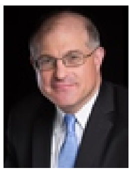
Mitch on the Markets

Forget Politics! Focus on Fundamentals



By Mitch Zacks
Portfolio Manager

Politics and policy could very well affect how stocks perform in 2017. But the key word in that sentence is *affect*, because I don't think politics and policy will actually *determine* how stocks perform. Performance, in my view, depends first and foremost on **economic fundamentals.**

All too often, we investors get swept up in the political narrative or a news story that flashes red on the screen, and we quickly set aside the macro perspectives that ultimately drive stock performance. Instead of looking at the yield curve and leading economic indicators, we look at Greece's debt situation. Instead of looking at corporate earnings and consumer spending, we look at President Trump's latest executive order or tweet. You get the picture. There are so many media distractions that it's difficult keep focus on what matters most - the boring, dense, and uncontroversial economic data that makes stocks go 'round.

Here's a reminder of how things are progressing in the world's largest and most diverse economy (the U.S.'s).

Strong and Confident Consumers

U.S. retail sales moderated at the end of 2016 but posted a solid January, even as weather and other factors generally keep consumers out of stores. January sales were up +0.4% which far outpaced a +0.1% increase, and December sales were also revised higher to +1%. On an annualized basis, retail sales grew a sturdy +5.6%.

Broad-based consumer spending - which accounts for over two-thirds of U.S. economic activity - increased +0.5% in December after notching +0.2% higher in November. It was the largest increase in Q4 and reaffirmed that the U.S. consumer has been steadily strong throughout this expansion. Consumer spending increased 3.8% in 2016 following a 3.5% increase in 2015.

It may come as little surprise, then, that the January reading of the University of Michigan's Consumer Sentiment Index was posted at 98.5 That marks the highest reading since January 2004, even as wages and salaries have only modestly ticked up over the last few years. Consumers may be anticipating tax cuts and fiscal stimulus as measures to boost economic activity going forward.

Modest Inflation with Favorable Interest Rates

Inflation has arguably been in somewhat of a sweet spot here in the U.S. - not too hot, not too cold. This prevents the Federal Reserve from having to raise rates too quickly, which can stifle economic growth. The personal consumption expenditures (PCE) price index rose 0.2% after 0.1% tick-up in November. With December's rise that puts the PCE price index at +1.6% year over year, which is below the Fed's 2% target but still acceptable by any measure.

Modest inflation with moderate growth has kept interest rates low, which maintains a favorable borrowing environment for individuals and small businesses. The National Association of Realtors said its pending homes sales index climbed 1.6% in December.

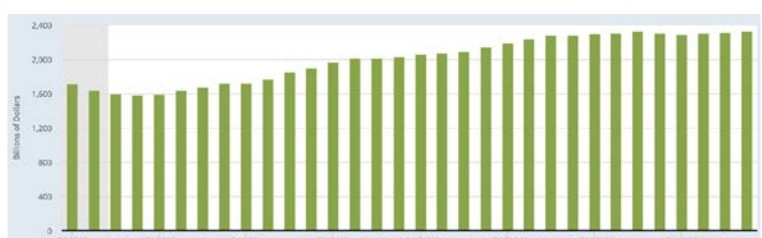
Corporate Profits and Investment

As of Wednesday, February 15, we have seen Q4 results from 375 S&P 500 members or 75% of the index's total membership. Total earnings for these 375 index members are up +7.2% on +4.6% higher revenues, with 68.8% beating EPS estimates and 54.4% coming ahead of top-line expectations. The proportion of companies beating both EPS and revenue estimates is 40%. Not only is growth on track to reach its highest level in two years, but total earnings are on track to reach a new quarterly record - *yet no one talks about this!*

Forward looking estimates for the current period (first quarter of 2017) are holding up nicely, which is reassuring since expectations for the period already reflected strong gains. Total earnings for the S&P 500 index are currently expected to be up +7.4% from the same period last year on +6.8% higher revenues. This is down from expectations of +10.3% earnings growth in early January, but still marks robust growth.

On the business investment front, the image below speaks for itself. Corporations continue to invest in growth even though a lot of capital is also flowing to share buybacks and mergers and acquisitions.

Private Nonresidential Fixed Investment on the Rise



Source: Federal Reserve Bank of St Louis

Bottom Line for Investors

The economy grew at a +1.9% in the fourth quarter, affected notably by a wider trade deficit. Even though imports are a sign of strong domestic demand, they count against GDP in calculations. If you look at just consumption, business investment, and real estate, the GDP reading would be higher.

As it is clear to see from the data presented above, the U.S. economy is in fine shape entering 2017 and appears to have growth momentum looking ahead. For investors that forget about politics and focus on fundamentals, the data suggests that being in stocks is a wise choice. And I agree.

-**Mitch**

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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