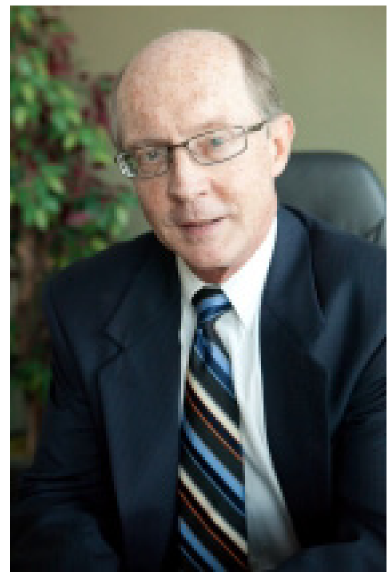
Verity Asset Management

Commentary

May 2018

The market started the year in spectacular fashion, but it took only a few days in late January and early February to deflate all the enthusiasm. We've spent the subsequent three months wandering back and forth in the middle ground between the late January high and the early February low. Corporate earnings are booming, and both U.S. and international economies are doing well – but there is concern in some quarters that this may be as good as it gets. Where do we go from here?

On the positive side, economically …



- There is indeed tremendous strength in corporate earnings. With earnings reports in for over 80% of the companies in the S&P 500, the earnings growth rate for 1st quarter is projected at 24.2%, the highest rate of growth since late 2010.
- International economic activity in general is also broadly strong, and the coordinated strength of international and U.S economies has been as significant as we have seen in some time.
- The U.S. economy's huge services segment, which provided the reliable foundation of growth when manufacturing faltered, continues to maintain a very solid rate of expansion.
- In recent months, the manufacturing segment has also more visibly strengthened, particularly in core capital goods (machinery, computers, etc.), which points to increasing fixed investment by businesses.
- In addition, jobs are plentiful, the unemployment rate continues to tick down, and formerly "discouraged" and long-term unemployed workers have continued to pour back into the workforce.

Valuations were a growing concern as market prices surged sharply higher in January. However, with earnings also sharply higher for 1st quarter and the market well off its January highs, immediate valuation concerns have moderated somewhat. Current forward valuations as measured by FactSet are among the lowest levels of the past 3 years.

It is true that volatility has increased sharply since the end of January, as anticipated, but the turbulence does not necessarily signal a negative outlook for the market moving forward. Volatility during 2017 was abnormally low and now seems to be fluctuating within a more normal long-term range following the severe spike in early February.

With much that looks good, do positive developments represent an accelerating trend or the peak of the cycle? Monetary headwinds, developing tariff policies, and a looming shortage of labor are material concerns:

- After an extended period during which Federal Reserve policy was extraordinarily supportive of economic expansion, the Fed has reversed its trajectory. Interest rates are rising, and the Fed has begun the process of shrinking its balance sheet. On the positive side, this is a much-needed transition reflective of a strengthening economy, but as investors we must also remain aware that these changes represent a tightening of monetary conditions, which could at some point put the brakes on the expansion.

- Potential tariff effects are a significant concern across the economic spectrum. To date, there has been little visible economic impact beyond inflation in steel and aluminum prices. But if trade conflicts should escalate, it would likely be disruptive to markets and damaging to the real economy.
- The pace of growth in job creation, while positive, is not sustainable. As noted in earlier commentary, we are facing a potential shortage of workers, and the problem is becoming more acute. The large numbers of formerly "discouraged" and long-term unemployed workers coming back into the labor force have helped delay the reckoning, but the remaining supply from those formerly huge pools of potential labor is rapidly dwindling. And there are more and more prevalent indications in business surveys that companies are having trouble finding skilled workers, with the April NFIB Small Business Optimism Survey showing that 89% of small businesses currently hiring report few or no qualified applicants. The latest data on job openings, from March, shows there are more jobs open than there are people actively looking for work in the entire labor force. In the absence of available workers, how will businesses continue to expand? Two potential answers are immigration and gains in productivity, but at present, neither source is showing any sign of being able to fill the gap.

Markets can always react quickly in either direction if the signals start to change, but despite the concerns, we do not see any near-term indication that the economy is on the verge of faltering or that markets are preparing to roll over. For now, we are maintaining a balanced outlook - recognizing that, despite clear downside risks, the potential for a significant move higher is still in play - while scrutinizing the incoming data for any material signs of peaking conditions.