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U.S. ECONOMIC AND MARKET REVIEW—SEPTEMBER 2015

Global markets were rattled in August by renewed drops in China's stock market and the price of oil and by trepidation over the prospect of the Fed hiking interest rates as early as September. The Shanghai Composite index fell by -12.5% in August, down -38% from its peak in June. Japan's Nikkei fell -8.2%, Germany's DAX fell -7.4%, London's FTSE fell -6.7%, and the MSCI Emerging Markets index fell -8.8%. In the U.S., the S&P 500 fell -6.3% in August, ending the month down -4.2% year-to-date.

Fears that China's slowdown will pull the rug out from under the U.S. economy, however, are greatly overdone. The collapse in Chinese share prices was a long-overdue correction that reflects a much-needed (albeit painful) adjustment in China's lopsided economy, one that will ultimately put the global economy on a much sounder growth path. The pattern we would expect from this kind of rebalancing is exactly what we see: weakness in commodities, energy, and other industrial inputs that fed China's over-investment boom, alongside resilient performance in more consumer-oriented sectors as Chinese overcapacity is reined in and savings unlocked. While the three input-oriented sectors of the S&P 500 index—materials, energy, and industrials—have seen steep drops in earnings, 6 out of the remaining 7 sectors actually have higher earnings per share (EPS) than a year ago.

Despite deep market concern, most U.S. economic data remains positive and points to continued growth which should support corporate earnings. U.S. GDP growth for Q2 was revised upward from +2.3% to +3.7%, a much bigger rebound than anticipated. Business investment, rather than falling -0.6% in Q2, is now estimated to have increased +4.1%.

While job growth fell short of expectations in August, with employment rising by 173,000, jobs gains for June and July were revised upwards by 44,000, and expanding payrolls continue to lay a solid foundation for rising consumer demand. The Conference Board's consumer confidence index surged over 10 points to 101.5 in August, with only 22% of those surveyed saying jobs are currently hard to find. Personal income rose a solid +0.4% in July, including a +0.5% rise in wages and salaries, the largest gain since last November. Consumer spending rose +0.3% in July, led by +1.1% gain in durables tied to auto purchases, even as the savings rate held at a healthy 4.9%. Retail sales continue to recover in fits and starts from their end-of-the-year slump, up +0.6% m/m in July. Restaurant tabs were up +0.7% in July, on top of a +0.5% increase in June. Auto sales, already quite strong, rose +1.5% in August to an annual rate of 17.8 million.

Strong auto sales helped support the manufacturing sector, which has been a weak point in recent months. Industrial production rose +0.6% in July, led by a +10.4% surge in motor vehicle production. Other manufacturing was only up +0.1%, due to weakness in foreign demand and the energy sector. U.S. factory orders rose weaker-than-expected +0.4% in July, with orders for non-durables down -1.3%. Durable goods orders rose +2.2% in July, for a second month in a

row, led by a +4.0% rise in vehicle orders, but remain well below last year's summer surge. The ISM Manufacturing index fell to a lower-than-expected 51.1 in August, the second lowest of the recovery, with new orders at a sluggish 51.7. This comes in sharp contrast to the ISM Non-Manufacturing index, which showed the U.S. service sector—which makes up a much larger portion of GDP—sailing ahead at 58.5, the second highest reading (next to July) since 2005, with new orders and backlogs orders exceptionally high.

The U.S. housing market continues to recover from a lackluster 2014. Existing home sales rose +2.0% in July, up +10.3% from a year ago, with median prices up +5.6% from last year. New home sales rose +5.4% in July, back from a June decline and up +25.8% from a year ago. Housing starts rose +0.2% in July, up +10.1% from a year ago. Construction spending rose +0.7% in July, up +13.7% from a year before, led by strength in single-family homes (up +15.8% from a year ago).

Despite competitive currency devaluations by Japan, Europe, and now China, U.S. exports rose +0.4% in July, while imports fell -1.1%, reducing the U.S. trade deficit. For the moment, the stronger U.S. Dollar is being partly offset by improving U.S. terms of trade: while export prices are down -6.1% from a year ago, import prices have fallen -10.4%. Still, August's ISM Manufacturing survey showed new export orders in contraction for the third month in a row, so the trade balance, along with the diminished dollar-value of overseas earnings, remains a real concern.

This month's drop in share prices was not entirely unexpected. We have warned for several months that U.S. equity valuations had become stretched and that the consensus has been overestimating corporate earnings, making the market fragile and vulnerable to a correction. Now that correction has taken place, bringing the 12-month trailing P/E ratio for the S&P 500 down from 19.6x operating earnings to 17.2x at its recent low point, 18.2x at month's end. This reset in prices, sparked by uncertain and often misplaced fears—not deteriorating economic fundamentals—should cause savvy investors to start looking for value, rather than run for the exits. China's economic difficulties are real, and they matter. But the broad global sell-off they triggered was a knee-jerk reaction that failed to draw much distinction between who wins and who loses from this sea change in the global economy. Some sectors of the U.S. economy are hurt, some are unaffected, and many actually benefit from the changes China is going through. It may take some patience—and a willingness to endure additional volatility as the Fed meets later this month—but the U.S. economy is not done growing yet, and neither are significant parts of this market.

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