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The renewal of trade tensions between the U.S. and China, and uncertainties where they might lead, dominated markets in August. After several sharp ups and downs, the S&P 500 ended the month −1.8% lower than it started, but with a total return (including dividends) of +18.3% year-to-date. Market anxiety caused the U.S. yield curve to become more deeply inverted, typically a sign of approaching recession, but corporate earnings growth proved more robust in Q2 than expected. The economic data remains mixed, with some weak spots growing weaker, but other signs that growth still retains some momentum.

Manufacturing, which accounts for 12% of GDP but roughly half of U.S. exports, appears to be bearing the brunt of the slowdown. U.S. manufacturing output fell −0.4% in July, down −0.5% from a year ago. Durable goods orders got a bump in July from a surge in aircraft orders, but exclude them and orders fell −0.4%, down −0.2% year-on-year. Orders for core capital goods—a key indicator of business investment—rose +0.2% in July but dropped into negative year-on-year territory for the first time since November 2016, down −0.6% from year ago. Perhaps even more attention-grabbing, the ISM Manufacturing Index for August fell −2.1 points into contraction at 49.1, its lowest reading since January 2016. Every sub-index except supplier deliveries is now in contraction (below 50), with new export orders at a dismal 43.3. Survey responses have shifted from voicing loud but largely prospective worries over new tariffs to noting "signs of a broad slowdown" taking hold. The Markit PMI survey also showed U.S. manufacturing slowing to just 50.3, its lowest reading since September 2009, while new exports orders fell at their fastest rate in 10 years.

The significantly larger service sector of the U.S. economy, however, continues to plug along at a decent pace. The ISM Non-Manufacturing Index rebounded +2.7 points in August to 56.4, in solid expansion territory. Production surged +8.4 points to 61.5, while new orders bounced +6.2 points to 60.3—both very strong readings—though on the trade front, new export orders and imports both fell −3.0 points to barely above 50.

A major factor keeping that momentum going is high consumer confidence, bolstered by continued jobs growth and rising incomes. Personal income, in July, was up a robust +4.6% from a year ago, while consumer spending was up a solid +4.1%. The U.S. economy added +130,000 jobs in August, falling short of expectations and pulling the average monthly rate of jobs growth so far this year down to +158,000, its slowest pace since 2010. Still, the number of consumers who say jobs are plentiful jumped to 51.2% in August, while the number who say "jobs are hard to get" fell to just 11.8%, boosting the Conference Board's consumer confidence gauge back to just a few points shy of the 18-year high it hit last October.

Even U.S. consumers, however, are not completely impervious to the uncertainties that could slow growth. The University of Michigan's consumer sentiment gauge in August slipped −2.3

points to 89.8—still reasonably strong, but its lowest reading since October 2016. Expectations, in particular, plunged −10 points, with 1/3 of those surveyed spontaneously mentioning rising tariffs and trade tensions, unprompted, as a concern. Consumers, willing and able to open their wallets on a daily basis, express more hesitation about making major purchases. Auto sales so far this year have averaged 16.9 million vehicles/year, down from 17.2 in 2018. And while a noticeable drop in mortgage rates has boosted home sales and new housing starts back into positive year-on-year growth, private residential construction spending in July was still down −6.6% from a year ago.

Weakness abroad isn't helping. Germany's GDP fell −0.3% (annualized) in Q2, pulled down by its export-oriented manufacturing sector, which is in deep contraction. Though Japan is seeing positive growth overall, it too is facing a serious manufacturing slump. China's economy, laden with bad debt and facing escalating U.S. sanctions, is slowing despite renewed stimulus efforts. The U.K., facing the uncertainty of Brexit, saw its economy shrink −0.8% (annualized) in Q2, its first quarterly decline since 2012. Those headwinds have pulled down inflation as well as long-term interest rates, giving the Fed both the motivation and flexibility to cut shorter-term rates. But they have also put upward pressure on the U.S. dollar, which rose +2.6% in August, on a trade-weighted basis, up +2.9% so far this year. The weakening Chinese yuan, which fell nearly −4% in response to the latest flare-up in trade tensions, presents particular cause for concern.

For all this, however, corporate earnings are offering better-than-expected news. After two straight quarters in decline, after-tax corporate profits, for the economy as a whole, bounced back +4.8% in Q2, up +1.7% from a year ago. Quarterly operating earnings per share (EPS) for the S&P 500, expected to be up just +2% year-on-year in Q2, beat expectations at +4.6%—though it's worth keeping in mind that a sizeable part of this likely came from share buybacks, as it did in Q1. Growth has also been uneven: while all but two of 11 sectors saw EPS rise from Q1 to Q2, a majority (7) were actually down year-on-year. Still, positive earnings growth has kept the S&P 500's 12-month trailing P/E ratio stable at around 19x, even as longer-term U.S. Treasury rates plummeted in August, widening the equity risk premium to 5.8%. The costs of seeking a safe harbor from equity risk remain uncommonly high.

The Atlanta Fed currently projects that U.S. GDP will grow +1.5% in Q3, while the New York Fed projects +1.6%. In other words, growth momentum remains positive, if far from exhilarating. The instinct to run and hide, amid so many uncertainties, can be powerful—but also costly. It's times like these when investment discipline plants the seeds for long-term gains.

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