What Would Goldilocks Do?

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So far this year, the S&P 500 has broken its previous record high six times and has appreciated about 8% since the end of 2016. The run actually began in the last two months of 2016, after the election, when optimism surged over the new administration's market friendly plans. The prospect of less onerous financial regulations, tax reform with tax cuts, billions in repatriated overseas corporate profits and much needed infrastructure construction trumped the previously held conviction that the world was coming to an end. Lately, however, the euphoria has waned: Congress has not been cooperative, the president's style has so far been counter-productive and now there's a special prosecutor on the hunt for impeachable offenses or crippling legal processes. So, since the thrill of political new hope and new change that drove the market to new highs is largely gone, why isn't the market reversing course?

Forgive our skepticism, but we've never had much faith in the ability of politics to single handedly alter the course of economic cycles; from our perspective, the effects seem to flow in the opposite direction. The market, for now, is paying more attention to economic possibilities than to political dysfunction. And although the recent reports of economic strength don't suggest acceleration, they also don't suggest weakness; not too fast and not too slow is, of course, the Goldilocks scenario. As long as the market foresees a steady and gradual improvement in future economic conditions, and as long as the preponderance of actual data reinforces this forecast, equity prices should continue their upward trajectory. So far, nothing definitively predicts an overheated boom or a collapsing bust -- the porridge is neither too hot nor too cold -- but the statistics deserve close monitoring.

This month marks the eighth anniversary of the end of the Great Recession in June of 2009. Eight years is not the longest period without a recession in the post WWII era, but it's in the top three. And it's number one when it comes to sluggishness: while the average quarterly growth for all eleven expansions over this period was 7.69% (annualized), the current expansion has only managed a quarterly growth rate of 3.36%, well below the second place winner at 5.34%. Explanations for this anomaly have been offered by politicians ("the result of stifling regulations and anti-business policies"), demographers ("this is the new normal for an aging population"), economists ("the 2008 financial crisis did more damage to the economy than we thought") and populists ("I blame it on globalization"). There's probably truth behind all of these arguments. No doubt something, or many somethings, are different about this post recession recovery. Besides the slow growth in GDP, other oddities are apparent: the unemployment rate has been below 5% for almost two years and yet there's still barely a hint of a wage increase; oil prices in the eighth year of a recovery should be trending higher or at least holding steady, not dropping; one would expect to see much higher interest rates at this stage of the recovery. And there are other quirks besides these. They all have at least one thing in common: they are more characteristic of the early to middle stages of expansions than to expansions in their eighth year. It's as if the animal spirits, whose contagiously optimistic investments normally trigger new economic expansions, lacked confidence in their optimism and spread their investments out over time. We may be seeing the result of this nervousness: a longer and slower expansion rather than a shorter and exciting one. For whatever reason, the expansion from June of 2009 through today has produced many untimely statistics. Probably one of the more intriguing anomalies in this expansion is the behavior of inflation.

Inflation, whether it's the PCE (the Federal Reserve's preferred measure), CPI or CPI less food and energy (the so-called Core), is probably the closest to cold porridge among recent economic reports: underlying inflation is registering at an annual rate below 2%, the rate the Fed considers necessary for an expanding economy. On this basis, there's been little incentive for the Fed to raise short term interest rates or to reduce its balance sheet. But, of course, that is precisely what it has undertaken to do. The Fed's recent actions spring from its often conflicting mandates of price stability and full employment. Having accomplished the latter -- the current unemployment rate of 4.3% is considered full employment -- it has turned its attention to keeping inflation within acceptable limits, which appears to be a narrow band around 2%. With oil prices below $50 a barrel and wage inflation, despite strong employment numbers, still quite subdued, the Fed has a lot of room to be patient. Since the inflationary threat remains largely imaginary at this point, we do not expect that aggressive action to raise interest rates will occur anytime soon. The Fed will likely wait for the porridge to warm before it acts: it has effective tools for cooling, but at these low levels of rates, not so many for re-warming.

We began this report by wondering why the stock market is setting records when the original premise for higher prices -- a business friendly executive in the Oval Office promising tax reform and the elimination of costly regulations -- has apparently disappeared into the Washington swamp. One answer to that question might be that current market conditions are attractive in their own right and that the presence of a friendly administration in Washington is helpful, but not critical, to economic growth and positive markets. Interest rates are low and the Fed is in no hurry to raise them in order to tame an inflation risk that for now appears to be imaginary. And if the Fed is reluctant to do this, the European Central Bank is all but opposed to it. The housing market is showing solid strength -- demand for single family housing is outstripping supply, a strong indication for future construction spending -- and suggests increasing confidence among consumers. Gasoline prices, following the lead of oil prices, remain under downward pressure and continue to provide extra cash to consumers' pocketbooks. Corporate profits have recently begun showing signs of life following negative readings at the end of 2015 and beginning of 2016. The S&P 500 is trading at approximately 17 times expected earnings, a not unreasonable multiple, assuming interest rates and profit margins don't change too much from here. Most importantly, the current expansion shows very few, if any, signs of the stress or overheating that one expects near the end of a cycle. Eventually, we will see those signs. But for now, the market seems to prefer a “not too hot and not too cold” state of affairs.

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