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## U.S. ECONOMIC AND MARKET REVIEW—JUNE 2015

The last several months have been challenging ones for many U.S. companies. The strong dollar, a sharp falloff in oil drilling, and a bout of consumer caution combined to sap much of the high-flying momentum they were riding last summer. Equity valuations have become a bit stretched, notwithstanding our confidence that the economy will improve.

Overall, after-tax U.S. corporate profits recovered +3.1% in 1Q15, after falling -3.0% in 4Q14, up +9.2% compared to a year ago. But according to S&P, operating earnings per share (EPS) for the S&P 500 fell -3.5% in 1Q15, on top of a -9.6% decline in 4Q14, down -5.5% from a year ago. The fall in reported earnings per share (not deducting for special "non-recurring" charges) for the S&P 500 was even steeper: -4.2% in 1Q15, on top of -16.9% in 4Q14, down -12.1% from a year ago. Of course, this varies immensely by sector: operating earnings per share for the energy sector is down -104.1% from a year ago (it is now running losses) and materials is down -30.2%, while health care has risen +19.4%, utilities +15.7%, financials +12.4%, and IT +11.2%. Some sectors are growing apace, others have suffered a big setback, while others (like telecom and consumer discretionary) have seen growth slow.

The overall decline in earnings performance, however, combined with a modest +2.4% year-to-date rise in the index, has pushed the S&P 500's P/E ratio steadily higher. Price over operating earnings per share for the trailing 12 months has risen from 17.2x at the end of 3Q14 to 18.9x today. Furthermore, the widening gap between reported and "operating" earnings (nearly $4 per share) makes us question how many of the "one-time" charges companies are taking are actually non-recurring, and can be safely ignored. The 12-month trailing P/E ratio on reported earnings is now 21.2x, up from 18.6x at the end of 3Q14. These are elevated valuations, even for a strong bull market. Unless earnings rebound by 14% next quarter, to match the year before, those multiples will slip even higher–and with them, the risk of a market correction back to more sustainable levels.

There is an important difference between the risk of a (temporary) correction, which we do see, and the risk of a (lasting) bear market, which we do not. Long-term bull markets die from one of two causes: a recession, or the Fed raising rates. While the Fed may introduce a small (25 bps) rate hike at some point this year, with inflation running well below its 2% threshold, we think the Fed is unlikely to follow up with the kind of steady rate increases that would undercut markets. Continued QE in Europe and Japan also will keep U.S. interest rates suppressed, and support higher equity valuations.

As for a recession (two consecutive quarters of negative GDP growth), that appears unlikely. The main headwinds that slowed the U.S. economy in Q1 have eased significantly. The trade deficit, which shaved nearly two full percentage points off GDP growth in the first quarter, shrank by -19.2% in April, the sharpest drop in six years. The ISM Manufacturing Index rebounded from a trough of 51.5 in March and April to 52.8 in May. Two leading indicators–employment and backlog orders–returned to expansion territory, while new orders hit 55.8, the best reading this year.

Steady job creation has been the main factor driving steady growth in consumer spending. While personal consumption was flat in April, it was up +2.8% from a year ago, and there are signs of a pick-up in May. Auto sales surged +7.9% from April to May, reaching an annualized rate of 17.8 million, the strongest since July 2005. The housing market is showing renewed strength this year, with residential investment growing +5.0% in Q1. In April, existing home sales were up +6.1%, new home sales up +26.1%, and new housing starts up +9.2% from a year before.

It may occasionally skip a beat, but the heart of the U.S. economy continues to pump. Nevertheless, elevated valuations–both in U.S. markets and abroad–along with widening disparity in performance among sectors and firms argue in favor of two strategies: (1) greater diversification among markets and (2) greater selectivity within markets. Have more baskets, and choose your eggs carefully.

June 4, 2015

Patrick Chovanec
Managing Director, Chief Strategist