MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

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The US equity market (as measured by the S&P 500 Index) generated a 1.1% total return for the quarter ended September 30, extending its winning streak to seven consecutive quarters of gains – the longest since the 1990s. For the first time in several years, however, other important measures of stock market performance have begun to diverge meaningfully from the large-capitalization S&P 500. For example, the S&P 400 Mid-Cap Index fell 4.0% and the S&P 600 Small-Cap Index fell 6.7% during the quarter. International markets have weakened as well, with the MSCI Europe/Asia/Far East (EAFE) Index falling 6.4%, and the MSCI Emerging Markets Index dropping 4.3%. As of this writing, all of these indices – except for the S&P 500 – are now showing losses for the year to date.[1]

On several separate occasions we have reminded readers of *Consilium* that higher corporate earnings are the fuel needed for additional stock market gains. If economic growth could improve from its subdued pace of the last several years, we argued, then more job creation, higher incomes, and higher spending could drive sales, earnings, and dividend growth. This scenario had the potential to create a positive-feedback loop for stock market investors and generate good returns, even without any further rise in market valuations. At the beginning of the year, we described ourselves as "cautiously optimistic" about an economic acceleration. In April, we were waiting both for the spring thaw and for the upturn. In July, we were able to highlight various signs of strength, but it remained an open question whether our expectations would be met.

Fortunately, we believe the verdict is now in: a period of stronger growth has arrived. The Commerce Department reported that second quarter real gross domestic product, its broadest measure of economic activity, expanded at a 4.6% annual rate in the quarter ended June 30 – the fastest pace since late 2011 and prior to that time, early 2006. Real final sales, which exclude inventory fluctuations, rose at a 3.4% pace, the strongest performance in four years. Business investment in structures and equipment and consumer spending on durable goods both grew at strong, double-digit rates. State and local government expenditures also rose at the fastest pace since 2001.

Other recent data suggest that this report is not a fluke. The Institute for Supply Management's monthly activity indices have risen to their highest levels in over eight years. Bank loan growth has accelerated and loan balances have reached new post-recession highs. Industrial production remains at record levels and capacity utilization is at an eight-year high, suggesting more capital spending ahead. This is in turn supported by six-year highs in the Architecture Billings Index, a leading indicator of construction activity. All of this is occurring while growth in consumer spending remains fairly modest by historic standards. If personal income growth accelerates as unemployment continues to recede, consumers – which represent almost 70% of total domestic spending – will be poised to shift the economy into an even higher gear.

[1] *Source: Morgan Stanley Wealth Management*

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This pickup in activity is occurring, not coincidentally, as the Federal Reserve is ending its massive bond-buying program and is laying the groundwork for the first increase in short-term interest rates since 2006. Economists are nearly unanimous that the first rate hike will occur in 2015, but beyond that, there is considerable uncertainty (even among members of the Fed's Board of Governors) as to how long it might take for monetary policy to "normalize", and how markets are likely to respond to the process. There is no precedent for the five years of unusual monetary accommodation we have just experienced. Even though no one should think of an initial increase (or several) in short-term interest rates as "tightening", *a change in course is clearly taking place*, and we are keeping an open mind regarding potential outcomes.

One possible scenario – which would take some time to develop – is an overheated economy and higher inflation expectations, leading to an overt tightening of monetary policy. Investors may be influenced by the events of 1994, 1999, and 2004, when eventual rate increases exceeded original expectations. Indeed, there may be a tendency to underestimate the speed and extent of Fed rate hikes once they begin, especially after a very long period of extremely low short term rates.

A more plausible scenario, especially in the near term, is a continuation of very weak economic conditions in Europe and Japan, along with continuing easy money policies. This could lead to a much stronger US dollar in foreign exchange markets. But a strong dollar is generally disinflationary, which should limit the upside potential for US interest rates. Further, long-term interest rates are determined in the global market, not by the Fed, and ultra-low yields on competing investments in Europe and elsewhere may put a lid on our own interest rates. There actually may be less risk of sharp rise in interest rates under these circumstances.

It would be understandable if the equity market's adjustment to the upcoming change in Fed policy was a bit bumpy. As the third quarter progressed, volatility was on the rise and stock market performance was considerably more uneven, as noted earlier. The extent of future rate increases, particularly for the long-term interest rates that are most determinative of market performance, cannot be predicted with much confidence. But we believe that, following a period of digestion, an investment environment characterized by a strong dollar, modest inflation, and somewhat higher interest rates could be very positive for US stocks. Despite near-term uncertainty, the longer-term outlook for equities is probably better than most expect.

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