

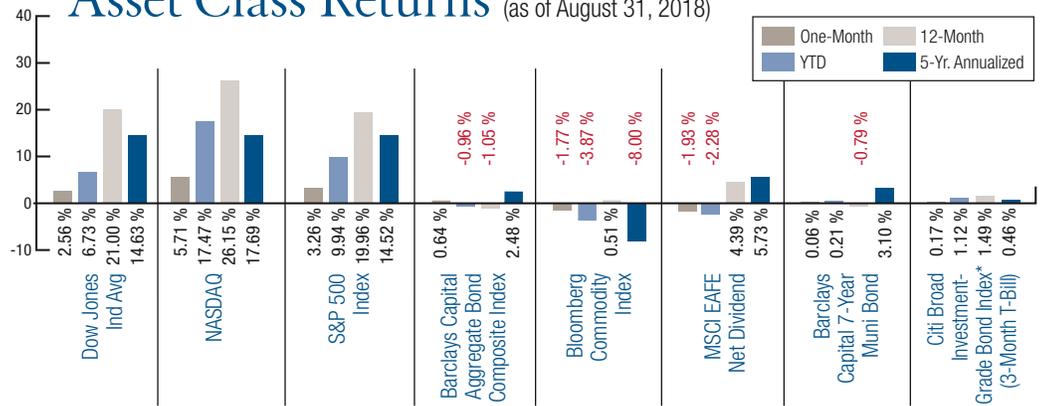
market update

From the Office of
Jeff Sgroi, CFP®



“Every man is the son of his own works.”
-Miguel de Cervantes

Asset Class Returns (as of August 31, 2018)



Material prepared by Raymond, James for use by its Financial Advisors

Market/Economic Synopsis

- U.S. equity markets continue a strong leg up as the S&P 500 nears its record level reached in August
- The U.S. dollar has weakened as of late, weighed down by weaker-than-expected U.S. inflation data
- U.S. Supreme Court nominee Brett Kavanaugh will testify next week before a Senate committee, answering to accusations of sexual assault from years ago
- New round of tariffs, to the tune of \$200 billion, ordered by President Trump on Chinese goods
- Hurricane Florence drops record amounts of precipitation on Southeast coast; flooding slow to subside
- Chinese stock market reflects trade concerns, with the Shanghai Composite Index closing at the lowest level since 2014
- Fixed income markets catching investors' attention as yield curve trending flatter

What Will Continue to Drive This Bull Market?

As we reach year ten of this bull market, I often hear the question, “How long will this market rally continue?” or, “When is the bottom going to drop out?” Certainly, trees don't grow to the moon and there is a limit on how long this impressive bull market can run. But, if we shift our focus from news-driven, short-term fluctuations and turn our attention to what drives the market on an intermediate and long-term basis, we need to look no farther than corporate earnings.

Andrew Adams is a Senior Research Associate in the Raymond James Equity Research Department and recently penned an article titled *Corporate Earnings: The Fuel that Powers the Stock Market*. Below are some key points from his report published in the July 2018 edition of Raymond James' Investment Strategy Quarterly.

Typically, when a company's earnings rise above the market's expectations over time, the price of its shares follows a similar path higher. And, when this kind of better-than-expected earnings growth occurs across the majority of publicly traded companies, a bull market is often the result. A similar environment has been in place since the end of the 2008 financial crisis, with notable improvements in both the pace and quality of earnings growth occurring over the past two years.

AN EARNINGS-DRIVEN BULL MARKET

This positive backdrop for businesses has been consistent with one of our major themes since 2016: An improving economy should transition the interest-rate and stimulus-dependent market to an earnings-driven secular bull market. Data confirm that both the U.S. economy and corporate earnings improved over this time period, which produced one of the best years on record for the stock market in 2017. The positive trend in profits does not appear to be slowing down. Twelve-month S&P 500 operating earnings growth hit its highest level since 2011 in the first quarter of this year and is projected to be even better over the next two quarters, according to consensus analyst estimates from Standard & Poor's (as of June 1).

A PAUSE IN THE ASCENT

To be fair, after such a remarkable price ascent over the previous two years, including a 7.5% gain for the S&P 500 in the first few weeks of January, some sort of meaningful pause in the market was likely in order. There has also been no shortage of headlines regarding global trade, rising input costs, tension with North Korea, and potential political landmines both in the U.S. and Europe to further discourage investors from committing capital to stocks, despite the healthy earnings landscape.

To be sure, the pace of earnings growth should slow down in future quarters. However, we believe the market understands this and does

not expect 20% earnings growth to continue indefinitely. There is also a big difference between the pace of growth slowing and negative earnings growth. Even if S&P 500 operating earnings only grow at 10% (the rate currently estimated for the end of 2019) instead of the more impressive pace seen in the first quarter of this year, it is still a very healthy growth rate that we believe can sustain the secular bull market. In fact, S&P 500 12-month operating earnings have grown at an average of 7.7% since 1990, so growth at a 10% clip would still be better than the recent historical average.

FUTURE DRIVERS OF GROWTH

So, what can help keep the economic and earnings expansion going? Since the end of the financial crisis, economic growth in the U.S. has largely been attributed to additions in the labor market as the unemployment rate has steadily decreased since 2008. It is unlikely that the U.S. will continue to add workers at the same pace of the past few years, which means companies will instead have to focus on productivity growth to keep the wheels turning.

TAX REFORM: A WILD CARD

Last year, Washington bet heavily that lowering taxes, particularly on corporations, would lead to more business investment, higher wages, and, in turn, better productivity and higher consumer spending. Perhaps, more than anything else, what companies decide to do with their tax bill-boosted cash balances will determine how the U.S. economy performs in the years ahead. If companies invest wisely in projects and M&A activities that will grow their businesses, and if wage increases translate into more consumer spending, the economy has the potential not only to keep growing but also maybe even grow at a faster pace.

WILL THE TREND CONTINUE?

Investors are still gathering evidence of what companies are doing with their excess cash, but preliminary signs show some pickup in both business investment and wages. Early evidence is promising, but we will need to watch these metrics closely in the coming months to see if companies are investing in the future and making productivity improvements a priority. If so, this will increase the chances of continued economic expansion while helping the stock market combat rising input costs and the higher expectations of today's investors.

The primary takeaway from Mr. Adams' article is if we focus on what has traditionally been the best indicator of stock market performance—corporate earnings—we have reason to be optimistic. Bull markets tend to last longer than many investors ever expect. Considering our thesis of this bull market having just recently rotated to an earnings-driven phase, we may see healthy market performance for years to come.

From the Homefront

Autumn means back to school for children, and our girls were certainly excited to restart their scholastic routines. So far the twins have had a field trip to the Maroon Bells and are enjoying their “distance” in separate kindergarten classes. Stella's homework load has picked up in third grade, which for her has been a welcome challenge.



Thankfully, the Lake Christine fire in Basalt and many other fires in the west have subsided, along with much of the smoke that blanketed Colorado this summer. Although the fire on Basalt Mountain is not yet entirely extinguished, I was amazed to see new green growth on the hillside that had burned so intensely just weeks ago. Although the scars from the fire will likely remain for years, it appears that Mother Nature is working quickly to rejuvenate the area.

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