A HEALTHY ECONOMY AMID TRADE TENSIONS

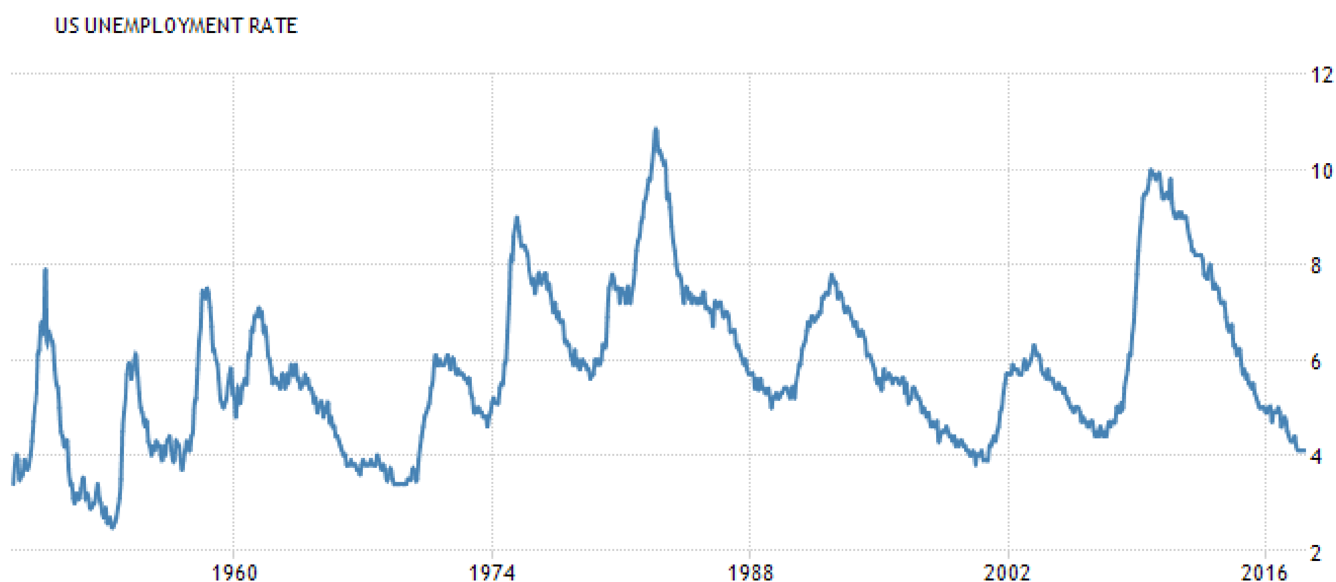
1ST QUARTER RECAP

The S&P 500 fell a little over 1% during the first quarter, but that gentle decline masks the fact that it had already risen over 7% during January. In my view, this volatility was driven by concern that the recently enacted tax cuts might cause the U.S. economy to overheat and, later, by concern that trade-related issues between the U.S. and some important trading partners might get out of hand.

UNEMPLOYMENT RATE LOW, BUT INFLATION STILL IN CHECK

With respect to the possibility of an overheating economy, the thinking was (and still is, I think) that if the unemployment rate were to fall to some unnaturally low level, wage pressures might then cause the rate of inflation within the U.S. to exceed the Federal Reserve's 2% target. If that were to happen, investors figure that the Federal Reserve would then do its part to stymie excess growth by raising interests rates more often and/or more aggressively than previously signaled.

In late March the Labor Department reported that jobless claims fell by 12,000 to 215,000. This reading was not only well below the expected reading of 230,000, it marked the lowest level of jobless claims since the beginning of 1973 even though the U.S. population has grown substantially since then. Jobless claims are historically low, but the unemployment rate remains at 4.1% as it has since October.

