Goldilocks…or the Three Bears?

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Key Points

- U.S. equities continue to grind higher, setting records, with volatility remaining historically low. We continue to believe the bull market has legs, but investors should be aware that risks are elevated.
- The labor market is tight, which could limit economic and profits growth, but should help to support the consumer. The Fed is likely to raise rates at the June meeting, but the market is looking for more clarity on the plans for the reduction of its balance sheet.
- Global trade has picked up, which could contribute to further stock market gains, with a likely bias toward larger companies.

Goldilocks…but bears are lurking

The summer doldrums may have come early this year, with stocks quietly moving higher and volatility hovering near historic lows. And why not? Goldilocks appears to have arrived—low interest rates, improving earnings, a strong labor market, calm inflation, and still-accommodative monetary policy. And in spite of stocks trading around record highs, sentiment remains relatively contained, with the Ned Davis Research (NDR) Daily Trading Composite remaining in neutral territory.

Stocks remain near record highs

Source: FactSet, Standard & Poor's. As of June 6, 2017. Past performance is no guarantee of future results.

And volatility is near historic lows

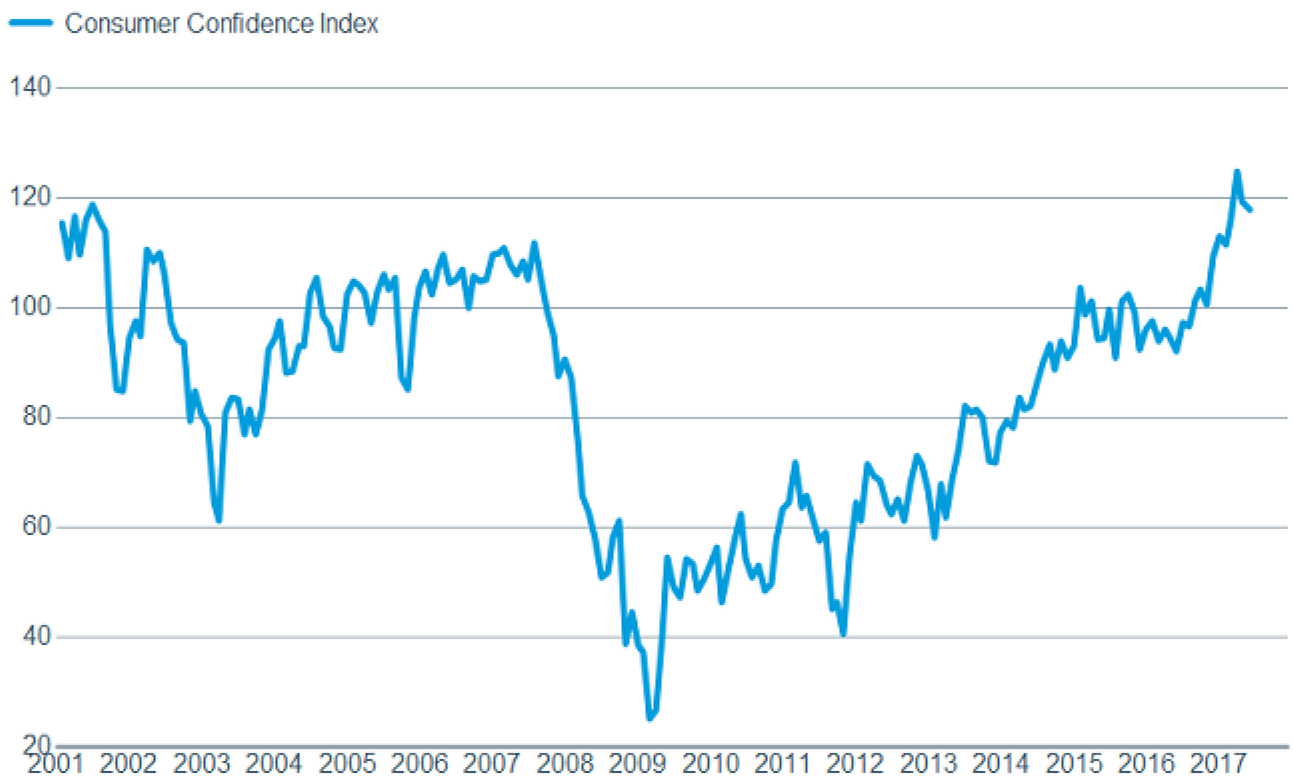
Source: FactSet, Chicago Board Options Exchange. As of June 6, 2017.

