SILVERCREST
ASSET MANAGEMENT GROUP

U.S. ECONOMIC AND MARKETS REVIEW—MARCH 2019

U.S. stocks cautiously advanced in February, amid mixed—and sometimes missing—economic data. The S&P 500 rose a further +3.0% to end the month up +11.1% on the year. Slowing growth abroad and a dip in corporate earnings at home give investors plenty of reason to be wary, but there are signs that U.S. growth momentum may hold firm for a while, while the price of retreating into safer havens remains high.

A great deal of economic data continues to be delayed by the federal government shutdown in January. Belated news of big drops in retail sales (down −1.2% in December, up a meager +2.3% from a year before) and new housing starts (which fell −11.2%, down −10.9% from a year before) caused many to downgrade their projections for Q4 GDP growth. But when Q4 GDP was finally released, it held firm at a quarterly rate of +2.6%—slower than a roaring +4.2% in Q2, but above average (+2.2%) for this long and sometimes sluggish recovery.

Household consumption grew at a respectable rate of +2.8% in Q4, bolstered by vigorous job growth and the reemergence of real wage gains over inflation. The U.S. economy added almost 2.7 million jobs in 2018, its strongest performance in three years. While initial jobless claims have ticked up slightly in recent months, they remain close to 46-year lows. Consumer confidence still has not fully recovered from the hit it took in January, from the government shutdown, but it remains high relative to where it stood before the 2016 election. Auto sales also wobbled in January, to their lowest levels since the multiple hurricanes in August 2017. The housing market remains in the doldrums, with existing home sales, new home sales, and new housing starts all down from a year ago. Residential investment fell −3.5% in Q4, its fourth straight quarter of decline, but the slump has been a modest one and hasn't put too much of a dent into wider growth.

Business investment proved fairly resilient, rebounding by +6.5% in Q4, after slowing to +2.5% in Q3. Still, orders for core capital goods peaked in the summer, and fell −1.0% in December, up just +2.0% from a year ago. Industrial production fell −0.6% in January, its first decline in seven months, though it remains up a solid +3.8% from a year ago. The most encouraging signals of continued business confidence come from the ISM purchasing manager surveys for February. The ISM Manufacturing Index slipped −2.4 points to 54.2, but both the main gauge and the new orders reading remain in solid expansion territory. The Non-Manufacturing Index, which measures a much broader swath of the economy, rose +3.0 points to a vigorous 59.7, while new orders surged +7.5 points to a sizzling 65.2. These are nowhere near the kind of flagging ISM figures that typically signal an approaching recession.

Government spending contributed only slightly to GDP growth in Q4, with a −5.6% drop in federal non-defense spending, due to the government shutdown, offset by a +6.9% surge in defense spending. The need to finance a larger federal budget deficit, however, helped drive a widening U.S. trade deficit in 2018, despite trade policies intended to shrink it. Exports and imports were very volatile throughout the year, as companies struggled to adapt to new and anticipated tariffs, and though annual exports rose by +3.9%, already larger imports rose by +4.6%. News of a possible trade deal between the U.S. and China, later this month, remain full of rumor and speculation, but threatened tariffs have been postponed and look less and less likely to be imposed, while some existing barriers may even be lifted. This should provide relief, not only to market sentiment, but to corporate earnings outlooks which had been clouded by fears of an all-out trade war's possible impact.

Corporate earnings could use the relief because their performance in Q4 was disappointing. Quarterly operating earnings per share (EPS) for the S&P 500 fell −15.3% from Q3, up a mere +3.5% from a year before. The decline was widespread, with only three out of 11 sectors (IT, energy, and telecom) seeing positive quarterly growth, and four sectors (consumer staples, financials, IT, and utilities) down year-on-year. Annual operating EPS for 2018, as a whole, was still up +21.8% from 2017, but the Q4 decline helped pull the 12-month trailing P/E ratio back up to 18.4x. Earnings are expected to rebound in Q1 2019, though year-on-year improvement will remain modest. But any easy upswing from overly depressed valuations, at the year's start, has likely run its course; further market gains will have to be earned on the income statement.

One reason earnings may be struggling is slowing growth abroad. Italy is now in recession, and Germany is just teetering on the edge. Growth in the U.K. slowed to an annual rate of just +0.7% in Q4, as its Brexit deadline approaches. Japan's economy has been treading water, and China's has probably slowed a lot more than its official figures admit. Though all of this makes the U.S. look, once again, like the cleanest shirt in a pile of dirty shirts, the fact remains that the companies in the S&P 500 earn roughly 40% of their profits outside the U.S. and are by no means immune from a non-U.S. slowdown.

That slowdown, however, has likely contributed to an easing of inflationary pressure lately. The U.S. consumer price index (CPI) fell to +1.5% (year-on-year) in January, down from +2.9% in July. The PCE price index, the Fed's go-to inflation gauge, rose at an annual rate of just +1.5% in Q4, down from +2.7% a year ago. The ISM surveys also report receding price pressures. All of this gives the Fed a lot more room to hold back on hiking interest rates. The fear of steadily rising rates was one factor that helped drive the end-year sell-off.

Continued low interest rates are a major reason why U.S. equities still look relatively attractive, despite their risk. The equity risk premium has narrowed somewhat to 5.4%, but remains well above its long-term historical average, in a range that typically indicates above-average equity returns over the following five years. For long-term investors who are wisely skeptical of their ability to perfectly time markets, the price of seeking a safe harbor from the risk of recession, as opposed to riding it out, remains painfully high.

Growing up in the Midwest, I was well familiar with the difference between a Tornado Watch and a Tornado Warning. A Watch meant that conditions were potentially right for cyclone, so keep your eyes and ears open. A Warning meant that a funnel cloud had been actually sighted forming, so head down to your basement. As investors noting various economic storm clouds on the horizon, we are currently in Watch mode, not Warning—and not for the first time in this recovery. We believe stocks remain attractively valued and are keeping our eyes peeled for signs of darkening gloom—or brighter skies—ahead.

March 7, 2019

Patrick Chovanec
Managing Director, Chief Strategist