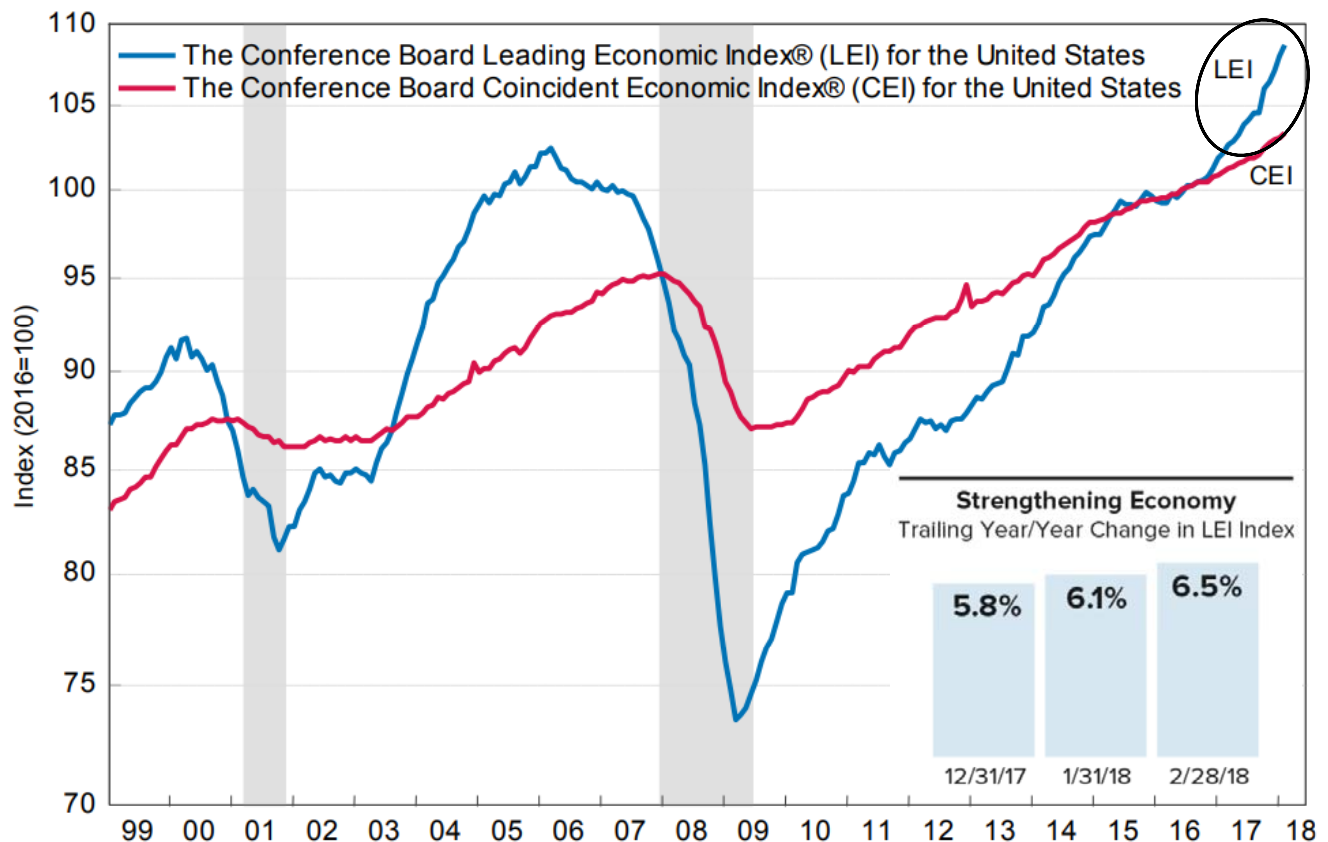


In certain parts of the U.S., economic activity has increased to the point that employers are having difficulty filling employment slots. There are approximately 6 million vacant jobs in the U.S. right now. In Portland, Maine, the unemployment rate is only 1.8% and in Ames, Iowa, it is just 1.5%. Of course, there will generally be some dispersion around a given average, but to the extent the overall unemployment rate falls to an unnaturally low level, wage pressures could force the Fed to raise rates more aggressively to prevent an overheated economy and investors are mindful of this possibility.

