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WEEKLY ECONOMIC COMMENTARY

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The Market Moves Ahead: Our Monthly Survey of the Economy, Interest Rates, and Markets

A long-lived Wall Street axiom is that stocks like a quiet, gridlocked Washington. The GOP has hegemony in the Congress and the White House; and Washington is anything but quiet. But stocks just keep on rocking, as we discuss below. Both in the U.S. and abroad, stocks moved nicely higher in February, building on solid January gains.

Since 1980, January-February have averaged a collective 1.1% gain. But when January and February collectively start strong, good years follow. We count 12 years between 1980 and 2016 in which January and February have collectively delivered more than 5% capital appreciation. For those 12 years, January-February capital appreciation have averaged a nifty 8.3%. And for the 12 years since 1980 in which January-February was up at least 5%, the S&P 500 has averaged full-year capital appreciation of 19.5%, much better than average annual appreciation of 9.7% over that span.

The calendar is not a predictor, but it is often a good indicator. Investors are hoping so, as they've priced a change agenda into the market, even as prospects for fiscal stimulus in 2017 begin to dim. Equity optimists continue to extract the good things they want from the Trump agenda, such as tax cuts and infrastructure spending, while tuning out the potential negatives. These include the potential negative impact of border tariffs on exports, worsening partisan positioning, and mainly the difficulty of moving forward on any single agenda item without figuring out how to pay for all of it.

THE ECONOMY, INTEREST RATES, AND EARNINGS

The preliminary 1.9% gain in 4Q16 real GDP reflected a decline from 3.5% growth in 3Q16, and capped a year in which GDP edged up just 1.6%. Although U.S. GDP was a staggering $18.9 trillion in 2016, that number unfortunately about matches the national debt.

Real GDP growth drivers in 4Q16 included contributions from personal consumption expenditures, private inventory investment, residential and non-residential fixed investment, and state and local government spending. These were offset by lower federal government spending, unfavorable imports-exports balance, and weak capital spending.

Personal consumption expenditures (PCE) increased 3.0% in 4Q, in line with the 3Q gain. Consumer spending on goods was 5.7%, but services was below 2%. The fourth quarter also marked a step-up in consumer pricing pressure, as the PCE price index was up 1.9% in 4Q16 versus 1.5% in 3Q16.

Gross private domestic investment, which captures consumer and business pending on structures, equipment and intellectual property, was up 9.2%, with nearly all of that coming from 9.6% growth in residential housing. Non-residential fixed investment, however, disappointed with just 1.3% growth, revised down from 2.0% in the advance 4Q GDP report. Capital spending was hurt by a 4.5% decline in spending on non-residential structures.

The export-import balance in 4Q16 was meaningfully worse than in 3Q16. Exports declined by 4% in 4Q after growing by 10% in the third quarter. Imports increased 8% in 4Q, after growing less than 1% in 3Q16.

Total federal government spending declined by 1.2% in 4Q16, pulled down by a 3.6% reduction in defense spending. State & local government spending increased 1.3% in 4Q16, better than the previously reported 1.0% gain.

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Those looking for silver linings in the GDP report pointed to the 5% gain in gross domestic income (GDI), which was the best growth since 3Q14. Additionally, gross national product (GNP), which is the sum of GNP plus net income from foreign investments, was up 3.4%, its best growth since 3Q14. This number signals the importance of U.S. participation in the global economy; it also underscores the risk that border tariffs could trigger a trade war.

Our outlook for GDP growth is in the 2.6% to 2.8% range for 2017. We look for growth in the 2%-4% range for personal consumption expenditures. We think positive signals on taxes and infrastructure from Washington could lead to momentum in corporate capital spending. Even with strong dollar pressures, exports are expected to swing back to positive. Based on housing price trends, residential construction should be strong this spring. Government spending is a long-term positive but tough to call in the near-term. For 2018, we are also modeling GDP growth in the 2%-3% range, with plans to provide further refinement to our estimate as 2017 progresses and we can gauge the impact of President Trump's programs on next year.

By far the biggest move in bond yields recently occurred at the short end of the curve. The three-month bill yield has moved to 0.69% as of March 6, after being at 0.44% one month ago. A month ago, relatively few investors were expecting a March hike. A year ago, the three-month yield was at 0.24%, with investors wondering if the Fed had any follow-through.

What has changed? The market now sees a high likelihood of a quarter-point hike in the fed funds and discount rates when the FOMC meets on March 15-16. Fed Chair Yellen said early in March that a rate hike is appropriate given current trends in employment and inflation. And the Fed's Stanley Fisher stated he had seen no data in the past three months that was not supportive of a rate hike.

While the swing in three-month yields has been most extreme, we have seen dramatic increases across the middle of the yield curve as well. The two-year yield is now at 1.29% and the five-year at 2.00%; both have moved up more than 10 basis points in the past month. At the upper end of the curve there has been less movement; the 10-year yield at 2.48% is little changed from a month ago. And the 30-year yield is still sitting just a few basis points above 3.0%.

Where do bond yields go from here? We expect them to move higher, but in waves punctuated by retracements. We also expect the Fed to move in fits and starts, resulting in gradual increases. The Fed has pledged an increasingly restrictive monetary policy, but will take its cues from actual data, not from a prescriptive agenda.

While our forecasts call for yields to be above current levels six months from now, retracement and stabilization over the past month, particularly at the long end, signals that investors are hedging their bets on the fixed income market.

