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U.S. ECONOMIC AND MARKET REVIEW—DECEMBER 2018

U.S. share prices struggled to find a bottom in November, following their latest correction, and continue to do so. Despite some roller-coaster ups and downs, the S&P 500 gained +1.8% in November, with total returns (including dividends) of +5.1%—though much of these gains have been erased in subsequent, and highly volatile, trading. Trade tensions with China, slowing growth abroad (including negative quarters in Germany and Japan), and the prospect of steady Fed rate hikes weighed down on corporate and investor outlooks. While focusing on these concerns, the market seems to be ignoring other data that indicates the U.S. economy still has significant positive growth momentum.

Confident consumers, bolstered by a vibrant job market, continue to lend their strength to the U.S. economy. Although consumer spending (up a striking +5.0% from a year ago) has outpaced income growth (+4.3%), the savings rate remains a healthy 6.2%. Retail sales surged +0.8% in October after two flat months, up +4.6% from a year ago. November auto sales beat expectations at 17.5 million/year, limiting the disappointment from a fairly lackluster year. News that General Motors will be closing plants and laying off workers have caused concern, and the rate of initial jobless claims has ticked up slightly (from historic lows). But just 12.2% (and falling) of consumers surveyed by the Conference Board say jobs are "hard to find", while 46.6% (and rising) say they are "plentiful".

While companies may be tempering their outlooks, they remain largely constructive. Industrial production continued to rise in October, up a solid +4.1% from a year ago. Durable goods orders are still up +6.8% from a year ago, but the strong rebound of the past year or so may be easing off. Orders for core capital goods—a key indicator of new investment—were flat in October, and down from their peak in July. Nevertheless, both the ISM Manufacturing and Non-Manufacturing indices in November rose further into solid expansion territory (59.3 and 60.7 respectively), about as far as you can get from an indicator of impending recession. New orders for both industry surveys are above 60, suggesting the momentum should continue.

One area where consumers aren't spending confidently is the housing market, possibly due to rising mortgage rates. Existing and new home sales, as well as new housing starts, are all down from a year ago, with new home sales down −12.0%. The median price of new homes sold is also down −3.1% from a year ago. Residential construction spending is up just +1.7% from a year ago, its lowest pace of growth since 2012. That's being partially offset by a boom in public construction spending, which is up +8.5%. It's also worth keeping in mind that the housing market has been stop-start for the entire recovery, and this is far from the first slowdown it has seen this cycle.

Trade tensions and the prospect of new and costly tariffs being imposed have cast a shadow over corporate earnings outlooks and market sentiment. While the (admittedly fragile) agreement that emerged from the U.S.-China meeting at the G20, last weekend, may not have resolved any of the underlying issues, it did give both sides a chance to step back from the brink and rethink their approach, instead of pressing ahead on tit-for-tat measures that could have caused increasingly serious economic harm. The respite might be temporary, but welcome. In the meantime, the need to fund a larger U.S. budget deficit has pushed up the U.S. dollar and widened the U.S. trade deficit, creating headwinds to U.S. growth and ensuring that trade tensions are likely to continue.

Worries over rising interest rates, and the prospect of future Fed rate hikes, have been another source of concern. Inflation has remained moderate, however, with the PCE price index at its target +2.0%. While the steep fall in oil prices, down −30% from their peak in early October, could cause pain for some sectors of the U.S. economy, it could also relieve pressure on the Fed to raise rates, as well as pressure on consumers' wallets. Meanwhile, headlines proclaiming that "the yield curve has inverted" (because the 2-year Treasury yield went higher than the 5-year) are premature. For now, the overall slope remains positive, though flattened. And the implications of a flat yield curve (that inflation is expected to remain low) are quite different from that of an inverted curve (that rising rates are likely to derail fragile growth).

Markets may feel uncertain over the pace of future growth, but the fact remains that operating earnings per share (EPS) for the S&P 500—boosted by a large corporate tax cut, a surge in share buybacks, and solid organic growth—are expected to be up +27% this year, compared to last. With prices relatively flat, this pulled the 12-month trailing P/E ratio down to 18.3x at month's end (and lower now, given the subsequent sell-off), the lowest valuations in three years. Meanwhile, the equity risk premium has blown back out to 5.7%, indicating a high level of risk-aversion in the market.

These low equity valuations might make sense if a U.S. recession were right around the corner. And some are saying just that. But while we certainly see soft spots in the economy, and issues that may well become bigger problems later on, the evidence we see indicates a U.S. economy that is decelerating—as it has several times this sluggish cycle—not coming to a halt. The Atlanta Fed currently projects that GDP growth in Q4 will be +2.8%; the New York Fed says +2.5%. Either would put annual GDP growth at our original target for the year, just below 3%. As one investor told Bloomberg, "There's a risk too much pessimism is priced in too early as everyone tries to anticipate the end of the current economic cycle." That is our view as well.

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