But, as always, there are clouds on the horizon and pullbacks are possible at any time so it's important for investors to remain vigilant in keeping a diversified portfolio with appropriate risk exposure. In keeping with the Goldilocks theme, we'll point out three potential pitfalls, or bears, worth watching: an economic slowdown, a domestic political implosion, or a geopolitical blowup. None appear to be imminent, but either of the latter two could appear suddenly.

Goldilocks economy, but frustrating

A little over a month in to the second quarter and it again looks like we're seeing a bounce back from a rough first quarter. Following an upwardly-revised 1.2% real gross domestic product (GDP) reading for the first quarter, the Atlanta Fed's GDPNow forecast is 3.4% for the second quarter, with the consumer appearing to lead the way. First quarter personal consumption expenditures were revised higher to a 0.6% rate of growth from the initial 0.3% ; which was followed by a solid gain in personal spending of 0.4% month-over-month in April. This has helped the "hard" data play a little catch up to the still-strong "soft" data; notably the still-healthy 117.9 reading of Consumer Confidence as measured by The Conference Board.

Consumer confidence remains high

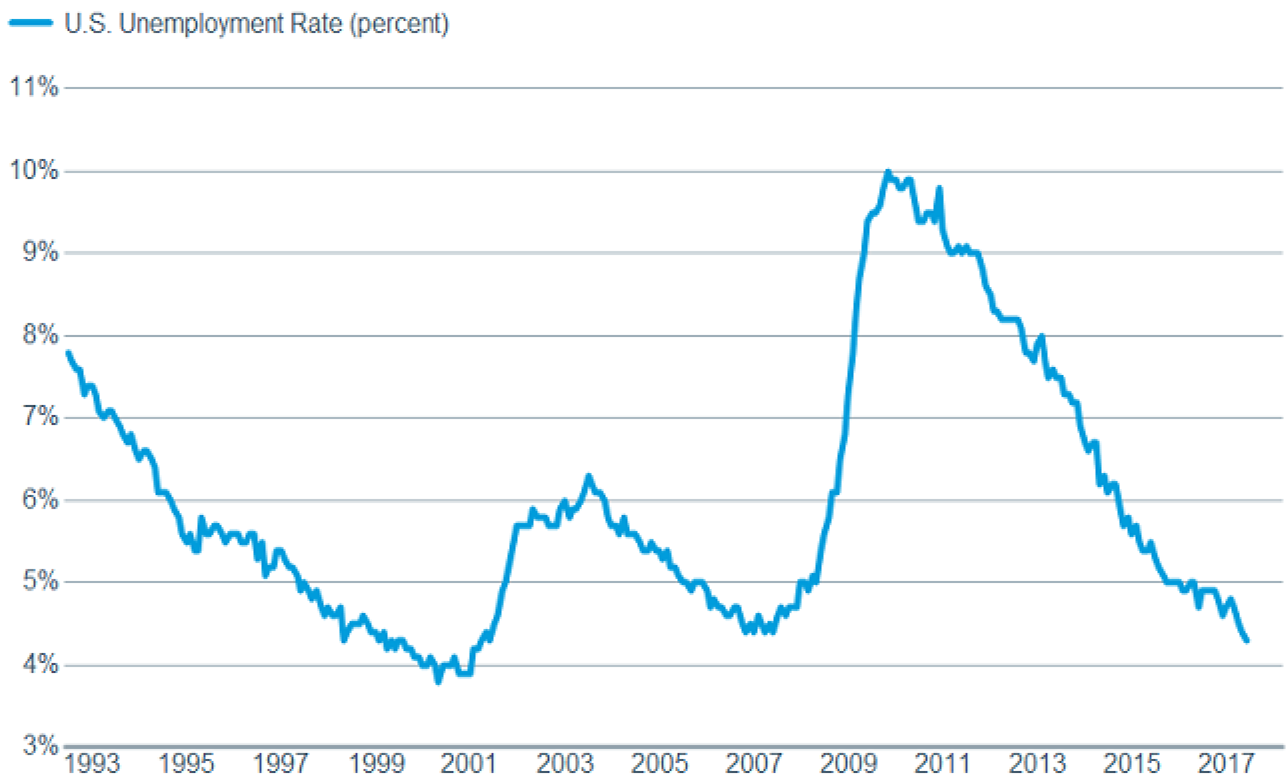


Source: FactSet, Conference Board. As of June 6, 2017.

