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Economic & Market Summary
April 2018

Volatility is back. A 10% correction in the S&P 500 and several 1,000 point daily swings in the Dow Jones Industrial Average reminded investors that last year's tranquility was the exception and not the rule. Meanwhile, the economy looks good with a healthy balance between consumer spending and business investment. Leading indicators suggest that GDP growth may accelerate from its post-recession trend of about 2%. Surveys from the manufacturing sector show the healthiest readings since 2011, and weekly claims for unemployment insurance are at multi-decade lows. We believe that 2018 will be a solid year, with GDP growth of about 3%.

Recent US fiscal policy developments are mixed. The Tax Cuts and Jobs Act incentivizes companies to aggressively deploy capital in the US while boosting consumers' discretionary income via lower tax rates. However, the federal government's budget for 2019 and recent protectionist actions are counterproductive. The budget is a spending bonanza that expands the deficit to a whopping $984 billion. This may improve economic growth in the short-run, but it meaningfully adds to the country's already high debt level and reflects a lack of fiscal discipline from our elected leaders. The steel and aluminum tariffs favor a select few businesses at the expense of many others and signal hostility toward the international free trade system which greatly benefits the US. If a global trade war were to start, it could prematurely end the economy's expansion.

Long-run structural factors such as an aging population, globalization, and technological innovation should prevent inflation from overheating. However, other factors like rising commodity prices, trade and immigration restrictions, and a tight labor market represent short-term inflationary threats. The labor market's muted wage growth is especially perplexing considering the low unemployment rate of 4.1%. Anecdotal evidence suggests that labor costs are growing faster than the 2.6% reported by the Bureau of Labor Statistics.

The Federal Reserve began normalizing monetary policy in December 2015 by steadily raising the federal funds target rate from close to 0% to about 1.7% today. By year-end, assuming the Fed follows its projections, the target rate will be between 2.0% and 2.25% - approaching levels we view as neutral but not restrictive. The Fed is also slowly unwinding its $4 trillion quantitative easing program by allowing bonds to mature without reinvestment. Combined with the rapidly growing budget deficit, this unwinding has the potential to shift the supply and demand dynamics of the US Treasury market. Our sense is that, whether driven by a change in supply and demand or inflationary threats, long-term yields will drift higher.

S&P 500 earnings for 2018 are expected to grow 25% year-over-year driven by a healthy global economy and lower corporate taxes. Estimates for 2019 call for 11% growth. This seems aggressive given the business cycle's maturity and the lack of another one-time benefit. Nerve-racking market swings could continue as investors weigh robust earnings against rising bond yields while also digesting the latest trade-related headlines and political drama. Additionally, with a PE ratio of 17x 2018 earnings, valuations are still mildly elevated. While we harbor some short-term valuation concerns and expect periodic market corrections, positive long-term fundamentals of our companies lead us to remain constructive on stocks.

Mark J. Sprtel – Analyst

To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address above.