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WEEKLY ECONOMIC COMMENTARY

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Mid-Year Update: Earnings Growth Can Extend Market Rally

With the year just past midpoint, Argus Chief Investment Strategist Peter Canelo weighed in on the global economy, the Fed's plans, earnings growth, the stock market cycle, and valuation. In broad strokes, Peter concludes that stocks could reach peak prices sometime this year and then experience a more challenging second half.

The Fed will likely begin the process of drawing down its enormous balance sheet. Stocks are late in the cycle. On the upside, the global manufacturing slump has ended, which sets the stage for above-trend economic growth in coming quarters. While stocks appear fairly valued, they also appear to offer much better value than bonds. Given their superior growth outlook, cyclical sectors appear undervalued relative to defensive areas, which appear overbought.

STRENGTH IN THE GLOBAL ECONOMY

To calculate fair value in the stock market, we use normalized earnings, meaning a centered five-year moving average of S&P 500 operating earnings that reaches three years back and looks two years ahead. The P/E was at 12-times normalized earnings at the 2011 correction low; moved briefly to fair value in 2014; then fell back to 16-times in early 2016 at the winter correction. At recent highs above 2,400 in the S&P 500, the P/E on normalized earnings is now above 19-times. Given prevailing economic conditions, including inflation and interest rates and based on the modified Fisher model, we regard the market as approximately fairly valued at current levels.

From current levels, the market can move higher without straining its valuation. The upper end of the valuation band would be about 24-times normalized earnings, or about 25% above current levels. But for a number of reasons, mainly related to the trend in interest rates, we think stocks will struggle to reach the upper end of the valuation band. The lower end of our valuation band, at 16-times, is about 18% below; we think stocks face real though limited risks of falling to that level.

Mainly, we believe tighter monetary policy will constrain the upper end of the valuation band. The Fed may raise rates just once more during 2017, but that it not the tool it is most likely to wield this year. As the Fed begins to draw down its $4.5 trillion balance sheet, which ballooned as the central bank sought to stave off recession and rekindle growth, "quantitative tightening" could push up interest rates.

The one potential positive for the market is a firmer tone to earnings growth. Given that non-U.S. activity contributes as much as 45% of S&P 500 earnings, global growth is increasingly important to keeping EPS growth vibrant. At the same time, U.S. activity is also important. We see high correlations between S&P 500 profits growth and both the ISM manufacturing index and ISM new orders. CRB raw industrial spot and metals prices are also correlated with EPS growth, though not as strongly. And, even though the U.S. economy is driven more by services than by manufacturing, these historical correlations remain intact.

These gauges are mainly flashing "green for go" signals. CRB raw industrial spot prices have risen 28% since year-end 2015; this index does not include energy prices. CRB metals are up 58% since December 2015. Both ISM manufacturing, at 55, and ISM new orders, at 60, are near cyclical recovery highs.

The outlier in the industrial economy is energy prices, which have declined more than 20% from year-opening peak prices in the mid-$50s per barrel for WTI crude. However,

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given historical volatility, we measure an energy bear market as beginning at a 37% decline – and crude has not fallen that much. We do not see the recent drop in oil as crippling for the U.S. economy, given the recent retreat in the US dollar and strength in industrial materials indicators. Moreover, secular change – such as the rise in electrical vehicles and more fuel-efficient engines – is partly behind this trend change.

While really weak energy prices negatively impacts the oil patch and the industrial economy, cheaper energy prices are positive for a whole range of companies. The Atlanta Fed's GDPNow forecast for 2Q17 GDP is 3.1%, which would be a nice bounce from 1.4% in 1Q17. The June payrolls data was very healthy, with 222,000 job gains, upward revisions in the spring months, and 4.4% unemployment despite rising job-seekers.

The glaring number in 1Q17 GDP was personal consumption expenditures (PCE), which even at the final revision was just 1.1%. Yet that number is at odds with most measures of consumer activity, which are generally positive. While auto unit sales have backed down from peak levels, by about 4%, dollar spending on vehicles and parts is up 4.4% in the past 12 months. This reflects a shift to higher-priced vehicles as cheap gasoline has become a reality, along with rising electronic content per vehicle. Core and control retail spending are up in low-to-mid single digits, while SpendTrend same-store sales recently reached annual growth of 4.0%, up from 2.6% a year ago.

Purchasing Managers' indexes (PMIs) are solid around the world. The Eurozone manufacturing PMI recently reached 57, reflecting employment growing at its best pace in 20 years. The UK PMI was close to 57 despite Brexit implementation; and Japan is at its highest level since 2015. Emerging markets are steady despite reliance on crude prices.

**STOCKS FAIRLY VALUED,
BUT EPS GROWTH IS KEY**

A key potential impediment to the market is rising rates. Unlike in past cycles, we see the pace of rate hikes as a modest impediment. The real issue will be the historical unwinding of the Fed's $4.5 trillion balance sheet. The Fed is expected to signal its intent as to the size and pace of this program, so it will not catch investors unaware. Still, given the scope of this unwinding, it will represent a real challenge to asset markets.

The Fed certainly has further room for restrictive policy, whether rate hikes or quantitative tightening. The three-month Treasury bill, now yielding 1.0%, offers a negative 0.8% real return given the 1.8% pace of inflation in the PCE deflator. Given the current 2.25% 10-year yield, the 10-year note offers a real yield of just 1.05%. Low real yields typically precede a big selloff in bonds. With the Fed likely to hike once more in 2017 and up to three times in 2018, and with balance sheet unwinding in prospect, the headwind for stocks is intensifying.

Stocks have one thing in their favor, however: prospects for rising EPS growth. First-quarter earnings growth of 14.7% was well ahead of projections in high single digits. 2Q17 EPS growth should also rise in low teen percentages. We continue to model EPS growth of about 12.6% for 2017 followed by 7.5% growth in 2018.

As long as earnings keep growing, we see steady gains in S&P 500 earnings power. Normalized earnings, currently around $126.94, could rise toward $130 by year-end 2017 and continue higher in 2018. The stock market tends to peak not at fair value but at a 15%-20% premium to fair value. Since 1972, only once has the stock market fallen 15% or more from a level that could be characterized as undervalued.

So, stocks are at or near fair value; but fair value could push higher as long as earnings continue to rise. And history says stocks will attain at a least a 15% premium to fair value before they flatten out and/or begin to decline. Additionally, with the Fed positioned for aggressive action and rates poised to rise, stocks appear much more favorably valued than bonds. Our bond yield-to-stock earnings yield spread favors stocks. The Moody's AAA yield is 3.71% vs. the S&P 500 earnings yield of 5.22%. The spread of 151 basis points is similar to levels prevailing since 2009; in the preceding 24 years, however, this spread averaged 200-400 basis points.

Our final point is that on PEG and PEGY analysis, cyclical stocks appear cheaper than defensive stock groups. Despite leading the market in 2017, several cyclical groups have improved their PEGY ranking. Consumer discretionary, with a 1.08 PEGY ratio on continuing operations earnings, is in first place. Financial services is second with a 1.37 PEGY ratio, followed by technology with a 1.49 ratio. Utilities and Real Estate, with PEGY ratios exceeding 2.00, appear the most overvalued. These yield-sensitive sectors will also be challenged by rising interest rates.

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