For now, however, the Fed's preferred measure of inflation, the latest Personal Consumption Expenditures Index reading of 1.6% remains somewhat below the Fed's 2% target, so an aggressive Fed response does not yet seem to be in the cards.

LEADING ECONOMIC INDEX (LEI) SURGES ... FED LIFTS OUTLOOK

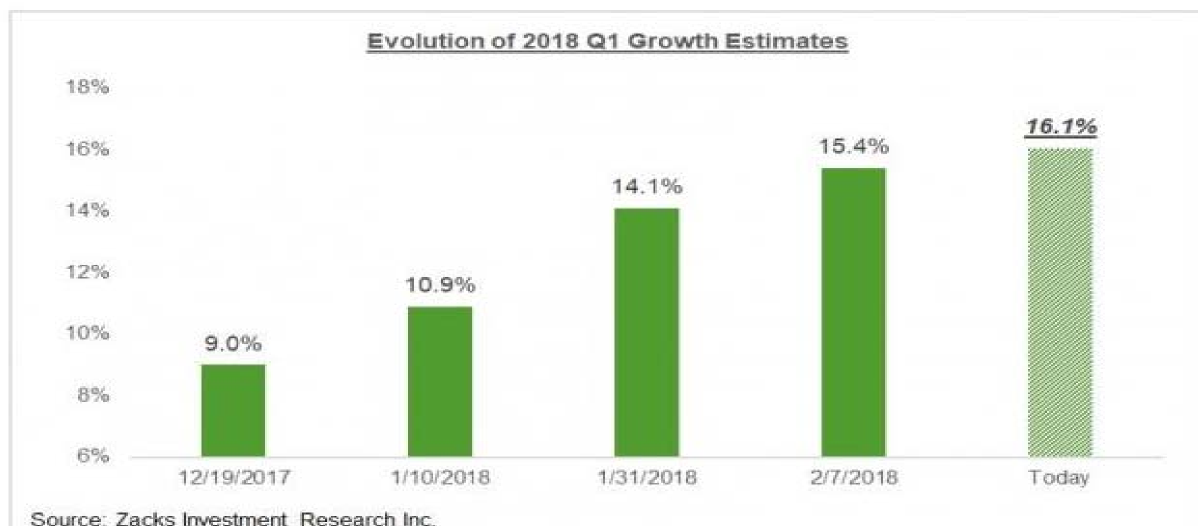
Having recently revised its 2018 GDP forecast from 2.5% to 2.7%, and its 2019 GDP forecast from 2.1% from 2.4%, the Fed's optimism is supported by the Conference Board's Leading Economic Index that has continued to surge.



Of course, the correlation between the LEI and stock prices is not perfect, but all else being equal, I'd rather own equities while business conditions are favorable than when they're not. And, over the past couple of years it has become increasingly apparent that equity values are being determined by strong business fundamentals rather than by Fed stimulus as shown, below.

