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U.S. share prices rebounded in January, erasing their net losses from 2018. The S&P 500 climbed back +7.9%, from year's end, but still stood −7.7% below its September peak. Three main fears drove the fourth quarter sell-off: that 1) the U.S. economy was trending towards a recession; 2) the Fed would prove over-aggressive in raising rates; and 3) an escalating trade war between the U.S. and China was on the verge of doing real harm to the economy. All three of these concerns have receded, for the time being, and any damage done by the 35-day federal government shutdown this past month is likely to prove temporary. Evidence of slowing growth abroad however, particularly in Europe, is likely to keep a lid on any renewed market optimism and force stocks to earn further gains this year.

The government shutdown has delayed the release of much of the data we normally look to, including last quarter's GDP numbers, in order to gauge the U.S. economy's health as it enters the new year. The numbers we do have suggest growth momentum remains reasonably firm. Consumer confidence fell noticeably in January, as federal workers were furloughed, but should heal quickly when they receive their back-pay. Households' willingness to spend should be further reinforced by remarkably strong jobs growth, which surged by +304,000 in January, nearly double expectations. The ISM Manufacturing Index, which stumbled in December, recovered nicely in January to a healthy 56.6, supported by a solid rebound in new orders. The Non-Manufacturing Index slipped −1.2 points to 56.7 but continues to signal robust expansion. The trends towards widening corporate bond spreads and weakening oil prices both reversed in January, signaling renewed confidence in economic conditions.

The Treasury yield curve partly inverted in December, suggesting the market believed overly aggressive Fed rate hikes would push the economy into recession. Though the Fed did raise rates another 25 basis points in December, as expected, it also clearly signaled that further rate hikes could wait, if the economy looked shaky. As long as inflation remains modest, the Fed can afford to be patient. The year-on-year rate of consumer inflation actually slowed from +2.7% last August to +1.9% in December, while the annualized quarterly rate slowed to just +1.7% in Q4, due in large part to softer energy prices. That also means workers, whose hourly wages are up +3.2% from a year ago, are seeing positive real wage gains again.

A few months ago, responses to the ISM purchasing manager surveys were aflame with worries that a new, more extensive round of tit-for-tat tariffs between the U.S. and China, scheduled for year's end, would do real damage across a broad range of industries. Those tariffs have been delayed, and while the two countries remain far apart on a number of contentious issues, they are now talking, rather than escalating. A larger federal budget deficit means that the U.S. trade deficit has widened, not shrunk, but threats of an all-out trade war in response have, for the moment at least, pragmatically been put on hold.

While several storm clouds have receded, others have appeared. Overdue efforts to rein in runaway credit growth have caused China's growth to slow, probably more than official figures admit—though we continue to believe that an end to China's over-investment binge would be a good thing for the rest of the world economy. Less propitious, from our viewpoint, is the slowdown taking place in Europe. Italy formally entered a recession in the second half of 2018, and Germany is wobbling right on the edge. Manufacturing purchasing manager indices (PMIs) for several countries centered on Germany have gone into contraction. Add the reckless game of chicken taking place between Britain and the European Union, over its scheduled exit from the E.U. at the end of March, and the road ahead looks rocky. A new think tank report, by the Institute for Government, outlines how—just eight weeks out—the U.K. has taken few practical steps to prepare for a "No Deal" Brexit. As a result, we think the most likely scenario is that Brexit will be postponed and negotiations extended, though politicians are loath to admit it. In any case, expect last-minute drama that could give markets a case of heartburn on top of the broader slowdown in growth and keep optimism in check.

January's rebound in U.S. share prices was warranted, but further gains will have to be earned. With 57% of S&P 500 companies reporting, operating earnings per share (EPS) for 4Q18 are expected to fall −5.8% from the previous quarter, with all but two of eleven sectors (health care and IT) seeing a quarter-on-quarter decline. That's still up +15.2% from a year ago, with all but three sectors (consumer staples, utilities, and real estate) seeing positive year-on-year earnings growth. Last year's strong earnings growth, together with fourth quarter drop in share prices, pushed the 12-month trailing P/E ratio to 16.1x at year's end, its lowest level in nearly six years. It has since bounced back to 17.4x, still well below where it stood (21.4x) a year ago. The Equity Risk Premium has narrowed over the past month from 6.0% to 5.5%—but that's still in a range well above the historical average which, as we've noted, correlates with above-average returns over the following five years.

The takeaway? Investors should have realistic expectations, but plenty of potential upside remains for those who are patient, in a U.S. economy that—despite a multitude of alarms, doubts, and worries—still seems to be resiliently chugging ahead.

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