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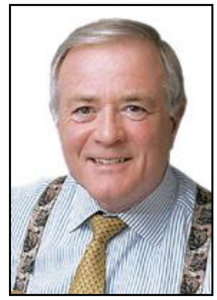

William Rutherford

Markets ignore tepid economic data, reach highs for ’17

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Equity markets have reached noteworthy new highs year to date. The Dow was up 5.96 percent, the S&P up 6.7 percent and the NASDAQ an unusually strong 12.34 percent through April 28.

The highs came with rising volume and lowered volatility. The highs came in spite of weak GDP numbers and personal consumption numbers. The GDP for the first quarter of the year increased an anemic 0.7 percent, and personal consumption was the weakest in seven years.

Additional burdens on the market were the threat of rising interest rates and storm clouds regarding North Korea. Also, U.S. factory activity eased in April, leaving growth on solid ground, but slowing the growth trajectory. Optimism about the Trump agenda had buoyed the markets after the election, but that optimism found limits as parts of the agenda failed or were stalled.

The rising markets reflected an increased appetite for risk, which in turn is now supporting consumer spending and investment. Business investment is expected, by some analysts, to increase 5 percent over the next two years. Personal consumption is expected to increase 2 percent over the same time frame. Core inflation is expected to reach the Federal Reserve policy goal of 2 percent by 2018 and 2.1 percent in 2019. Inflation expectations will support the Fed effort to raise interest rates gradually.

The Fed is expected to raise interest rates three times this year. With one rate increase already done, two more may be in the offing. Noting slowing economic growth, the Fed passed on a rate rise in May, but left a June increase on the table. Future markets predict a 70 percent chance of a June raise and a coin flip chance of one more raise in 2017. The Fed in its statement said, “The Committee views the slowing in growth during the first quarter as likely to be transitory and continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will stabilize around 2 percent over the medium term.”

It is also expected that the Fed governors will let their balance sheet run off, thereby reducing the massive holdings in U.S. Treasury debt. Such a runoff would have the effect of an interest rate increase. With this scenario, the yield on 10-year bonds could be at 2.7 percent in 2017 and 3.06 percent in 2018, since investors, other than the Federal Reserve, will have to be enticed to purchase the ever-increasing U.S. debt load. Of course, that outlook may change with the recently reported budget proposals by the Trump administration. But with the budget and tax proposals as yet still printed on a single sheet of paper, it is hard to forecast the outcome.

Generally, rising rates on U.S. Treasuries (the risk-free rates) place a cap on equity market returns, which could be offset by the appetite for more risk. If the Trump administration can deliver tax cuts, equities could show more strength.

Labor markets keep tightening as the labor force participation rate increases. The unemployment rate could fall further, which would support higher hourly compensation. Combined with increased hours worked, compensation to employees could increase as much as 4 percent, which would be welcome relief to beleaguered workers and presumably boost personal consumption.

It is possible, even more than likely, that forecasts will be off for the year, because of the uncertain policies of this administration and festering trouble spots around the globe. But if the U.S. can avoid policy missteps, we should be able to see a growing economy and rising markets.

Upcoming French elections could also influence the global markets. When Emmanuel Macron, a centrist candidate, emerged as the leader after the first round of voting, the market heaved a sigh of relief. Now the final round pits Macron versus 'Marine' Le Pen, a rightest candidate who threatens to move France out of the European Union and return the French currency to the franc. Such proposals have the markets on edge. However, should Macron prevail, we could see another rally in the markets.
Remain a long-term investor.

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