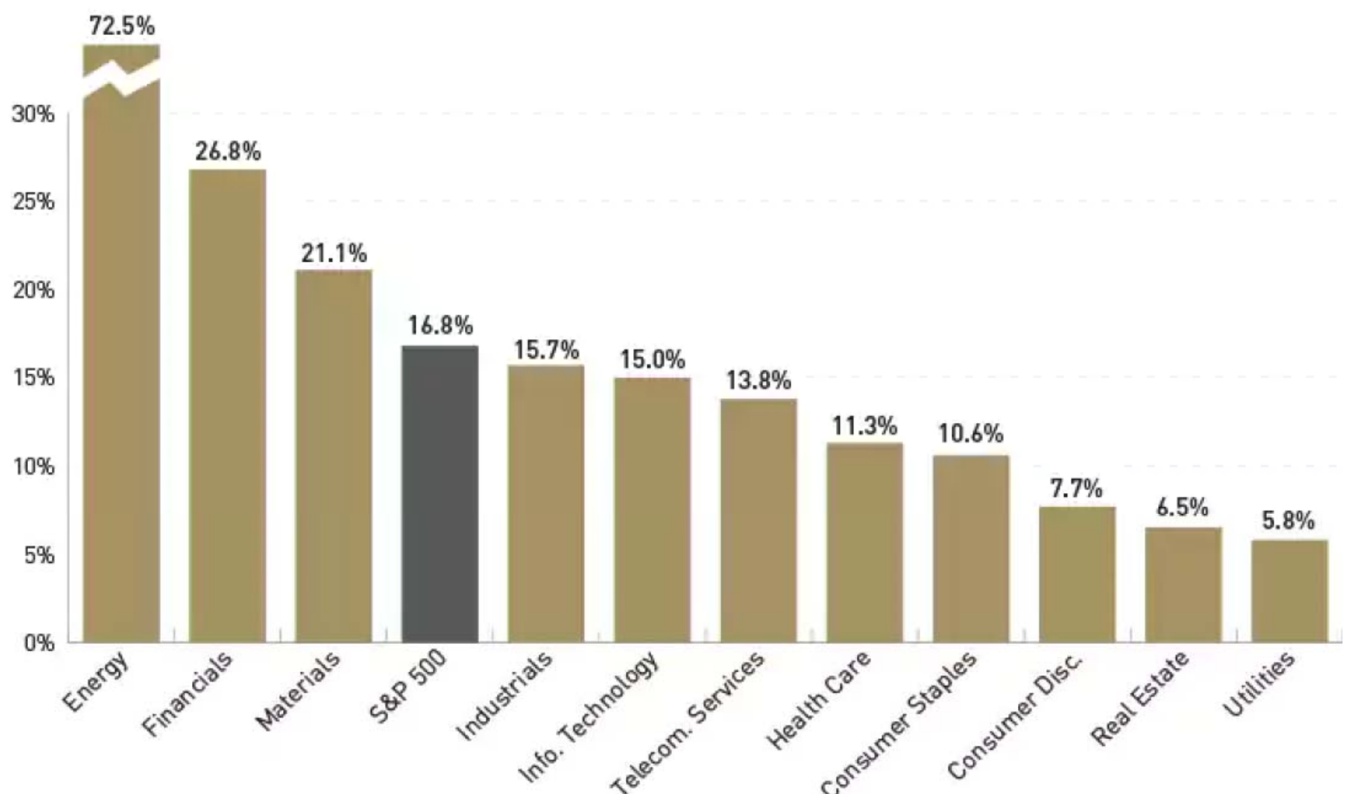
1ST QUARTER EARNINGS ESTIMATES ALSO SURGE

In addition to the Leading Economic Index improving at an increasingly positive rate, Zacks Research noted that the expected year-over-year improvement in first quarter earnings for S&P 500 constituents rose from an already good 9% in mid-December to over 16% by mid-February (below). That represents the largest surge in optimism Zacks has seen since it began tracking such things in 1996.



Earnings estimates typically fade as reality replaces conjecture, so this surge in optimism is especially notable. By early April, Zacks' bumped its 1Q-2018 earnings growth estimate up a bit further, this time to 17%. If that figure were to hold, it would mark the highest year-over-year corporate earnings growth rate since the first quarter of 2011 when earnings jumped by 19.5%. 17% is a big number, but Zacks isn't alone. In February, data analytics firm, Factset, estimated that full-year, 2018 earnings for companies within the S&P 500 would rise by 16.8%, as detailed, below.

Forecasted earnings growth for sectors in the S&P 500 Index for 2018



As positive as all of these estimates are, Zacks now expects earnings growth for companies that comprise the S&P 500 to approximate 18.9% for the entirety of 2018.

OTHER DATA POINTS ALSO SOLID

The housing market seems healthy. In late March, mortgage application volume rose 4.8%, pending home sales were up 3.1%, and actual home purchases increased 3.0%. The annual run-rate for GDP during the final quarter of 2017 was revised from an annual rate of 2.5% to 2.9%, due mostly to an upwardly revised consumer-spending figure that saw its largest gain in three years.

