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ASSET MANAGEMENT GROUP

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The buoyant gains across global equity markets in July, amid decidedly mixed economic news, have given investors good reason to wonder how long the upswing will last. Volatile market sentiment makes another sharp but short-lived downdraft—like the market has experienced several times in recent months—quite likely. But considering the latest data, and the unappealing alternatives investors face, we don't see a *sustained* downturn in U.S. equities in the immediate cards.

The headline U.S. GDP growth number for Q2, +1.2%, fell well below expectations. Scratch the surface, though, and a more interesting—and less discouraging—story emerges. We would be quite concerned if that sluggish GDP number reflected a continued deceleration in consumer spending growth, alongside a mounting pile-up in inventories—a path we've warned could end in recession. Instead, consumption bounced back +4.2%, its strongest showing in over a year, while a much-needed pull-back in inventories cut −1.2 points off growth. The real story of Q2 was the sharp divide between robust consumption and deep-seated business caution, with non-residential investment falling for the third straight quarter. The weakness in business confidence was underscored by the decline in new orders for core capital goods, down −4.1% in Q2 from a year before.

The economy is being tugged in opposite directions: resilient consumption could rekindle business confidence, or the investment slump could undermine the job creation driving the consumer economy. So far, the signs are encouraging: solid growth in jobs (+255,000 added in July) and wages (up +2.6% from a year ago) should continue to support a steady rise in disposable income and consumer demand. Consumer confidence remains close to its highest levels of this recovery. Both the ISM surveys, Manufacturing (52.6) and Non-Manufacturing (55.5) indicate expansion momentum supported by a solid stream of new orders.

With 86% of firms reporting, operating earnings per share (EPS) for the S&P 500 index is expected to rise +10% from Q1 to Q2, up +1% from the year before, putting a more solid foundation under share prices. However, the recent stock market rally—the S&P 500 rose +3.6% in July, up +6.3% from year's end—has still pushed the index's P/E ratio to 21.8x 12-month trailing operating earnings, 24.8x reported earnings. Plenty of investors look at such valuations—rich by historical standards—and ask, quite reasonably, whether they are sustainable.

What is most remarkable about this market, though, isn't the price people are paying for risk, but the much higher price they appear willing to pay to *avoid* it. Equity P/E ratios in the mid-20s may seem daunting, but the implied P/E ratio for 10-year U.S. Treasuries yielding 1.5% is 67x—not to mention the nearly $12 trillion worth of global bonds out there trading at negative yields.

The U.S. equity risk premium, even after July's stock market rally, stands at 6.1%, compared to a 50-year average of 4.1%.

The point is not that stocks aren't historically quite expensive, or that the risk of a downturn can be brushed aside. It's that the cost of insulating yourself from that risk is even more expensive. Fixed income plays an important role in any properly diversified portfolio. But too much safety comes at a cost that needs to be weighed against the benefit—especially over the long term.

Over the next 4-5 years, we project that U.S. equities will produce returns of approximately +7.5% per annum. That doesn't assume smooth sailing – in fact, it factors in an end-of-cycle recession, followed by a recovery, as outlined in our 1Q16 quarterly note in January. Based on the latest economic data, we don't see that recession about to materialize, but even if we did, we think many people in the market are paying an excessive price, in foregone returns over many years, for a "safe harbor" from ups and downs they'd be better off just riding out with the appropriate asset allocation. Their fear has become a habit that's costing them dearly.

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