AGFINSIGHTS

MARKETS

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U.S. Growth Investment Posture

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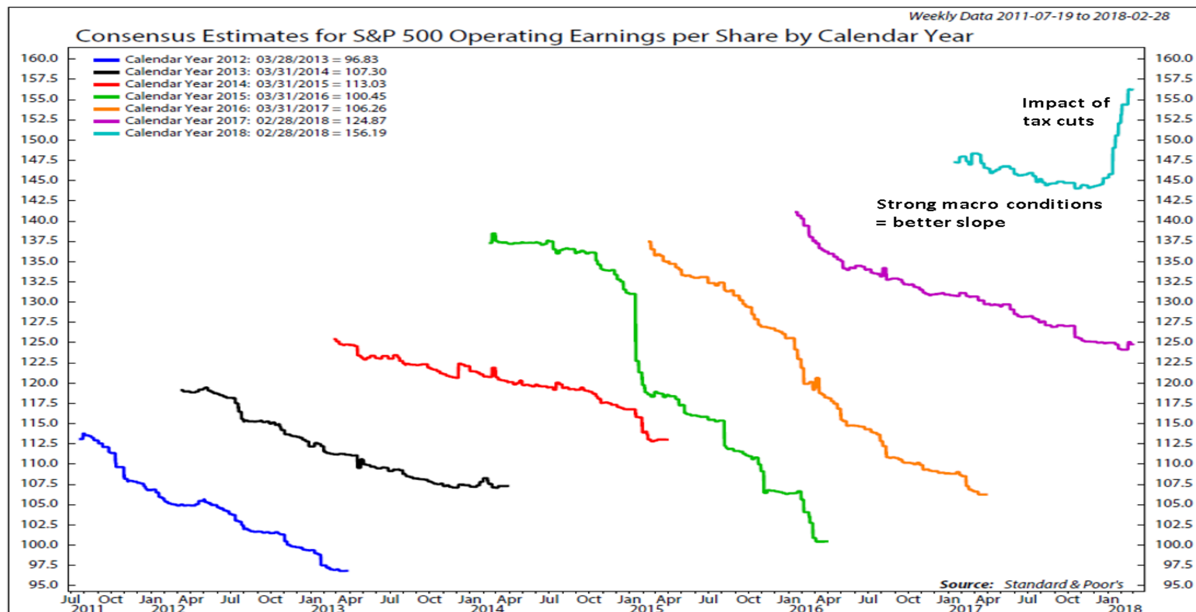
Beyond the Noise, Earnings Propelling Market Higher

The final stages of a bull market are often the most rewarding, fuelled by a combination of earnings growth and an upward bias in valuation with the latter typically providing the outsized returns of the final years. Earnings growth for 2018 is going to be unusually robust (+16-20%) as not only are U.S. companies benefitting from global synchronized growth and a weaker U.S. dollar which has resulted in the most upside to revenue growth of the past decade, but also from the material impact on earnings from tax reform. Figure 1 illustrates that consensus earnings estimates tend to decline as each year progresses, but this year that rate of decline has been much more gradual, indicative of a strong and supportive economic environment. Further, the impact of tax reform has led to consensus earnings expectations rising significantly.

Figure 1 – What's Different This Year?



