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WEEKLY ECONOMIC COMMENTARY

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High as the Flag on the Fourth of July: Our Monthly Survey of the Economy, Interest Rates, and Markets

As this long unloved bull market plows to fresh highs, we are getting a bit concerned that retail investors are starting to buy in. Yes, retail investors still scatter at the first hint of bad news; and bond mutual funds beat equity mutual funds month in and month out. Yet the stock market continues to treat every modest selling jag as a chance to buy in to the rally on the cheap.

Although we are concerned if the rally becomes too loved, it is hard to argue with the solid fundamentals underpinning the advance. We sense another contributor to this new positive attitude toward stocks: investors appear to have disassociated from the goings-on in Washington. Investors treated the surprising win by Donald Trump with momentary disbelief, followed by wild enthusiasm. For a few months, the market stutter-stepped at each agenda swerve or policy defeat. Stock investors may now have reached the point at which the world of Washington is a shadow play in the background, rather than the main event.

THE ECONOMY, INTEREST RATES, AND EARNINGS

Investors breathed a sigh of relief when 2Q17 advance GDP came in at 2.6% growth. That was more than twice the rate of 1Q17 GDP, which was revised down to a final 1.2%. The economy is not near the MAGAnomics target of 3%-4%, and it may not get there anytime soon given current demographics and productivity growth. Nonetheless, getting GDP growth within shouting distance of 3% is essential to sustaining earnings growth, which we regard as the key determinant of stock market valuation and appreciation.

The 2Q17 GDP report had something for everyone to like, featuring growth in nearly every category except housing. The headline event was the recovery in personal consumption expenditures, which rose 2.8% in the quarter after growing 1.9% in 1Q17. This included 6.3% growth in durable goods spending; that category declined fractionally in 1Q17 mainly on the sudden slowdown in new vehicle spending. Non-durable spending also perked up.

Non-residential fixed investment grew 5.2%, and within this measure – seen as a proxy for capital spending – spending on equipment rose 8.2%. That is a positive sign that companies are investing in operations. With the housing market cooling, residential spending declined 7%, after growing 11% in 1Q17; we do not see this reversal as indicative of a major trend change.

Exports were up a healthy 4%, double the 2% gain in imports; trade was thus contributive to GDP growth. Government spending swung to positive, growing less than 1% in 2Q17 after declining less than 1% in 1Q17.

We continue to model full-year 2017 GDP growth in the 2.0%-2.5% range. Year-to-date weakness in the dollar should keep the export trend favorable going forward. With oil coming down, imports should remain subdued and potentially grow less than exports. The industrial economy is showing positive signs, but will need to sustain growth. Consumers may resume new vehicle spending with the new model year, but scarce supply continues to impact the housing economy; automobiles and housing are vital to overall consumer spending.

For 2018, we reiterate our GDP forecast in a broad 2%-3% range, though we are currently shaded toward the low end of that range at about 2.25%. Where the final number falls is at least partly dependent on the President's ability to

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drive fiscal stimulus from tax reform and infrastructure spending next year.

The major trend changes in 2017 to date have been dollar weakness and bond strength. The dollar is down 10% against the euro and down in high single digits against the MTP (major trading partners) currency basket. The weak dollar is hurting commodity prices, which risks understating industrial economy activity. The good news is the euro would not be strengthening unless industrial activity were picking up in Europe.

The rebound in Treasury prices has a variety of contributors, with weak dollar only part of the picture. Bond yields shot higher with the President's victory in November on the perception that rapid implementation of a fiscally stimulative agenda, facilitated by GOP dominance in Washington, would spur growth and unleash inflation. Furthermore, fiscal stimulus in the form of lower taxes and government infrastructure spending, it was assumed, would widen the deficit, thus requiring higher Treasury issuance to close the spending gap. Yields peaked in March just as the first speed bumps for the agenda became visible.

The Republican Party has failed to convert its Washington hegemony into fiscally stimulative policy, and optimism is fading that major new policy will be enacted this year. In the absence of such policies, growth remains middling and inflation remains about where it has been for the past two years. Additionally, existing tax policy coupled with the absence of government-sponsored infrastructure spending means that the deficit has not moved much. In short, Treasury issuance has not increased, Treasury bonds are in short supply in a time of global anxiety, and those factors are supporting bond prices.

After bottoming around 2.25% at mid-month, the 10-year Treasury yield has moved out to the 2.32% level. Still, that is not much of a move off the closing low of 2.15% in mid-June and nowhere near the 2.6% peak reached in March.

The middle maturities tell a different story. After rising in June, two-year and five-year Treasury yields have each dipped in the past month: 5-year yields are down about 10 basis points, and the 2-year is down five basis points during July.

Rates at the short end continue to edge higher. The three-month bill is now at 1.11%, compared to 1.03% one month ago and 0.96% two months ago. The Fed Chair and various Fed governors have signaled that the Fed may need to act again regardless of economic activity in order to stay ahead of the inflation curve.

Later this year, the Fed will address its timetable for "quantitative tightening," as it begins the task of unwinding its massive balance sheet. In our view, the reality of quantitative tightening could send yields higher once more as investor contemplate a potential massive rise in bond supply.

Calendar second-quarter earnings are so far not coming in as strong as in 1Q17 nor as strong as we had forecast. However, the timing of EPS releases – weighted heavily toward financial service companies early in earnings season and toward energy companies late in the season – may be distorting early returns.

Even so, with about 57% (286 out of 500) of S&P 500 constituent companies having reported, the annual change in earnings per share for 2Q17 is a solid 11.6%. Excluding financial service companies, earnings growth would be a point better at 12.6%. Excluding the limited number of energy companies that have reported, earnings growth would be reduced to 9.2%. This represents a significant trend change: over the prior two years, excluding Energy from the earnings composite would have had the effect of raising overall quarterly earnings.

