MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

Stock Markets Impress; Economy, Maybe?

The US equity market, as measured by the S&P 500 Index, generated its sixth consecutive quarterly advance, rising 5.2% on a total return basis in the quarter ending June 30. Perhaps more remarkably, gains were global and spread across asset classes, with 34 of 40 major global stock markets in positive territory for the quarter. This was the first time in recent memory that markets were so thoroughly "synchronized". Highlights include (total returns):[1]

Gold	1.8%	Japan	2.7%	Canada	5.7%	Germany	2.9%	Thailand	8.7%
Bonds	2.3%	UK	2.2%	India	12.4%	Argentina	27.5%	Spain	9.3%
Oil	3.7%	Hong Kong	5.2%	Brazil	6.8%	Russia	16.3%	Mexico	6.6%

In several previous issues of *Consilium*, we have questioned the ability of the equity market to continue to rise much further solely on the strength of higher and higher valuations. We continue to believe that corporate earnings must carry the day for investors, and a stronger pace of economic growth is now needed to propel earnings forward. We have downplayed talk of a stock market "bubble" because we do not see much evidence that share prices have become uncoupled from underlying corporate performance, and because we have been cautiously optimistic that a period of faster economic growth lay just ahead.

Are these assumptions turning out to be correct?

This question is relevant in light of two recent developments. First, the Commerce Department's final calculation of first quarter growth in real Gross Domestic Product was revised downward to a -2.9% annual rate. Not only did this represent a dramatic change from the original estimate of +0.1%, it was the economy's weakest performance ever recorded during a non-recessionary period.

Second, the Bank for International Settlements (BIS) – the "central banker to the world's central banks" – warned in its annual report that global stock markets were "euphoric" and that monetary authorities were ill-equipped to deal with any negative surprises. The report also spoke of "a puzzling disconnect between the markets' buoyancy and underlying economic developments globally." With a single adjective, the staid and uncontroversial BIS joined the list of pundits and commentators casting aspersions on a stock market advance that has never earned much respect.

At this time, we are sticking with our "no bubble" call. Not only is S&P 500 Index trading at a price/earnings multiple (17.5 times, on trailing results) that is broadly in line with long term averages (16-17 times), but the five-year, 175% market advance (on a total return basis) appears to be fairly close to what should have been expected, given the dramatic change in corporate profits (up 72%) and interest rates (10-year US Treasury yields down from 3.84% to 2.54%) since the end of 2009.[2] Other traditional measures of valuation, including price/book value, price/sales, and dividend yield, support the view that the stock market is not terribly far from its fair value. To reiterate our comment in the previous issue of *Consilium,* our concerns will rise if stock prices become meaningfully uncoupled from underlying corporate performance.

[1] Source: Baseline
[2] Ibid, Standard & Poor's, Prof. Robert Shiller

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Whether our expectation of faster economic growth will be met is still, however, an open question. The weak first quarter GDP report, noted above, is not supportive of an optimistic forecast. However, two non-recurring factors appear responsible for the decline: (1) extremely cold weather by any standard, which drove consumers indoors, and (2) a big change in how the government calculates heath care spending in the wake of the implementation of the Affordable Care Act. After an original estimate that health care spending grew by 9.1%, the subsequent calculation showed that spending actually fell by 1.4%. This factor alone knocked two percentage points off reported growth, providing a useful reminder that the economy's performance cannot be captured in a single statistic.

With that in mind, we note that there is an array of other signs that the expansion has gathered strength, including:[3]

- The Institute for Supply Managers (aka Purchasing Managers) Index has broken out to its highest levels since early in the economic recovery.
- Federal Reserve data show total bank loans growing at the fastest pace since the recovery began, particularly loans to small businesses. In turn, the National Federation of Independent Business survey shows small business optimism at its highest level since in this cycle.
- Ignoring monthly volatility and instead focusing on quarterly data, employment has been expanding at a very consistent 500,000-600,000 pace, but at a faster 800,000 pace in the last three months. Unsurprisingly, a higher share of businesses is reporting paying higher wages than at any time since 2007.
- Inflation has crept up, rising from a 1.1% year-over-year rate in February to a 2.1% pace in May, the fastest in 18 months. This is a good sign of reduced slack in the economy and of the need for businesses to expand to meet demand.
- Industrial production, led by the booming energy sector, has reached an all-time high, and capacity utilization has reached its highest level in this cycle.

In addition to the recent data, the underlying rationale for a stronger economy remains compelling:

- Business and consumers have substantially de-levered, corporate cash balances are at record highs, household net worth is at an all-time high, and debt-service burdens are at an all-time low. Conditions are ripe for an acceleration of spending.
- Financial conditions are accommodative and will likely remain so for some time to come. The Federal Reserve is ending its bond-buying program but appears willing to "fall behind the curve" to some extent by allowing inflation and unemployment rates to penetrate its targets. Officials want to make certain that the expansion is very well entrenched before allowing short term interest rates to rise again.
- The impact of last year's tax increases is over.

"We won't know until we know" – but when current economic data suggests faster growth, and there is a good reason for it to be occurring, we can only conclude that faster growth is probably at hand. Under such a scenario, the outlook for corporate earnings remains solid enough to call for "staying the course" in equities at this time.

[3] *Sources: ISM, Goldman Sachs, Baseline, FRB St. Louis*

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