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U.S. ECONOMIC AND MARKET REVIEW—SEPTEMBER 2018

The U.S. stock market delivered another month of buoyant gains in August, bolstered by positive economic news and corporate earnings reports. Anxiety abroad, however, pulled most other equity markets down. We continue to keep our eye on a number of factors that are driving global unease and could, at some point, disrupt the strong positive momentum lifting U.S. markets.

In the meantime, the vigor that drove +4.2% GDP growth in Q2 appears to be holding up. Based on the latest data, the Atlanta Fed is currently projecting +4.4% growth in Q3, while the New York Fed projects a more modest +2.2%. The Conference Board's consumer confidence gauge hit a new 18-year high in August, its strongest since the dotcom frenzy in October 2000. Consumer spending rose +0.4% in July, up +5.2% from a year ago, its strongest year-over-year pace in four years. Retail sales were up +6.4%; while some of this came from a +22.2% surge in gasoline sales due to higher prices at the pump, stripping that out still leaves solid sales growth of +5.1%, from a year ago. While housing and auto sales remain somewhat sluggish—weak spots that could potentially spread—concerns that consumers might be overextending themselves, by drawing too deeply into savings, have been alleviated by recent upward revisions to income growth, which reset the personal savings rate to a much healthier 6.7%.

Consumer confidence and income growth have been driven in large part by steady jobs growth, in a virtuous cycle driven in turn by solid consumer demand. The U.S. economy added another +201,000 jobs in August, and just 12.7% of consumers the Conference Board surveyed say jobs are "hard to get", compared to 42.7% who say jobs are "plentiful." Businesses are willing to hire, and invest, because their order books are full. Industrial production is up +4.2% from a year ago, its highest growth rate since the recovery's initial bloom, in December 2010. Durable goods orders in July were up an impressive +9.4% from a year ago, while orders for core capital goods—a key indicator of business investment—surged +1.6% in July, up +8.8% from a year before. The ISM Manufacturing Index for August jumped +3.2 points to 61.3, its highest level since 2004, while the ISM Non-Manufacturing Index rose +2.8 points to 58.5, both boosted by a strengthening stream of new orders that should sustain production in the months to come. Despite the sluggish housing market, overall construction spending in July was up a healthy +5.8% from a year ago.

After-tax corporate profits, across the entire U.S. economy, rose +3.7% in Q2, up +6.7% from a year ago. Operating earnings per share (EPS) for the large-cap S&P 500 rose at an even stronger pace of +6.0% in Q2, up +26.9% from a year ago, boosted in part by record levels of share buybacks. So, while the S&P 500 Index is up +8.5% this year (for a total return of +9.9%, including dividends), it's been outpaced by earnings gains. If Q3 earnings come in close to expectations (up another +4% from Q2), the 12-month trailing P/E ratio will have declined—at current market prices—to 19.3x operating EPS, its lowest quarter-end valuation in three years.

And while the Equity Risk Premium has narrowed slightly, to 5.0%, it still stands well above its long-term average of 4.1%. These numbers make U.S. equities look more attractive than they have for some time.

One factor that appears to be holding back U.S. large-cap valuations—compared to the tech-heavy Nasdaq, up +17.5% this year, or the more domestic-oriented small-cap Russell 2000, up +13.4%—is greater exposure to international risk. A variety of worries, from trade wars to Brexit to debt troubles, have weighed down on non-U.S. shares. Britain's FTSE 100 Index fell −4.1% in August, down −3.3% on the year. The MSCI Eurozone Index fell −3.3%, down −4.8% on the year, while the MSCI Emerging Market Index fell −2.9%, down −8.9% on the year. China, in particular, has been hammered, with its benchmark Shanghai Composite Index falling −5.3% in August, down −17.6% on the year.

The imposition of new and possibly wide-reaching trade sanctions remains a valid concern, both at home and abroad. The announcement of a tentative deal with Mexico, on changes to NAFTA, gave some reassurance to markets, but potentially serious U.S. quarrels with Canada, as well as Europe and Japan, remain unresolved. Meanwhile, the march towards the U.S. placing more and more tariffs on Chinese imports—to which China vows to retaliate in kind—continues apace, refocusing attention on vulnerabilities in China's economy (such as high levels of bad debt, and over-reliance on investment to drive growth) that already posed severe risks. In the U.S., companies' responses to the ISM surveys indicate a high level of concern, across multiple industries, over the harmful effect new and proposed tariffs are already having on input costs, export sales, and future investment plans, despite otherwise strong conditions for growth.

Trade is hardly the only concern casting darkening shadows overseas. The need to finance a widening federal budget deficit, due to recent tax cuts, is causing capital to flow into the U.S. from abroad—even without significant hikes in U.S. interest rates. This strengthens the U.S. dollar (up +6.0% so far this year, on a broad trade-weighted basis), which—somewhat ironically—is causing the U.S trade deficit to widen, rather than shrink. It's also putting stress on a number of developing countries that have relied on cheap U.S. dollars to finance high levels of debt-fueled growth. In August, Turkey faced another panicked drop in its currency, and some worry that Argentina or South Africa could be next. While the effects might be localized, like the 1997 Asian Crisis, there is always the risk of contagion, and even unanticipated ripple effects in Western financial markets.

The fear of rapidly rising U.S. interest rates triggering financial crises abroad may be premature. Inflation, while gradually rising, isn't sounding any alarm bells: the Fed's preferred inflation gauge, the PCE Index, nudged up to +2.3% in July, while core PCE (excluding more volatile energy and food prices) stood at +2.0%, the Fed's long-standing inflation target. Some on the Fed board are expressing reluctance to hike rates if it means inverting that already-flattened yield curve, a sign that typically signals (or possibly helps cause) an impending recession. The real problem, for now, isn't runaway inflation, but lackluster wage growth. While average hourly earnings growth inched up to +2.9% in August, its strongest pace of the recovery, the Consumer Price Index (CPI)—driven in large part by rising energy prices—has picked up more quickly to match that, pulling the pace of real wage gains down to zero. Wage pressure isn't driving inflation, it's only barely keeping up. That's good news if you're worried about the Fed having to hit the brakes, but it's bad news for wage-earners, and could eventually undercut the consumer confidence that has been helping to drive strong U.S. growth momentum.

For now, the U.S. economy looks like it's on a sound footing—in sharp contrast to anxiety-ridden markets abroad. But the concerns giving rise to those overseas anxieties may have implications for the U.S., and are worth keeping a close eye on.

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