On a preliminary basis, the sectors with the best annual growth include Energy (up over 200%), Information Technology (21.5%), Materials, (10.0%), Healthcare (8.4%), and somewhat surprisingly Real Estate (up 9.7%). On the other side, the consumer sectors are not showing much growth, with earnings from Staples and Discretionary up 4.7% and 2.8%, respectively. The yield sectors, telecom and utilities, are both growing earnings at around 6%-7%, which while lagging the market is better than historical; sector trends.

We are reiterating our forecast for full-year 2017 S&P 500 earnings from continuing operations of $134, which would be up 12.6% for the year. There are a range of possibilities in 2018 EPS outlook. For now, we continue to model high-single-digit growth in 2018, with first-half 2018 quarterly EPS growth in the 7%-8% range giving way to second-half quarterly EPS growth in the 6%-7% range. Potential roadblocks to EPS growth include the potential for worsening inflation; higher interest rates as the Fed seeks to cap pricing pressures; and a further rise in geopolitical tensions. There are also potential positives that might impact 2017 and more meaningfully 2018 earnings, including possible tax cuts, infrastructure investments, or other stimulative fiscal policy measures.

DOMESTIC AND GLOBAL MARKETS

Our composite of domestic indexes is up about 10.7% year-to-date, consistent with the approximately 2% move in the stock market during July. While nearly all sectors are rising to some degree, stocks are not sharing the wealth completely equally.

Nasdaq is up nearly 5 percentage points in July; and growth stocks overall are up 4%. These two indexes are up just under 20%. Among the blue chips indexes, the S&P 500 rose a bit more than 2% for the month as we neared the end of July, while DJIA was up about 1.5%. Value continues to lag, reflecting relatively weak defensive sector performance, but it did join the general move higher in July.

As noted, even bonds rallied last month, pushing the Lehman US Aggregate bond index up by 60 basis points last month. If the risk-on rally continues, we are not sure how long the bond rally can last; but the dynamics discussed above, including Treasury issuance scarcity, make us wary of predicting a bond rout anytime soon.

Amid much sound and fury, sector weightings are not significantly changed from a month ago. The tech wreck of August drove the technology weighting down by 90 basis points from an all-time high of 23.2% at the end of May. Just when it looked as though technology was getting back on track, weak EPS from AMZN and weak guidance in the memory segment scatted long tech positions once again.

On a full-year basis, the Technology weighting in the S&P 500 is still nearly 200 basis points higher than it was a year ago. Financial services also extended its June winning streak. Financial services has gained nearly a percent and a half in the past year, as the rate environment turns favorable. Banks are rallying on the Fed's commitment to higher short-term rates and successfully passing their stress tests, allowing them to hike dividends.

Big annual gains in these sectors have come at the expense of defensive sectors, such as Consumer Staples and Healthcare. Energy is also down year-over-year, even though positive EPS is causing an improvement in sentiment. The strong earnings performance in Energy has helped that starved sector regain some much-needed weight, but it is still at the low end of its historical band. As Staples has lost weight, Consumer Discretionary has gained and is now about 330 basis points bigger than Consumer Staples.

For the year to date, amid a fairly broad rally, two sectors are being left behind: Energy and Telecom Services. It is simple to understand why Telecom is struggling; the sector is dominated by AT&T and Verizon, both of which have been hemorrhaging subscribers to upstarts such as T-Mobile and Straight Talk willing to give away unlimited data at fire sale prices. The ongoing underperformance in Energy is more puzzling, given that Energy earnings are roaring ahead and industry fundamentals continue to recover.

While those sectors are down in double-digits year-to-date, every other sector except Financial Services and Consumer Staples are beating the market. This includes a mix of defensive sectors, such as Utilities and Healthcare; economically sensitive sectors such as Technology and Discretionary; and resource-sensitive sectors such as Materials and Industrial.

Although 2017 leadership to date remains primarily with economically sensitive sectors, we learned last year how quickly sector leadership can change. In this environment in which there is wide dispersion of returns and frequent leadership changes, we recommend trading within existing positions as opposed to making whole-position trades. This includes selling strength and buying weakness among high-quality and trusted names in your portfolio.

Compared to one month ago, our aggregate of international stock markets appreciated by over 300 basis points in July. But there was a fairly wide dispersion of returns among our market themes during the month. China reinforced its market leadership in July, and is now up about 34% year-to-date. That helped the BRIC basket, despite ongoing bifurcation between commodity consumers (China and India) and commodity producers (Russia and Brazil).

On that theme, our basket of resource-sensitive stock markets continues to struggle, but did bounce back to about break-even for the year after being down 3% at mid-year.

Our Americas composite moved up month-over- month and now holds an annual 9% gain, versus 6% at mid-year. Mature economy markets recovered in July after the second Brexit shock in June. Stock-price momentum continues to shift to growth economies, including several too immature to be featured in our composite.

CONCLUSION

Relegation of events in Washington to page two of the financial papers is not only how it should be, but pretty much as it always has been. The unlikely rise and election of Donald Trump, coming in this bitterly partisan period and at a time of unprecedented instant electronic commentary, has certainly been exceptional.

Ultimately, however, stocks rise on earnings growth; and earnings growth is the result of strategic choices made by thousands of companies over many years. The election of a different kind of president does not matter much when Washington's swamp continues to bog down a different kind of agenda.

We are about a half-year into the Trump presidency, and not much has changed. Investors always liked it when Washington stayed out of the way. Perhaps they are beginning to remember just how much they liked it, and that is why stocks are on the rise this summer.

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