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U.S. ECONOMIC AND MARKET REVIEW—AUGUST 2018

U.S. share prices saw more buoyant gains in July, in response to a steady stream of positive economic data and corporate earnings reports which upstaged—for a while at least—concerns over trade tensions and a flattening yield curve. The S&P 500 index rose +3.6% in July, for a total return (including dividends) of +6.5% year-to-date. U.S. GDP growth for Q2 underscored the positive mood, coming in at +4.1%, its strongest quarterly showing in almost four years. Growth momentum is expected to continue: the Atlanta Fed is currently projecting, at this admittedly early stage, +5.0% GDP growth for Q3, while the New York Fed is projecting a more modest but still rather respectable +2.8%.

The most noticeable boost to second quarter GDP growth came from a rebound in personal consumption, after falling to +0.4% in Q1, its slowest growth rate in nearly five years. In Q2, consumption grew by a robust +4.0%, adding +2.7 points to GDP. Consumer confidence remains near cycle highs, with just 15% describing jobs as hard to get and 43% saying they are plentiful. Retail sales rose a solid +0.5% in June, on top of an upward revision to +1.3% in May, putting June sales a striking +6.6% higher than a year ago, +7.1% higher if auto sales are factored out. Auto sales were flat in the first half of 2018, at an annual rate of 17.1 million, the same as 2017. The housing market is also in a bit of a slump, with residential investment falling −1.1% in Q2, on top of a −3.4% decline in Q1. New housing starts in June fell −12.3%, down −4.2% from a year before.

One very good piece of news from the GDP report: a large upward revision in the personal savings rate, to 6.8% in June. This is a potential narrative-changer: previously, we expressed concern about the apparent decline in the savings rate from 5.4% two years ago to just 3.2% in May, which suggested that confident consumers were digging rather deeply into their pockets, rendering them more vulnerable to economic shocks. We are now told that small business owners' incomes are larger than once thought, boosting overall personal incomes (now up +4.9% from a year ago) and making consumption levels look a lot more sustainable.

Business investment grew by a solid +7.3% in Q2, adding +1.0 point to GDP growth, though a pullback in inventories exactly cancelled that out. Over time, though, the reluctance of firms to over-stockpile is likely a good thing, as inventory-to-sales ratios continue to fall back from the alarmingly high levels they reached two years ago. The inventory decline is certainly not due to any fall-off in anticipated business: durable goods orders, excluding volatile aircraft orders, rose +0.2% in June, up +8.8% from a year ago. Orders for core capital goods—a key indicator of new business investment—also rose +0.2% in June, up +7.8% from a year ago. Both the ISM Manufacturing and Non-Manufacturing indices in July saw a noticeable pullback from very strong showings in June, including a downshift in new orders, but at 58.1 and 55.7 respectively, both remain in solid expansion territory. And while the +157,000 jobs the U.S. economy added in July fell somewhat short of expectations, May and June were revised upwards by +59,000 jobs, keeping the average this year steady at a robust +215,000 per month, which should help support continued consumption growth.

GDP growth topping +4% is bound to raise the question of inflation. It's true that the headline Consumer Price Index (CPI), comparing today's prices to a year ago, has inched steadily upwards to +2.8% in June, its highest rate in over six years, pushed up in large part by steadily rising oil prices. But the quarterly pace of the Fed's preferred consumer inflation gauge, the PCE price index, has actually *decelerated* from its recent peak of +2.7% (annualized) in 4Q17 to +2.5% in Q1 to +1.8% in Q2. In contrast, the GDP deflator—which measures price pressure across the entire economy—accelerated from +2.0% in Q1 to a new cycle high of +3.2% in Q2. That suggests that the cost pressure reported in recent ISM surveys and earnings calls is real, but that a stronger dollar and other deflationary pressures are making it difficult for companies to pass those higher costs on to customers—which could create a profit squeeze. Employees are facing their own squeeze, as frustratingly sluggish wage gains (up +2.7% from a year ago) are getting erased in real terms by even fairly modest price rises.

Several companies responding to the June ISM surveys reported that new and threatened trade tariffs, at home and abroad, are pushing up costs and undercutting sales, despite otherwise strong demand. One wood products firm noted, "The so-called trade war is now taking its toll on business activity, resulting in substantial reductions to new export orders. China has all but stopped taking orders, causing inventories to build up in the U.S." Another, in primary metals, reported, "Our customer demand is high, but supply of aluminum is tight. Also, tariffs are negatively affecting our bottom line, as we are unable to pass increases to all our customers." These artificially-imposed constraints—as limited as they may be, so far—come at a sensitive time in the business cycle and may impinge on future growth and earnings.

Nevertheless, corporate earnings growth in Q2, at least, looks quite strong. With 75% of companies reporting, S&P 500 operating earnings per share (EPS) is expected to grow +6% from Q1, up +27% from a year before. Eight out of eleven sectors are expected to show positive earnings growth from last quarter, and all eleven are expected to be up year-on-year (all but one of them by double digits). Even after July's rise in share prices, this would put the index's 12-month trailing P/E ratio at 19.4x operating earnings, down from 23x at the peak of January's short-lived rally. In other words, strong earnings have caught up with—and validated—what were then somewhat premature hopes, while share prices have not. While the equity risk premium declined slightly to 5.2% at month's end, it remains more than a full percentage point higher than its historical average, suggesting that over the long haul, investors who can afford to should be well rewarded for braving the market's ups and down.

While prospects for inflation and trade wars remain a valid concern, and we continue to keep our eye on the flattening yield curve for bonds, the immediate outlook for growth—and corresponding equity returns—remains quite positive.

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