New Albany
Investment Management

May 30, 2017

Market Insight: Resilient & Confident
Global Growth Story Continues
By Barbara Huff

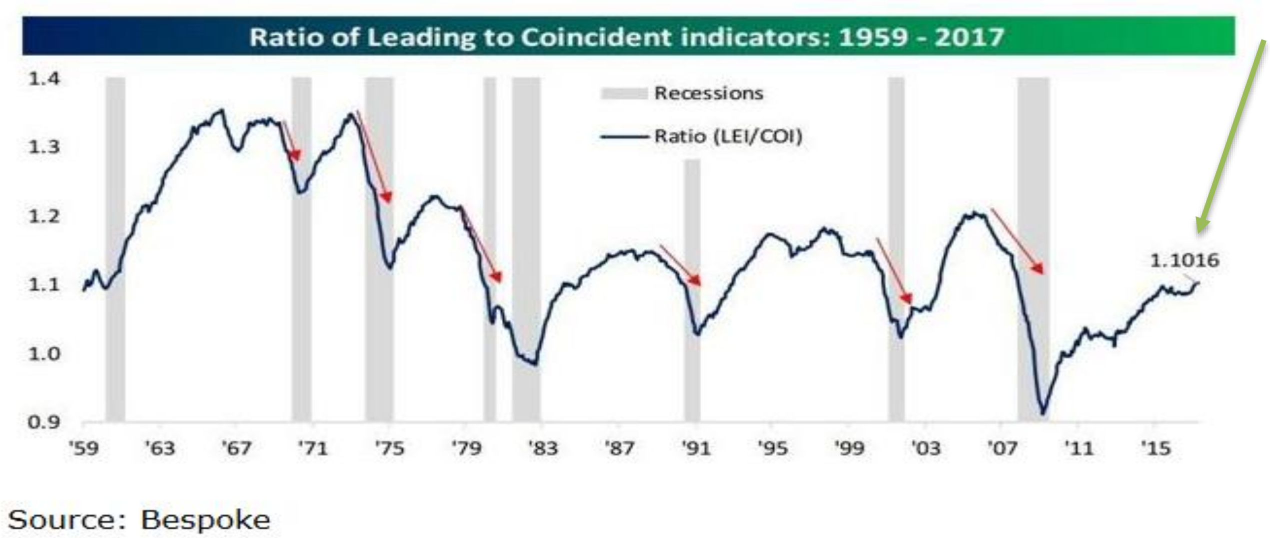
'Resilient' & 'Confident' is the best way to describe the current state of the financial markets. And with good reason, because the global growth story continues. Despite the newswire's addiction to politics and all of its ugliness, the real story, at least from an investment standpoint, is the acceleration in global growth and corporate profits. Improving fundamentals of both earnings and the economy have been the fuel for investors to be more confident and stock prices to move higher. However, many market gurus remain skeptical as their main focus is on politics and not on the improving fundamentals. But skepticism is actually healthy for the market and will keep stock prices in check with reality.

As we move into the summer months, any policy changes out of Washington are unlikely, and hence the markets will remain focused on the prospects of future earnings, confirmation of strengthening economic growth, and the Fed's transition to quantitative tightening. Below is a look at some of the key drivers:

