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U.S. ECONOMIC AND MARKET REVIEW – MAY 2015

U.S. equities continued to tread water in April, as markets came to grips with a first quarter slowdown and its implications. The economy's performance in Q1 was disappointing, but from our viewpoint, not unexpected. The three headwinds we pointed to over the past several months each left its clear mark on quarterly GDP growth. The strong dollar reduced exports by -7.2% and shaved -1.25 percentage points off GDP. Lower oil prices led to cutbacks in domestic drilling, causing business investment to fall by -3.4%, and shaving another -0.44 percentage points from growth. The tendency of U.S. households to save rather than spend the windfall from cheaper fuel prices reduced consumption growth from +4.4% in Q4 to +1.9% in Q1, contributing just 1.3 instead of 3.0 points to growth. Let's be honest: without production that went into inventory, instead of sales, the U.S. economy shrank by -0.5% in the first quarter.

For investors, the question is whether the slowdown will persist and deepen, or whether we can expect a rebound—perhaps the kind of sharp rebound the U.S. saw in Q2 and Q3 last year. We think that the economy has already borne the brunt of these headwinds—the dollar and the price of oil are stabilizing, and retail sales have bottomed out—but the effects will take some time to dissipate. Unlike last year at this time, when the monthly data already showed clear evidence of a rebound, we are still looking for convincing signs that the turnaround has taken hold.

There are some positive initial signs. The ISM Manufacturing Index stabilized at 51.5 in April, after several months of decline, with 15 out of 18 industries reporting growth, up from 10 in March. Pricing remains weak, but new orders rose to 53.7 in April (from 52.0 in March), production was strong at 56.0 (up from 54.5 the month before), and exports were positive for the first time this year at 51.5 (up from 47.5 in March). However, the employment sub-index retreated into contraction at 48.3 (down from 50.0 in March), further tempering expectations of a sharp rebound from March's weaker-than-expected jobs number. Orders for non-transportation durable goods remain stuck low gear, falling -0.2% in March, down -1.9% from a year ago.

Retail sales rose +0.9% in March, after falling the previous three months, but are up a mere +1.3% from a year ago. Much of that March recovery was driven by a surge in auto sales, which slipped back again in April (to a still-solid 16.5 million per year). The Conference Board's consumer confidence index also slipped from 101.4 in March to 95.2 in April, underpinned by worries about future job creation. The housing market—a source of chronic weakness last year—is showing renewed signs of life. Existing home sales rose +6.1% in March, up +10.4% from a year ago. Even though new home sales fell back -11.4% in March, they were still up +19.4% from the year before. Still, it's premature to declare a (much hoped-for) resurgence in the U.S. housing market: although inventories are tight (4-5 months of sales), home prices remain soft

(down -1.5% in March, -1.4% from a year ago), and housing starts have yet to catch fire (up +2.0% in March, but still down -2.5% from a year ago).

With roughly 75% of the S&P 500 (by market cap) reporting, operating earnings per share (EPS) for Q1 appears on track to rise +0.8% compared to Q4, which is down -1.3% from a year ago. Much of this decline, of course, is due to the energy sector, where operating EPS is expected to have fallen -63.9% from a year ago. Other sectors such as health care (+21.8% year-on-year), information technology (+15.3%), and utilities (+13.9%) have fared far better. This uneven earnings performance is one reason for a selective, bottom-up stock picker to take heart, in the face of a sluggish index. There may be no rising tide lifting all boats, but it's still possible to catch a ride.

The other factor indirectly supporting U.S. share prices has been inflows of capital into U.S. fixed income from Europe, where record low (and often negative) interest rates have pushed investors to seek yield elsewhere. Despite a recent uptick, the U.S. 10-year Treasury rate remains well below that 3.0% it achieved mid-taper, in December 2013, and continued QE in Europe and Japan is likely to keep U.S. rates suppressed, whatever the Fed might choose to do. Ironically, the same overseas QE that, by propping up the dollar, is taking a bite out of U.S. growth and earnings, is also supporting higher U.S. equity valuations by keeping the global cost of capital low. It's a cushion that may well see the U.S. bull market through to a renewed round of growth.

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