Bull & Bear Bulletin

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Wrapping up 2017

Over the last eight years, real growth in the economy has averaged around 2%. It was unable to break decisively above 3% or fall significantly below 1% for any length of time. Overall, it has been a middling and stable performance relative to history that has left consumers without that extra discretionary dollar to spend, businesses fearful of investing in the face of lackluster demand and governments stretched to do more with less while infrastructure is intractably neglected for the future.

With that kind of a backdrop, any company that is innovating and growing in a way not tied to that slower growth world will likely see its share price continually bid upwards because it is providing that which is scarce – GROWTH (see chart 1). Other companies, whose business models may be more closely tied to the trend rate of growth in the economy, may still see their share prices rise with the tide of the overall market but just not as robustly. This type of dynamic is not unusual. There are always sectors and varying styles of companies which at different times either lead, lag or perform in line with the overall market. Could significant rotations be in order for 2018 and, if so, what will they likely be? It is probably too early to tell, but there are things that we can observe over time to help show us what may come.

Should the landscape marginally change for the better in terms of trend growth in the economy, that could be a catalyst which drives some rotation in the market as pro-cyclical types of companies enjoy a better environment for sales and earnings. At the same time, high innovation and strong growth type companies may not command a premium for their shares as opportunities begin also appearing for out of favor sectors. There is now some optimism that we may be hitting a higher trend rate of growth. Real GDP growth for Q2 2017 came in at 3.1% and Q3 2017 followed with a 3.3% quarterly annualized rate. Estimates for Q4 GDP are currently at 2.9%, as per the Atlanta Fed's GDPNow forecast, and as high as 3.9% according to the New York Fed's Nowcast. If growth remains strong into Q1 2018, we could be looking at a trailing 12 month rate of growth near 3%, which is significantly higher than the 2% average of recent years.

At the same time, the Fed has very slowly been raising short-term interest rates. Yet, over the last two years, overall financial conditions have still remained loose, and therefore, very accommodative. Looking at the Chicago Fed Adjusted National Financial Conditions Index versus real GDP (see chart 2) shows a situation where growth has been moving higher since the summer of 2016, while conditions are actually looser. If the improving growth trend continues, then this is a situation not likely to persist forever. Investors will key in on long-term rates and inflation and growth dynamics to find clues as to where this is headed. A word of caution is in order because we have seemingly been here before and not found the sustained higher growth environment that can handle a faster tightening phase. If we are indeed there, then change is afoot. The extra growth would solve a lot of problems and it may also create some interesting rotations within the market that have not been seen for some time. It is an exciting time and, as always, there are bulls and bears on either side of these issues.

