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The S&P 500 stock index leapt +7.5%, at its peak, in January, before stumbling to end the month up +5.6%. (Subsequent market declines in early February erased the rest of these gains.) Optimism over the effect of recently-passed tax cuts on corporate earnings that helped push up share prices almost a full P/E multiple gave way to concerns over the prospect of rising inflation and interest rates, forcing a rethink that perhaps the market had gotten ahead of itself. Despite these doubts, we believe solid economic numbers—including key forward-looking indicators—should continue to buoy earnings growth and share prices in the months ahead.

The U.S. economy grew +2.6% in Q4, bringing annual GDP growth for 2017 in at +2.3%, as expected. The quarterly figure fell somewhat short of expectations, mainly because of a drawdown in business inventories (which shaved −0.7 points off GDP growth) and a widening trade deficit (which shaved off −1.1 points). But domestic demand grew by a robust +4.3%, driven by confident consumer spending and business investment.

Consumption grew at a rate of +3.8% in Q4, its strongest pace in more than a year. Gauges of consumer confidence remain quite high, with households willing to dig deeper into their pockets, pulling the personal savings rate down to its lowest level (2.4%) since 2005. While that could make the economy more vulnerable to shocks, it is a positive for the moment. Retail sales were up an impressive +5.4% in December, from a year before. The housing market has also seen a rebound, with residential investment bouncing back +11.6% in Q4, after two negative quarters, although that momentum appeared to cool a bit in December. The reason the trade gap widened in Q4 wasn't flagging exports, which grew +6.9%, but a +13.9% surge in imports, driven by burgeoning consumer demand.

Solid job growth is one factor supporting consumer spending, with the economy surpassing expectations by adding another +200,000 jobs in January and the unemployment rate staying put at 4.1%, its lowest level in 17 years. Hourly wages also perked up in January, up +2.9% from a year ago, its highest year-on-year growth rate of what has been, up to now, a rather sluggish cycle. Anecdotal evidence suggests that at least some of the new corporate tax cuts are being passed along to employees in the form of bonuses and raises.

Despite their inventory drawdown, businesses appear confident of demand and willing to invest in new (or updated) plant and equipment, perhaps encouraged by new tax provisions that allow them to count their full cost against profits immediately. The rebound in U.S. oil production, bolstered by steadily rising crude prices, to its highest level in nearly 50 years has also helped drive investment. Overall, business investment rose a solid +6.8% in Q4, and industrial output was up +3.6% in December, from a year before. Factory orders surged +1.7% in December, up a striking +8.4% from a year ago, while orders for core capital goods—a key indicator of business investment—were up +8.0% from a year ago. The ISM Manufacturing and Non-Manufacturing surveys in January continue to

show both sectors in solid expansion mode, buoyed by a steady stream of new orders that should keep that momentum going, for the near future.

Another thing the ISM surveys have shown, for the past several months, is U.S. businesses across a broad range of industries reporting mounting price pressures. The Fed's preferred inflation gauge, the PCE price index, rose +2.8% on an annualized quarter-on-quarter basis in Q4, and the weaker dollar has pushed import prices up +3.0% from a year ago. Longer-term interest rates—after remaining flat throughout last year, despite steadily rising short-term rates—began creeping up again as January came to a close, with many thinking that the 10-year Treasury yield could soon reach 3%. The pick-up in wage growth in the January jobs report crystalized concerns over inflation and future Fed rate hikes, bringing the month's equities rally to an end. It's important to keep in mind, though, that the signs of inflation we've seen so far have been modest and tentative. In previous cycles, wage growth has had to hit 4% or so for a sustained period to generate broader inflationary pressure. Despite its acceleration in Q4, the PCE index is still only up +1.7% year-on-year, the usual method for calculating the inflation rate, while core PCE (excluding more volatile food and energy) is up just +1.5%, well below the Fed's target. The recent uptick bears watching, but it is premature to set off any alarms.

With the trailing P/E ratio for the S&P 500 topping 22x operating earnings, there is concern that rising interest rates could undermine share prices. Given the solid economic data, along with tax cuts, however, there is little reason to believe that corporate earnings won't continue to see healthy growth, which means share prices should rise as long as valuations hold. And while the Equity Risk Premium has steadily fallen to 4.8%, that is still above its historical average. That means there should be room for equity valuations to absorb higher rates—as long as those rates reflect rising confidence in continued growth, not the need to stave off inflation at the expense of that growth. Investors should not fear a return to more "normal" interest rates if it means the economy is better able to stand up on its own.

Bull markets come to an end when the economy falls into recession, or when the Fed pushes it into recession by aggressively raising rates to stamp out inflation. While there may be clouds on the horizon we should monitor, we see no signs that either development is imminent. What we do see is a stock market that may have gotten a bit ahead of itself and needs to find a more solid footing founded on realized earnings growth—a footing it should be able to find.

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