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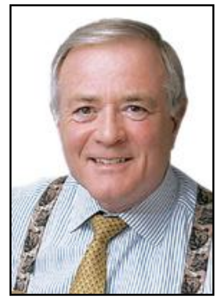

William Rutherford

Economy and markets ignore headline news, surge ahead

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U.S. gross domestic product (GDP) grew at an annualized rate of 4.2 percent in the second quarter of 2018. The GDP came in 0.1 percentage point ahead of the “advance” estimate (released in July) and almost double the 2.2 percent increase witnessed in the first quarter. This growth represents the strongest economic performance in nearly four years and the highest rate since the third quarter of 2014, when the GDP growth was reported to be 4.9 percent. Government spending rose 2.3 percent, compared to the 1.5 percent increase in the first quarter of this year. Exports increased 9.1 percent, while imports fell 0.4 percent. The Fed forecasts GDP to grow by 2.4 percent in 2019 and by 2 percent in 2020.

Federal Reserve Chairman Jerome Powell stated in comments during the Fed meeting in Jackson Hole, Wyoming, that the U.S. economy is strong and does not appear at “elevated” risk of overheating.

“Many of the most significant challenges facing the U.S. economy – such as slow wage growth and rising government debt – remain outside the powers of the Fed to address,” he added.

U.S. shares increased and the dollar index fell after Mr. Powell’s remarks were published – a sign of diminished concern among investors that the pace of rate increases would suddenly accelerate. Nevertheless, it is expected that the Fed will raise interest rates by 0.25 percent in September.

For the second quarter of 2018 (with 99 percent of the companies in the S&P 500 reporting actual results for the quarter), 80 percent of S&P 500 companies have reported a positive EPS surprise and 72 percent have reported a positive sales surprise.

Earnings growth: For the second quarter of 2018, the blended earnings growth rate year over year for the S&P 500 is 25 percent. If 25 percent is the actual growth rate for the quarter, it will mark the highest earnings growth since the third quarter of 2010 (34.1 percent).

Earnings revisions: On June 30, the estimated earnings growth rate for the second quarter of 2018 was 20 percent, year over year. Ten sectors have higher growth rates today (compared to June 30), due to upward estimate revisions and positive earnings surprises.

Earnings guidance: For the third quarter of 2018, 72 S&P 500 companies have issued negative EPS guidance and 24 S&P 500 companies have issued positive EPS guidance.

Valuation: The forward 12-month price-earnings ratio for the S&P 500 is 16.8. This P/E ratio is above the five-year trailing average of 16.3 and the 10-year trailing average of 14.4. So the market remains fully priced, but with positive growth numbers as a tailwind.

Year to date, markets' performances have been positive, with the following results: Nasdaq Composite +17.5 percent, Russell 2000 +13.4 percent, S&P 500 +8.5 percent and Dow Jones Industrial Average +5.0 percent.

The economy and markets remain strong. Growth can be expected. Investors should remain fully invested in a diversified portfolio of U.S. equities, which can be expected to outperform bonds and cash. As Warren Buffett said recently, "over time a basket of stocks will outperform both cash and bonds."

Inflation should remain benign. Ignore the headline news.

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