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## U.S. ECONOMIC & MARKET REVIEW—NOVEMBER 2019

Postponements in Brexit and the U.S.-China trade war lifted markets in October, despite rather mixed economic and earnings data. The S&P 500 Index rose a further +2.0% last month, for a total return (including dividends) year-to-date of +23.2%. Though the relief is understandable, these valuations could be tested if growth doesn't pick up, or the slowdown deepens.

The U.S. economy grew +1.9% in Q3, down from +2.0% in Q2. The Atlanta Fed projects it will slow further in Q4, to +1.0%, while the New York Fed projects +0.8%. Annual GDP growth for 2019 as a whole will likely be either +2.2% or +2.3%, down from +2.9% in 2018. The main brake on momentum has been an erosion of business confidence due to trade tensions and sluggish growth abroad, which have weighed most heavily on the manufacturing sector. The ISM Manufacturing Index remained in contraction in October, at 48.3, for the third month in a row. Factory orders in September were down −3.5% from a year ago, while factory output was down −0.8%. In Q3, business investment dropped −3.0%, its second straight quarterly decline. Orders for core capital goods in September were down −1.0% from a year ago.

Manufacturing accounts for 12% of the U.S. economy; the rest of the economy appears to be doing a bit better. The ISM Non-Manufacturing Index bounced back +2.1 points in October to 54.7, still in expansion territory. Forward-looking new orders also rose +1.8 points to a solid 55.6. The key factor has been consumer spending, which grew at a respectable rate of +2.9% in Q3. Though the gauges of U.S. consumer confidence have wavered at times, they remain high, bolstered by continued jobs and income growth. The U.S. economy added +128,000 jobs in October, beating expectations, and initial jobless claims remain near 50-year lows. Though job growth has slowed from last year, personal income in September was up a robust +4.9% from a year ago, and retail sales were up +4.1%.

Low inflation (the PCE price index is up just +1.3% from a year ago), underpinned by lower oil prices (down −20% from a year ago), has helped consumers. It's also given the Fed room to cut interest rates for a third time since July. Lower mortgage rates may be one factor that has helped revive the struggling housing market. Residential investment grew +5.1% in Q3, after six straight quarters in decline. New housing permits—which were down year-on-year for the whole first half of the year—had bounced back by September, up +8.0% from a year ago.

Despite the possible boost from Fed easing, corporate earnings have hit a soft patch. With 74% of companies reporting for Q3, quarterly operating earnings per share (EPS) for the S&P 500 is expected to slip −0.3% from Q2, down −3.3% from a year ago. Out of 11 sectors, only two—health care and consumer discretionary—are expecting higher Q3 quarterly earnings than a year ago. Given the slower economic outlook for Q4, this may take time to improve. In the meantime, higher share prices have raised the 12-month trailing P/E ratio to 19.8x, its highest quarter-end level since 1Q18. Rising bond yields and rising share valuations have narrowed the

Equity Risk Premium to 5.4%, though it remains well above its historic average of 4.2%, and still strongly favors equity risk.

Optimism over the prospect of even an interim U.S.-China trade deal, and relief at a further delay in Brexit, may justify these higher valuations. To last, however, they will have to be validated by stronger signs of recovery from the economy's latest slowdown than we've seen so far.

November 7, 2019

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