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What a difference a year makes, in terms of market sentiment. Last December, fears that continued Fed rate hikes could tip the economy into recession caused the S&P 500 to plunge to within a hair's breadth of a bear market. Today, Fed easing and rising hopes that the economy's slowdown has bottomed out have pushed the S&P 500 to new all-time highs and generated total returns (including dividends) of +27.6%, year-to-date. Just as last year's pessimism clearly overshot the mark, however, we'd caution that today's optimism may be outpacing the evidence, so far, that the economy is really ready to bounce back.

The Atlanta Fed is currently projecting U.S. GDP growth will remain at +2.0% in Q4. The New York Fed, which places greater weight on sentiment surveys versus hard data, projects it will slow to just +0.6%. The U.S. economy is locked in a tug-of-war between confident consumers, who keep spending, and more cautious businesses, worried by trade war uncertainties and slowing growth abroad. The global slowdown has been most keenly felt in manufacturing, which accounts for just 12% of U.S. GDP but about half of U.S. exports. The ISM Manufacturing Index saw its fourth straight month of contraction in November. Industrial production fell −0.8% in October, down −1.1% from a year ago. While durable goods orders saw an unexpected rebound in October, raising hopes for Q4, that still put them −0.7% lower than a year ago.

Consumer confidence, in contrast, may be down from the 18-year highs it hit a year ago, but remains strong, bolstered by a strong jobs market. In October, the percentage of the prime working age population holding a job rose to 80.3%, its peak during the last cycle (in January 2007). In November, the U.S. economy added +266,000 jobs, soundly beating expectations. Rising incomes, up +4.4% from a year ago, are also getting a helpful hand from low inflation, underpinned by lower energy prices, which are keeping CPI at just +1.8%, down from +2.9% in July 2018. Supported by these tailwinds, consumer spending rose +0.3% in October, up a robust +3.7% from a year ago. While the ISM Non-Manufacturing Index slipped an unexpected −0.8 points in November to 53.9, that still puts most of the economy in expansion territory. New non-manufacturing orders actually firmed up +1.5 points to a healthy 57.1, indicating that positive momentum could continue.

Low inflation—in part due to slowing growth abroad—has given the Federal Reserve room to cut interest rates. Lower mortgage rates, in turn, have given housing a noticeable and much-needed boost. New home sales in October were up a striking +31.6% from a year ago, while new home-building permits were up +14.1%, after languishing in negative territory for much of the past year. The Fed has also started expanding its balance sheet again by buying bonds. While the Fed insists its move is merely a technical fix to credit markets, many see it as a new round of quantitative easing (QE), a belief that likely has helped lift share prices.

The S&P 500 rose another +3.4% in November, despite the fact that quarterly operating earnings per share (EPS) declined in Q3, down −3.2% from a year ago. Only three sectors—consumer discretionary, financials, and health care—showed modest earnings gains, year-on-year. The surge in corporate share buybacks that helped bolster EPS earlier this year has also receded. A great deal of this year's eye-catching stock market gains is a recovery from the sharp sell-off in Q4 of last year; in fact, the S&P 500 is only up +7% from its previous peak 14 months ago. Still, the 12-month trailing P/E ratio has gradually edged upwards to 20x, for the first time since January 2018.

The fact that jobs and spending have remained so resilient, with a little help from the Fed, appears to have markets convinced that growth is set to stage a comeback. While bright spots certainly exist, however, the data as a whole is mixed, and suggests the economy isn't out of the woods yet. We can easily envision further bumps along the road that rattle investor, business, and even consumer confidence. Persistent talk of a "Phase I" trade deal in the works between the U.S. and China has eased market worries, for the moment, but a concrete agreement has proven frustratingly elusive, and protests in Hong Kong and security concerns over Chinese technology firms will continue to fuel tensions. President Trump can't seem to stop stirring the pot on trade, with new tariffs on France, Brazil, and Argentina. The U.K. faces a fractious election this month and an uncertain future over Brexit.

Recent market moves have narrowed the equity risk premium (ERP)—between what investors can expect to earn on more volatile shares versus safer bonds—to 5.3%. That gap, which remains well above historical average, still favors riding out possible storms rather than seeking a safe harbor at any price. The nerve to stay in the market has reaped solid rewards this year; over a multi-year time frame, it should continue to do so. Investors, however, should keep their more immediate expectations grounded. The economy's slowdown may not be over yet, and the market's now-buoyant optimism will likely face renewed tests in the new year.

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