WESTLAKE
PRIVATE WEALTH MANAGEMENT
WELLS FARGO ADVISORS FINANCIAL NETWORK

Halftime

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It's hard to believe we're at the midpoint of another year. But once more, as we always do, it's time to take a look at where we've been and where we believe we're headed and try to wrap some perspective around the economic tea leaves that shape our financial thinking.

One thing for sure, the last eighteen months have brought surprise after surprise: the sharp market selloff in Jan/Feb 2016 followed by the equally sharp and immediate rebound, the June 2016 Brexit referendum, the selection of Donald Trump as the Republican Party's Presidential nominee, then the ultimate election of Trump as President in November and investors' collective response thereafter. This year started no differently – with political wrangling in Washington DC and doubts over the sustainability of economic growth once again giving way to markets that marched on in defiance. By the end of June, the S&P 500 had gained 8.2% for its best first-half performance in four years and the NASDAQ notched its best half since 2009. We participated in those returns, yet we were still a bit surprised.

So where now?

The debates over tax reform and the repeal and/or replacement of Obamacare will continue, but it would be foolish to think the market's fortunes will be determined by political outcomes in Washington DC. Certainly any legislation that frees capital by reducing tax burdens or easing regulations will give the economy a shot in the arm - good policy ideas beget good market performance - but those issues are not the driving force behind stocks. It's earnings and economic growth - always has been and always will be - and those fundamentals right now are in good shape. On the earnings front, according to First Trust Advisors, first quarter 2017 profits for the S&P 500 were 14% higher than in the same period a year earlier - the best quarterly performance in six years. Looking into the second half of 2017 and ahead to 2018 we anticipate more of the same, with 10% earnings growth forecast for both years. Regarding the macro economy, GDP growth has been stubbornly sub-par, averaging about two percent a year during this recovery. Yes the growth story could be better but at the same time we'd be silly to argue against an economy at full employment and boosted by low interest rates and a still-accommodative Fed. Should we see tax reform - even modest tax reform - we would anticipate a substantial pick up in GDP growth.

Some have asked us whether the market is overvalued or whether it has run too far too fast, and we say no. Based on trailing (real) earnings, stocks are modestly expensive but they're nowhere near bubble territory, especially when we see profits accelerating. In fact, if we assess valuations using a capitalized profits model which takes into account US Treasury yields, the market may actually be substantially *undervalued*. And if we remember that the market's twelve-month returns have simply matched underlying earnings growth, we see few valuation concerns at all.

We caution our clients however against complacency, as we've advised in recent months. The fundamentals, as outlined above, are solid and supportive of a continued uptrend in equity prices, but investor sentiment can be a fickle thing and fear always does a better job of calling investors to action than greed. With stocks eight years into a bull market and the economy at the latter stages of its recovery, it wouldn't take much bad news to tempt those with shorter time horizons or less patience to sell. But we won't. Corrections are hard to call and even harder to trade. According to Nick Murray Interactive, the market has corrected 57 times and we've experienced eleven recessions since 1946. Yet in that same time the market has advanced by a factor of 150. Pullbacks happen, but that's why our portfolios are thoughtfully diversified and that's why those of us who remain patient and optimistic are always handsomely rewarded.

In conclusion, our course is unchanged and we view the environment for equities to be in good shape, but we're mindful that risks are somewhat elevated and the possibility for a pullback exists.