Source: Ned Davis Research, as of February 28, 2018

[1] Does not make investment recommendations

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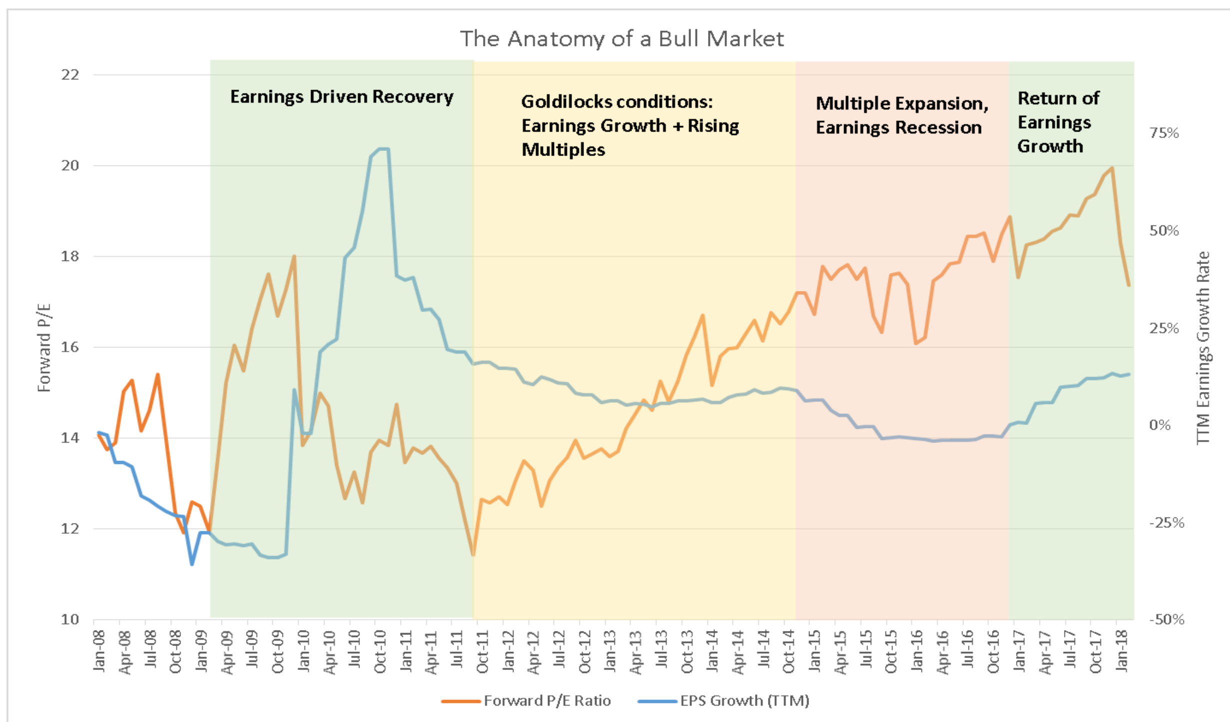
This marks a continuation of conditions seen since early last year, when we saw a return to an earnings growth-driven market. As illustrated in Figure 2, we have seen markedly different stages in the bull market since it began in March 2009. The initial three year recovery following the equity market trough was driven primarily by earnings growth. From there investors entered a "goldilocks" period, whereby corporate profits grew at a healthy double digit rate while multiples expanded amidst strengthening economic conditions and accommodative monetary policy. The third stage of the bull market was one where multiples continued to expand, but earnings growth stagnated, impacted by depressed energy prices and a strong U.S. dollar.

However we have seen strong fundamentals return to the market as earnings growth has accelerated since late 2016. Furthermore, the set-up for the period ahead remains attractive, as the forward P/E multiple has fallen significantly – not because of a market contraction, but because forward earnings expectations have spiked with the significant tax cut package.

