The Surprise is in the Economy

The stock market continues to surprise investors with its strength as the S&P 500 rose by 6.07% in the quarter. However, the real shocker was the reversal of the "Trump Trade" that dominated markets at the end of 2016 when small capitalization (cap) and value stocks outperformed while international stocks stalled, and interest rates and the dollar rose. The exact opposite happened to start 2017. Small cap stocks trailed large caps by about 3.5%; growth stocks dominated value by about 5.5%; international stocks shone brightly, especially emerging markets which were up over 10%. Finally, interest rates were flat and the dollar weakened.

This market action is very encouraging and suggests the strength is due more to improving fundamentals rather than just a temporary sugar high after the election. The Conference Board's US consumer sentiment index hit the highest level in 16 years. First quarter operating income by S&P 500 companies is expected to climb 9.1%, the fastest pace since the fourth quarter of 2011, and a nearly 10% rise for the year, according to FactSet Research. These earnings expectations are supported by improving global economic data. The Citigroup Global Economic Surprise Index has improved dramatically of late signaling better times ahead (see chart in Outside Commentary). Even trade data looks promising in spite of worries about a trade war from the Trump administration. Global merchandise trade is expanding at its fastest pace for nearly seven years in volume terms.

Even Europe is seeing substantial improvement. The Eurozone economy has now posted 14 consecutive quarters of growth, the unemployment rate has returned to single digits, and economic sentiment has reached its highest level in six years. According to Markit, the Eurozone's private sector activity has improved vastly, with PMI figures beating consensus by a significant margin. Corporate profit growth in Europe has started to outpace earnings from U.S. companies. According to data from JPMorgan Chase, Stoxx Europe 600 Index members recorded an 11% increase in profits in the fourth quarter versus a 5% growth in S&P 500 companies. Better yet valuations are much lower in international equity markets.

Bears will claim stocks are wildly expensive. However, if you take out the energy sector where earnings are very depressed, valuations are much less frightening. Bears also rightly point out that "soft" economic data like sentiment is much stronger that "hard" economic data like durable-goods orders. While we expect more improvement in the hard data a failure to do so would cause us to get more defensive. Political risk seems the most threatening both here and abroad. An aggressive move to protectionist policies by the White House would not be well received. In Europe the possibility of political disruption later this year will keep investors on edge.

Despite these risks the path of least resistance remains higher given improving fundamentals, reasonable valuations and plenty of cautiousness. From *Barron's:* "The latest American Association of Individual Investors survey shows the percentage of bullish respondents fell to 30.2%, 16 points lower than the start of the year, while bearish sentiment rose to 37.4%, 12.2 points higher." Although more volatile and challenging than the most recent past, we expect the path for equities to still be higher.

Best wishes, *James Tillar, CFA and Steve Wenstrup*

OUTSIDE COMMENTARY

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1st Qtr. 2017 Strategy Outlook-excerpt

The Reflation Continues

If there is one chart that best encapsulates the reflation theme, (chart below) is it. It shows the sum of the Citibank global economic and inflation surprise indices. The combined at the highest level in the 14-year history of the survey. Consistent with the surprise indices, Goldman's global Current Activity Indicator (CAI) has risen to the strongest level in three years. The 3-month average for developed markets stands at a 6-year high

What accounts for the acceleration in economic growth that began in earnest in mid-2016? A number of factors stand out: The drag on global growth from the plunge in commodity sector investment finally ran its course. U.S. energy sector capex, for example, tumbled by 70% between Q2 of 2014 and Q3 of 2016, knocking 0.7% off the level of U.S. real GDP. The fallout for commodity-exporting EMs such as Brazil and Russia was considerably more severe. The global economy emerged from a protracted inventory destocking cycle.

In the U.S. inventories made a negative contribution to growth for five straight quarters starting in Q2 of 2015, the longest streak since the 1950s. The U.K., Germany, and Japan also saw notable inventory corr -ection.