SILVERCREST
ASSET MANAGEMENT GROUP

U.S. MARKET AND ECONOMIC REVIEW—MAY 2019

Stronger than expected GDP growth and firmer corporate earnings for the first quarter helped boost U.S. share prices back to new highs. The S&P 500 Index gained +3.9% in April, with total returns (including dividends) so far this year of +18.3%. Beneath the headline figures, however, there are signs that growth continues to slow, which could leave markets vulnerable to another correction.

The U.S. economy grew by +3.2% in Q1, far surpassing expectations. Much of the outperformance, however, came from a continued inventory build-up (which added 0.7 points to growth) and a smaller trade deficit (which added a full percentage point). The latter owed as much to falling imports (−3.7%), potentially a sign of economic weakness, as to relatively modest growth in exports (+4.7%).

Domestic demand growth, in contrast, continued to steadily slow, from its latest peak of +4.1% in 2Q18 to just +1.5% in 1Q19. Household consumption slowed to +1.2%, adding less than a point to overall growth. The renewed surge in business investment that followed President Trump's election appears to be over, with business investment also slowing to +1.5%. A slump in housing, which began last year, has become a modest but persistent drag on growth: residential investment fell −2.8% in Q1, its fifth straight quarter in decline. Private residential construction spending was down −7.6% in Q1, from a year ago, while construction spending as a whole was propped up mainly by a big surge in public spending (up +9.4% from a year ago) on projects like streets and highways. Government spending grew at a rate of +2.2% in Q1, with a continued surge in defense spending (+4.1%) helping to offset a drop in non-defense spending (−5.9%) due at least in part to the month-long federal government shutdown.

None of this implies a recession is imminent. Employment continues to expand, with the U.S. economy adding a better-than-expected +263,000 jobs in April, and initial jobless claims falling back to near 50-year lows. Consumer confidence has gradually recovered from the hit it took during the government shutdown. Retail sales, which had been in the doldrums, surged +1.6% in March, up +3.6% from a year ago. However, consumers are expressing more caution in their plans for major purchases such as cars, homes, and appliances, and auto sales slumped back to an annual rate of just 16.4 million vehicles in April, after a brief rally in March. The inventory to sales ratio, across the whole economy, remains at a somewhat elevated level since November.

Still, most companies, in most sectors, say they see business growing. The ISM Manufacturing Index slipped −2.5 points in April to 52.8, its lowest reading since November 2016, with export and import orders both falling into contraction. But the much broader Non-Manufacturing Index came in at a more robust 55.5, bolstered by a steady stream of new orders. Companies responding to both surveys report that they see growth slowing, but remaining positive.

Inflation slowed to nearly a crawl in Q1, with the PCE price index rising at an annualized rate of just +0.6%. That has given the Federal Reserve a great deal of room to hold off raising interest rates, which in turn ought to be supportive of both the economy and stock market valuations. Though inflation has probably reached a bottom and has begun to tick up again, led in part by a +40% recovery in the price of oil this year, it remains below the Fed's 2% target, and as yet poses no real constraint on growth.

With 82% of the S&P 500 reporting, operating earnings per share (EPS) for Q1 is expected to be up +1.8% from a year ago. While positive, that's a long way from the +21.8% earnings growth the index saw for last year as a whole, boosted by a major tax cut and a surge in share buybacks. What's more, while quarterly earnings for the index as a whole rebounded in Q1, from the sequential drop they saw in Q4, this rebound was mainly led by the financials and health care sectors. Out of 11 industry sectors, eight are expected to see quarterly earnings further decline in Q1, and for almost the same eight, those quarterly earnings will actually be down from a year ago. While earnings performance in Q2 is expected to be more broadly positive, and the 12-month trailing P/E ratio for the S&P 500 is still, at 19.4x, a far cry from its peak of 21.5x just over a year ago, investors should take the softness in earnings across multiple sectors as a warning to keep their short-term expectations realistic.

U.S. shares are far from the only ones to see a strong rebound this year. By the end of April, Japan's Nikkei had a total return of +11.2% this year, Britain's FTSE +10.3%, the MSCI Eurozone Index +15.6%, and the MSCI Emerging Markets Index +12.2%. All have been buoyed by a number of stories—the postponement of Brexit, hopes for a U.S.-China trade deal, a new round of stimulus in China, "green shoots" possibly signaling recovery in Europe—which could easily take a new turn and reintroduce volatility into markets. In the U.S., a high equity risk premium (ERP), at 5.6%, continues to favor shares over the long run, but the rewards come with an acceptance of short-term risk. After a surprisingly smooth ride for the past four months, it could be a bumpier road ahead.

May 8, 2019

Patrick Chovanec
Managing Director, Chief Strategist

This communication contains the personal opinions, as of the date set forth herein, about the securities, investments and/or economic subjects discussed by Mr. Chovanec. No part of Mr. Chovanec's compensation was, is or will be related to any specific views contained in these materials. This communication is intended for information purposes only and does not recommend or solicit the purchase or sale of specific securities or investment services. Readers should not infer or assume that any securities, sectors or markets described were or will be profitable or are appropriate to meet the objectives, situation or needs of a particular individual or family, as the implementation of any financial strategy should only be made after consultation with your attorney, tax advisor and investment advisor. All material presented is compiled from sources believed to be reliable, but accuracy or completeness cannot be guaranteed. © Silvercrest Asset Management Group LLC