SILVERCREST
ASSET MANAGEMENT GROUP

U.S. ECONOMIC AND MARKET REVIEW—MAY 2016

The U.S. economy is not in recession, but it's not firing on all cylinders either. We see signs for encouragement as well as concern, but until it becomes clearer which will win out, it's hard to see much short-term upside in equity markets.

The economy registered an uninspiring +0.5% growth in Q1. Three main factors dampened performance: cautious consumers held back, as did worried businesses, and a strong dollar widened the trade gap.

Growth in consumer spending has steadily decelerated over the past three quarters, from +3.6% in 2Q15 to +1.9% in 1Q16. Retails sales, in particular, were wobbly in the first quarter. That's a concern, but the underlying drivers of consumer demand haven't gone away. Real disposable income grew by +2.9% in Q1, and consumer confidence remains relatively strong. The addition of 160,000 new jobs in April came as a disappointment to some, but doesn't overly concern us yet, especially with new jobless claims at 42-year lows and wages beginning to rise. Auto sales rebounded sharply in April, after a one-month slump. Housing was a major bright spot in Q1, growing at its fastest rate (+14.8%) in over three years. Both autos and homes are sectors that have large multiplier effects on the rest of the economy.

The U.S. Dollar peaked in January at a 13-year high, widening the U.S. trade deficit and chipping −0.3 points off GDP growth in Q1. But the dollar has fallen −6.3% from that high point, down −3.8% on the year. That should spell relief for U.S. companies by helping to restore exports, pricing power, and the dollar value of overseas earnings. In March, the trade gap fell to its lowest level in over a year, while surveys indicate a pick-up in export orders that should aid Q2 growth.

Meanwhile, businesses are reluctant to bet on growth until they can see where it's coming from. Business investment fell a striking −5.9% in Q1, down the second quarter in a row. Firms continued to rein in inventories for the third quarter in a row, shaving −0.3 points off GDP growth. This pull-back by business bears watching: if it were to begin translating into a slowdown in hiring, it could undermine consumption growth—a potential recipe for a recession. Still, a few indicators suggest a brighter path forward. Factory orders bounced back +1.1% in March, with orders for durable goods showing their first gain since October, and the largest since June 2014. The ISM Manufacturing Index registered its second month of expansion in April, after a lengthy slump, while the Non-Manufacturing gauge continued to display strong momentum. Both were buoyed by a solid flow of new orders.

On corporate earnings, some critical perspective is in order. As the Q1 reporting season began, media headlines trumpeted that earnings were expected to fall −9.5%, both year-on-year and quarter-on-quarter, the worst performance since 2009. These numbers were based on analyst hitor-miss calculations, which lack consistency across sectors. The numbers we have always used are derived from a consistent approach as practiced by the authors of the S&P 500 index earnings report. Unlike the analyst figures, the S&P numbers already reflected a significant earnings downturn—particularly in the energy and materials sectors— in previous quarters. In Q1, with 88% of the index reporting, the S&P 500 figures show a +6.0% rebound in operating earnings per share (EPS), compared to Q4, due to significant recovery in energy and materials, as commodity prices stabilized. The consumer and industrial sectors came under greater strain, but the key point is, it's vital to look past the headlines to gain an accurate view of what is, in fact, a complex and uneven earnings picture. That's precisely the kind of environment where active management, as opposed to index investing, comes to the fore.

The S&P 500 ended April up +1.0% on the year, at a 12-month trailing P/E of 20.8x. This is richly priced, and we continue to think the S&P's forward P/E ratio of 17.0x, based on a +23% rise in earnings over the next 12 months, rests on some very doubtful foundations. The recovery in oil prices, to $46/barrel by the end of April, provides some support to current valuations, but anxiety over earnings remains high, and the chance of some confidence-disrupting event—arising from military tensions in the South China Sea, Britain's referendum on leaving the European Union, or this year's tumultuous U.S. presidential race—cannot be dismissed. Even in emerging markets, up +6.8% year-to-date on the back of a rebound in Brazil and Russia, we advise treading carefully, as misplaced excitement over China's renewed stimulus efforts begins to wane. At the start of the year, we said we expected a flat performance for the S&P 500, punctuated by downward volatility, with opportunity for positive returns reliant on patience and selective stock-picking. That remains our cautious but constructive view going forward.

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