First Trust
ECONOMIC RESEARCH REPORT
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# This is Just a Correction…

Last year US stock markets experienced the least volatile year on record, hitting new highs seemingly every day. Then came the tax reform bill to end 2017, and a huge January with the S&P 500 rising 5.6%. Investors, especially individuals who finally became convinced that the rally would go on, piled in. It wasn't massive 1999-style euphoria, but many investors finally succumbed to the fear of missing out.

And as if on cue, sentiment (but not fundamentals) shifted, and stock markets gave up their 2018 gains. The S&P 500 - as of the close on February 8th - was down 10.2% from its all-time closing high set on January 26th.

Everyone wants to find a "reason" for a correction, to explain what happened, especially when it takes them by surprise. And these days the prime culprit, according to the financial press, is interest rates heading higher. Some attribute this increase to rising wage pressures and inflation, some blame ballooning budget deficits. But beneath it all is a widely-held belief that stock market gains have been propped up by easy money and low interest rates – a sugar high.

Our answer to this: No! The stock market has been driven higher by earnings growth. In fact, given the recent downdraft in stock prices and the simultaneous increase in earnings estimates, the S&P 500 is now trading at roughly 16.7 times 2018 earnings estimates. That's not high by historical standards. In fact, that is lower than the 30 year average of 19.4.

More importantly, we have been expecting interest rates to go higher and have urged the Fed to raise rates more quickly. Given the pace of economic growth, the Fed is a long way from being tight. At the same time, economic data has been strengthening and earnings are booming. With 337 S&P 500 companies having reported Q4 earnings as of the 8th of February, 76.9% have beaten estimates, and earnings are up 17.0% from a year ago. This double-digit earnings growth is forecast to continue through 2018, even with higher interest rates. Corporate balance sheets are stronger than they have been in decades, spending is accelerating and the recent tax cut is an unambiguous positive.

Corrections scare the snot out of people. For many, who thought markets only go up, they feel like the end of the world. This is especially true when pundits start trying to explain the drop in stock prices by arguing that there are fundamental problems with the economy. This time is no different. But, in our opinion, this is an emotional correction, not a fundamental one. The US is not entering a recession, and higher interest rates over the next few years do not spell doom for the economy or markets.

In fact, because of better policy, economic growth this year looks set to accelerate to 3%+ (we are forecasting 4% real GDP growth in Q1). That is why interest rates are rising, because of better than expected economic growth. This is a good thing! Not a reason to sell stocks. In this case higher interest rates are a byproduct of a stronger economy, not the unwinding of QE or higher deficits.

Retail sales rose 0.4% in December, are up 9.0% annualized over the past six months and are up 5.5% year over year. January's ISM Manufacturing and Non-Manufacturing indexes just hit the highest readings for a January in seven and 14 years respectively. In January, hourly earnings were up 2.9% from a year ago, the best reading since 2009. At the same time, initial claims have been below 300,000 for 153 consecutive weeks. Private payrolls were up 196,000 in January, and the unemployment rate is down to 4.1% and headed lower. And no, this is not a "part-time" recovery. In the past twelve months, full-time employment has grown by 2.39 million jobs while part-time employment is **down** 92,000! With 5.8 million unfilled jobs and quit rates at the highest levels of the recovery, there should be little question why the Fed continues to hike rates.

We use a Capitalized Profits Model (the government's measure of profits from the GDP reports divided by interest rates) to measure fair value for stocks. Our traditional measure, using a current 10-year Treasury yield of 2.85% suggests the S&P 500 is still massively undervalued. The model needs a 10-year yield of 3.9% today to conclude that the S&P 500 is already at fair value with current profits. Fair value, not over-valued.

What we focus on are the Four Pillars of Prosperity: Monetary Policy, Tax Policy, Trade Policy, and Spending & Regulation. So, let's see where those stand:

1. Monetary Policy – The Fed is still easy and will be for the foreseeable future. Remember, there are still over $2 trillion in excess reserves!
2. Tax Policy – Tax policy has improved dramatically on the margin, a tailwind for growth and earnings.
3. Trade Policy - The protectionist talk coming from Washington is worrisome, but, so far, there has been

much more hot air than substance. In fact, total trade (exports + imports) sits at record highs.

4. Spending & Regulation – This is a mixed, but still positive, bag. On the regulation front, 2017 saw the biggest decline in regulation, at least since the Reagan-era, and possibly in history. That's great news for growth. The spending side is still a concern. The recent budget deal reached in the U.S. Senate boosts spending at least as fast as GDP growth over the next couple of years. That's not a recipe for long-term economic acceleration, but also not an immediate threat to growth.

The bottom line shows that the fundamentals of the economy are strengthening. Higher interest rates are a byproduct of a stronger economy. And, out of the four potential threats to the economy, only one is moderately negative.

It's not often you get a substantial pullback in the market when both economic and earnings growth are strengthening. Stay calm. Stay invested in equities. Don't fight the fundamentals.

*This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*