Economic uncertainty from this winter soft patch will linger for months, but strong housing fundamentals should underpin a strengthening U.S. economy while low inflation augers well for stock prices.

This extended winter soft patch could lead investors and policymakers to question if something more fundamental than bad weather is to blame for weakness in recent U.S. economic data. Personally, I have a great deal of confidence that the U.S. economic expansion remains on track. Notwithstanding an unexpected surge in existing home sales for January, U.S. housing data has been mixed for months. However, the inventory of unsold homes is lower now than it was in 2004. Considering a likely rebound in household formation and strong fundamentals, once winter breaks, housing is primed for a surge in construction and sales that should boost GDP growth in the second half of the year.

It will most likely be late April before investors can conclude with certainty whether this weakness in economic data on everything from housing to retail sales is related to severe weather or if some larger force is at work in the U.S. economy. The betting has already begun in markets on whether the Federal Reserve will pause or slow the planned exit from its quantitative easing program, however, I do not believe policymakers will change from their pre-stated course.

At their March meeting, FOMC members are unlikely to find the data compelling enough to alter course and by the time they meet again at the end of April, the economy should be showing signs of improvement. Nevertheless, speculation is mounting, and bad weather and weak economic data are continuing. I see the possibility that yields on 10-year U.S. Treasuries will fall meaningfully from their current level of 2.67 percent. Of course, lower interest rates will provide a boost to underlying economic momentum and would support a recovery in second quarter housing activity, ensuring that the current soft patch is nothing more than a mirage.

After the S&P500 gained nearly 30 percent in 2013, and with stocks once again flirting with all-time highs, some have wondered if we are due for a correction which would crimp the wealth effect of rising markets. However, history suggests that in periods of low inflation, stock markets can sustain higher earnings valuations. Low inflation environments have historically corresponded with an average price-to-earnings ratio of 19.6 for the S&P500. The average P/E ratio for the index now sits at 17 and with the Fed not forecasting any imminent uptick in inflation, equities appear to have room to rise further. The recent surge in the NYSE Advance/Decline Line confirms this bullish sentiment.
We remain in a risk-on environment.

**U.S. Stock Multiples Have Room to Expand**

Low inflation tends to support larger price-to-earnings ratios, as the lack of price pressure facilitates easy monetary policy which encourages multiples expansion. Though the P/E ratio of the S&P500 has been on an upward trend in recent years, historical ranges suggest there is further room for expansion due to low inflation. With inflation expected to remain below the Fed’s target through 2015, the P/E ratio could rise as far as 24X and still remain within historical norms.

**HISTORICAL P/E RATIO IN DIFFERENT INFLATION ENVIRONMENTS**


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