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WEEKLY ECONOMIC COMMENTARY

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Over the September Hump

As September winds down, the U.S. stock market is holding gains that could be a positive indicator for full-year performance, as we'll detail below. The old wisdom holds that stocks do well when they climb a wall of worry. This year, stocks may be at least partly climbing a wall of Washington. But don't assume that is the only factor in a rising market.

The year 2017 has been uncommon in that, nine months after the inauguration, Wall Street remains preoccupied with Washington. There are a number of reasons for this preoccupation, the most important of which is that the change in leadership came with a promise of a massive shift in tax, infrastructure, healthcare, immigration and even social policy.

The change agenda has bogged down, reflecting the deliberately slow processes fashioned by farsighted founding fathers, along with the factional fighting normal to any "big tent" party. The president's tendency to shoot from the hip rather than read from the script has also potentially contributed to the slow pace of change, while keeping the media's and investors' focus on our nation's capital.

GOOD NOT GREAT ECONOMY…

Wall Street is having a good year, and much more than fascination with Washington is in play; after all, another bit of old wisdom holds that Wall Street best loves a gridlocked, low-profile Washington. The consumer economy is healthy, even with new vehicle purchases slowing and housing activity constrained by low homes-for-sale inventory. The industrial economy is benefiting from the weak dollar and European industrial recovery (although a too-strong euro could become a headwind to EU production).

Another positive in the picture is an economy that is grinding forward rather than bounding higher. That has kept purchasing managers focused on the near horizon and has prevented the kind of excess production and inventory build-up associated with an over-extended economy. The market level of U.S. interest rates, held down low inflation and the low global level of rates, is still positive those looking to finance a home, car, or pickup truck.

The drags on the economy are familiar, and more secular than cyclical. The aging baby boomer cohort, which holds most wealth, is past its prime for "big ticket" purchases. Boomers are not in position to pass their wealth down to their Gen Y and millennial offspring. The millennials, an even bigger "bulge in the python" than boomers, have not fallen in line with spending and "maturity" patterns associated with prior generations.

It is a fact that millennials are saddled with student loan debt. It is a frequently held opinion that millennials are too fond of their post-collegiate lifestyle to buy into the steady job, 2.5 kids, and white picket fence milieu their parents worked toward. These choices, informed by a still-formulating digital age, have real implications for the traditional consumer bedrocks of housing, vehicle ownership and even elementary education. At the same time, the entrepreneurial U.S. economy has adapted to every prior transformation, and should adapt to another new set of spending patterns.

…IS GOOD FOR STOCKS

Although September was not quite concluded as we went to press, the major stock indexes were all on track to finish the month with double-digit gains. Entering the final week of the month, year-to-date gains for the major indexes included 19.4% for the Nasdaq, 13.1% for the Dow Jones Industrial Average, and 11.8% for the S&P 500. While nothing is guar-

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anteed for the final week of trading, stocks would do well to hold those gains across the September-end hump.

BUILDING ON SEPTEMBER GAINS

Since 1980 and through year-end 2016, as we have pointed out, the S&P 500 has averaged capital appreciation of 9.8% annually. For the nine months ended September, the S&P 500's annual gain since 1980 has been 5.3%. That is consistent with the back-end-loaded nature of stock gains: the S&P 500 averages appreciation of 4.5% across October, November and December.

For 13 of the 37 years between 1980 and 2016, the S&P 500 has finished September with a more than 10% year-to-date gain. While that is a less than 0.333 batting average, those double-digit nine-month periods have been uncommonly strong. In total, nine-month gains have averaged 19.3% for those years in which the index was ahead by at least 10% as of 9/30.

Given that head-start, 12-month gains for those double-digit nine-month gainers have been strong – but stocks in those years have coasted rather than sprinted into the finish line. Full-year gains for those 13 years have averaged 22.3%, just 3 points more than at the nine-month mark – and on average, 1.8 points less than fourth-quarter gains for all years since 1980.

There is an easily identifiable culprit in the equation. In 1987, the S&P 500 was up 32.9% at September's end. Then came Black Monday, on 10/19/87, a day on which the S&P 500 fell 20.5%. Dated from the market peak on 10/2/87, the S&P 500 fell 31.6% to its fall low. For all of 1987, the S&P 500 finished with just a 2% gain. Backing out 1987 from the equation, for years in which the S&P 500 was up at least 10% as of September-end, the market has tacked on an additional 5.8 points of gain across the final three month of the year.

IN 4Q, WATCH THE ECONOMY, NOT WASHINGTON

Not every fourth quarter is a winner, as 1987 so clearly demonstrates. When investors think about risks in the outlook for the end of this year, they may be tempted to worry about further disappointments in Washington. The market has baked in at least some amount of fiscal stimulus into year-end; and if nothing is accomplished, this thinking goes, investors will cash out and move to the sidelines to see what 2018 brings.

In the absence of attractive alternative asset classes, we would not make easy assumptions about investors abandoning the stock market. A broad move to the sidelines is particularly unlikely, in our view, given that market gains have been based more on solid economic underpinnings than on stimulus hopes. We too have concerns; but they are more fundamental in nature.

The Fed is signaling high likelihood of another rate hike in December 2017, suggesting it sees more inflation risk than the market has been factoring in (based on the decline in the 3-month Treasury bill yield). New York Fed President Bill Dudley, in a recent speech in upstate New York, stated that "temporary, idiosyncratic" factors that had restrained inflation were now fading. The Fed governor, a close associate of Chair Yellen and who has a permanent vote on the FOMC, believes that the weak dollar and strengthening growth in overseas economies should support slightly-stronger-than-trend U.S. economic growth. That in turn can support the wage growth that, while necessary, is also tinder for inflation.

At the other end of the spectrum, there is no guarantee that the current soft spot in consumers' big ticket spending will give way to stronger activity. In short, as the fourth quarter gets underway, we would focus on real risks around too much heat in the economy (inflation) or too little (consumer softness), rather than potential policy disappointments that may or may not have been built into the stock market.

CONCLUSION

In another few weeks, 3Q17 earnings season will get underway. We are modeling high-single-digit annual EPs growth for 3Q17 earnings, which would represent moderation from the low-double-digit pace of the first half. But we also see potential for upside strength, based on dollar weakness that is helping big companies win deals and grow in overseas markets.

Based on earnings prospects and economic fundamentals, we believe the S&P 500 is well-supported at fair value just under the current 2,500 level. According to Argus Investment Strategist Peter Canelo, past valuation patterns suggest the market could sustain a premium to fair value in the high-single-digit to mid-teens percentage range. We would be alert for a possible S&P 500 peak near 2,680-2,780 over the coming six months and 2,740-2,840 within a year.

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