Our Perspectives: Amid Extremes, Where to Next?

Homestead Funds

This article was prepared in March 2017 and first appeared in the Q1 2017 issue of *Horizons,* Homestead Funds' quarterly newsletter.

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Stocks have been setting new record highs and the U.S. stock market has been trending up for eight years, the second-longest period on record.[1] But interest rates are poised for further hikes, and global politics seem loaded with event risk. Where to from here? Is there room for more gains, or are the risks piling up?

Rising Rates Can Be Benign

Traditional thinking holds that rising interest rates are always bad for stocks. This theory rests on the idea that higher borrowing costs hurt company profitability, while also cutting into discretionary dollars among consumers.

But studies show that stocks can perform just fine during a typical period of rising rates. In fact, when interest rates are going up, it's usually because inflation is ticking up and the economy is humming along. This is an excellent backdrop for overall company profitability and growth, and this stage of an economic cycle can go on for quite a while. The exception is a period when inflation is in a "runaway" pattern — a time when policymakers don't just raise rates, they hike them far and fast to gain control over the inflation situation. The economy is nowhere near this scenario today.

What's more, gradually rising rates do not spell doom for long-term investors with short-term bond holdings. Remember, there are two components of a bond's total return: income and price change (appreciation or depreciation). While bond prices typically decline in response to a rise in rates, yields typically go up. Over long holding periods, that rising level of income can more than offset a decline in price.

Market Cycles Don't Die of Old Age

Perhaps you've seen statistics or news stories about how the present bull market (period when stock prices are rising) just turned eight years old, the second-longest bull market in history. First, that is only true if we all agree on when a "bull market" ends. The conventional definition is that a bull market is over when stocks fall by 20% or more, marking a "bear market." But what if they fall 18%? Or stay flat for a prolonged period? Since the stock market first recovered

[1] money.cnn.com/2016/04/29/investing/stocks-2nd-longest-bull-market-ever/

after the financial crisis, beginning in March 2009, there has not been a single pullback of 20% or more. But stocks have had a number of mid-sized pullbacks, including a retreat of more than 14% between May 2015 and February 2016 amid tumbling oil prices and fears of a slowing China.[2]

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The Trump Trade

Many details of the administration's plans are not yet known. Still, Trump has announced a number of policy ambitions that could be positive for company earnings. Lower corporate taxes are widely anticipated and would have a direct effect on the bottom line for companies. His plans to ease regulatory burdens for a number of industries are also viewed as a business-friendly move.

And clearly company managements are taking note. In fourth-quarter earnings calls, more than half of S&P 500 companies mentioned "Trump" or "the administration" as they discussed earnings and outlooks. Over a quarter of the calls included discussions of "tax policy," while one in five mentioned "regulation" in the context of company performance.

Many Signs of a Healthy Economy

By many measures, the economy remains healthy, rather than extreme. GDP growth, the broadest measure of overall economic health, came in at a 1.9% annual rate in the fourth quarter, following a robust 3.5% rate in the third quarter. Inflation has rebounded to a healthy zone, with the January Consumer Price Index reading showing 2.5% year-over-year growth in prices, boosted by stable commodities and wage increases. The latest unemployment rate was 4.8%, continuing a steady track downward since spiking to 10% during the financial crisis, while company earnings grew at a 5% year-over-year rate in the fourth quarter, the second consecutive quarter of increases after a long run of dwindling profits. And merger and acquisition activity, which broke records in 2015, continued at a strong pace in 2016 and is forecast to grow another 6% globally in the first half of this year.[3] While markets may seem positioned at the extremes today, the fundamental measures of economic activity are actually in a moderate and positive place.

[2]time.com/money/4399887/today-will-determine-if-the-bull-market-is-still-alive/
[3]finance.yahoo.com/news/global-m-activity-predicted-increase-133000352.html

Homestead Funds client services team would be happy to talk with you about your goals and current investment program. Give us a call at 800.258.3030.