Figure 2 – The Anatomy of a Bull Market – S&P 500 P/E Multiples vs. EPS Growth



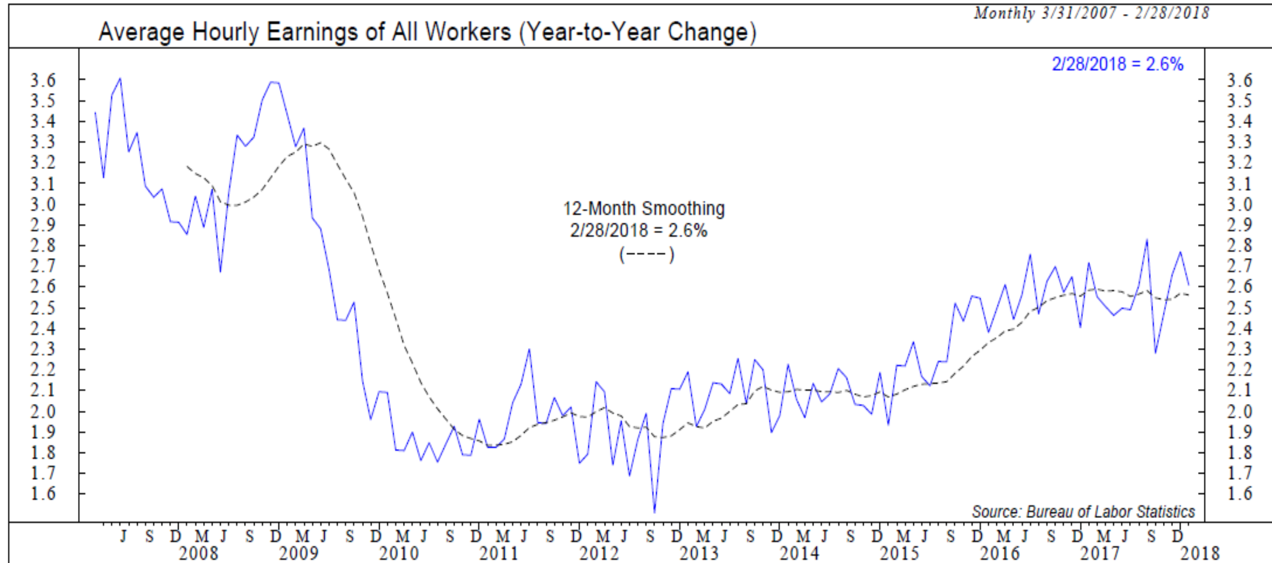
Source: Bloomberg, as of February 28, 2018

Inflationary Pressures Remain In Check

That the healthy economic growth has translated into some cost pressures and the resultant marginal increase in inflationary forces is widely understood. Less clear, however, is the impact of the significant number of U.S. companies whom have been sharing the benefits from tax reform through higher wages and bonuses, and whether this will translate into higher product prices. Since the action of increased wages is partly coming from the voluntary action of companies passing along some of the savings from the significant drop in the corporate tax rate, the typical cost-push pressure on product prices may not materialize in the same way as past cycles. Moreover, companies (especially domestically oriented ones) have a materially higher margin from lower taxes, and are thus in a position to remain much more price competitive despite some rising cost pressures. The consequence for inflation, therefore, would be for a more gradual increase, despite the rising trend for labour compensation.

A modest inflationary environment would result in a much more tempered increase in long-term bond yields than would otherwise be the case given the strength in the employment market. While there have been some on-the-ground signs of wage inflationary pressures, February's jobs report showed strong job growth with moderating wage growth, with the year-over-year change in average hourly earnings ticking downwards to 2.6%. The data is an indication that the job market may still have more slack, also evidenced by unused capacity from a manufacturing perspective (U.S. capacity utilization rate was at 77.5% as of January). This may alleviate worries about some cost pressures.

Figure 3 – Wage Inflation Remains Moderate



Source: Ned Davis Research, as of March 2018

With these offsetting factors in mind, we believe inflation should remain under control for the foreseeable future, and as such the environment is likely to remain supportive with treasury yields not being problematic for equity valuations.

Other Upside and Downside Risks

Other considerations for the stock market uptrend continuing include:

- record level of corporate buybacks for 2018
- a return of the retail investor to active funds and quite possibly the start of the "Great Rotation"
- net capital inflow to U.S. stocks

Risks to the equity investor are in two primary categories, namely:

- Monetary Policy which sees a further flattening of the yield curve beyond that coming from 3 or 4 Fed Rate hikes for 2018;
- Geopolitical developments relating to trade, fiscal policy and foreign affairs

Overall, we remain constructive on equity markets. We expect a more volatile environment this year than what transpired last year, though this is likely to be an opportunity for active managers who are able to participate on the upside while protecting on the downside.

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