—New Albany—
Investment Management

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Market Insight: Political Hysteria Ignored, Markets Focus on Fundamentals

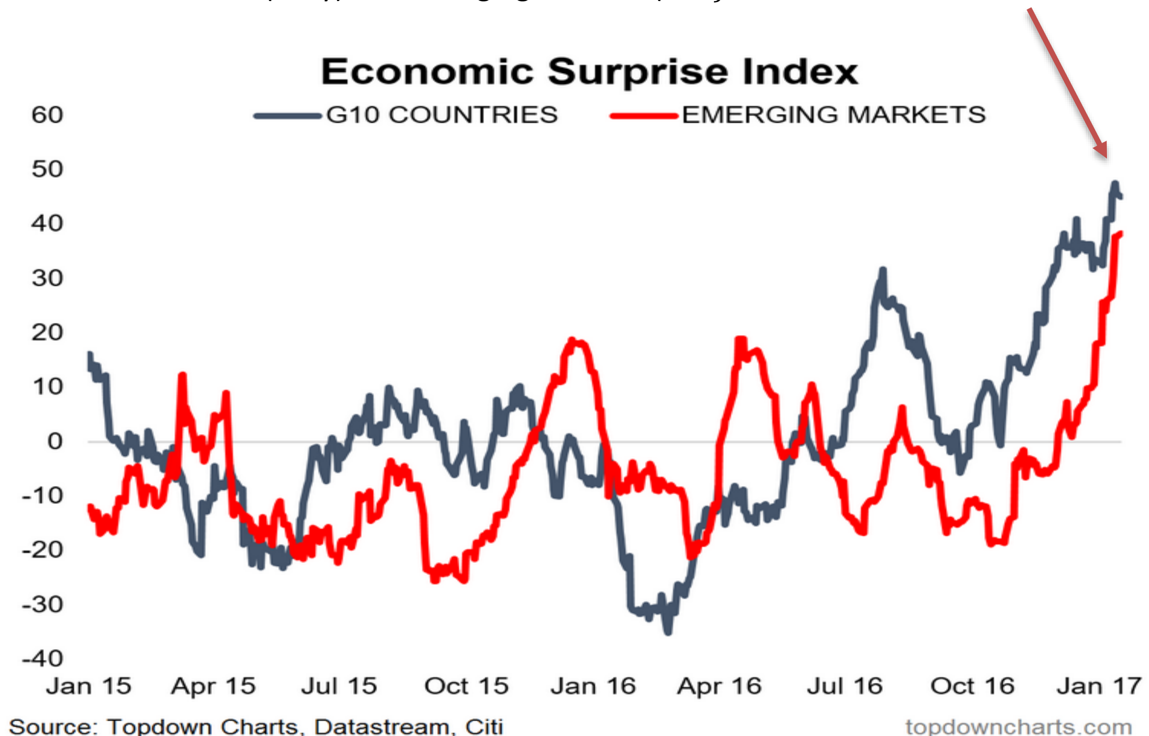
Though politics continue to grab the spotlight, the financial markets keep chugging along. The fundamentals are steadily improving: economic activity is gaining momentum and 4th quarter reported earnings were the best in two years. At the same time, consumers are more confident, investor sentiment is rising and inflation is showing only moderate acceleration. Even the Fed has changed their tune, expecting stronger growth. All of these factors have provided a very positive backdrop for the equity market with prices making new highs. Many skeptics say the market has come too far too fast and point to a list of concerns: Valuation, political unrest, 'animal spirits' surrounding the new administrations fiscal policy plans, and rising interest rates. While these are legitimate concerns, there are also legitimate reasons for the synchronized rise in global stock markets, namely strengthening fundamentals of growth and earnings.

Let's take a look at what the fundamentals are saying:

The Economy: Surprise! A broad mix of economic measures both in the US and around the globe continue to improve and indicate the global economy is gaining not losing momentum. This a stark turnaround from just six months ago when it appeared stagflation was a genuine threat.

Below are some recent economic indicators:

- **Economic Surprise Index at high end**. This is a measure of the pace at which economic indicators are coming in stronger or weaker than expected. The current high level indicates that economic indicators have been stronger and explains why the global markets have risen. The chart below shows the index for both the G10 Countries (Grey) and Emerging Markets (Red).



