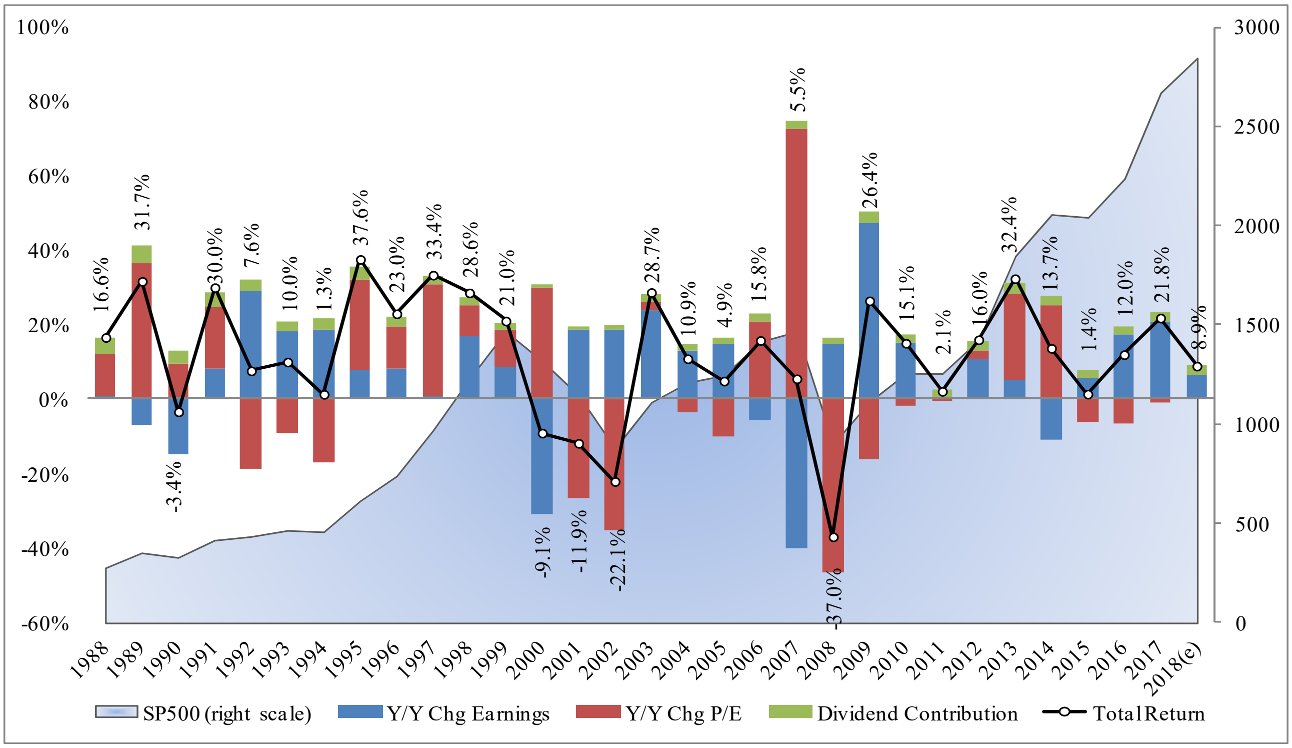
Chart 16 S&P 500 Over/Under Valued



Source: FVCM

Our base expectation is that the S&P 500 will provide a total return of about 9% in 2018 (see Chart 17 below). The chart shows the total return of the S&P 500 broken down into three components: 1) change in earnings in the *next year*; 2) change in stock valuations--forward P/E's; and 3) the contribution from cash dividends paid to shareholders. The analysis was done this way because the market looks forward when it comes to earnings. So, for example, we attribute the 21.8% total return for the S&P 500 in 2017 to the 20.8% increase in earnings *this year* (2018), a slight 1.1% contraction in the forward P/E ratio, and a 2.4% return from dividends (includes compounding effects). Now in 2018, investors are looking forward at the likelihood of more modest earnings growth in 2019. So our 2018 expectation for stock returns is about 9%, with 7% coming from estimated earnings growth in 2019, no change in P/E ratios and a 2% dividend yield.

Chart 17 **S&P 500 Return Disaggregation**



Source: FVCM, Standard & Poor's Corp.

Final Comment

Uncertainties abound, as always, but we remain Bullish on equities and will remain so until the data begins to suggest a recession is on the horizon. There has never been a time when the markets were not facing various combinations of political, social and economic instability. Now is no different. The best practice has been to discount much of this as noise and focus on the business cycle and corporate profitability. We are carrying a slightly higher than normal level of cash at this time because of the clouds noted in this report. But there is an increasing possibility that the movements in the emerging markets, as well as perhaps on the trade front, may result in the Federal Reserve scaling back plans to raise short term interest rates. We would not be surprised to see the Fed slow the tightening process by late summer or early Fall. Such a move by the Fed could be the trigger for the next big upward spike in stock prices. We are looking to invest our cash beforehand.