MAY 2018

MONETA INVESTMENT MONTHLY

Looking Beyond the Sideways Market

The U.S. stock market, as measured by the S&P 500 Index, has been mired in a tight trading range (between 2,600 and 2,800) since February's market correction. This isn't the first time we've seen the market stuck in a sideways pattern since the bull market recovery that began in 2009, and many factors indicate the bull run may continue. But there are plenty of justifiable reasons causing the market to remain unwilling to affirm a specific direction—either up or down.

Plenty of Support

On the positive side, factors supporting the market include earnings growth, economic activity and confidence. But these are, perhaps temporarily, being partly offset by overly optimistic earnings expectations, a flattening yield curve, trade worries, tighter monetary policy by the Federal Reserve (Fed) and extended valuations.

Earnings growth, on a year-over-year basis, has been significant and broad-based in 2018, with the first quarter and second quarter (to-date) reporting growth of nearly 20%. Tailwinds that could propel growth include the tax cuts for businesses and consumers, which are just beginning to have an effect. This growth has resulted in heightened consumer and business confidence, potentially leading to more capital spending and hiring.

Also, many economic signals continue to point toward ongoing strength, with the first-quarter U.S. real GDP growth number exceeding expectations, the Index of Leading Economic Indicators maintaining its high year-over-year growth rate, and the headline unemployment rate reaching a 17-year low.

Drivers of Hesitancy

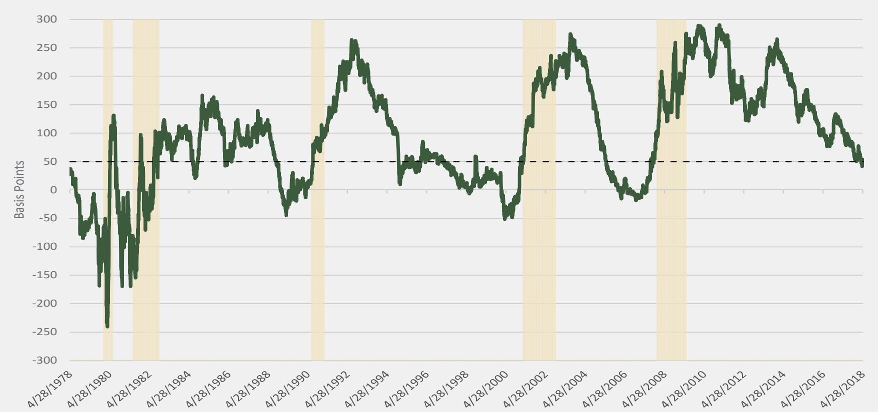
As noted above, despite the strong fundamentals, stocks have struggled to find their footing, indicating that there are other factors creating hesitancy for investors.

One threat to earnings' positive effect on the market is the potential overestimates in market forecasts. For the first time in years, analysts' earnings growth estimates have held steady—and even increased throughout the most recent quarters and have not declined. Therefore, unlike the momentum the market has received from the outperformance of what may have been considered conservative earnings estimates in the past, underperformance of lofty expectations could trigger a downward movement in the market.

Additionally, investors have expressed concerns about the flattening yield curve, which has historically been an indicator of a potential recession. It's worth noting though that a flattening in the yield curve (which we will define as 50 basis points) or inversion does not always guarantee a recession, and even if it does occur, there can be a long lag between the inversion and the eventual recession *(Display).*

Display

A Flat Treasury Yield Curve Does Not Always Signal a Disaster for the Economy
10-Year Minus 2-Year Treasury Constant Maturity Spread
(Recession Shading in Yellow)



Source: Federal Reserve Bank of St. Louis and Moneta *As of April 30, 2018*

Another factor on the minds of many is the rockiness of the political environment, most importantly concerns for trade policy, which seems to change daily. While the rhetoric has become tamer for most foreign trading partners, tensions remain high between the current U.S. administration and China, as the U.S. continues to aggressively pursue a more balanced trade relationship. With no current end game in site, the market unfortunately has to react to the occasional cues it receives from White House advisors.

Meanwhile, we are approaching another round of midterm elections in which a newly elected president's party historically loses a sizable amount of seats—an event that could flip control of both chambers of Congress. Given the political environment since the last presidential election, the effects of a Congressional party change in one or both chambers could be more impactful than they have been in the past.

Finally, although the economy seems to be moving on the right track, many investors remain cautious that this pace of growth will at some point lead to an acceleration in inflation, and in turn much tighter monetary policy from the Fed. However, inflation has only been nudging up gradually. Also, on the valuation front, some have continued to highlight that the price-to-earnings multiples continue to trade well above historical averages, potentially indicating the need for a larger drawdown than the correction experienced earlier in the year.

Where We Stand

We believe the market has plenty of issues to worry about, as noted above, which have been reflected in the recent period of heightened market volatility. In particular, we think that high valuations across most asset classes will likely be one of the larger headwinds in the foreseeable future. However, fundamental earnings growth and positive economic activity should be enough to offset these concerns, though the gains may be slower and the risks higher.

It's easy to start becoming restless when the market is filled with mixed news after a long period of seemingly everlasting growth with historically low volatility, when the S&P 500 gained more than 50% in two years. It's in these periods that we should attempt as much as possible to focus on what we can control, including resistance to panic and euphoria, diversification, and disciplined rebalancing.

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