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Last month we warned that the stock market, which had reached new highs, was vulnerable—amid softening economic data—to news headlines that might refocus attention on downside risks. That is precisely what happened in May. The renewed outbreak of trade tensions with China—and possibly Mexico, as well—helped send the S&P 500 tumbling −6.6%, pulling total returns year-to-date back down to +10.7%. The yield curve on U.S. Treasury bonds grew more clearly inverted, signaling market worries over slowing growth. While we believe U.S. equities are attractively valued over the long term, relative to "safer" assets, we expect market volatility to continue as growth slows and perhaps stumbles.

Recent economic data has been soft, especially in manufacturing. Based on the latest inputs, the Atlanta Fed and New York Fed are both projecting GDP growth of +1.5% in the second quarter. Industrial production fell −0.5% in April, up just +0.9% from a year ago, while manufacturing output in April was flat year-on-year. Factory orders declined in April, as did orders for core capital goods. Both are seeing their lowest year-on-year growth rates (+1.0% and +1.2% respectively) in over two years. The ISM Manufacturing Index slipped another −0.7 points in May to 52.1. That's still in expansion, but noticeably weaker than six months ago, and both backlogs and imports are in contraction. The ISM Non-Manufacturing Index, which covers a much larger portion of the economy, is more resilient, rising +1.4 points to 56.9 in May. It remains in clear expansion territory, bolstered by a steady stream of new orders.

The strongest aspect of the U.S. economy, right now, lies in job growth and resulting consumer confidence. Monthly job growth has averaged a solid +205,000 in the first four months of 2019. As a result, personal incomes in April were up +3.9% from a year ago. Consumer confidence, which took a hit from the government shutdown in January, has fully recovered to near cycle highs. In May, the number of surveyed consumers who said jobs are "hard to get" fell to 10.9%, while those who said "jobs are plentiful" rose to 46.5%. As a result, consumer spending in April was up a buoyant +4.3% from a year ago. The housing market, however, remains sluggish, with existing home sales and new housing starts still down from a year ago.

Trade policy created the biggest headlines that rattled markets in May. Negotiations between the U.S. and China, which looked set to produce a deal, broke down in acrimony, prompting the U.S. to raise existing tariffs from 10% to 25% and slap a commercial ban on Chinese telecom giant Huawei. Chinese retaliation, and the threat of much broader U.S. tariffs, are very much on the table. Then President Trump surprised everyone by threatening to impose tariffs—starting at 5% in June and rising to 25% by October—on all imports from Mexico, unless it reins in illegal immigration. A study by Bloomberg estimates that both sets of tariffs, if implemented, could shave −0.7% from U.S. GDP and −0.6% from global growth by 2021. We don't assume they will be, but we take the prospect seriously. Responses to the ISM Manufacturing survey in May cited tariffs, tariffs, tariffs as the primary worry across multiple industries, and the uncertainty trade tensions are creating is weighing on the economy—and on markets.

One market response was a deepening inversion of the yield curve, as longer-term U.S. Treasury yields fell. Markets appear to be expecting that weakening growth will prompt the Fed to cut interest rates by at least 50 basis points by the end of the year, in order to stave off recession. With the Fed's preferred inflation gauge, the PCE price index, up just +1.5% year-on-year, the Fed certainly has room to cut rates. Such a move could give share prices a boost, though how lasting that boost proved would depend on its actual effectiveness in reviving growth.

For now, that growth looks on shaky ground. After-tax corporate profits, for the U.S. economy as a whole, fell −0.8% in Q1, their second decline in a row, up just +1.6% from a year ago. Operating earnings per share (EPS) for the S&P 500 bounced back +8.9% in Q1 over Q4, up +4.4% from a year ago. But the growth was lopsided, concentrated in financials, health care, and utilities; eight out of 11 sectors saw earnings decline quarter-on-quarter, and a similar eight had earnings down year-on-year. Year-on-year quarterly EPS growth for the index as a whole is expected to remain modest (around 4%) for the next two quarters.

At least some of this slowdown, however, has already been priced into markets. The recent drop in share prices has shaved about half a multiple off equity valuations, pulling the 12-month trailing P/E ratio back down to 18.0x. Perhaps more importantly, the fall in long-term Treasury yields, on growth fears, has boosted the equity risk premium to 5.9%, its highest level since the peak of the panicky sell-off at the end of last year. Uncertainty may be unnerving, but "safety" right now—perhaps for that very reason—comes at a steep price. As we've noted many times, such levels of price-in risk-aversion tend to be strongly associated, historically, with above-average equity returns over the following five years. But be prepared: the road to those higher returns may get bumpy.

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