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## U.S. ECONOMIC AND MARKETS REVIEW – MARCH 2016

U.S. equity markets stabilized in February, with the S&P 500 down −0.4% but ending the month on an upswing. In terms of sentiment, the market took its cue from oil prices which, while still down −11% this year, rebounded from an unsettling low of $26 back to $33. In terms of substance, the rebound was supported by new economic data making it clear that, contrary to fears that drove a stock sell-off, a U.S. recession is not in the offing.

U.S. GDP growth in Q4 was revised upwards to +1.0%, and based on the latest data, the Atlanta Fed projects growth will rebound to +2.2% in Q1, consistent with our forecast for the year. The 242,000 jobs added in February demonstrate continued momentum, which should continue to drive consumption growth. Personal income rose +0.5% in January, as did personal spending. Retail sales excluding gas stations rose +0.4%, up a solid +4.5% year-on-year. Auto sales are up +6.9% from a year ago, and held strong in February at 17.5 million/year. In contrast to the well-publicized challenges faced by some traditional retailers, sales by non-store (online) retailers were up +8.7% year-on-year in January.

Even the long-struggling manufacturing sector shows signs of life. The ISM Manufacturing Index for February recovered 1.3 points to 49.5, with new orders and current production both in positive expansion territory. Factory orders in January surged +1.6%, with orders for durable goods up +4.7% and core capital goods up +3.4%, compared with December. Industrial production rose +0.9%, on a sharp +2.8% gain in automobile production. Industrial capacity utilization rose in January, following five straight months of decline. Meanwhile, the ISM survey for February showed the much larger service sector of the economy continuing its expansion, supported by a healthy stream of new orders. The housing market stumbled in January, and February's NAHB Housing Market Index fell to its lowest reading since last May, but at 58, the industry's outlook remains confident.

This is not the sick U.S. economy that everyone was worried about. The oil sector is seeing a shake-out, business inventories remain high, and external demand remains weak, but the U.S. dollar—for the moment at least—has stabilized, and actually fell −1.0% on a trade-weighted basis in February, which should help restore earnings and competitiveness. These factors are capping growth, but are not dragging the economy into recession. As we expected they would, domestic growth drivers are proving remarkably resilient.

At $100.44, the average operating earnings per share (EPS) for the S&P 500 fell −11.1% in 2015, below even our highly conservative estimate of $106. However, this number obscures more than it reveals about the true health of corporate earnings. Virtually all of the negativity derives from two sectors—energy and materials—that have borne the brunt of China's investment slowdown. Seven out of the 10 sectors in the S&P 500 actually saw earnings per share rise, not fall, in 2015. Telecom (+68.7%), consumer discretionary (+9.8%), and health care (+8.2%) led the pack, in line with our expectations, but even hard-pressed industrials saw a

+4.4% gain. The index, at 19.2x earnings, remains somewhat richly priced, but that only reinforces what we have been consistently stating: investors need to look *within* not *at* the index, and rely on strong bottom-up analysis in picking stocks to generate desired returns from this environment. Even at the index level, however, the S&P 500 as a whole, down −5.5% year-to-date at February's closing bell, still has performed better than the MSCI World (−6.7%) and Emerging Market (−5.8%) benchmarks.

As far as what to expect next, as we've noted, so far this year stock market sentiment has taken many of its cues from the price of oil. On any given day, if you knew which way oil prices moved, you probably could tell which way the stock market moved. While we believe this linkage fails to recognize the critical distinctions we have so often highlighted, it can't be ignored in anticipating future market movements, at least in the near-term. The recent firming of oil prices reflects some important developments. After more than a year, we are finally seeing the initial signs of capitulation on the supply side: U.S. oil output has topped out and the most vulnerable OPEC members are agitating for cutbacks. Nevertheless, accumulated crude oil inventories remain at record high levels, which makes us wary concluding that the oil market has reached a hard bottom. While we think the oil price, and the producer industry, will gradually recover, we also think "consensus" expectations of a dramatic +20% gain in S&P 500 operating earnings this year, driven by a large and sudden rebound in the energy and materials sectors, continue to be overly optimistic. With this in mind, we are likely to see more sentiment-driven volatility in U.S. stock prices ahead, even as the U.S. economy continues on its path of slow growth.

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