July 2017

It seems about the only thing that has remained calm amid all the recent turmoil here and abroad is the stock market. Bolstered by an improvement in corporate earnings growth, the market has continued its steady climb higher despite facing issues that could have easily wobbled a less resilient market.

It is safe to say that the stock market is no longer being driven by the so-called Trump rally. The rise in stocks in the first few months after the election was in large part due to investors' hopes that the new administration would be able to quickly push through business-friendly policies such as corporate tax reform and infrastructure spending. However, with so much political controversy and gridlock continuing to bog down our nation's capital, it is unlikely that any such measures will be enacted in the near future. Still, the market has proven to be strong enough to shake this off and continue its march forward.

The market has also so far been able to successfully absorb the Federal Reserve's recent interest rate hikes. After boosting rates only once in the prior ten years, the Fed has raised rates three times since December. Historically, a series of rate increases has tended to serve as a headwind for stocks. Hence the old investment adage, "Don't fight the Fed." And, in fact, the market did not react well in recent years to even the slightest hint that the Fed might be moving closer to raising rates as investors deemed the economy was not healthy enough to withstand that process. However, with increased investor confidence that the global economy is on more stable footing and that the Fed's path toward a normalization of monetary policy is likely to be very gradual, the market has so far handled the rate hikes without a hitch.

The pickup in corporate earnings growth has been the biggest contributor to the market's rise in recent months. The market is far better equipped to deal with obstacles such as interest rate hikes and political dysfunction when companies are churning out strong profits. Following an earnings recession that included five consecutive quarters of profit declines, S&P 500 earnings have rebounded nicely with three straight quarters of growth. In fact, the 14% rise in overall earnings in the first quarter marked the fastest pace of growth since 2011. And while that pace will likely slow a bit as the year goes on, earnings growth for the year is still expected to come in at a very solid 10%. It is no coincidence that the earnings recovery has occurred as the global economy has started to improve. While the U.S. economy continues to grow at a steady but uninspiring pace, global growth this year is expected to accelerate to its highest level in seven years. With about 45% of the sales of S&P 500 companies coming from overseas, this has provided a significant boost to overall corporate profits.

We think the most significant issue the market is facing is a valuation that is pretty rich. The forward price-to-earnings ratio of the S&P 500 has steadily risen throughout the eight-year bull market to around 18 today, above its historical average of 15. While this is not exorbitant, particularly in the context of an equity-friendly low interest rate environment, it is a level that we believe prices in a lot of optimistic expectations. Should earnings


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growth decelerate or Fed rate hikes come at a faster pace than expected, it could result in a long overdue correction. As a result, we have become a bit more cautious on the market as a whole in recent months.

While we view the overall market as fully valued, our focus continues to be on investing in high-quality individual stocks that are trading at a discount to what we deem their intrinsic value to be. To be sure, as the market has risen, the number of attractive long-term investment opportunities has dwindled, and we have become even more selective with our purchases. Should a pullback occur, we stand prepared to more aggressively add new positions. In the meantime, there are always opportunities to be found, and we will continue to work hard to identify them for you.

Sincerely,

Gamble Jones Capital Management