Recent retail and wholesale inventory figures suggest increased demand. The Institute of Supply Management's gauge of activity in the U.S.' service sector relaxed a bit during February, but the most recent reading suggests that the largest component of the U.S. economy will continue to expand beyond its current streak of 98 consecutive months. And although the companion manufacturing index also declined a bit in March, it too remains solidly in expansion territory as it hovers near record highs. During March, all but one of the 18 manufacturing industries experienced growth. Noting that "the economic outlook has strengthened in recent months," the Fed nudged its 2018 GDP forecast up to 2.7% from 2.5%, and its 2019 forecast up to 2.4% from 2.1%.

DIVIDEND PAYOUTS JUMP DURING 1Q-2018

During the first quarter of 2018, companies within the S&P 500 distributed 7.6% more in dividends than they did a year ago. That increase may pale in comparison to the earnings growth rates I just mentioned, but that 7.6% figure actually represents an astounding 72.5% jump over the 5.5% dividend increase that was realized during the first quarter of 2017.

Not only does this 7.6% increase easily outstrip the current 1.6% rate of annual inflation, it suggests corporations are confident in their ability to generate the cash flows that will be necessary to cover these increased dividend commitments. After all, corporations are generally reluctant to suffer the indignity associated with suspending or even trimming dividend payments once they've begun.

TRADE-WAR CONCERNS

In an effort to shore up the steel and aluminum industries in the U.S., President Trump's announcement in early March that he would impose a 25% tariff on steel imports and a 10% tariff on aluminum imports rattled equity markets as investors feared retaliation. He later walked that announcement back a bit by suggesting certain exemptions could apply, but the president rattled markets anew as he vowed to invoke tariffs on up to $60 billion worth of Chinese imports on some 1,300 product categories. Additionally, the administration also committed to blocking Chinese acquisitions of U.S. companies and technology transfers. As such, it has already squashed the acquisition of tech–leader, Qualcomm.

China indicated that while it didn't wish for a trade war, it would not hesitate to defend its interests. It has since retaliated by imposing tariffs of its own on well over 100 U.S. products. Predictably, fears of a trade war have caused the risk premium investors demand to invest in equities to spike. Of course, this has pressured equity valuations. Presently, the S&P 500 is still off its January 26th high by about 7.5%.

Although President Trump has asserted that trade wars are easy to win, academicians are fairly united in the belief that they're not only not easy to win, but that bilateral trade disputes tend to yield no benefit to either participant. To the extent any short-term benefits are to be had, they tend to inure to the benefit of alternative producers located in countries that are not a party to the dispute.

President Trump is almost assuredly aware of this. Nonetheless, it seems apparent to me that China has, in fact, engaged in a variety of unfair trade practices, so maybe this initial flurry of tariffs and tough talk is just bombast that will give way to constructive dialogue.

According to a recent Wall Street Journal Survey, the U.S. economy could stand to lose some 845,000 jobs if trade barriers were to rise to levels that existed before the creation of the North American Free-Trade Agreement and the World Trade Organization in the mid-1990s.

