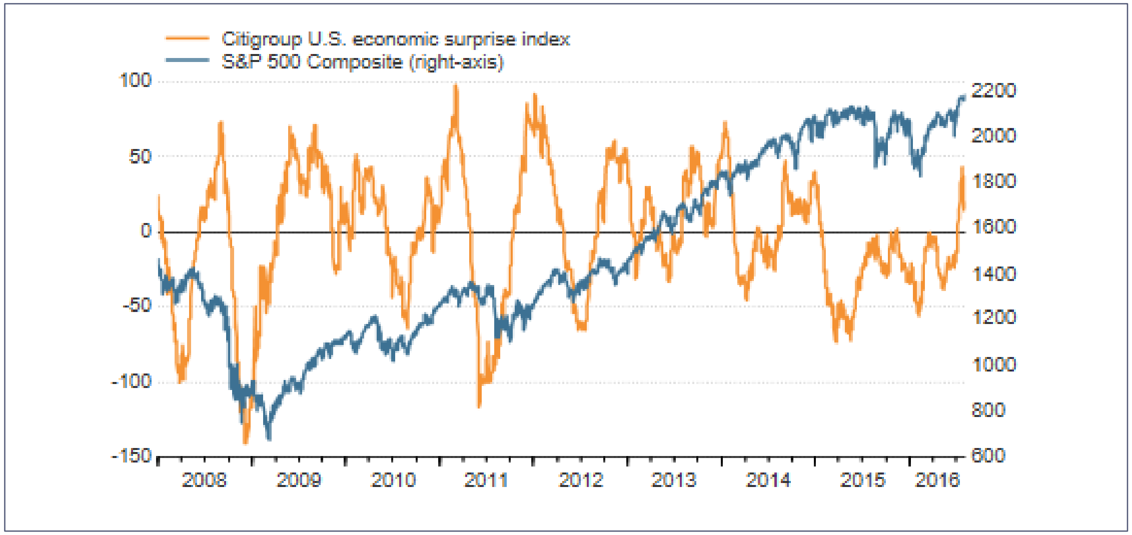
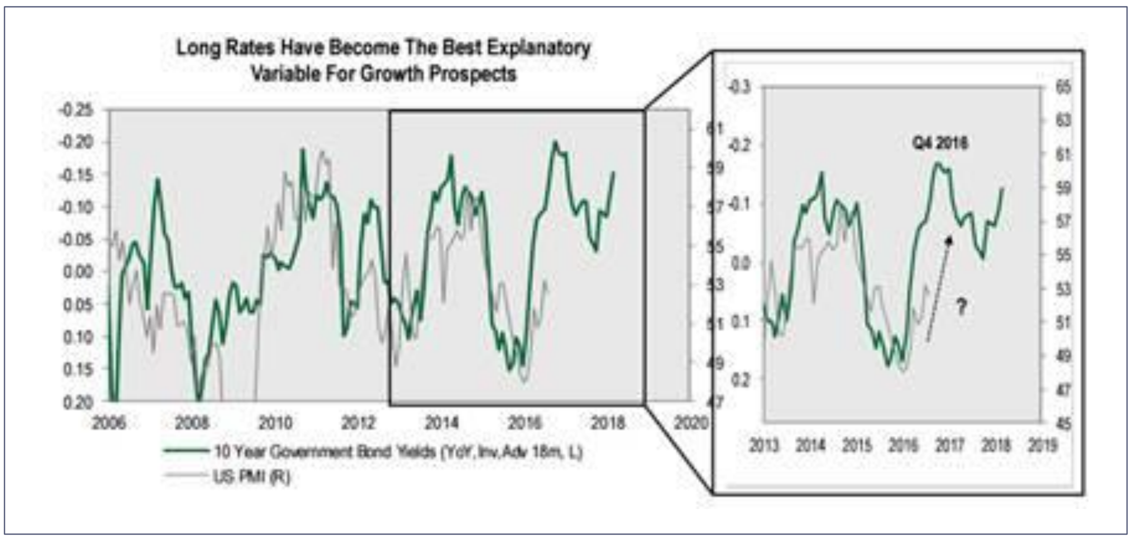
Market Recap

U.S. Economy is Surprising to the Upside



Source: Thompson Reuters

Lower Rates Suggest Better Days Lie Ahead



Source: Cornerstone Macro

Following a year and a half of negatively skewed reports, U.S. economic data is now surprising to the upside. The Citigroup Economic surprise Index tracks how economic data as a whole are faring against expectations, rising when data exceeds economists' estimates and falling when the numbers come up short. After 18 months in negative territory, the July reading finally put the index above 0. While economic growth has not necessarily picked up during this time frame, better than expected data has been supportive for stocks. Over the past 10 years, a break above zero in the Economic Surprise Index (14 occurrences) yielded a higher stock market over the subsequent 6 months 79% of the time. The median increase during this time period was 5.2%, with better than average performance from cyclical and economically sensitive sectors seen as well. The relationship between stocks and the economy is not necessarily linear, but is instead dependent on the degree and direction of surprise relative to economic expectations.