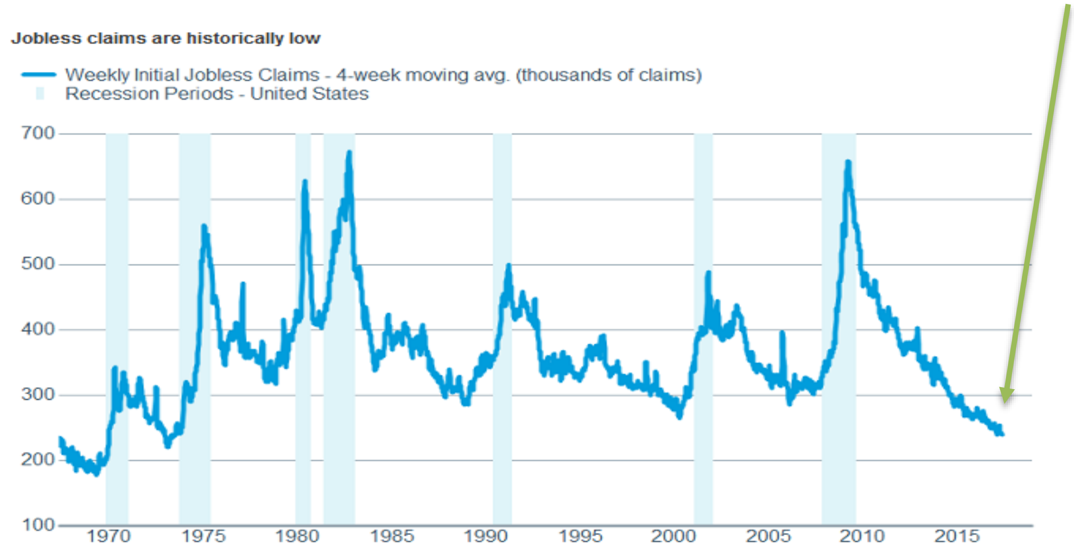
Earnings & Valuation Scoreboard Looking Strong:
According to Factset, earnings for the first quarter of 2017, showed a growth rate for the S&P 500 of 13.9%, the highest (year-over-year) earnings growth for the index since Q3 2011 (16.7%). The forward 12-month P/E ratio for the S&P 500 is 17.6. This P/E ratio is above the 5-year average (15.2) and the 10-year average (14.0).

Of Note: 1Qtr saw the highest Number of DJIA Companies Reporting Sales Growth in Europe since 2014. Eleven of the thirty companies in the DJIA provided revenue growth numbers for Europe for the first quarter. Of these eleven companies, five reported year-over-year growth in revenues and this was the highest number of Dow 30 companies to report revenue growth in Europe on a quarterly basis since Q3 2014.

The US Economy continues to show a growing economy and leading indicators are positive: The ratio of Leading to Coincident indicators, which is a good guide to near term direction of the economy, is showing its eighth straight monthly gain, a sign of continual strength. (chart below)

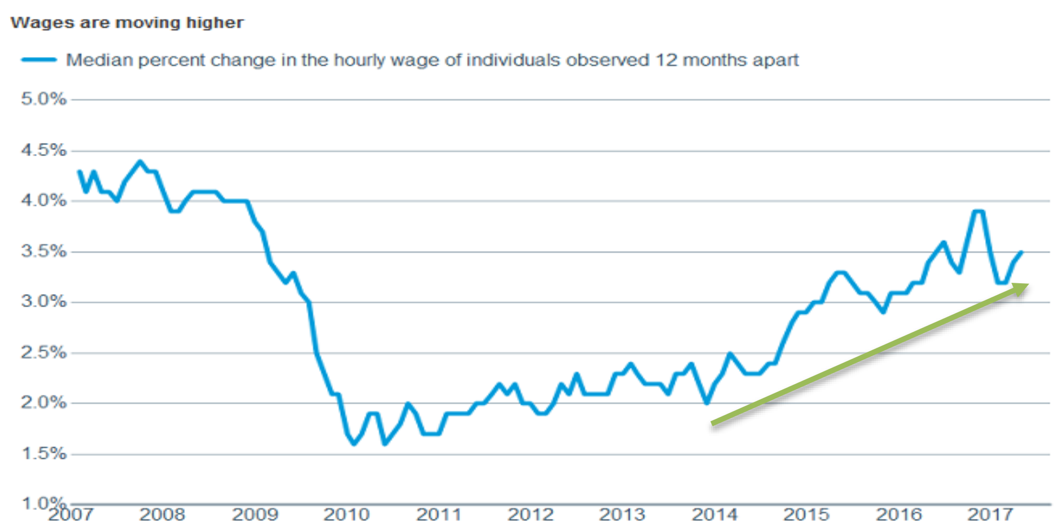


Jobless Claims are historically low: A good measure of both consumer and business confidence is initial jobless claims which are remarkably low and indicates a continued tightening labor market. Low claims has helped push the unemployment rate down to 4.4% and gives the Fed a green light to continue to raise rates.



Source: FactSet, U.S. Dept. of Labor. As of May 23, 2017.