Confidence is aided by a strong labor market, despite the weaker-than-expected payroll increase of 138,000 announced with the May Department of Labor report. The modestly softer report isn't all that surprising as labor market tightness results in fewer available workers, which has helped bring the unemployment rate down a tenth to 4.3%. Adding to the Goldilocks economic scenario is contained inflation and still-subdued wage growth—average hourly earnings (AHE) are growing at a tepid 2.5% year-over-year. Other measures—like the Atlanta Fed's Wage Tracker—show higher rates of wage growth, which is worth watching. For more on the labor report please read Liz Ann's article, *Turn Down for What: Why is Job Growth Slowing*.

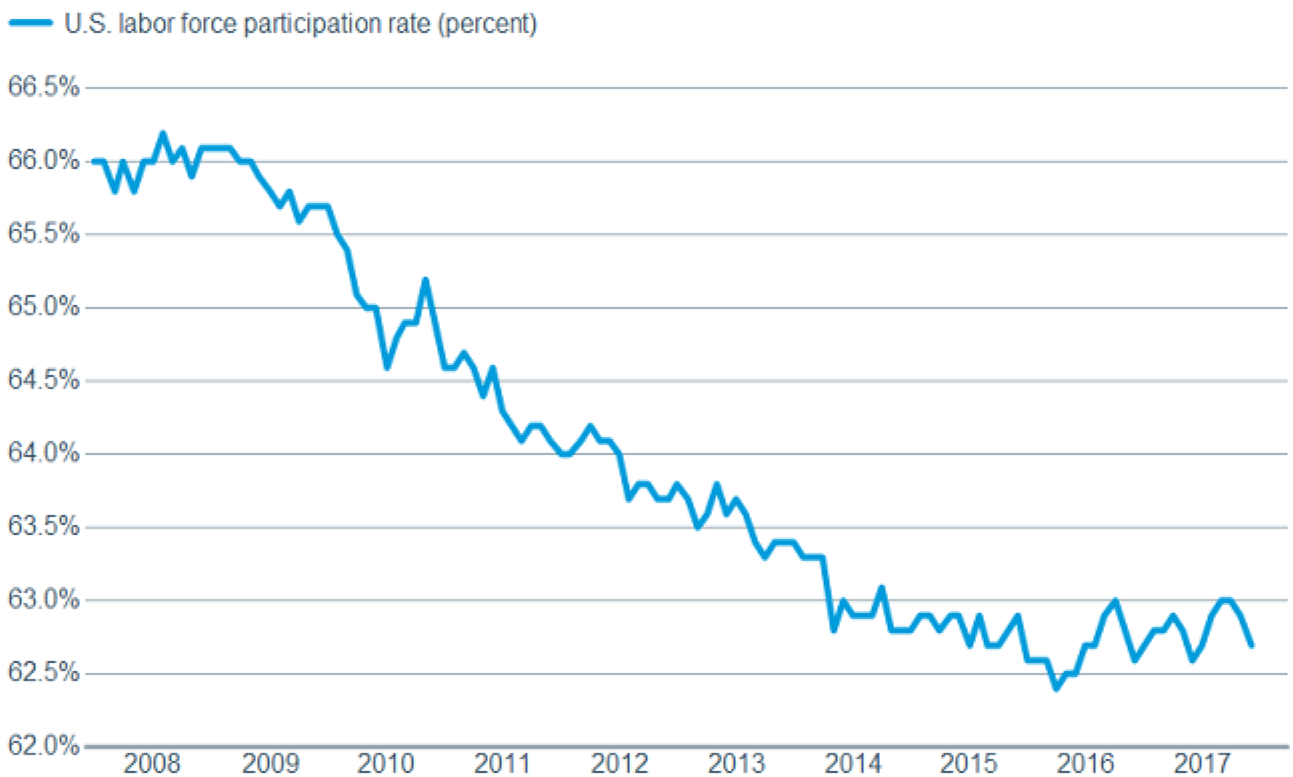
Unfortunately, there is a darker side to this golden scenario. The unemployment rate is below what most economists believe is "full employment," also known as the non-accelerating inflation rate of unemployment (NAIRU), which is believed by a consensus of economists to be about 4.8% according to Macroeconomic Advisors. In theory, this means that wage inflation should start accelerating; which may be initially good for consumers, but could crimp profits and likely push the Fed to be more aggressive. Additionally, with the United States above full employment, it may be tough to get the economy to grow noticeably faster. In order to achieve faster growth, the participation rate will have to move higher—unlikely due to demographic forces; or productivity will have to increase—which doesn't appear on the horizon.