- **Consumer Strong**: Unemployment and delinquency rates (a good measure of consumer strength) are at pre-recession lows. Credit is expanding and existing home sales hit their highest levels in 10years.

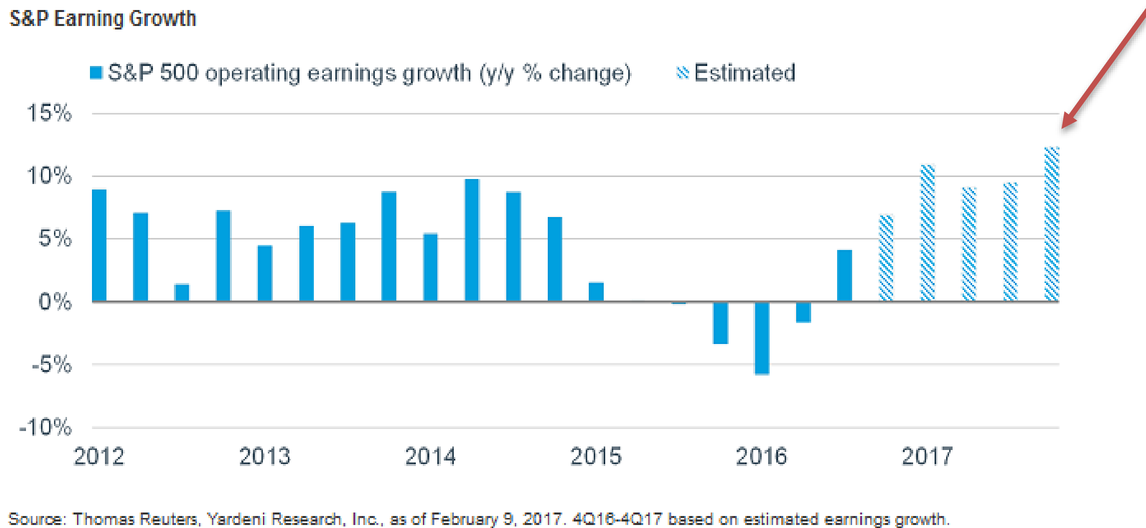
Chart of Existing Homes sales

- **US Factory Growth at two year high.**
- **Eurozone Composite Purchasing Manager Index (PMI) at six year high**. New business increased the most since April of 2011; job creation was the strongest in nine and a half years; order book growth picked up and business optimism increased while price pressures intensified.

Chart of Euro Zone PMI:

The Earnings Picture: from recession to recovery…

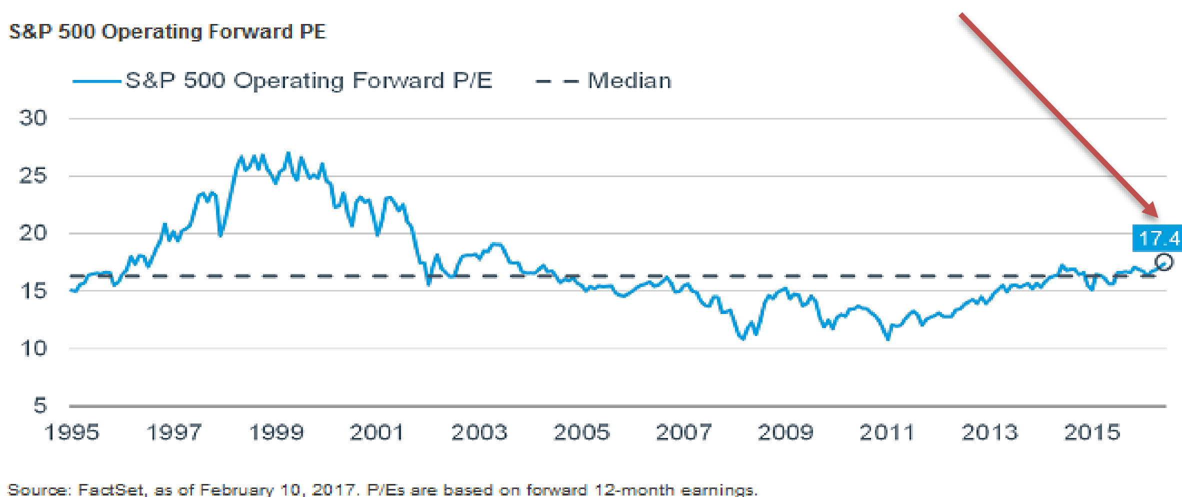
According to Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, 'earnings growth for the S&P 500 has risen over 5%. This will be the first time the S&P 500 has seen year-over-year earnings growth for two consecutive quarters since the fourth quarter of 2014. From the earnings recession—which spanned four consecutive quarters and ended in the third quarter of 2016—**earnings are expected to rebound back into double-digit territory in 2017.'** The chart below looks at the trajectory for S&P 500 earnings growth back to 2012 and includes estimates for the next four quarters.