Chart 1

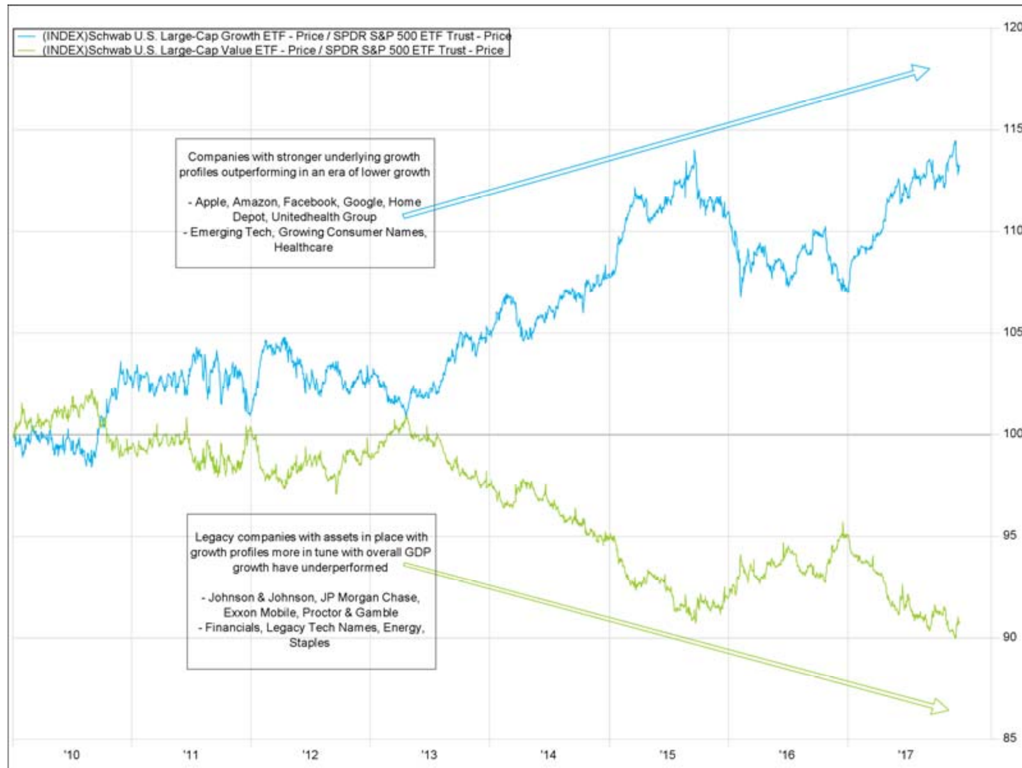
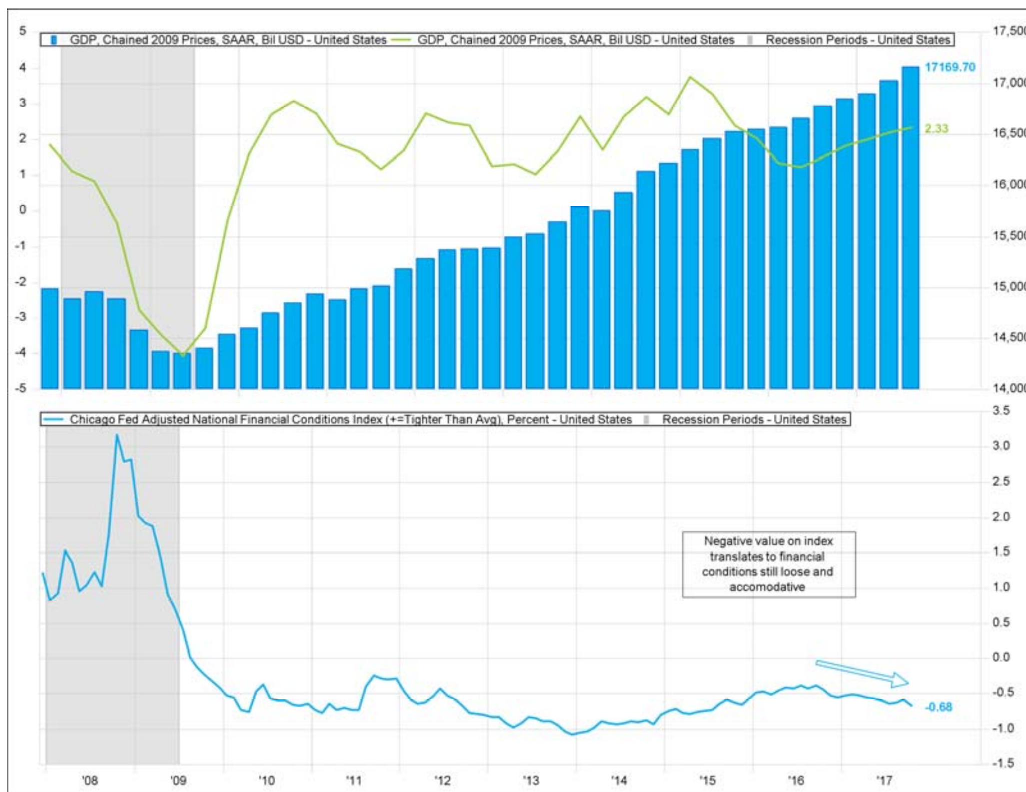


Chart 2



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