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US Equities: Policy Smoke or Solid Pillars?

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With US equities charging to new heights, some market observers are questioning whether the market is climbing a "wall of worry" based in part on policy promises that haven't yet been delivered. Grant Bowers, vice president, research analyst and portfolio manager, Franklin Equity Group, weighs in on whether the state of the US economy can support further market gains, and whether US stocks may be getting a bit pricey. He says the two "pillars" of the US economy—consumers and corporates—still look solid.

We view current US economic fundamentals as strong, and characteristic of an economy that is still in a mid-cycle phase. Economic activity is picking up but inflation remains benign. Meanwhile, credit growth is strong, corporate profitability has been healthy and interest rates remain historically low and accommodative. Typically, this phase of the economic cycle creates a good backdrop for equities.

Much of the immediate post-presidential election optimism in the United States focused on the potential for pro-business policy proposals, including lower taxes and less regulation. Recently, investors have expressed some uncertainty surrounding the implementation of such policies, and have also been focused on politics abroad.

From an investment standpoint, we are hopeful for potentially positive changes to come, but prefer to focus on specific company fundamentals, the core economic backdrop, and bigger-picture secular growth trends.

Two Solid Pillars: Consumers and Corporates

What we see as the two main "pillars" of the US economy—consumers and corporates—still look solid to us and supportive of the market longer term.

On the consumer side, we've seen a few signs of softening data in recent weeks, namely in the area of retail sales. However, the overall leading indicators of consumer health remain strong and at high levels.

In March, consumer confidence reached its highest level since December 2000.[1] The housing market has been improving, job growth remains strong, the unemployment rate continues to be very low and we are starting to see improved wage growth in many areas. Two of the biggest areas of job growth recently are manufacturing and construction, which had lagged since the 2007-2009 financial crisis.

In our view, the US consumer is healthy and should continue to be a driver of the economy going forward.

Turning to corporate America, we are just entering the first-quarter earnings season in the United States. Earnings results should provide evidence as to whether the post-election optimism of late last year has translated into tangible fundamental improvement this year.

As of end of April, 58% of the S&P 500 companies have reported earnings, and we've seen roughly three-quarters beating estimates for both earnings and sales. Current estimates are for earnings to grow in excess of 10% in 2017.[2] We think this level of growth should support the corporate side of the economy and provide a tailwind for the market.

A Technological Transformation

We continue to see potential opportunities in many sectors of the market, but one area we are particularly excited about is the technology sector. In the past, we've talked about how many companies have realized that investments in technology improvement are required to remain competitive in the global marketplace. New software and data analytics work together to improve productivity and lower production costs for many companies, keeping them ahead of the competition. These trends are very much intact, and should, in our view, continue to drive spending in the technology sector.

Even more exciting and less obvious are the behind-the-scenes, technology-driven transformations taking place in many industries outside of the technology sector. From industrials to energy to health care, technology applications are disrupting traditional industries and driving efficiency improvements across the board.

One example is in the industrials, where the connectivity between different industrial devices is becoming standard. Data collected is being combined with the power of cloud computing and the implementation of artificial intelligence applications to broadly transform traditional, non-tech industries into more efficient global enterprises. In the industrials, many experts believe this will set the stage for the truly "smart" factory, which we believe is the next step toward the fourth industrial revolution.

The Impact of Rising Interest Rates

We view the prospect of rising US interest rates as a reflection of a healthy economy. We think stocks should be able to weather modest interest-rate increases over the next few years. The current Federal Reserve outlook is projecting two more rate increases in 2017, and barring a major change in the economic picture, the market seems to be comfortable with this pace. We don't see well-telegraphed and incrementally rising rates as significantly impacting our positive view for US equities.

Equity Valuations: Reflecting a Strong Market

We have seen valuations rise over the past few years. The current forward price-earnings ratio (for the S&P 500 Index) is above its long-term average level, but doesn't appear to be unsustainable, in our view.[3] Current valuation alone is not a cause for concern to us, but is something we pay close attention to when we monitor our portfolios. We look at valuations in a broader context, seeing them as a reflection of a strong economy, improving corporate earnings outlook and the prospects for pro-business tax and regulatory policy from Washington.

It is worth noting that historically when stocks have had relatively low valuation ratios, the market has easily absorbed some disappointments, particularly early in the cycle. Setbacks tend to be overcome fairly quickly in a recovering economy, but as we are eight years into the current business cycle, we think the days of cheap US valuations have long since passed. That doesn't mean there aren't opportunities for growth investors, however.

We think earnings will likely be the biggest driver of investment returns in the years ahead. I would caution that disappointments will likely lead to greater volatility, similar to what we saw in 2016 when global markets sold off as earnings growth moderated. Historically, these selloffs have created opportunities for investors to opportunistically buy high-quality companies at more attractive prices.

Our focus as active managers is the identification of multi-year secular growth themes and on investing in companies with strong competitive advantages we believe are poised to benefit from long-term growth trends beyond near-term market gyrations.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Investing in fast-growing industries, including the technology sector (which has historically been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement.

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1. Source: Conference Board Consumer Confidence Survey, March 2017.

2. Source: FactSet, as of April 28, 2017. There is no assurance that any estimate, forecast or projection will be realized. See www.franklintempletondatasources.com for additional data provider information.

3. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. The P/E ratio is a valuation multiple defined as market price per share divided by annual earnings per share.

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