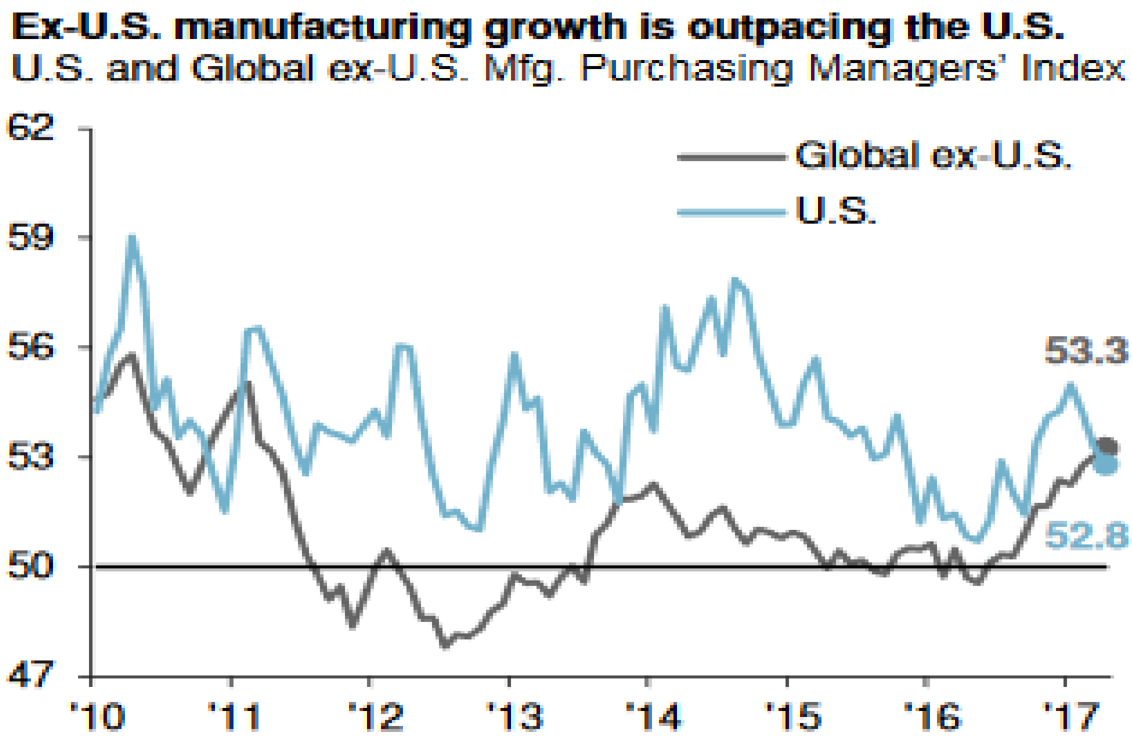
Wages are moving higher: Low jobless claims (above), combined with the historically low unemployment rate of 4.4%, is contributing to an upward trend in wages. Higher wages support consumer spending and eventually will flow into corporate profitability.



Source: FactSet, Federal Reserve Bank of Atlanta. As of May 23, 2017.

The Global Economy Ex-US is Strengthening:

According to JPMorgan: "Manufacturing activity, as measured by the Global Purchasing Managers' Index (PMI), is one of the strongest leading indicators of economic growth." Increasing activity can be seen as an economic boon, because it can indicate an increase momentum of both consumer and corporate demand for goods. The PMI can be viewed in four buckets: Global, Developed Markets, Emerging Markets and the U.S. In the chart below, the <u>ex-U.S. manufacturing PMI is at its highest level since March 2011,</u> and furthermore, **manufacturing activity outside of the U.S. is outpacing domestic activity for the first time** since October 2013. Taken together, these metrics not only point to a <u>global economy that is strengthening, but also highlight that this strengthening is occurring without such a heavy reliance on the U.S</u>. "



