THE
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Separating markets from politics, is it really a "Trump rally"?

Rising equity prices and bond yields pose a puzzle for investors. Given equity valuations, some investors question whether the rally is peaking. This month, we examine the fundamental underpinnings of a steady economy, growth of company earnings and revenue, and pent-up consumer spending. We also look at equity prices in the context of a host of other investment options, all of which implies support for the rally to continue.

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We are now two months into the new year, a month or so into a new administration in Washington, and nearly four months removed from the fall presidential election. During that time, equities have risen steadily, and to a lesser extent, so have yields on U.S. government bonds. The strength of equities has been a source of puzzlement to many, and not a day goes by without major voices in markets and Wall Street questioning when the so-called "Trump rally" will run out of steam.

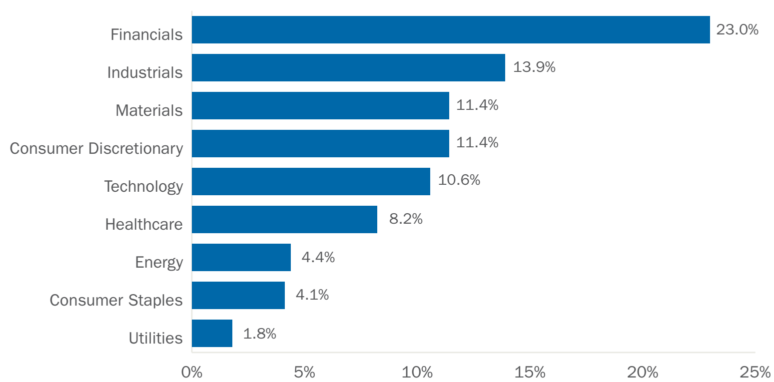
The widespread assumption is that the strength of markets—equities and yields both rising—is largely a byproduct of the election. Take this recent headline: "Investors may be banking too much on Trump lifting earnings." One can find similar sentiments expressed daily. This framework, however, may be misleading. In fact, one can make a sound argument for equity strength based on solid fundamentals that are now more in focus with the noise and uncertainty of an election year that is in the rear-view mirror. And one also could make a case that some rise in bond yields and a tapering of the bond bull market has been long overdue. It's time to separate the markets from politics, which the markets themselves appear to have already done.

Fundamentals anyone?

Let's say, for the sake of argument, that there are two possible reasons that stock and bond yields have been going up: expectations of gains for certain sectors because of new policies in Washington, and solid company fundamentals. The two, of course, are not mutually exclusive. What if we remove Washington from the equation, what actually changes? Expected changes in infrastructure spending, or substantial financial industry deregulation, or reform of healthcare may amount to less than expected, or perhaps to nothing at all. With Washington out of the picture, we can even make a solid case for why stocks are doing well.

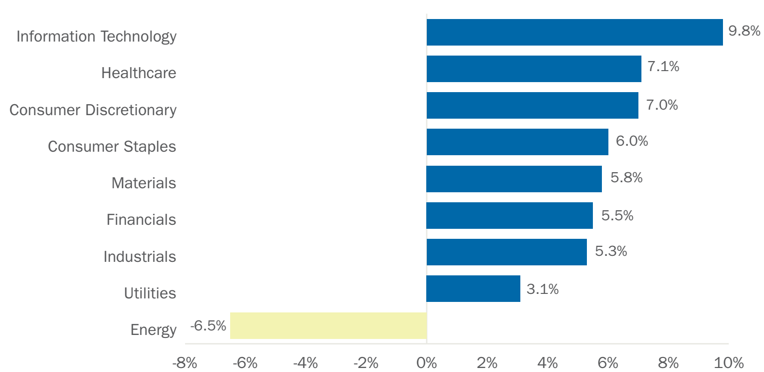
And they have done well, with the S&P 500 up about 5.7% through late February, and up more than 10% since Election Day November 8, 2016. Small caps stocks have been even stronger. Global equities have performed well too, with emerging markets showing double-digit gains. Sectors that are perceived to be tethered to Washington's potential policies surged in November, such as Financials and Industrials, but recently Healthcare, Information Technology, and Consumer Discretionary names have made up for their lag (Figures 1 and 2). The only sectors that have performed poorly are Energy and Utilities.

