CAMPBELL NEWMAN

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REFLECTIONS & PERCEPTIONS

THE PAUSE THAT REFRESHES

The almost decade-long bull market remained on solid footing through the end of the quarter, with the S&P 500 recording a 7.71% total return while hitting new all-time highs in the third week of September. The stock market's strength was broad-based as all but one of the 62 Russell US Indices posted positive returns in the quarter (Russell Microcap Value® Index, -1.26%).

Stocks' gains were driven by robust earnings within a 4% GDP growth backdrop. For example, earnings growth for the S&P 500 was 24% year-over-year in 2Q (for the second quarter in a row) and it is anticipated to be reported at roughly 20% in 3Q. Healthy earnings outweighed the quarter's more negative developments, including higher interest rates, higher mortgage rates, Hurricane Florence and the impact of new tariffs on international trade, providing investors with ample reason to buy stocks.

To be sure, 2018's earnings increases have been aided by more favorable tax rates, however improved top-line performance has been as important a contributor. Credit Suisse estimates that revenue growth and tax benefit will each account for roughly 35% of the projected ~20% growth in 3Q 2018 EPS for the S&P 500, with margin expansion (~20%) and share buybacks (~9%) accounting for the remainder. This is important because, while the current economic expansion has been long, its growth trajectory has been shallow (until recently) and a little bumpy, making revenue growth (and, therefore, earnings growth) more difficult to generate.

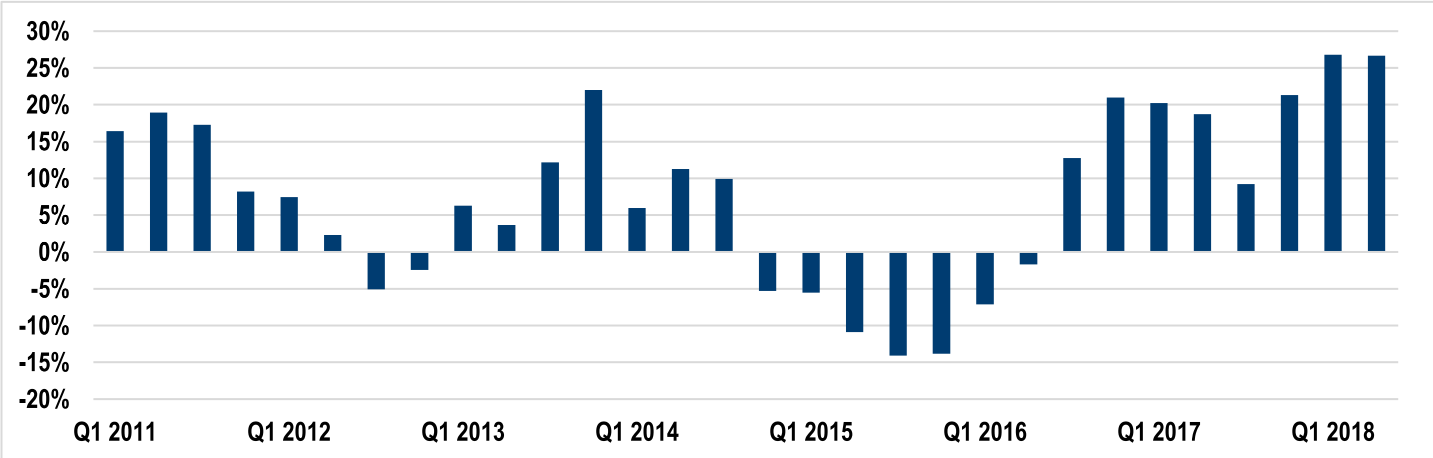
A favorite past-time during economic expansions and bull markets is predicting their demise. This time is no different: The S&P 500 is showing 20% plus EPS growth yet concerns of recession and an accompanying bear market are garnering greater attention, with the impact of rising interest rates on business activity and valuations seen by many as creating a tipping point.

We remain constructive regarding the stock market's progress, with the expectation that the underlying fundamentals will support higher prices over time. Our outlook is grounded on a handful of key factors:

<u>This recovery has produced slower growth than prior extended recoveries</u>. Northern Trust's CIO Bob Browne notes that, if GDP grew at a 3.8% rate for the next five years (above most economists' forecasts), it would produce a 70% expansion of GDP from June 2009 to September 2023, a period of 14 years. This 70% would still fall short of the growth achieved in the two other extended recoveries: The eight-year expansion that began in 1982 produced a 75% increase, while the nine-year expansion that began in 1991 produced a 74% increase. This analysis implies this cycle has been an underachiever and has room for further growth.

<u>Interest rates are rising but remain low compared to historical averages</u>. For example, the 40-year average for the Fed Funds Target Rate is 5.00% versus

YEAR-OVER-YEAR GROWTH IN S&P 500 OPERATING EARNINGS



Source: Standard & Poor's

its current level of 2.00-2.25%. As rates go up, the markets need time to adjust to the new reality. At the same time, it's important to emphasize interest rates are going up in response to strong economic activity and high rates of employment.

This bull market has been punctuated by periods of retrenchment. There were greater than 15% corrections in 2011 and 2015 brought on by declines in earnings growth, but the market achieved new highs 12 months later. Stock prices tend to follow earnings growth, but this relationship is not perfectly timed. The 2011 correction was projecting the slowdown in the second half of 2012. The 2015 correction was concurrent with an earnings growth decline, and what turned out to be three years of flat S&P 500 earnings. Also, let's not forget this year's January-February 10% correction which developed from a "growth scare" that did not come to pass.

We believe the market is rational over longer periods and will follow the trend in corporate earnings. As illustrated in the chart above of the Year-Over-Year Growth in S&P 500 Operating Earnings, growth has ebbed and flowed during this bull market, but the trend has been positive and supportive of higher stock prices.

Bull markets do not die from old age but from excess i.e. overleverage or overspending. Given the weakness of this recovery, neither has arrived. At the same time, earnings are marching higher. The S&P 500's earnings were $124.51 in 2017, and the 2018 and 2019 estimates currently call for $158.50 and $169.50, respectively.

If these projections are correct, this cycle is yet to achieve its full potential. After hitting new all-time highs in stock prices in the third week in September, a deceleration in the rate of earnings growth from its current lofty levels, is expected. As such, short-term stock market volatility and weakness may result as the degree of change becomes evident. Not to fear—It's the pause that refreshes.