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U.S. ECONOMIC AND MARKET REVIEW—JUNE 2016

Equity markets, including the U.S., saw a modest rally at the end of May, with the S&P 500 index gaining +1.5%, up +2.6% on the year. A variety of encouraging data points revised Q1 GDP growth upwards from +0.5% to +0.8%, and boosted the Atlanta Fed's much-watched growth forecast for Q2 to +2.5%. But a surprisingly weak jobs report for May, along with Britain's upcoming vote on whether to leave the European Union, cast a shadow of uncertainty over whatever confidence markets were starting to feel.

Despite some stumbles in Q1, the U.S. consumer economy remains on track—for now. In April, consumer spending surged by +1.0%, the largest monthly jump this economic cycle. Retail sales rose +1.3% in April, bolstered by strong auto sales, which continued into May. Excluding auto and gas sales, core retail sales are up a healthy +4.4% from a year ago. The housing market continues to serve as a positive driver, with new home sales surging +16.6% in April, up +23.6% from a year ago. Residential construction spending is up a solid +8.0% from last year.

The industrial economy, which was in the doldrums last year, continues to show tentative signs of recovery. In May, the ISM Manufacturing Index rose to 51.3, its third month of expansion. Industrial production, down −1.1% from a year ago, rose +0.7% in April. New factory orders, down −1.8% from last year, surged +1.9% in April. But orders for core capital goods fell −0.8% in April, down −5.0% from a year ago, reflecting a real reluctance of businesses to invest, especially as they wrestle with elevated inventory levels.

The question we posed last month was whether this slowdown in investment will translate into a slowdown in hiring, undermining a key driver of continued consumption growth. This month's surprisingly weak employment report, which showed the U.S. economy adding just +38,000 new jobs in May, brings that question to the fore. Even though wages held up and new jobless claims remain near record lows, a noticeable fall-off in temp hires and a consistent decline in average weekly hours worked, compared to last year, could be early warning signs of a weakening job market. Even the ISM Non-Manufacturing Index, which has registered strong expansion this past year, saw its hiring gauge dip into contraction territory in May. If hiring does continue to slow, and wages don't pick up enough to make up the difference, incomes will suffer, and pull consumer confidence and spending down with them.

The slowdown in jobs growth—an average of 150,000 jobs per month so far this year, down from 229,000 last year—makes it less likely the Fed will move again to raise interest rates in June or July. In May, the U.S. dollar rebounded by nearly +3% on anticipation of Fed tightening, jeopardizing the relief U.S. firms were starting to feel after the dollar fell back from a 13-year peak in January. The U.S. trade deficit has come down in recent months, and exports have recovered. A more patient Fed, by reducing pressure on the dollar, should help that continue.

The late-May rally in U.S. equities boosted the 12-month trailing P/E ratio for the S&P 500 to 21.2x operating earnings, 24.2x reported earnings. To support such valuations, the market must remain confident that companies will deliver strong earnings growth for the rest of this year. What we've actually seen, over the past year, however, is a jittery market prone to recurring bouts of fear and doubt, overreacting to single data points. The next trigger could readily be Britain's June 23 vote whether or not to quit the EU. The latest polls have been neck-and-neck, with momentum seeming to favor the once-unthinkable choice to leave. If that shock doesn't materialize, others will.

We believe the U.S. economy and corporate earnings will grow this year, albeit sluggishly, and think many of the market's worries have been excessive or misplaced. But we also recognize that short-term sentiment is highly volatile and that not all signs are pointing to better days ahead. We caution against overreacting to these volatile waves of sentiment, and see this as a market that will end up rewarding patience and realistic expectations, rather than black-and-white predictions of boom or bust.

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