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The U.S. economy came through and delivered in the 3rd quarter, despite a series of severe weather events that could readily have thrown it off track. Corporate earnings also saw steady gains that provided support for rising share prices. In other words, fundamentals, not sentiment, has been the driving force-lifting markets. While any of a dozen things could potentially disrupt this positive momentum, most likely it will carry forward through the end of the year.

U.S. GDP growth for Q3 was 3.0%, surpassing expectations. Behind the headline figure, consumption and business investment slowed a bit, and underlying domestic demand growth was closer to 2%. Consumption growth, for instance, slowed from +3.3% in Q2 to +2.4% in Q3, perhaps partly due to the hurricanes in Texas, Florida, and Puerto Rico. Nevertheless, consumer confidence soared in October, with the University of Michigan's gauge hitting a 14-year high, and the Confidence Board's reading hitting a 17-year high. Retail sales for September rebounded a buoyant +1.6%, up a solid +4.4% from a year ago. Some of this boost came from auto sales, which following a lackluster first half of the year, saw an impressive two-month bounce in September and October, as people replaced cars damaged in the hurricanes. But even excluding autos, retail sales bounced back +1.0% in September, up +4.6% from a year ago.

The consumer economy depends on jobs and wages. That's why all eyes were on the October jobs report, after September showed the first net job loss (−33,000) of the recovery, a downturn attributed by most observers to the hurricanes. That confidence turned out to be vindicated when October saw a rebound of +261,000 new jobs, with positive revisions bringing September back to +18,000, leaving the recovery's positive jobs streak unbroken. Initial jobless claims, which saw a big spike following the hurricanes, have also come back down to their previous 44-year lows. Wage growth remains mediocre, at just +2.4% over last year, but that also suggests there is room for continued jobs growth without driving up inflation.

Business investment saw a big surge at the start of the year, which has since moderated, from +7.2% in Q1 to +3.9% in Q3. The ISM purchasing manager surveys still show business confidence riding high, however. The ISM Manufacturing Index retreated slightly in October, but at a still-strong 58.7 racked up its 14th straight month of expansion. The ISM Non-Manufacturing Index inched up to 60.1, its highest reading since 2004. Respondents to both surveys reported an unusually strong stream of new orders, which should keep business humming. In actual fact, new factory orders slipped somewhat in the early part of Q3, but bounced back +1.4% in September, up an impressive +7.0% from a year ago. Orders for core capital goods, a key indicator of investment, rose +3.0% in Q3, up +5.6% from a year ago.

The housing market, in contrast, continued to slump in Q3, with sales of both new (−0.3%) and existing (−3.1%) homes declining, along with new housing starts (−0.2%). Residential investment fell −6.0%, after dropping −7.3% in Q2. However, new home sales saw a big +18.9% rebound in September, and post-hurricane rebuilding should help boost both construction and sales. On the other hand, Congress' plan to cap the future tax deductibility of mortgage interest payments, and eliminate them entirely for second homes, could pose a further challenge to the industry, if enacted.

House Republicans have finally introduced their long-awaited tax bill, kicking the legislative process into high gear. Several of the bill's provisions—cutting the corporate tax rate from 35% to 20%, allowing immediate write-offs of capital investments—could boost after-tax corporate earnings in future years. But the complex package faced mixed reviews, even from generally supportive business groups, and its pathway to the president's desk is by no means certain. Investors should be wary of any stock market rally sparked by quick House passage, since the Senate is where the hard work—and the toughest obstacles—come into play. That said, if congressional Republicans don't succeed in passing a tax cut by Christmas (their current goal), they will almost certainly try again in the spring.

The U.S. trade deficit narrowed a bit in Q3, adding +0.4 points. However, solid GDP growth, plus rising expectations for a tax cut, have revived the U.S. dollar, which rose +1.7% in October, on a broad trade-weighted basis. That's still down −5.2% from its high at the end of last year, but could once again pose a headwind to growth, should the rebound continue.

President Trump's selection of Jerome Powell to replace Janet Yellen as Federal Reserve Chair does little to alter expectations of future rate hikes. As a close ally of Yellen, Powell is likely to continue on the Fed's current, very patient course. Although the Fed is expected to raise rates another 25 basis points in December, the fact that its preferred PCE price index, at +1.6%, is still lower than its 2% inflation target means the Fed isn't under pressure to move any faster than it wants. Meanwhile, even as short-term rates have risen, longer-term 10 and 30-year Treasury yields are slightly lower than where they started the year.

Low interest rates, alongside steady earnings gains, should continue to support share prices. With 84% of the S&P 500 reporting, operating earnings per share (EPS) are expected to rise +3.5% in Q3, up +10.1% from a year ago, helping to keep the 12-month trailing P/E ratio steady around 21x. Positive earnings performance, on an annual basis at least, has been broad-based, with 9 out of 11 sectors of the S&P 500 up year-on-year, though only 6 of those 11 saw earnings rise in Q3, compared to Q2. The strongest gains, of course, come in the energy sector, where the ongoing consolidation in oil prices, albeit at a much lower level than before the 2015 crash, have helped restore U.S. producers back to profitability.

The S&P 500 index rose +2.2% in October; so far this year, it has produced total returns (including dividends) of +16.9%. Even that has been surpassed by European and Emerging Market equity returns, boosted by a weak U.S. dollar, and more recently by Japan's Nikkei. Faced with such buoyant share prices, logical investors will naturally exhibit some skepticism, and begin seriously querying about what can go wrong. In fact, the equity risk premium for the U.S. market—which we have watched carefully throughout this cycle—has fallen substantially, from 6.5% a year ago to 4.8% today. Yet it remains above its historical average (4.1%), indicating—as it has, accurately, all along—that investors pay a steep price for avoiding equity risk. As long as the economic and earnings fundamentals remain sound—and right now, they do look sound—the bull market should keep climbing that wall of worry.

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