Figure 1:
Strong Sector Performance Since Election Day



Source: Bloomberg. S&P 500 sector data through Feb 22, 2017.

Figure 2:
Strong Sector Performance 2017 YTD



Source: Yardeni Research. S&P 500 sector data through Feb 22, 2017.

Financial stocks are widely assumed to be doing well, based on the presumption that Dodd-Frank regulations that had supposedly been stifling lending with higher capital requirements would be rolled back. Perhaps. But one can make a cogent case that financial services stocks in general, and bank stocks in particular, have been trading at a steep discount to the market based on years of low interest rates. As the Federal Reserve (Fed) signaled its intent to continue raising short-term rates after years of zero rates and quantitative easing, it makes sense that investors would take a renewed interest in inexpensive bank stocks that are poised to reap more profit from higher rates and less compressed yield spreads. In addition, after a long period of companies' delayed capital spending and consumers' purchases of bigger ticket items, some new spending was almost inevitable. And that means more credit creation and, presumably, more borrowing and lending—also good for banks.

In short, financial stocks may have been due for a rally no matter *who* won in November. The fact that it was Trump who won does not, therefore, imply a Trump rally any more than a similar rally after a Clinton victory should have been dubbed a "Clinton rally."

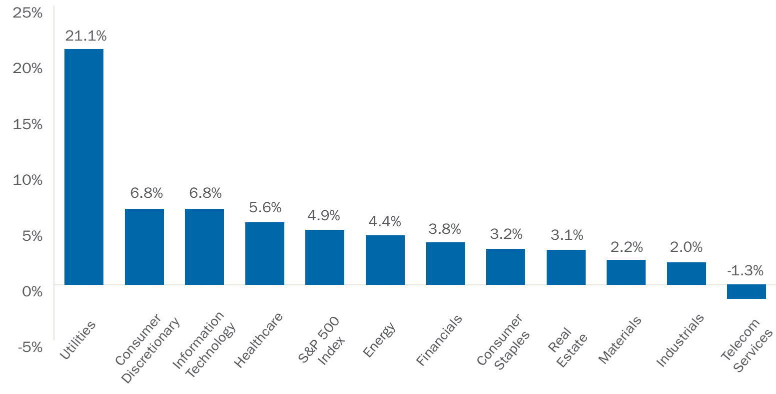
Industrials clearly received a post-election bid based on the assumption of a coming infrastructure push from Washington. But even without that push, there have been signs of increased spending, both in the US and abroad. Base metals and industrials commodities have been surging after a dismal few years—supplies of everything from copper to iron ore have decreased in the face of plummeting prices and weak demand. As is usually the case, supply tends to expand too much in up cycles and contract too much during down ones. US economic activity is steady, global surveys (such as global purchasing managers indices) point to rising infrastructure spending, and new projects are being authorized. Equity prices naturally would be *expected* to reflect these events, regardless of who had won in November.

Then there is the evergreen concern about valuations. Yes, the multiple on equities in general has been higher than the 100+ year average of about 15X forward earnings. At around 17.5X, in fact, the S&P 500 is trading at a higher multiple than it has in more than a decade. But does that matter? Although valuation is a sacred cow that many believe should not be questioned, in investing, as in life, everything should be examined and probed periodically.

The multiple is high, but crafting a portfolio entails a series of relative choices among stocks, bonds, cash, real estate, alternatives, and a plethora of other investment options. For example, a “risk-free” U.S. government 10-year Treasury Note now yields, at most, 2.5% if bought on a peak day. And it’s only “risk-free” insofar as the yield is safe; the price could be quite volatile, as we saw in November and December. But the earnings yield on the S&P 500 is closer to 4%, with a dividend yield of about 2%. And stocks can generate price appreciation, which adds to the total return.

