Market Insights | 2016 August

RIVERPOINT
CAPITAL MANAGEMENT | INVESTMENT ADVISORS

MARKET INSIGHTS

From RiverPoint Capital Management

Starting the Second Half of the Year on a High Note

The S&P 500 index recently made a new, all-time high. It had struggled to break through the 2130 level, which was originally reached a year ago. Since that time, the S&P 500 index has been in a broad trading range, bounded by 1810 on the downside and 2130 on the top end. The U.S. stock market has been trading in this range over the last two years. As of July 20, the S&P 500 set a new all-time high at 2173, an upside breakout from the previous trading range.

At RiverPoint we have maintained a positive view towards the U.S. stock market this year, even in the face of the tough start the market experienced at the beginning of the year and the more recent Brexit vote. Now that the market is near new highs, we want to examine our market views and outline our expectations for the U.S. equity market over the short-to-intermediate term.

Fundamental Long-Term Bullish Theme Intact

Over the last three to four years we have remained fundamentally bullish towards the stock market, emphasizing we are currently experiencing the fourth secular bull market since the year 1900. From Jan. 1, 2013 to present, the S&P 500 index is up 54 percent as the market's average annual total return has been around 14 percent. This is consistent with historical standards, when it comes to past secular bull markets. The current secular bull has been in existence for 7.4 years. The shortest secular bull lasted about eight years (the bull market of the 1920's) and the longest ran for 24 years (1940's – 1960's). The average secular bull has lasted 13 years. The current bull is becoming a bit more aged, but probably still has life in front of it prior to full exhaustion. We always say bull markets don't die of old age, they tend to die from a recession. Focusing on the short-to-intermediate term, we have coined the Head Down, Eyes Up, Moving Forward theme for the remainder of the year. This theme asserts we are in an investment environment where asset class prices should be volatile (both on the up and downside – head down), but investors should treat these periods of high volatility as an opportunity, rather than as periods of higher, sustained risk (eyes up). In the end, we believe stock prices should have an upside bias this year (moving forward). From January 1 we laid out our expectations for the market to return somewhere in the 5 – 10 percent range in 2016, and that heightened volatility would be a major theme throughout the year. Following the latest upward move in stock prices, the S&P 500 has generated a return of roughly 6 percent this year, a return many would have scoffed at when the market was down around 11 percent for the year in the middle of February.

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Since we are within the range of our return expectation for the stock market this year, does this mean the market is ready for a tumble, or may trade sideways for the remainder of this year? Below are some thoughts that might lead us to an answer to the above question.

Economic Outlook Calls

The fundamental core of our positive-biased outlook for the U.S. equity market this year has been based on the expectation of higher corporate earnings. Earnings growth tends to be the most reliable driver of stock prices, both higher and lower. For corporate profits to rise, the economy in general has to first stay out of recession. Next, the economy needs to show a reasonable level of overall Gross Domestic Product (GDP) growth, which tends to go hand-in-hand with rising corporate profits. Additionally, corporate pricing power needs to be retained and enhanced (general inflation rates need to be modestly positive). Let's examine these items and how they are trending so far in 2016.

- Real GDP growth continues to be slow but steady…and that's good enough - GDP growth is a reflection of overall potential earnings growth. Second quarter U.S. GDP growth was 1.2 percent, a little disappointing given many economists expected growth to be around 2.5 to 3.0 percent for the quarter. Looking under the hood of the report we continue to see strong consumer spending (up 4.8 percent for the quarter) and saw inventories weigh on the report (down -1.1 percent). If spending remains healthy, you would expect businesses to have to replenish inventories setting the third quarter up to have the potential for very nice GDP growth.

- Inflation is creeping up…something we've wanted to see - the consumer price index is up 1.02 percent over the last 12 months (headline rate) and the core rate is up 2.1 percent over the same period. This compares to the headline rate of 0.0 percent for the year ending in December 2015 and 1.7 percent for core inflation over the same period.

- Profit growth should accelerate in the second half of 2016 - Nominal GDP (GDP growth + inflation) has consequently accelerated from 1.9 percent in the first quarter of this year to 3.4 percent for the second quarter. If maintained, the improvement in overall economic momentum should carry into the second half of this year, fueling higher corporate profit growth rates. In fact, second quarter corporate earnings have been better than expected so far. We believe Q2 earnings will mark the end of the corporate earnings recession (we have experienced multiple quarters of negative earnings) and we should begin to see earnings re-accelerated in the back half of 2016 on in to 2017.

Other recent economic data releases also have shown strength overall and relative to expectations:

Economic Release	Result	Consensus Expectation
June Industrial Production	+0.6%	+0.3%
June Retail Sales	+0.6%	+0.1%
Initial Unemployment Claims	254,000	265,000
NFIB Small Business Optimism Index	94.5	93.9
Payrolls for June	+287,000	+180,000
ISM Non-Manufacturing Index	56.5	53.3
ISM Manufacturing Index	53.2	51.3

Based on the recent data, it appears our outlook for acceleration in overall GDP growth is on track, as positive economic surprises have been occurring on a regular basis.

Conclusions

As you know, we rely on our assessment of the fundamental, valuation and technical price trend data to determine our outlook. This allows us to make objective rather than emotional decisions. This data remains positive in our view. Fundamentals such as economic growth remains steady, driven by solid consumer spending (70 percent of the overall economy in the U.S.) and earnings growth looks to be stabilizing and set to accelerate in Q3, Q4 and on into 2017. Stock valuation is fair to appealing, particularly when taking into account low interest rates…dividend yields are very attractive, for instance, relative to current bond yields. Finally, technical price trends in the S&P 500 are supportive for further advancement as illustrated by the breadth of stocks and sectors participating in this most recent rally. The strong performance of small cap stocks along with large cap stocks is also an indication of technical strength in the markets. Seldom do such observations preface a recession… or a bear market. We do expect the U.S. election rhetoric and post-Brexit fall out to generate turbulence through the fall, but anticipate a solid close and overall good result for the year.

If you have any questions please don't hesitate to contact your Wealth Advisor Team.