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U.S. ECONOMIC AND MARKET REVIEW—NOVEMBER 2018

The U.S. stock market finally fell prey to the anxiety pushing down overseas markets since August. It suffered its second −10% correction of the year in October, erasing most of its annual gains to date. Worries over rising interest rates, rising prices, trade wars, and the prospect of slowing growth abroad caused investors to shrug aside mostly positive earnings reports and focus on future uncertainties. That pulled the S&P 500 down −6.9% by month's end, up a mere +1.4% year-to-date (for a total return, including dividends, of +3.0%). Yet while some positive trends that drove share prices upwards this year may be decelerating, they remain broadly positive. We see firm indications that growth, while moderating, will continue. Meanwhile, valuations have dropped to their most attractive levels in quite a while.

As expected, the U.S. economy grew +3.5% in the third quarter, down slightly from +4.2% in Q2. The mainstay of this continued growth was personal consumption, which grew at an annual rate of +4.0%, its strongest in almost four years. Consumer confidence, as measured by the Conference Board, rose to an 18-year high in October. A major factor driving this confidence is solid jobs growth. The U.S. economy added +250,000 jobs in October, surpassing expectations, and average monthly jobs growth this year is a robust +213,000, the strongest since 2015. Average hourly wage growth is up +3.1% from a year ago, the strongest rate of the recovery so far, though still modest by historical standards.

Not everything is running on full cylinders. Retail sales growth slowed to just +0.1% in August and September, though sales are still up +4.7% from a year ago. Auto sales picked up a bit, to 17.5 million per year in October but have been lackluster the past two years. Residential investment fell −4.0% in Q3, its third straight quarter in decline, as the housing market remains stuck in low gear and mortgage rates begin to rise. For now, these soft patches look more like the sluggish, uneven growth that has been typical of this entire recovery, as opposed to a real inflection point.

One of the most noticeable shifts in Q3 was a sharp deceleration in business investment, from +11.5% in Q1 and +8.7% in Q2 to just +0.8%, the slowest growth of the Trump presidency. While industrial production is up a solid +4.7% from a year ago, and overall factory orders are still up +7.9%, orders for core capital goods—a key indicator of business investment—have declined for the past two months in a row. One reason may be that trade conflicts are finally beginning to bite. Responses to the ISM Manufacturing survey in October turned into a chorus of worried complaints about the negative impact of new tariffs on input prices, export sales, and investment, overshadowing previous positives. Despite new barriers to imports, the stronger dollar—boosted by inflows of foreign capital to finance a bigger U.S. budget deficit—actually widened the U.S. trade deficit, shaving −1.8 points off GDP growth in Q3. Exports fell −7.0%, while imports rose +3.5%, highlighting our long-standing point that trade restrictions offer no easy "fix" to what are really deep-seated structural imbalances.

Companies may be facing higher costs—from tariffs as well as a gradually tightening labor market—but their ability to pass them along to customers is uncertain. Far from accelerating, as many feared, overall inflation rates have actually moderated this year. The PCE price index has declined from a peak of +2.7% (annualized) in 4Q17 to +1.6% in Q3. Consumer prices, as measured by CPI, are now +2.3% higher than a year ago, down from a peak of +2.9% in July. Oil prices have played a part, but core inflation (excluding food and fuel) also slowed. That means the Fed may feel less pressure to raise interest rates. It also means that firms unable to pass along higher costs could face a squeeze on profits.

With 68% of the S&P 500 having reported Q3 earnings, quarterly operating earnings per share (EPS) is expected to be up +4% from Q2 and a whopping +29% from a year before. While all but one of 11 sectors are up year-on-year, five saw earnings decline from last quarter, suggesting a more challenging road ahead. Two factors that boosted EPS this year—a major corporate tax cut and a big surge in share buybacks—are unlikely to provide a similar boost next year. The broad momentum is still positive, but the tide won't necessarily lift all boats. Part of the market correction we've seen is about investors figuring out how to come to terms with that.

Equity valuations have come down significantly, even before the latest correction. At the start of the year, the 12-month trailing P/E ratio for the S&P 500 stood at 21.5x. It has since fallen more than three full multiples to 18.1x—its lowest level, for any length of time, in nearly four years. Even factoring in the expected slowdown in the pace of earnings growth next year, the forward P/E ratio has fallen from 18x to 16x. While interest rates have risen, share values have fallen even more, pushing the equity risk premium out to 5.8%, the widest (and most risk-adverse) gap in expected returns since December 2016. This kind of slide in valuations might make sense if you are anticipating sharp Fed rate hikes or an imminent recession. We do not think the latest data points to either.

The U.S. midterm elections will generate copious news coverage and may cause some short-term market volatility, but have little influence on our economic outlook. The most likely outcome, a split in party control between one or more chambers of Congress and the White House, may generate plenty of sound and fury but is unlikely to produce any new legislation, or repeal past legislation (such as tax cuts), that would significantly alter that outlook. Continued Republican majorities in both houses, on the other hand, would find it no easier to carve agreement on health care, immigration, infrastructure spending, entitlement reform, or even additional tax cuts than they have over the past two years.

The U.S. economy was accelerating earlier this year and is now decelerating. But that is very different from going from positive to negative. It's important to keep in mind that while the ISM Manufacturing and Non-Manufacturing indices may be cooling a bit, perhaps due to well-founded worries over trade battles, they both remain clearly in expansion territory, including the forward-looking gauge of new orders. The Atlanta Fed is currently projecting +2.9% GDP growth for Q4, while the New York Fed projects +2.6%. That may be a comedown, perhaps, for anyone who thought 4% growth was the new normal after an exceptional second quarter, but it should be reasonably encouraging for any investor approaching the tenth year of a sometimes fitful economic recovery with realistic expectations.

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