Low unemployment…



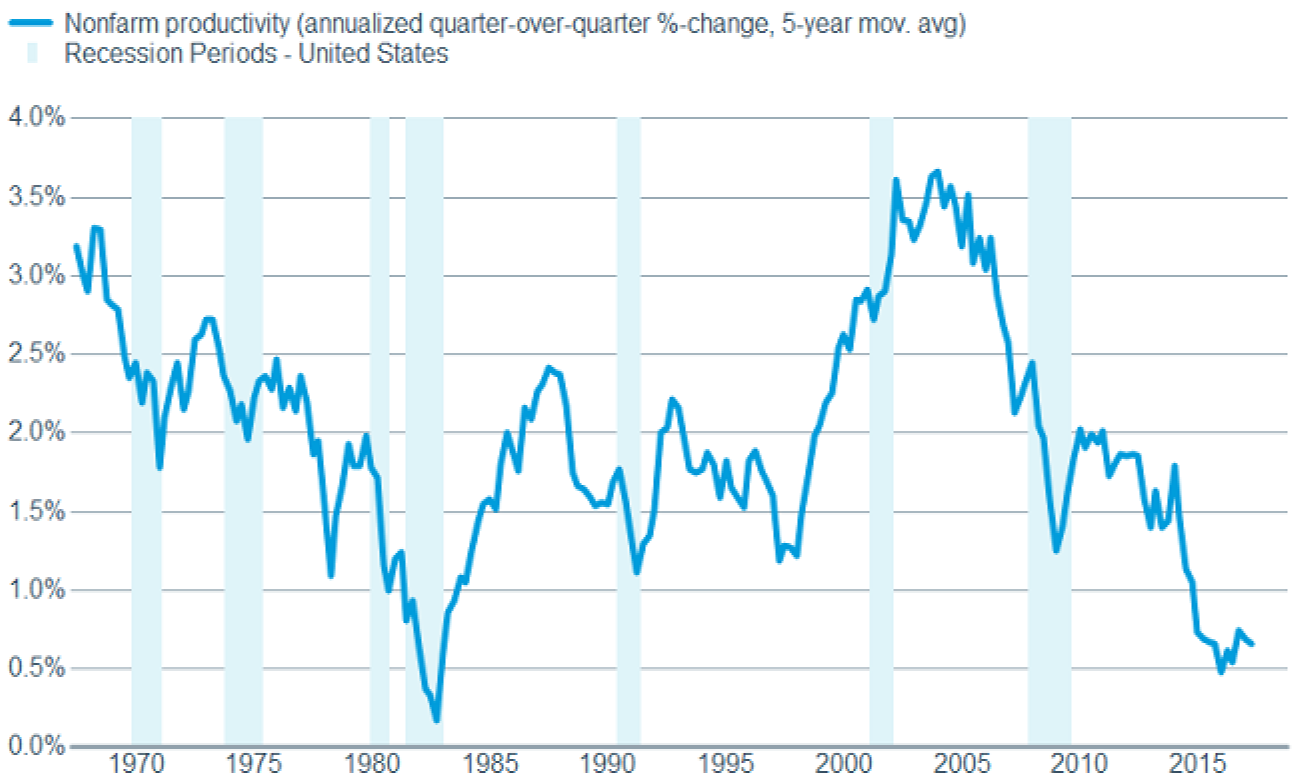
Source: FactSet, U.S. Dept. of Labor. As of June 6, 2017.