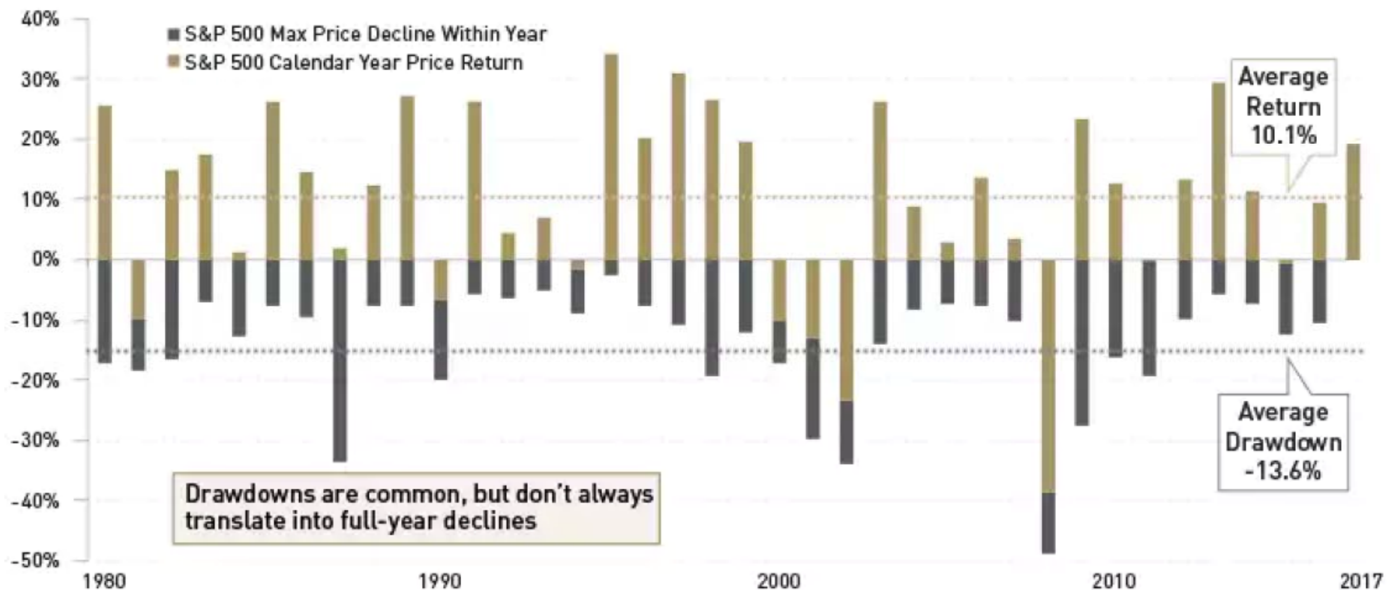
Since both countries know that retaliatory tariffs are likely to work to the detriment of each party, I would expect this issue to continue to command attention until it is at least somewhat resolved. In the interim, I would expect investors to remain wary.