Fundamentals can certainly support modest price appreciation. According to data from FactSet, the S&P 500—which (again) we use simply as a proxy for equities in general—has had two quarters of revenue growth, with almost 5% growth in the fourth quarter of 2016 (Figure 3), and more expected for the first quarter of 2017. Of course,

Figure 3:
S&P 500 Sector Revenue Growth Q4 2016



Source: FactSet, Feb 17, 2017.

earnings growth has been steady, but many have been legitimately skeptical of future valuations without revenue growth. Now we are seeing it.

Finally, growth stocks have been outperforming value stocks, small cap has been outpacing large cap, and international has been doing somewhat better than domestic US. This all signals modest confidence in both a US and global economic expansion. Even with uncertainties surrounding America’s free trade and regulation, much of the world has seen increased trade and a pick-up in economic activity after a rocky couple of years. The US is important, but certainly not the only actor. China has slowed, but has failed to collapse; Europe has (so far) failed to implode; and Latin America is seeing a surge in competent governance and its middle class. That all spells a calmer picture than the popular image of a world in chaos – which it is, of course, in certain places, but those are the exception rather than the rule.

Figure 4:
Growth Stocks and Small Caps: Signs of Future Strength

	Total Returns			
	Since Election	YTD	1 Year	3 Years
Russell 1000 Growth	**10.72**	**7.71**	**21.93**	**11.02**
Russell 1000 Value	12.13	4.24	28.19	10.29
Russell 2000	**17.92**	**3.57**	**39.46**	**7.93**
Russell 1000	11.42	5.94	24.97	10.67

Source: FTSE Russell. Total return data through Feb 22, 2017.

So what now?

Ascribing market strength to the election runs the risk of incorrectly identifying what is driving capital. We will never know what would have happened with a different outcome in the US election—we don't get to replay the historical tape to determine if another variable would have mattered more. But just as Brexit in Britain has not led to quite the dire effects feared (though to be fair, Brexit itself has yet to happen), the election may be less a factor in the markets than many think. The Fed had begun a modest tightening cycle well before November, and equities have been chugging along nicely since the rather sharp and substantial pull-back at the beginning of 2016. Although such pull-backs are always possible, and indeed likely from time to time, they don't mean that the market is on fundamentally shaky ground. As long as the preponderance of economic indicators and company fundamentals remains positive (which they are), and as long as inflation remains tame (which it is), and as long as global and domestic crises remain more feared than actual, then equity markets can continue their modest run. ■

February Takeaway:

Now that the election is nearly four months in the rear-view mirror, investors question whether the "Trump rally" is peaking. Removing politics from the picture suggests the rally may have had less to do with the election than with an improving economy. Thus the case for equities to continue their modest run appears compelling. The Fed is continuing to raise interest rates, making yield spreads less compressed, coupled with more corporate and consumer spending, which increases demand for credit. Combined with tame inflation, all of this justifies higher prices for financial stocks, particularly banks. A dearth of supply and greater demand has pushed up commodity prices, signaling rising industrial activity (and higher prices for equities). And stock prices for companies in other sectors are gaining, too. Factoring in bond yields that are relatively low, compared to the S&P's earnings and dividend yields, points to an equity rally that, in spite of high stock valuations, may still have steam.

INDEX DEFINITIONS: The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **Russell 1000 Index** is a market capitalization-weighted benchmark index made up of the 1000 largest U.S. companies in the Russell 3000 Index. The **Russell 1000 Growth Index** is an unmanaged index considered representative of large-cap growth stocks. The **Russell 1000 Value Index** is an unmanaged index considered representative of large-cap value stocks. The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks.

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