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ASSET MANAGEMENT GROUP

U.S. ECONOMIC AND MARKET REVIEW—MAY 2018

Despite strong corporate earnings growth, markets kept looking over their shoulders in April, worried by the prospect of inflation, higher interest rates, and trade conflict. The S&P 500 Index zigged up, zagged down, and ended the month up slightly (+0.3%) from where it started, down −1.0% year to date. While a couple of recent data points are likely to reinforce market worries and weigh down enthusiasm at any good news, most of the economic numbers remain positive, and equity valuations look more attractive than they have for some time.

The U.S. economy grew at +2.3% in the first quarter, well within the range of expectations. A quick look under the hood, however, reveals two potential concerns: consumer spending and inflation.

Based on initial estimates, consumption growth slowed to just +1.1% in Q1, its lowest rate in nearly five years. Real disposable personal income rose by a healthy +3.1%, but despite very high survey readings of consumer confidence, the savings rate bounced back to 3.1% from a cycle low of 2.6% in Q4. Greater consumer caution may also have been reflected in a modest 3-month slide in retail sales, from December to February, though sales in March bounced back by a resilient +0.6% and are still up a solid +4.5% from a year ago. April auto sales came in at a rate of 17.2 million per year, better than last year's slump, but not growing. The GDP data indicated residential investment was flat in Q1, though new housing starts rose +4.9% from Q4 to Q1, up +6.5% from a year before. Sales of new homes, up +8.3% in Q1 from a year ago, are doing better than existing home sales, still down year-on-year.

In contrast, business investment grew at a confident +6.1% pace in Q1, contributing—rather unusually—more to overall GDP growth than consumption. Two years ago, business investment was in the doldrums, and the question was whether that slump would undermine steady consumption growth or be rescued by it. Today, the shoe is on the other foot: will the slowdown in consumer spending force companies to scale back investment, or will steady job growth and business expansion help power consumer incomes and revive spending growth?

We think that, as before, growth will win the day. While both the ISM Manufacturing and Non-Manufacturing indices have cooled a bit from prior highs, they remain in solid expansion territory (57.3 and 56.8 respectively for April), supported by a strong flow of new orders. Factory orders rose +1.6% in March, up +8.1% from a year ago, and though orders for core capital goods—a key indicator of future business investment—declined −0.1% in Q1, they were still up an impressive +6.8% from a year before. Perhaps most importantly, job growth continues apace. The 164,000 jobs created in April may have fallen a bit short of expectations, but the average so far this year (200,000 per month) is higher than the past two years, and one reason consumers remain so confident is that very few report jobs are hard to find.

What businesses are reporting, however, is rising prices. The ISM Manufacturing Index shows price pressure across different industries at an alarmingly high 79.3 and rising, while backlogs are also mounting. Some manufacturers, along with purchasing managers in mining and construction, are saying that the recently-imposed steel tariffs are contributing to raising their costs. Firms like Caterpillar and 3M have announced they expect cost pressure to cut into their profits in coming quarters. Perhaps more importantly, the Fed's preferred inflation gauge, the PCE Index, rose at an annualized rate of +2.7% in Q1 for the second quarter in a row. In Q4, that increase was largely due to energy prices, but in Q1 that broadened out with core PCE rising +2.5%, up from +1.9%. That recent acceleration has finally pushed the PCE Index up +2.0% (the Fed's target) compared to a year ago and is likely to push it up further. That's one reason why the 10-year Treasury yield nudged above 3.0% in April. Though it has since fallen back slightly to just below 3%, the 10-year rate has advanced a full +55 basis points since the start of the year.

As far as our investment outlook is concerned, rising interest rates have been more than offset by growing corporate profits. With 84% of the S&P 500 reporting, operating earnings per share (EPS) for Q1 is expected to rise +9.5% from Q4, up +28.6% from a year ago. Out of 11 industry sectors, eight are expected to show positive earnings growth from last quarter and all of them should be well up from a year ago. While higher inflation and interest rates could impinge on future earnings growth—and on share buybacks—this is still impressive performance, and corporate tax cuts will weigh on the positive side of the ledger. With share prices down slightly, earnings growth has pushed the 12-month trailing P/E ratio for the S&P 500 below 20x to its lowest quarter-end level in nearly three years. Even with higher Treasury yields, the Equity Risk Premium has rebounded from 4.8%, at the start of the year, to 5.2%—well above its historical average of 4.1%. Regardless of when this market cycle comes to an end, there is still a strong case that taking equity risk will be rewarded over the long-term.

The recent data suggests that some market concerns regarding inflation, interest rates, and trade are not without merit. But that heightened awareness of downside risks has come to eclipse the positive news that is out there and the more reasonable equity valuations that have resulted, especially compared to lower-yielding "safe havens". The economy has strengths as well as vulnerabilities, and we expect that the market, fretful as it may be, will come to see this.

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