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Capital market insights

Conversation guide

September 2018

Stock returns: substance or sugar rush?

Stocks have continued their steady climb this calendar year, but the fuel driving recent returns is more substantial. Fears of tariffs and torn-up trade agreements seem to have faded from investors' views, replaced by a welcome focus on fundamentals.

Fiscal stimulus from tax reform and increased government spending has contributed to recent stock gains. As "hard data" confirms the overall positive outlook on the economy, improving fundamentals have the potential to sustain the current equity rally for some time.

"Hard data" are starting to align with positive "soft data."

A virtuous circle of improving conditions should sustain growth.

Stronger fundamentals have put the market on a solid foundation.

“Hard data” are starting to align with positive “soft data.”

- “Soft data” figures are often survey-based readings of sentiment (e.g., consumer confidence, purchasing manager surveys) that can be subjective or emotional in nature.
  - Many “soft data” indexes jumped immediately after Trump’s presidential election victory and have been elevated ever since.
- “Hard data” are based on reporting of actual results that are objective and tangible (e.g., retail sales, industrial production).
  - “Hard data” reports over the past 18 months have generally lagged “soft data” reports until recently.
- The latest reports on employment, retail sales, industrial production and other “hard data” have improved over the last 18 months, closing the gap with “soft data” and reflecting favorable conditions in the overall U.S. economy.
  - Recent improvement in retail sales and consumer spending reflects the confidence people had in the economy a few months ago (see Chart 1 below).
  - Industrial production is also narrowing the gap with manager sentiment, which has been on an upswing since Trump’s presidential term began (see Chart 2 below).

Chart 1: Consumers still feel confident, but now they're actually spending

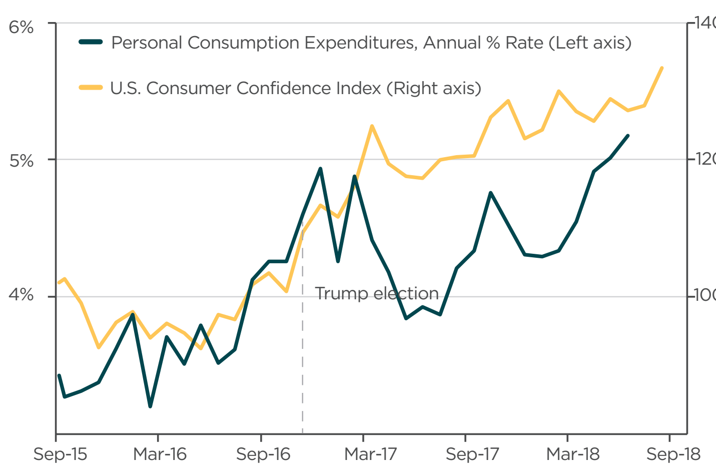
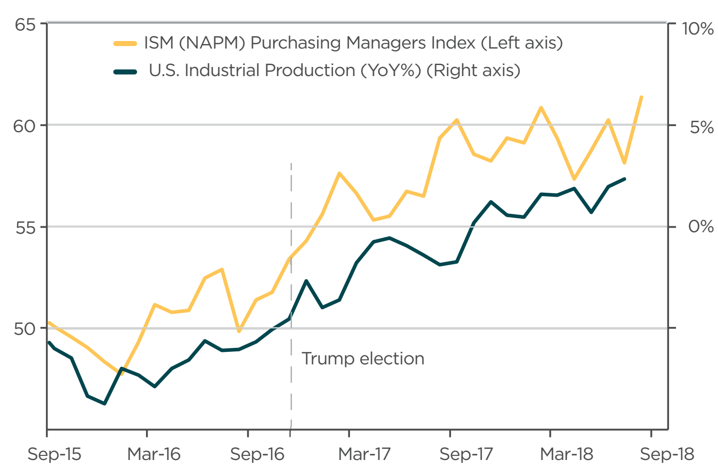