MARKET DIPS ARE NORMAL

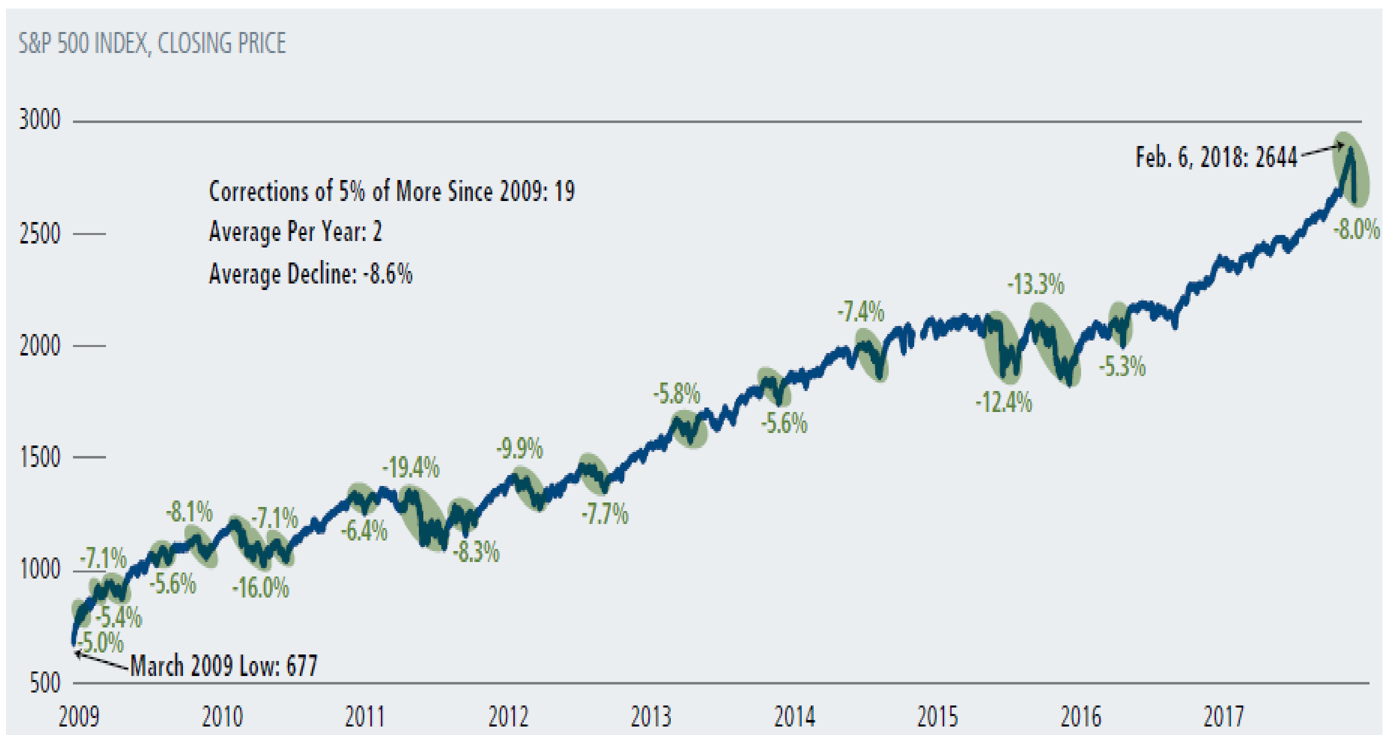
When news broke in June of 2016 that the United Kingdom had opted to exit the European Union ("Brexit"), investors were rattled, but like so many other unsettling events, the impact that referendum had on equity markets turned out to be little more than a hiccup in the rearview mirror of time.

In that context, the following graphic from Morningstar offers some perspective about the frequency with which market dips have occurred. Since 1980, the average annual drawdown during a given year has averaged 13.6%. Despite that, the S&P 500 still generated an average annual return in excess of 10%.

Annual price returns versus maximum price decline in the S&P 500 Index, 1980–2017

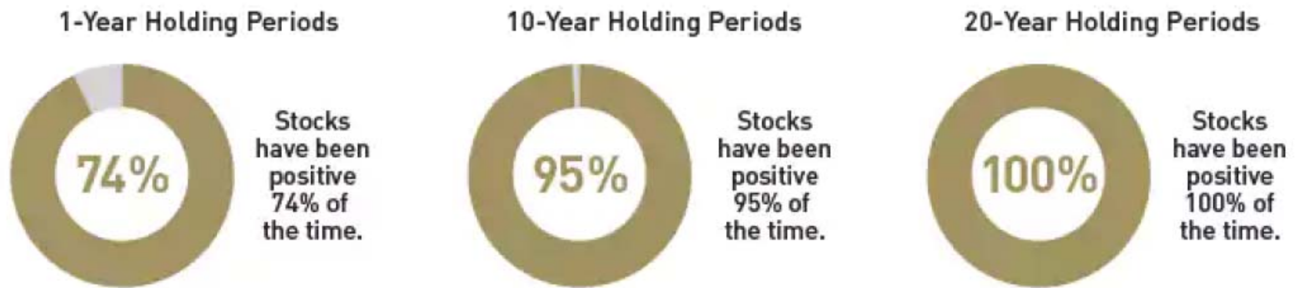


This image, from Bloomberg, tells a similar story.



I've pasted in a few more perspective fixer-uppers on the chance they might ease your mind. — Glenn Wessel

Equity returns in calendar-year periods, 1927–2017



For the years 1968-2017

S&P 500 Average Forward Performance After Daily Decline of -3% to -6%			
1 Month	3 Month	6 Month	12 Month
1%	3%	5%	10%

Growth of $10,000 in the S&P 500 Index, January 1, 1992–December 31, 2017