Sonders also gave a positive caveat: 'the expected earnings trajectory highlighted above is exclusive of fiscal stimulus via some combination of tax cuts, regulatory reform and infrastructure spending. Anything on those fronts which get implemented this year would likely lead analysts to ratchet up their earnings expectations for 2017.' With the market always forward looking, confirmation of fiscal stimulus would add fuel to the current rally.

Valuation: reasonable on forward earnings…

Valuation alone has never been a reason for the market to change direction. It is the change in expectations about the future of earnings and/or the economy that causes the market to reverse course. The current forward looking S&P 500 PE is slightly above the 20-year median. Bull markets do not end at median valuations. Forces involved in bull and bear markets tend to swing these ratios wider at market troughs and peaks. Although the recent march to all-time highs has brought valuations up with it, the prospect of better earnings growth ahead has kept valuations in check.



Another way to look at valuation is with an inflation "filter". When inflation is high, interest rates are higher, and future earnings are worth less. The table below shows that we are presently in the inflation sweet for valuations.

S&P Forward Inflation Valuation

1958-2016			
Inflation	Average P/E	Highest P/E	Lowest P/E
0 – 1%	16.3	20.9	11.7
1 – 2 %	17.0	20.6	13.1
2 – 3% (We are here)	17.6	26.7	10.8
3 – 4%	16.0	20.7	10.1
4 – 5%	14.0	21.0	9.5
5 – 6%	14.9	20.2	8.2
6 – 7%	11.6	17.9	7.2
>7%	8.4	11.5	6.6

Source: Bureau of Labor Statistics, FactSet, as of December 31, 2016. Inflation is y/y % change based on core CPI. P/Es based on forward 12-month earnings.

What could derail the market: Inflation? European Elections? Fiscal Roadblocks? It would be foolish think there are no downside risks and so a degree of caution is warranted. With growth and inflation accelerating the Fed could hike rates too quickly which would push the dollar higher and pressure corporate earnings. Concerns about French elections are growing over fears that French candidate Marine Le Pen could win the presidential election and have France move off the euro. Back in the US, the details and timing of new fiscal policy initiatives have yet to be unveiled which is making many ' talking heads' skeptical and convinced the market will be disappointed. These are just some of the potential factors that could change investors' expectations about the future.

Focus on the fundamentals, not the drama. As investors, we must constantly assess all the variables and weigh the probability of these outcomes and potential market impact. But listening to the media has rarely been a good guide in predicting an outcome, especially when it comes to investing. The last twelve months has been a great example of how the consensus predictions were far off the mark because the media focused on the political drama and not the fundamentals. It is important to stay open minded, objective, and fluid in approaching the markets.

Market Shift: **The first shall be last, and the last first**. From *Fear Greed & Trader: '*The equity market is going through a transformation. Leadership in the stock market has shifted (back) toward risk-on investments and away from conservative positioning. Defensive yield oriented (Value) stocks were the place to be from late 2013 until the recent upswing that started in late 2016. During the same time, economically cyclical (Growth) stocks were the big under performers. Small caps stocks were also laggards as they underperformed their large cap counterparts by about 14%. Since the summer of last year when the economic data started to turn more positive, the companies most sensitive to the economy (Growth stocks) and small caps have been the new leaders.'

Investment Strategy: With the recent market run up, it may be time for a consolidation phase, possibly for several months. The outcome and timing of new fiscal initiatives and Fed rate moves will be hotly debated and remain center stage. As the market filters the noise, volatility could increase. Investment strategy remains broadly diversified in equities, with risk remaining the same. On the bond side, rates will likely continue to creep higher over the year, thus duration is short with exposure to investment grade and high yield corporates, and floating rate bank loans.

As always, please contact me with any questions or concerns.
Kind Regards,

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