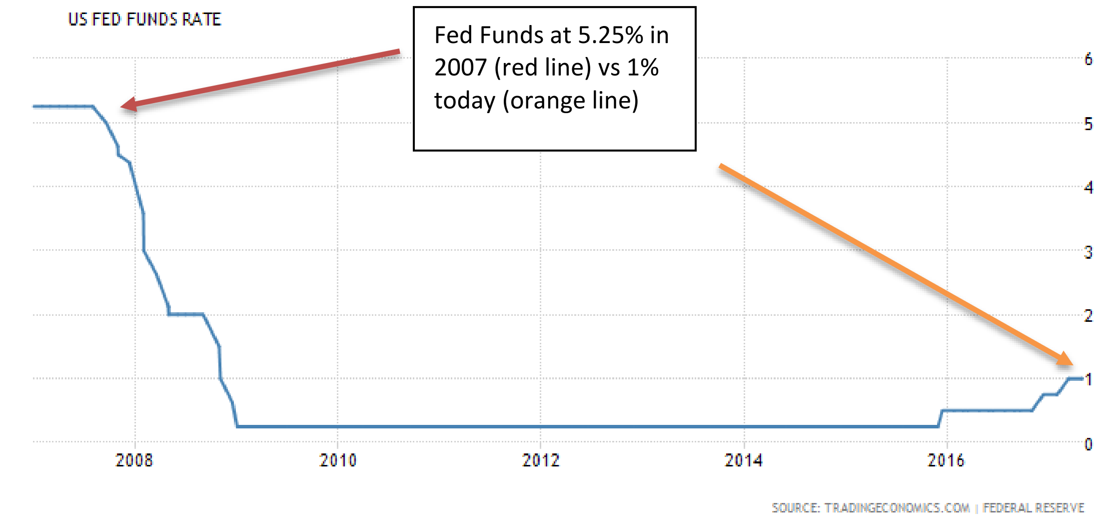
Source: JPMorgan

Federal Reserve on the Move to Normalization:

The Fed has a dual mandate—full employment and contained inflation. Today, these mandates have been met. The Unemployment rate is at 4.4% (below the Fed's target) and inflation is nearly 2%, and thus justifies the Fed moving toward policy normalization. This means **not only do short term interest rates need to continue to rise, but the $4.5 trillion of Quantitative Easing needs to be unwound.**

Rate hikes have already begun, but still have a long way to go. A June rate hike is now expected, pushing the overnight Federal Funds rate (overnight borrowing rate between banks) up another .25bpts to 1.2%. Stocks tend to perform well during the initial stages of rate hikes because it is confirming a strengthening economy. But if the economy becomes too strong, rates would have to move much higher, and could become a tipping point for stocks to change direction. The chart on the next page shows the range of rate moves in the Federal Funds rate since 2007, and how the recent hikes in the Fed Funds rate is still way below the pre-crisis level of over 5%.

Chart of the Federal Funds Rate since 2007. Current level at 1%.



From Quantitative Easing (QE) to Quantitative Tightening (QT):
The era of QE is over, and the era of QT is about to begin. We are entering uncharted waters and really no one, including the Fed, knows how the unwinding of $4.5 trillion debt position will impact the financial markets.

A look back: In the midst of the financial crisis, the Fed used its balance sheet to buy long dated Government debt. By buying up bonds, the Fed provided demand that kept government yields low. In keeping the balance sheet large, the Fed helped prevent a flood of bonds into the market that might have driven yields higher and pushed up borrowing costs. Cheap money fueled prices of financial assets prices to rise. In fact stocks surged almost in lockstep with the Fed's balance sheet growth.

The chart below show the S&P 500 (dark blue line; price on left axis) and the growth of the Fed Balance Sheet (light blue line; amount on right axis)

Now, the Fed has begun tightening by both raising short term rates, and it is planning on starting Quantitative Tightening (QT) by allowing maturing debt be absorb into the financial markets**. The unprecedented nature of this tightening cycle suggests bouts of volatility are likely.** Fed watchers have worried that the process, if not done correctly, could be disruptive and drive up rates unexpectedly.

"According to minutes released Wednesday from the Federal Open Market Committee meeting earlier this month, the central bank sees a system where it will announce cap limits on how much it will allow to roll off each month without reinvesting. Caps will be set at low levels initially then gradually raised every three months. The cap level would reach a limit that would be designed to take the balance sheet down to a certain level — perhaps around $2.5 trillion, according to some reports." (Source Charles Schwab) **As more debt returns to the public market, pressure will mount for longer term rates to rise and bond prices fall.**

In Sum: The warm months of summer will be interrupted with lots of news headlines. As an investor, it is important to stay focused on the fundamentals that drive the financial markets. At this point the economy looks solid and corporate profitability continues to improve. The process and impact of QT will continue to be assessed as we get closer to its implementation this fall.

Investment Strategy:

Stocks: Equity exposure remains at high end of each client's risk bands. Some exposure was reallocated to foreign developed markets to participate in the improving fundamentals.

Bonds: Interest Rates will likely continue to creep higher over the year in anticipation of QT. Thus duration is short with exposure to investment grade and high yield corporate bonds, and floating rate bank loans.

These are my thoughts on the current market environment and investment strategy. As always, please contact me with any questions or concerns.

Kind Regards,

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