…plus low participation…



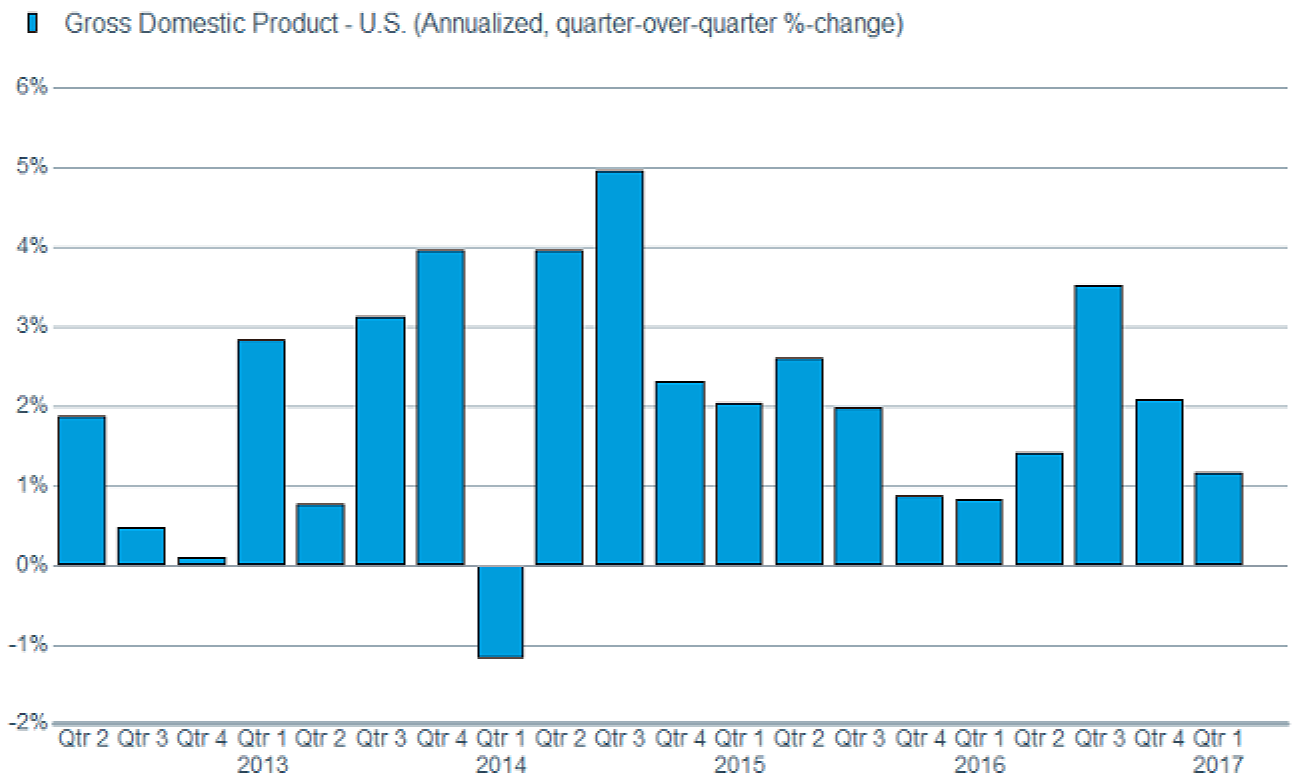
Source: FactSet, U.S. Dept. of Labor. As of June 6, 2017.