Two months ago, we made revisions in our S&P 500 earnings estimates for 2017 and modeled preliminary earnings for 2018. Earnings for 4Q16 came in about as expected with mid-single digit growth. We look for the final accounting for 2016 earnings to reach $119.00.

Notably, 2016 marked the third consecutive year in which EPS was in the $119 range. Earnings growth slowed in the second half of 2014; was flattish for all of 2015; and only began to recover in the second half of 2016. We think earnings are set for a meaningful bounce off this three-year plateau.

Another reason to expect a big EPS recovery is that the preponderance of companies are growing earnings very well. Companies posting positive annual comparisons in 4Q16 were growing EPS an average 12%, but companies posting negative annual comparisons were declining an average 24%. As energy earnings swing to positive, and assuming the preponderance of companies already reporting double-digit growth can maintain that trend, total earnings should be positioned to grow at low-teens percentage growth rates for the next several quarters.

We are modeling 2017 EPS of $134.00, which implies 13% annual growth. Our preliminary EPS forecast of $144 for 2018 implies additional 8% growth. While 2017 earnings should benefit from the swing in the energy sector from losses to profits, we expect 2018 earnings to benefit from the effects of infrastructure spending and tax cuts.

DOMESTIC AND GLOBAL MARKETS

On average, our aggregate of major domestic indexes is up 5.5% as of the end of February, which is 230 bps better than it was at the end of January. Compared with one year ago, stocks are performing solidly. When we took our snapshot in early March 2016, the indexes were down on average by a few percentage points, after being down as much as 11% late in January and into early February 2016.

So far in 2017, less seasoned names are out in front of blue chips. The Nasdaq remains on top, followed closely by Wilshire Growth. The DJIA and the S&P 500 are deadlocked with a 6% gain.

The Lehman bond index remains fractionally positive but will be challenged to build on that slight gain, particularly if we see a new round of higher interest rates.

The winning sectors in 2016 were several wealth in the ground sectors, including energy and materials; financial services, which made a tremendous late-year sprint; industrials, which paced the gains in commodity sectors; and the odd man out, telecom services.

The surprising winner in 2017 is healthcare, which was the most avoided sector last year. Technology is also out of in front, after a middle of the pack 2016. Among last year's winners, the most conspicuous loser is energy, which is down in mid-single-digits. Another winner from 2016, telecom services, is also fractionally lower. Telecom and energy were in the top-three sectors last years, suggesting this may be normal profit-taking.

There are five sectors all up in the 6% range, suggesting that the advance in the year-to-date has been balanced. If the advance remains this balanced, that would be a positive technical sign.

Sector trends evident in January largely persisted over the past month. Technology continued to expand its share of S&P 500 market weight, adding 20 basis points in February alone. Energy continued to contract, shedding 60 basis points in February. Interestingly, this represents a round trip for energy, which had 6.6% sector weight a year ago, was at 7.2% at the end of January, and is now back around 6.6% after investors took outsized profits across February.

We have now completed our recommended sector rebalancing designed to provide insight for investing decisions across the second quarter of 2017. We have made four rebalancing changes. We raised technology to overweight from market weight, while lowering industrials to market weight from overweight. We raised REITs to market weight from underweight, and we lowered consumer discretionary to underweight from market weight.

Technology is showing clear investor momentum, topping the market over the trailing one month, three months and year to date. At the same time, average two-year-forward PES growth exceeds our broad-market estimate and sector averages. This is keeping technology sector valuations from becoming too rich, and also resulting in technology PEG ratios that are below the median for all sectors.

Industrial sector stocks are lagging the market on a near-term basis, as investors respond to strong dollar and fears of a border war. Sector EPS growth is below the market average, while two-year-forward P/Es are above the market and well above the five-year average P/E for the industrial sector.

We believe rate-hike and rising interest rate fears are now largely priced into the REIT sector, which may be able to translate higher rates into higher rent and lease rates. Real estate PEG ratios signal attractive valuation. By contrast, consumer discretionary stocks appear expensive while two-year-forward average EPS growth lags our market forecast.

Stocks have advanced broadly around the world in the past month. Our basket of international bourses is up 4.8% year to date, versus 2.7% a month ago. Among our themed sub-groups, BRIC is up 6% even though Russia is negative year to date. The Americas composite if up a steady 6%, with gains spread fairly evenly across Mexico, Canada and the U.S. aided by a strong Brazil.

Last year's leading theme was commodity; with the dollar newly strong, our commodity group lags the global average. Finally, mature economy stock markets are showing some life, with gains averaging 4.4% year to date.

CONCLUSION

If this were any other year in which the presidency changed party hands, by now investors' interest in Washington would be starting to cool. This time of year, there are plenty of economic distractions. With spring right around the corner, ramped-up spending by industrial & commercial companies and by consumers would be swinging into focus. Investors would be debating the upcoming nonfarm payrolls report. Speculation about the Fed's next move would be dominant.

That all seems like a carny show compared to the grand spectacle playing out in D.C. The President's dramatic oscillation between statesman, as he showed in his address before Congress, and provocateur, as he has lately shown with wire-tapping charges against the Obama White House, is keeping investors much more attuned to Washington than they normally would be at this time.

Stocks are overdue for a correction, and that would be true even if President Trump were as mild-seeming as President Eisenhower. We continue to see value in the stock market, and we would see slightly more value following a mid-single-digit correction. As always, we would focus on high-quality names, as those are best positioned to hold value during and after any adverse market event.

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