This summer marks the eighth anniversary of the economic expansion that began in the wake of the 2008/2009 financial crisis. The good news is that economic cycles do not come with expiration dates, and, as the nearby chart illustrates, the current period of economic growth is closing in on a record for longevity. Looking back as far as World War II, the current stretch of growth has been surpassed only by the 1961 to 1969 expansion (eight years, 10 months) and the current record holder 1991 to 2001 expansion (10 years). Unfortunately, the current cycle holds the unenviable record for the weakest expansion since the middle of the 20th century. Real GDP growth has averaged a modest 2.0% over the past eight years, half the average, and well below the pace of earlier recoveries and expansions.

And yet this modest pace of activity is precisely why this cycle may set a record for duration. Faster growth creates the excesses that lead to a recession, and those excesses simply have not built up in this anemic expansion. What this economic cycle lacks in vitality, it makes up for in durability. Nevertheless, the calendar alone prompts concerns about the next downturn in the economy. The business cycle is not dead, and there is undoubtedly another recession lurking in the future. Despite rumblings in the financial press that the economy is posed on the brink of a downturn, a quick glance at a few leading indicators of economic conditions shows that a recession is not likely imminent.

The National Association of Purchasing Managers (NAPM) surveys its members monthly and constructs a sentiment survey based on their responses. In the nearby graph of the Purchasing Managers’ Index (PMI), readings above 50 indicate expansion, while readings below 50 indicate contraction. As the shaded periods of recessions show, the PMI is not only below 50, but is usually dropping rapidly prior to the onset of a recession. As with all economic indicators, this is far from a perfect indicator; the index often falls below 50 without an ensuing recession. Nevertheless, the current index level of 57.8 stands at a three-year high, indicating no near-term downturn in the economy.
The index of Leading Economic Indicators (LEI), compiled by the Bureau of Economic Analysis, paints a similar picture. Prior to recessions, the LEI drops sharply, although the historical accuracy of its forecast is as imperfect as the PMI. The LEI has risen for 90 consecutive months, and as of May was up 3.5% since last summer. Again, the old adage holds that one should never say never, but the economy has never slipped into recession with a rising LEI.

The combination of steady, albeit slow, economic activity and a robust recovery in corporate earnings has continued to fuel the advance of equity markets. For the first half of the year, the large capitalization S&P 500 index rose 9.3% (including the reinvestment of dividends) and stands 17.9% higher than June 2016. Remarkably, this year-over-year performance is the laggard of the pack, as smaller capitalization stocks (measured by the Russell 2000) and various measures of international equities have performed even better. Growing confidence in European economic activity has taken some wind out of the dollar’s sails so far in 2017. A stronger euro, yen and pound boost the performance of international equities when international stock prices are translated into the U.S. dollar. Developed international markets (MSCI EAFE) rose 20.3% over the past 12 months, while emerging markets (MSCI EM) are up 23.6% over the same time period, both measured in U.S. dollars.

Over longer time periods, non-dollar markets have lagged the U.S. substantially, giving rise to value opportunities outside the United States. For us, the most remarkable figure in the nearby equity performance graph is the 10-year annualized return of 7.2% for the large capitalization S&P 500 index. Keeping in mind that this period included the bear market of 2008/2009, it is difficult to imagine a better proof statement for the importance of taking a long-term approach to investing and letting the power of patient compounding work for you.
We have written in the past about the narrow leadership of the U.S. equity market – how only a handful of very large stocks were determining the direction of the index. That has begun to change, and the divergent fortunes of various market sectors demonstrate that over the first half of this year. Technology stocks have led the way this year. Even after a 3% sell-off in June, the technology sector posted a 17.2% rise in the first six months of 2017, followed closely by consumer discretionary and healthcare stocks. The industrials, materials, utilities, staples, financials and real estate sectors were clustered around the overall market return, while telecom and energy stocks posted double-digit losses. The 30-percentage-point difference between the top and bottom performing sectors indicates that investors have started to make finer distinctions between market opportunities and that market leadership is broadening as a result.

Fixed income markets posted modest returns in the first half of 2017, as rising interest rates pushed year-over-year total returns into negative territory for Treasuries and municipal bonds. Investors were rewarded modestly for investment grade credit risk, as corporate bonds posted a total return of 3.9% for the first half and 2.3% for the trailing 12 months. High-yield debt has offered the best return over every measurement period, more in line with equity returns than traditional fixed income.

We remain leery of traditional fixed income markets as the Federal Reserve works toward a more normal monetary policy by raising interest rates. The short end of the yield curve has risen in line with the Fed’s decision to hike short-term interest rates, although longer-term yields have actually fallen over the first half of 2017 as investors have grown complacent about the threat of inflation. This flattening of the yield curve has no doubt prompted the Fed to accelerate its march toward more normal monetary policy by starting to reduce the size of its balance sheet. We continue to look for opportunities to allocate capital to traditional fixed income, but for now the tradeoff of risk and return remains unappealing for the most part.

Over the course of July, we will get further insight into the health of corporate America as companies report earnings for the second quarter. We believe that results will be positive, with profits for the S&P 500 likely growing 20% or better year over year. Rising earnings have served to insulate the equity market from a litany of external threats to sentiment, and that support should continue as second-quarter earnings reports come in.

Once we get into the fall, exogenous risks rise, not the least of which is the all-too familiar debate over the federal budget and debt ceiling. This will not be the first time that politicians use fiscal deadlines to score political points, but
the current climate in Washington threatens to exacerbate what has become familiar political theater. The Federal Reserve will likely start reducing the size of its balance sheet in September by not reinvesting the proceeds of holdings that mature. The scale of this action ($10 billion per month to start, a mere 0.2% of the balance sheet), coupled with the Fed’s communication about the timing and intent, probably poses little threat to market sentiment, but the interaction of budget debates and Fed policy always raises the possibility of disruption.

Risks always abound in financial markets, although we have not seen them in quite some time. The last correction of more than 5% in the U.S. equity market took place at the beginning of 2016, more than 18 months ago. When disruption inevitably occurs again, our job as investors is to make a distinction between those things that impair price and those that impair value. Price disruption creates opportunity for a disciplined investor focused on the durability of value. Stay tuned.

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