…and low productivity….



Source: FactSet, U. S. Dept. of Labor. As of June 6, 2017.

…likely means continued modest economic growth



Source: FactSet, U.S. Bureau of Economic Analysis. As of June 6, 2017.

We believe, an economic outlook of "more of the same" doesn't necessarily mean bad things for stocks, as modest growth with low inflation has tended to be a good environment for equities; much as it has during this entire recovery/expansion.

Goldilocks has left Washington…but might visit the Fed

It is becoming more apparent that the likelihood of any major fiscal stimulus in the form of a tax reform package or an infrastructure spending plan occurring this year is declining. Republicans likely won't focus on taxes until health care reform is done; and with the Senate now promising to produce their own bill instead of following the one the House passed, further delays are possible. On a larger scale, the Democrat strategy currently appears to be much like the Republican one under the last administration—obstruction—meaning getting anything of substance passed is going to be difficult. We still believe that tax reform (or simply tax cuts?) will eventually get done, but it's increasingly likely to be a 2018 story.

Fortunately, neither analysts' corporate earnings estimates nor the Federal Reserve, have assumed any such action occurring. This keeps earnings estimates in check, while helping keep the Fed gradual in its approach to removing monetary policy accommodation. We believe the Fed will raise rates again on June 14, with the futures market pricing a hike at a near certainty. But the market will likely largely look past that expected move, and focus more on any information with regard to the Fed’s balance sheet. It is now expected that the Fed will begin the process of slowly reducing its bloated balance sheet by the end of this year, but that process (and commentary surrounding it) could be a source of elevated volatility in the months to come.

Trading up

Another potential contributor to Goldilocks for companies and economies in the months ahead is the rising trend in global trade. The companies in the MSCI AC World Index get slightly more than half of their revenues from international trade. This percentage ranges from as low as 11% for China to as high as 77% for Germany (among the companies from 15 countries that make up 94% of the value of the index), as you can see in the chart below.

