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WEEKLY ECONOMIC COMMENTARY

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Stocks Carrying Momentum into 4Q17

As the stock market rallies into its strongest quarter of the year, to paraphrase our 32nd president, we have nothing to fear but the absence of fear itself. The market is rising across nearly all sectors, styles and size categories. Bonds, while not in a rout, are clearly being impacted by rising interest rates, and exiting bond investors are contributing to the piling-on in stocks.

While greed and complacency in the stock market are cause for concern, the fundamental and technical setup is favorable. The market appears to have accepted and even embraced the stalled legislative agenda in Washington and looks ready to welcome a watered-down tax reform program for fiscal 2018.

Ahead of the close of the government's fiscal 2017 year-end on 9/30/17, the Senate unsuccessfully sought to repeal and replace the Affordable Care Act. The tax-reform program proposed by the Republican Party met with a more-favorable response, although details are thin and the final plan may not be ready by calendar year-end.

Economic data reported in 3Q17 was highlighted by 3.1% GDP growth for the second quarter. After a weak first quarter, 2Q17 GDP featured a rebound in personal consumption expenditures, solid capital spending, a positive export-import balance, and increased private inventory investment. Summer-long weakness in the key consumer engines of housing and automotive could soon rev-up again. We anticipate that post-hurricane recovery and rebuilding will be so regionally massive that it will positively impact national housing and automotive numbers, also impacting GDP.

Non-farm payrolls growth remained strong, until a September decline (the first since 2010) that was impacted by multiple hurricanes. The key takeaways from the September non-farm payrolls data were the dip to 4.2% unemployment (the lowest since February 2001) and 2.9% annual growth in wages (a number that almost guarantees the Fed will hike rates again in December).

Although the consumer appears to have hit the pause button in areas including automotive sales, housing and retail sales, we expect this pause to be short-lived, given underlying strength in employment, rising wages, increased consumer confidence, and still-low gasoline prices. Late in the third quarter, Hurricanes Harvey, Irma, and Jose ravaged South Texas, Florida, and U.S. territories in the Caribbean. Lost commerce in the immediate aftermath of the storms may impact 3Q17 GDP. But the colossal rebuilding effort required could drive multiple quarters of above-average regional growth that will register nationally.

The U.S. industrial economy is showing healthy signs, aided by the year-to-date decline in the dollar versus major trading-partner currencies, improving industrial materials and metals prices, renewed vigor in the Eurozone (fueled by years of euro depreciation), and signs of emerging economy strength. Expectations this past summer that the pace of economic growth was weakening have been countered by cyclical highs in ISM manufacturing and non-manufacturing purchasing managers' indexes.

The Fed provided details of the planned unwinding of its $4.5 billion balance sheet. Even at a peak level in which $50 billion in bonds mature and roll off each month, the Fed's balance sheet will require seven years before it is "normalized."

The Fed also signaled further rate hikes are ahead, based on signs the economy is heating up. Fed officials cited the boost to overseas trade from a weak dollar as well as more

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output from strengthening foreign economies. The Fed's hawkish intentions sent yields rising into September-end. Strengthening wage growth reported with September non-farm payrolls likely cemented the Fed's plan for a year-end hike.

The second-quarter earnings season, stretching from mid-July to mid-August, was a clear success. Double-digit EPS growth in 1Q17 and 2Q17 acted to drive equity markets higher and extend the bull rally.

Against a backdrop of earnings growth, solid economic data, rising consumer and business confidence, and accelerating global growth, U.S. stocks rallied broadly in 3Q17. All major indices finished September 2017 up at least 10% year to date, in what is typically a positive sign for final-quarter and full-year stock performance.

Following a strong post-election rally partly built on now-weakening confidence that the new administration would succeed in enacting fiscally stimulative policy, the U.S. stock market is close to full value. However, stocks are likely to continue moving higher across 2017, given that bull markets almost never conclude until stocks are 8%-18% above fair value; continued EPS momentum could keep the fair-value bogey moving forward; and stocks are a better value than bonds by at least one standard deviation.

Bull markets do not die of old age. Their demise usually is linked to recession, a bursting asset bubble…or inflation. Investment trends and Fed policy appear to reflect a growing concern that inflation could reemerge in 2017. With U3 unemployment at 16-year lows, accelerating wage growth is awakening inflation fears.

As the calendar moves into the final quarter, and with all major equity indexes up at least 10% through nine months, bearish investment advisors may have to capitulate to bullish sentiment or risk losing clients.

Late in 3Q17, the market experienced significant leadership changes. On a sector basis, investors switched into Financial Services and Energy, in response to a more-aggressive signal from the Fed and to the rise in energy prices. The market also experienced a size and style rotation, with investors moving toward small caps that are perceived to benefit more than global large caps from lower corporate tax rates.

Sector and style rotation is positive in its ability to extend the bull market, but it may not last. As the calendar moves into the final quarter, and with all major equity indices up at least 10% through nine months, bearish investment advisors must capitulate to bullish sentiment and buy into the rally, or risk losing clients. We believe these capitulating advisors will chase this year's winners.

We thus see a high likelihood that leadership among risk-on and economically sensitive sectors will persist and even intensify into year-end. Additionally, with more rate hikes on the horizon and with political uncertainty heightened, we believe investors will gravitate toward high-quality industry leaders as the year winds down. While the absence of fear is worth fearing, the fundamental and technical setups are positive — and more times than not that is a good thing for stocks.

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