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U.S. ECONOMIC AND MARKET REVIEW—JUNE 2018

Despite plenty of anxious handwringing—over inflation and higher interest rates, a currency crisis in Turkey, a political crisis in Italy, and growing trade friction between the U.S. and just about everyone—the S&P 500 actually rose +2.2% in May, putting it back into positive territory for the year. Shares seen as less exposed to these risks—the tech-heavy Nasdaq Index and more domestic-focused Russell 2000 small caps—performed even better, gaining +5.3% and +5.9% respectively in May, buoyed by strong earnings results and positive economic data. In contrast, most non-U.S. equities struggled, with the MSCI Emerging Markets Index falling −3.5% and the MSCI Eurozone Index dropping −4.4%. The tension between encouraging fundamentals and mounting concerns, and the disparity between assets seen as vulnerable to those concerns, versus not, is likely to deepen and complicate the investing environment in the months ahead.

In fact, the data is encouraging and suggests that the U.S. economy still has significant growth momentum. Based on the data so far this quarter, the Atlanta Fed is currently projecting Q2 GDP growth of +4.5%, while the New York Fed is projecting +3.3%. Though these estimates are likely to come down, perhaps significantly, as more data comes in, they suggest the economy is far from slowing down.

U.S. consumers remain confident, bolstered by strong job creation. While wage pressure remains modest, the +223,000 jobs added in May surpassed expectations, and new jobless claims continue to descend to new 45-year lows. Personal incomes are up a solid +3.8% from a year ago and consumers are also willing to dig deeper into their pockets to spend, pushing the personal savings rate back below 3% for the first time this year. Consumption growth may have slowed in Q1, but it bounced back in April with both retail sales and consumer spending more broadly up a vigorous +4.7% from a year ago. Auto sales in May, however, slipped to 16.9 million per year, their slowest pace since last September's hurricanes capped a 5-month slump triggered by concerns over loose subprime lending. The start-stop housing market has also cooled again in recent months, though new home sales and new housing starts are still over 10% higher than a year ago.

A steady stream of new orders has kept businesses both hiring and investing. While volatile aircraft orders fell in April, other durable goods orders rose +0.9%, up +7.9% from a year ago. Orders for core capital goods—a key indicator of business investment—rose +1.0% in April, up a solid +5.7% from a year ago. The ISM Manufacturing and Non-Manufacturing indices for May both advanced further into strong expansion territory, and also indicated a healthy flow of new orders that should keep business growing in the months ahead.

For several months, however, the ISM purchasing manager surveys have also indicated rising price pressure, growing backlogs, and tightening supply chains—anecdotal signs, at least, that the economy could be in danger of overheating. While consumer inflation has accelerated over the past two quarters, the PCE price index—the Fed's preferred inflation gauge—remains on target at +2.0% year-on-year, while core PCE (excluding food and energy) stands at +1.8%. The Fed's latest statements suggest it doesn't feel under any urgent pressure to raise rates faster than planned, which may help explain why the 10-year Treasury yield has pulled back from the 3% threshold to 2.8%. The "flight to safety" triggered by new uncertainties in Turkey and Italy has also kept U.S. interest rates from rising, as once expected.

One factor that could bolster inflation in future months is the price of oil. The Brent oil price briefly hit $80 per barrel in May before falling back on news of Saudi Arabia and Russia lifting self-imposed curbs on production. But the underlying factor that has steadily lifted global oil prices +21% last year and another +11% this year—the suspension of many large fixed-cost projects following the sharp drop in oil prices that started in mid-2014—continues to place constraints on the capacity of supply to meet rising demand, even though U.S. shale production has surged. And because these projects—unlike U.S. shale drilling—have a long lead time to delivery, that upward price pressure is unlikely to be relieved anytime soon.

Another factor behind rising cost pressure, which several companies have mentioned in their recent earnings calls and in the ISM surveys, is new trade tariffs. Although President Trump's tariffs on steel temporarily exempted about half of all steel imported to the U.S., from Canada, Mexico, and Europe, domestic steel prices have still risen by +38% since the threat of sanctions was initiated last year. As of June 1st, those exemptions expired, amid increasingly bitter threats of retaliation from hitherto friendly trade partners. Three rounds of high-level talks with China to avoid threatened U.S. tariffs—and Chinese counter-tariffs—have failed to reach an agreement, as have negotiations with Canada and Mexico on saving NAFTA from a threatened U.S. walkout. While many of the threats may be posturing for negotiating advantage, words are gradually marching closer and closer to action and the risks of a showdown, on multiple fronts, must be taken seriously. The potential impact of tit-for-tat trade sanctions—on inflation, corporate earnings, and even longer-term equity returns—is, in our view, a key factor holding back markets from reflecting the more positive growth momentum the data is otherwise showing.

Unadjusted U.S. corporate after-tax profits in Q1 were flat year-on-year after being down −6% in Q4. But given recent tax changes—the incentive to take losses against a higher corporate tax rate last year, and the ability to immediately charge off capital investments, starting this year—we wouldn't read too much into these numbers, for now. Operating Earnings Per Share (EPS) for the S&P 500 in Q1 was up an impressive +7.4% from last quarter, +26.2% from a year ago. With share prices pretty much flat this year, those earnings gains have brought the index's 12-month trailing P/E ratio down to 20.5x, a full multiple lower than year's end. The Equity Risk Premium (ERP) still stands at 5.1%, a full percentage point higher than its historical average, suggesting that even for large cap shares, taking equity risk—and accepting the volatility that entails—should be well rewarded over time. In the shorter-term, however, the gap in performance between more traditional large caps, heavily exposed to global uncertainties, and sectors that are relatively shielded from them, may very well grow more pronounced.

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Patrick Chovanec
Managing Director, Chief Strategist