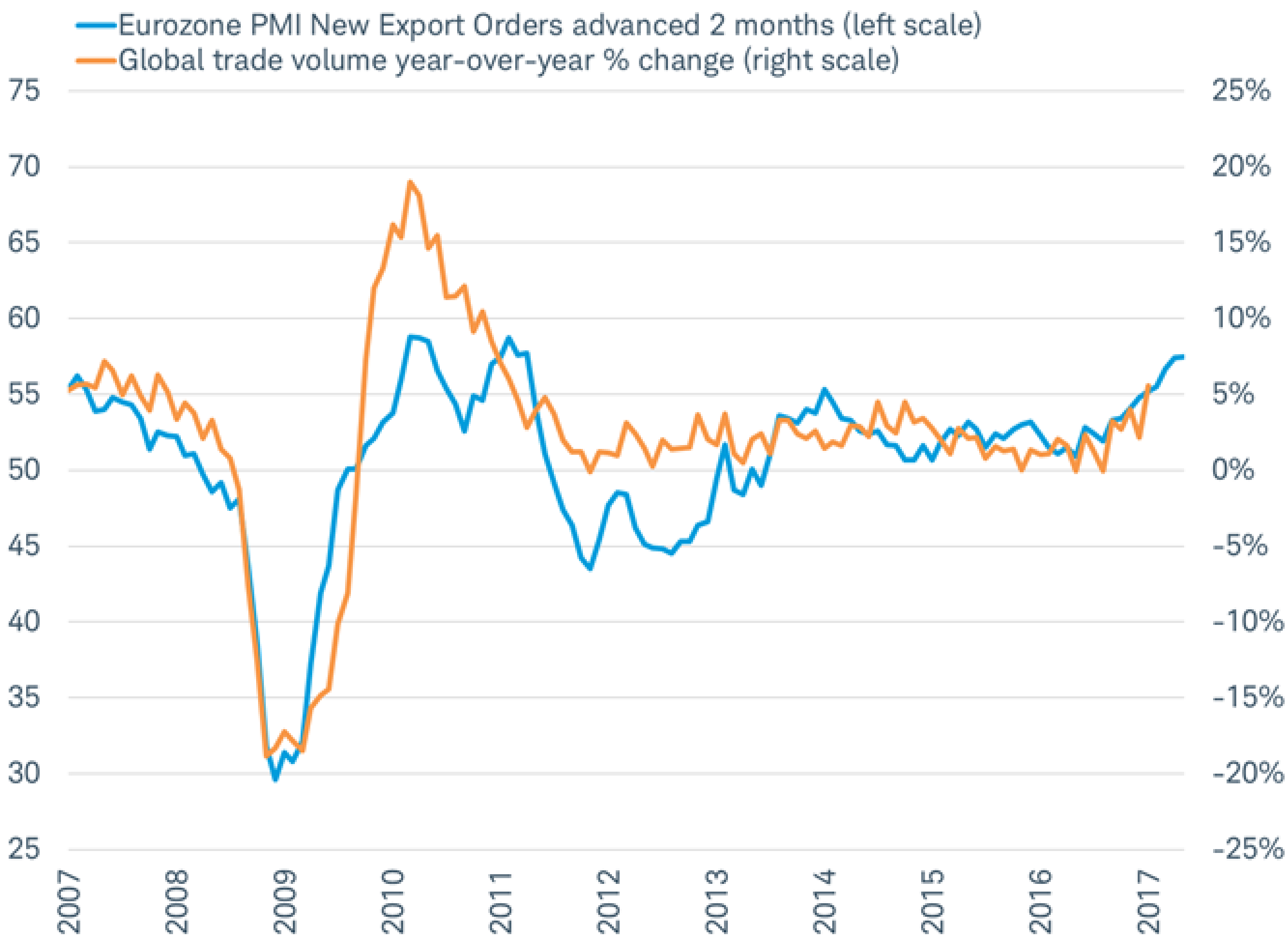
Over half of the world's corporate revenue comes from international trade

MSCI All Country World Index components.

Source: Charles Schwab, Factset data as of 6/7/2017.

Trade growth can have a meaningful impact on corporate revenue growth and, as a result, drive earnings and stock price performance. Fortunately, global trade growth looks set for the highest pace in a decade, with the exception of the snapback in 2010-11. This is indicated by the export orders component of the Eurozone purchasing managers' index (PMI) ,which has done a good job of forecasting global trade growth in the months ahead, as you can see in the chart below.