One factor contributing to the recent improvement in economic data is the flow-through of support received from central banks over the past year and a half. Rates have been one of the strongest explanatory variables for growth – with lower interest rates supporting higher growth. Central bank stimulus tends to have a lagged impact, as it takes time for the effects of accommodative policy to filter through the system. Hence, when we adjust for this lag (applying an 18 month lead time for rates) we can clearly see that we are in the midst of a period where lower rates should begin to affect economic growth in a positive manner. We've seen the beginning of this trend play out since February of 2016, with PMI's (a leading economic indicator) rising, the Economic Surprise Index turning positive and the stock market taking on a decidedly more cyclical bent.

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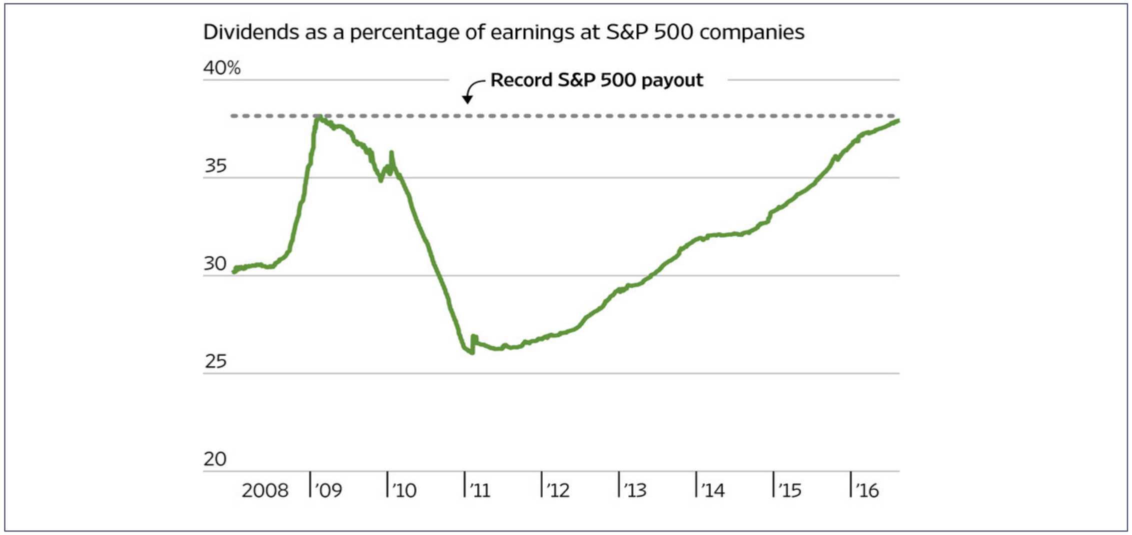
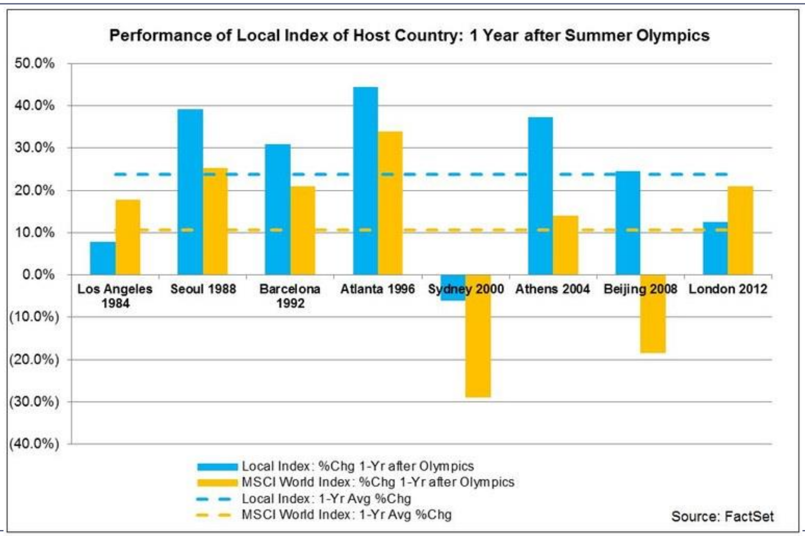
Dividend Payouts on the Rise



Source: Fact Set

Olympics Show Positive Effect on Host Nation Economic Performance



Source: The Economist; Fact Set

Large cap firms are returning a greater proportion of profits to investors in the form of dividends. Record low bond yields are causing the market to place a higher premium on dividend yielding stocks, and CEOs have continued to hike those dividends in an effort to please shareholders as they navigate a relatively slow growth business environment. Dividend payouts from S&P 500 companies have amounted to 38% of net income over the past 12 months, the highest level seen since February 2009. While this has been welcome news to yield-seeking investors, some analysts see this as an unsustainable trend. A focus on returning an outsized proportion of cash flow to shareholders comes at the expense of business investment, which has historically had a high correlation to long-term corporate earnings. If the focus on dividends has the effect of muting future earnings, stock returns will eventually suffer as well.

While questions have been raised about the economic legacy of hosting the Olympics, given that massive, federally funded projects often end up lying dormant following the conclusion of the games, it does bear pointing out that the massive inflow of tourist activity and spending during the game can have a stimulating effect on the local economy, at least in the short run. One way to examine this is through the relative performance of the host-country's stock market – Investing in the local index of the host country following the conclusion of the Olympic games has historically served investors well. Looking back over the past 8 Summer Olympics, the average change of the local index for the 12 months following the closing ceremony has been 23.8%, well above the average 10.7% returned by the MSCI World Index during the same period.

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