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U.S. ECONOMIC AND MARKET REVIEW—FEBRUARY 2015

Markets in January were driven by three main factors: 1) anxiety over the future earnings outlook for U.S. companies, 2) excitement over monetary easing in Europe, and 3) a growing divergence among emerging markets. Only the third, we believe, will prove lasting.

Consensus expectations for S&P 500 earnings growth in Q4 were slashed sharply over the past several months, from +9.6% year-on-year (y/y) at the start of the quarter to +1.2% at the end, due largely to the impact of falling oil prices on the energy sector—bringing year-end earnings closer to our own, more conservative, projection. Expectations for Q1 and Q2 earnings growth have fallen even more sharply, from +10.8% and +7.4%, to -1.8% and -2.7%, respectively. With expectations falling, it may come as no surprise that the S&P 500 index fell -3.1% in January (while 20+ year U.S. Treasury ETFs rose +9.8% in the same month).

But these gloomy revisions may have overshot the mark. As of today, with 274 companies accounting for just over 2/3 of the S&P 500's capitalization reporting, earnings are up a surprising +6.7% y/y, although revenues are up a much weaker +0.2%. Excluding the outliers (the -17.7% profit drop in energy on the downside, and Apple's astonishing profit performance on the upside), Q4 earnings growth so far is up +7.9% y/y, on revenue growth of +3.0%. These are solid numbers, and if they remain consistent, they would put the 12-month trailing P/E ratio for the S&P 500, at the end of January, at a very comfortable 17.1. The price of oil also appears to be stabilizing, which may signal value opportunities in the energy sector, as well as provide a steadier basis for Q1 and Q2 earnings projections.

The main threat to U.S. corporate earnings, especially for larger-cap companies, is a stronger U.S. dollar. Several U.S.-based multinationals have already reported a hit to their overseas profits, now worth less in dollar terms. For a while, the U.S. trade balance appeared resilient, with the trade deficit actually narrowing in October and November due to cheaper oil imports. But the December trade figures showed the widest monthly deficit in over two years, with exports actually falling, and non-oil imports surging to a record high, reinforcing initial Q4 GDP numbers that showed a drop in net exports shaving 1.0 percentage points off U.S. economic growth.

Other drivers of the U.S. economy, however, appeared to be on firmer ground. Consumer spending, boosted by cheaper fuel prices, rose +4.3% in Q4 (up from +3.2% in Q3) to contribute 2.9 percentage points to GDP. Despite a steep fall-off in oil and gas-related investment, overall business investment remained positive. Residential investment rose +4.1% in Q4 (up from +3.2% in Q3), as new home sales saw a sharp recovery in December (up +13% month-on-month, +10% y/y). While government spending appeared to detract from Q4 growth, this was a statistical blip – year-on-year, spending was actually up +0.7%. Overall, the U.S. economy grew at a respectable 2.6% pace in Q4, and 2.4% for the year as a whole (up from 2.2% in 2013), with little sign of inflationary pressure that might prompt Fed tightening.

By contrast, however, other markets fared better than the U.S. in January. The announcement of full-blown quantitative easing (QE) by the ECB encouraged a +9.1% gain in Germany's DAX index and an +8.4% gain in France's CAC 40. Yet none of the European policy-makers we've talked to are seriously willing to defend, when pressed, the proposition that ECB monetary measures will actually revive growth. At best, a weaker Euro will give European exporters and multinationals a nominal earnings boost, and siphon off a fraction of U.S. growth. Euro QE has pushed 27% of European sovereign bonds into negative yields, which in turn will push investors to seek higher returns elsewhere. There is no guarantee the liquidity pumped in by the ECB will stay in Europe, rather than migrate to U.S. Treasuries, U.S. equities, or emerging markets. While a stronger dollar may hurt U.S. growth and earnings, the capital flows away from a weakening Euro may bolster the valuation of U.S. assets—bonds certainly, but stocks as well, if domestic-driven U.S. growth stays resilient.

The impact on emerging markets will vary enormously. One year ago, the big worry was that countries like India and Turkey that needed to finance trade deficits (for importing energy, in particular) could wind up in trouble as the Fed's exit from QE caused global liquidity to dry up. Today, Europe and Japan appear primed to supply plentiful liquidity, in lieu of the Fed, while the cost of oil imports has plummeted. The MSCI India index rose +7.2% in January, on top of a +21% gain in 2014. In sharp contrast, the MSCI index for oil-exporting Russia fell -1.9% in January, on top of a -48% drop last year. Brazil, also a major commodity exporter, fell -6.2% in January, on top of a -18% fall in 2014. Meanwhile, China is struggling to keep its domestic property and stock markets inflated, even as GDP growth slows, profits decline, and capital exits the country in record quantities. This wide divergence in performance among different emerging markets—which used to track together far more closely—highlights the fact that the changes taking place in the global economy are producing big winners and losers. That is the one respect where we agree with the market's verdict in January.

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