Rising new export orders indicate trade growth likely to continue to accelerate



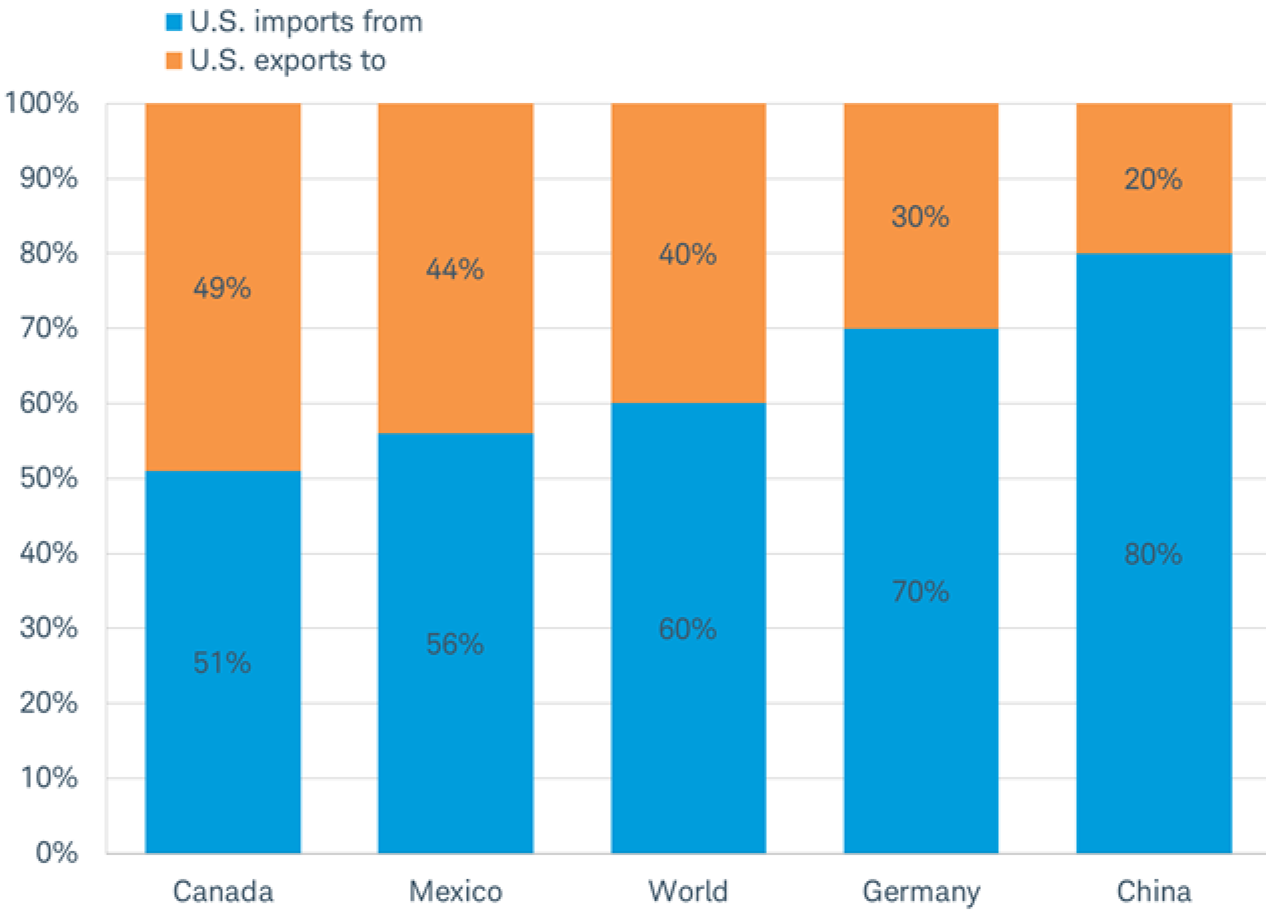
Global trade volume from CPB Netherlands Bureau for Economic Policy Analysis

Source: Charles Schwab, Bloomberg data as of 6/5/2017.

This is important to keep in mind as the end of the month brings the end of the 90-day trade review ordered by President Trump to identify trade abuses. The outcome of the trade study will likely focus on those countries which have goods trade surpluses with the United States. China tops the list, with a $347 billion surplus last year, followed by Japan's $69 billion surplus, Germany's $65 billion, and Mexico's $63 billion. But it may also be the balance of trade, rather than just the size of the surplus, that drives the impact of the focus. For example, Mexico's trade surplus is nearly as wide as Germany's; but it is far more balanced in terms of total bilateral trade since Mexico makes up 56% of total bilateral trade with the United States, while Germany makes up 70% of bilateral trade with the

United States, as you can see in the chart below.

U.S. trade balance by country



Source: Charles Schwab, International Monetary Fund data for 2015 as of 6/5/2017.

Despite the potential for worries over trade wars to resurface accompanying the outcome of the 90-day trade review, the rising trend of improving trade growth means investors may want to consider favoring large cap stocks over small cap stocks. Larger companies tend to have more exposure to international trade as a percentage of their revenues than do smaller companies.

So what?

Goldilocks appears to be taking up residence on Wall Street, with modest growth, low inflation and a cautious Fed combining to make things "just right" for investors. Additionally, the apparent improving global trade trend could help contribute to further stock market gains and support large-cap outperformance. But the risk of a pullback and/or sharp acceleration in volatility is elevated courtesy of both domestic and world political uncertainty, and the potential of a Fed misstep.

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