ACCESS | WEALTH MANAGEMENT

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Uncertainty: Does the Stock Market Still Care?

"The market hates uncertainty" is an often-repeated stock investing adage. But it didn't seem to be true during the first half of 2017, when the S&P 500® Index had a total return of 9.34% despite significant political and monetary policy uncertainty.

Or perhaps it just hasn't had an impact yet. As expected, the Federal Reserve raised the target range for the federal funds rate by a quarter of a percentage point at its June meeting, bringing the benchmark rate to a 1.0% to 1.25% range. The Fed also stuck to its projection of another rate hike later this year, followed by three more quarter-point increases in 2018, despite a recent drop in inflation.

Political Uncertainty

President Donald Trump's Campaign focused on sweeping reform. However, six months past the inauguration, there have been delays in achieving health care reform, tax reform and other perceived pro-growth policies. To date, this has not had a significantly negative impact on stocks.

"The hope around policy did have a positive impact on 'soft' economic data, which are survey- and confidence-based measures—they surged post-election but have recently been in retreat," says Schwab Chief Investment Strategist Liz Ann Sonders. "I continue to believe the spread between the soft and 'hard'—or actual—economic data will narrow, with the soft data continuing to catch down to the hard data, until we get more clarity on pro-growth policies' timing, especially tax reform."

Liz Ann is one to know about tax reform. In 2005, she served on President George W. Bush's nine-member bipartisan tax reform commission. "Let's just say it's not easy," Liz Ann says. "I believe tax reform would be great for the economy and markets, while tax cuts without true reform would be less good, and tax cuts that sunset—i.e., are temporary—would not be good."

Federal Reserve policy uncertainty

The Fed is attempting to gently raise short-term interest rates, which dropped to near zero for years after the 2008-2009 financial crisis. At the same time, it is looking to scale back some of the roughly $4.5 trillion of assets currently sitting on its balance sheet. In addition to slashing interest rates in response to the financial crisis, the Fed also bought Treasury and mortgage-backed securities as part of an unprecedented effort to inject more money into a wobbly economy. Shedding some of these securities, either by selling them or simply not replacing bonds as they mature, is part of the Fed's return of policy to normal. In theory, tightening monetary policy should slow economic growth, ideally just enough to keep inflation in check without choking off economic growth. Tightening too much or too fast could pose a risk to the economy, which is why investors are keeping a close eye on the Fed's next moves.

Data Divide: Are People Too Enthusiastic About the Economy?

Do people have unrealistic expectations about the strength of the economy? And does it pose a risk to the stock market?

Experts have been asking this question because something strange is happening in the world of economic data. At issue is a major months-long split between "soft" and “hard” measures of the economy that has people wondering if the public’s “animal spirits” have gotten too far ahead of reality.

In this context, “soft data” refers to survey-based economic indicators such as consumer confidence readings and business surveys, while “hard data” covers things like actual economic growth, retail sales, capital expenditures, and industrial production.

High spirits

In recent months, the soft data has been running strong—possibly too strong. The Conference Board’s Consumer Confidence Index is at its highest level since late 2000, the Business Roundtable’s first quarter CEO Economic Outlook Index posted its sharpest jump since late 2009 and the National Federation of Independent Business' Small Business Optimism Index also remains near its highest level in more than a decade.

The trouble is that although the economy seems to be ticking along, it hasn’t improved to anywhere near the level you might expect from the survey data. Job growth has been improving over the past year and wages are slowly moving up, which could be good for consumer spending, but overall economic growth has been moderate at best. Recent auto sales and bank lending data have also looked sluggish, and the Federal Reserve Bank of Atlanta has lowered its hard-data-focused GDPNow forecast for first quarter economic growth to a paltry 0.5%.

Stock market moves

The divide between sentiment and reality raises the question of what will happen if the hard data fails to live up to people’s expectations? It’s unlikely that consumers and businesses would maintain their enthusiasm indefinitely, without some fresh, “hard” reason to cheer on the economy.

This matters for the stock market. While sentiment can help drive stocks higher, lasting gains in the market require the kind of economic improvements that drive gains in companies’ bottom lines.

Guidance for our Investors

We often explain our current strategic investing with a story we can all relate to about driving a car. When you get in your car to drive somewhere you don't turn the car on and stomp the gas pedal to the floor until you come screeching into your eventual destination at an alarmingly high rate of speed. At times, you do stomp the gas pedal to the floor, at times you have the gas pedal partially down, and at times you apply the brakes. And at other times you don't have your foot on the gas pedal or the brake — you just coast waiting to see what comes next. That's where we are now investment wise - just coasting. We are at or near all-time stock market highs depending on the day. That's not a place where we want to "stomp on the gas". The nice thing is our client portfolio values are continuing to rise as we have implemented this coasting approach – which is by design. Picture someone throwing money into the back seat as we coast down the road. That's a pretty nice spot to be.

Timing the market is impossible to do correctly and consistently. Stocks still tend to be the best option for generating significant long-term returns and have had a strong run-up during the past eight years or so. Now the bull market may be entering a more mature phase, which could be marked by bouts of volatility and/or pullbacks. As we often preach, it is essential to make sure your investment portfolio is structured to match your financial goals, timeframe, and risk tolerance so that you can continue working toward your goals *without* having to worry too much about volatility. We are working diligently every day to make that your reality!

Respectfully,

Tony Christensen

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President

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