Chart 2: Industrial production catches up to managers' sentiment

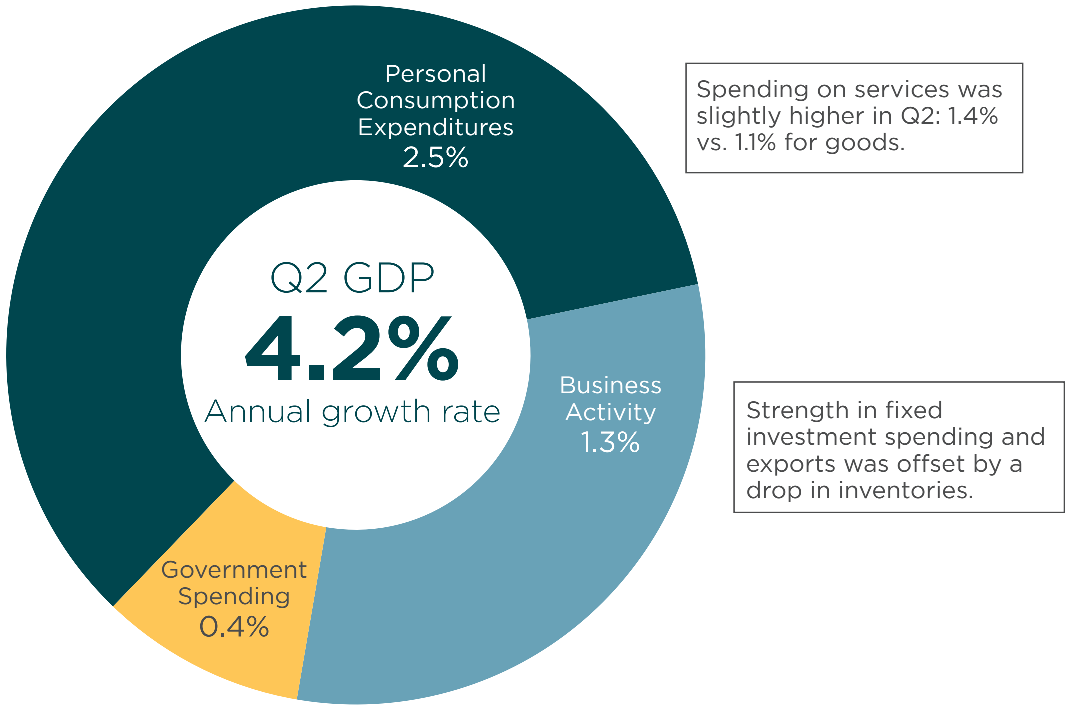


Source for chart data: FactSet.

A virtuous circle of improving conditions should help sustain growth.

- Positive data on personal income and consumption has fueled the biggest driver of economic growth—consumer spending.
  - More than half of the growth in Gross Domestic Product (GDP) for Q2 2018 came from personal consumption expenditures (see chart 3 below).
- When consumers are spending, an acceleration in business activity often follows as companies produce more goods and services to meet increased consumer demand.
- Increased business spending should improve wages and brighten job prospects to complete the circle, creating a virtuous circle of economic momentum that can help keep the current expansion going.

Chart 3: A virtuous circle of economic growth

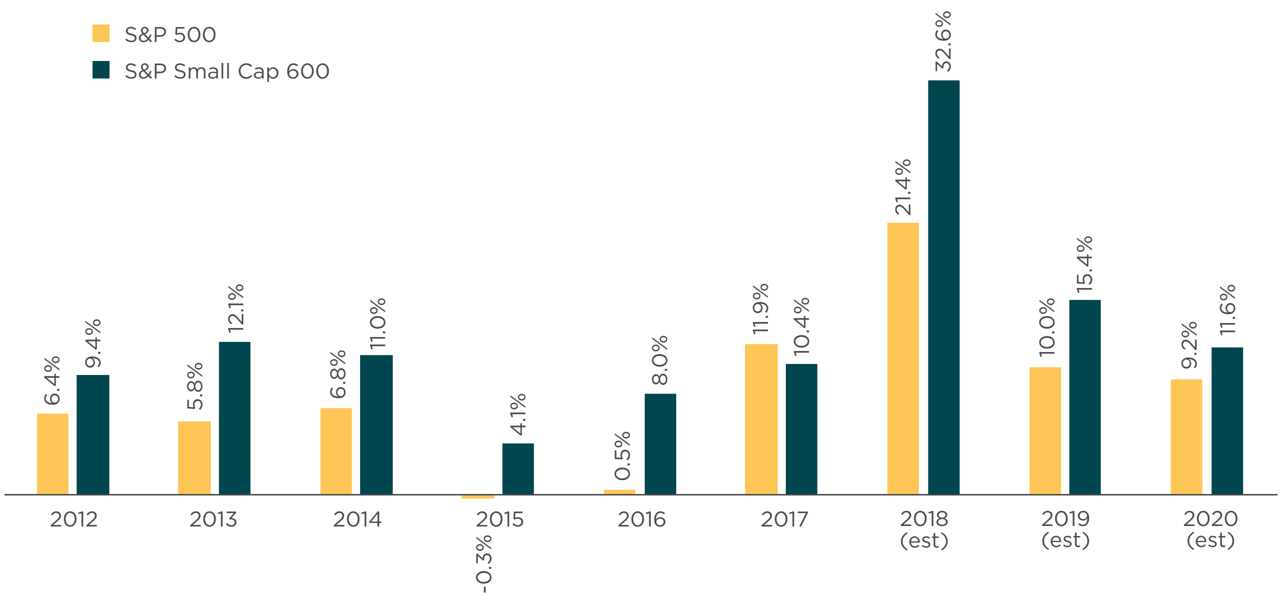


Source for chart data: Bureau of Economic Analysis (BEA)

Stronger fundamentals have put the market on a solid foundation.

- News headlines seem to have less influence on market performance and investor sentiment so far this year, as investors largely focus on good numbers for the economy and corporate results.
  - Trade wars and tariff threats wobbled equity markets earlier this year, but more recently investors don't seem to be as focused on them (even though they still pose a potential threat to business performance and the continuing economic expansion).
- When fundamentals are as strong as they've been, it's easier for investors to invest with greater discipline and avoid the temptation of emotional decision-making.
- Measures of confidence — whether from consumers, businesses or investors — may be useful, but they can easily fade if that confidence is not backed up by the reality of hard data.

Chart 4: Corporate earnings should grow strongly this year



Source for chart data: FactSet

Key takeaways

Are U.S. stocks enjoying a “sugar rush” from tax reform and government spending, or is something more substantial and enduring at work? Improving fundamentals in the broader economy indicate there’s a solid foundation beneath the current equity rally. “Hard data” figures on consumer spending and business investment are starting to align with corresponding “soft data” measures of sentiment, which have been mostly elevated since President Trump took office. As consumers and businesses provide important boosts to growth, the virtuous circle of growth they create can help sustain the current economic expansion.

- Pay attention to key indicators of consumer and business performance for signals on the direction of the overall economy.
- Stay invested in a diversified basket of quality companies with exposure to different sectors as well as international markets.
- Continue to focus on fundamental signs of economic performance and view news reports on the economy and the markets with an objective eye.

For more help or information, contact your financial advisor.

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