SILVERCREST
ASSET MANAGEMENT GROUP

U.S. ECONOMIC AND MARKET REVIEW—NOVEMBER 2015

Let's take a step back and look at the big market picture this year. At the start of 2015, large-cap U.S. corporate earnings stumbled on a strong dollar and lower oil prices. While we expected the damage to heal, we warned that share prices had become vulnerable to a correction. When that correction happened—triggered by anxiety over a slowing China—we emphasized that the changes taking place created winners as well as losers, and that fears the U.S. would be dragged into a recession were misplaced. We argued there was life left in the U.S. stock market, and so it has proved. In October, the S&P 500 index bounced back +8.3%, ending the month up +1.0% year-to-date. Looking forward we believe the U.S. economy will continue to grow, and earnings will grow with it, though not at the rate the market consensus currently anticipates. We see great disparity among segments of the economy and valuations at the index level that, for the moment at least, may have gotten a bit ahead of themselves.

U.S GDP growth for Q3 was +1.5%, down from a sizzling +3.9% in Q2, but roughly in line with our own cautious expectations. Every major component—personal consumption, business and housing investment, and government spending—contributed positively to growth, with the sole exception of net exports, which were flat. In fact, had it not been for a large sell-off in inventories, Q3 growth would have come close to 3.0%. October's standout jobs report confirmed that this momentum has continued into Q4. The U.S. economy added 271,000 new jobs last month, new jobless claims are at all-time lows, and long-awaited wage growth (up a solid +2.5% from a year ago) is finally materializing.

The weakest part of the economy, alongside the hard-hit energy sector, continues to be manufacturing. Industrial production declined again in September, up a meager +0.4% from a year ago, with factory orders down –6.9% from the year before. The ISM Manufacturing Index for October registered a stagnant 50.1, with new orders offering a glimmer of hope, but backlog and export orders in deep contraction, and payrolls are facing the chopping block.

In sharp contrast, the U.S. retail and service economy is going strong. The ISM Non-Manufacturing Index was flying high in October at 59.1, buoyed by a surge in new orders. Personal consumption, supported by steady job gains, grew at a solid +3.2% annual pace in Q3, adding +2.2 points to GDP growth. When cheaper gas at the pump is stripped out, retail sales in September were up +4.9% from a year ago, with restaurant sales up +7.9% and auto sales up +8.8%. This year's housing rebound continues, albeit in fits and starts, with the NAHB Housing Market Index up 3 points in October to a solid 64. Residential investment rose at a +6.1% annual rate in Q3, and construction spending in September was up +14.1% from the year before.

Despite a strong dollar, the U.S. trade balance remained stable in Q3, neither adding nor detracting from growth. Government austerity is no longer the drag on growth that it once was, with state and local spending in particular rising at a +2.6% annual rate in Q3. While the negotiation of a 2-year bipartisan budget deal by the departing Speaker was hard for many Republicans to swallow, it averted the looming prospect of another government shutdown, which could have impaired Q4 growth, or a debt limit crisis, which might have further damaged the country's credit rating.

As December nears, all eyes will be on the Federal Reserve and the recurring drama over whether, this time, it will raise rates. Just as before, expect plenty of volatility as each day's new data, no matter how trivial, is scrutinized as a supposedly vital indicator of whether the Fed might move. It appears to us that the FOMC's members are highly motivated to get the federal funds rate back above the zero bound, and will likely introduce a modest rate hike next month, unless new data presents them with a very compelling reason not to. However we do not see the Fed embarking on a path of consistent rate hikes that might undercut the real economy.

With 89% of companies reporting, S&P 500 operating earnings per share (EPS) for Q3 are expected to be down –15.8% from the same quarter a year ago. The negative news, however, is overwhelmingly concentrated in two sectors: energy and materials. Excluding the energy sector, earnings are actually up +0.2% from a year ago. Telecoms (+2.2%), IT (+4.6%), health care (+5.9%), consumer discretionary (+15.9%), and even the struggling industrials sector (+9.1%) have all seen earnings improve from a year ago.

Nevertheless, it is clear that share prices are once again outpacing earnings. The 12-month trailing P/E ratio for the S&P 500, which stood at 18.5x operating earnings a month ago, has shot up to 20.3x with the latest rally—its highest level this cycle, and one that is again vulnerable to correction, particularly if the Fed raises rates. Although we believe earnings will grow along with a resilient economy, we see consensus estimates that S&P 500 EPS will rise by over 30% in the next 12 months, predicated on very large rebounds in both energy and materials, as excessively optimistic. We continue to find opportunities in U.S. equities, but see this as a later-stage bull market that will reward judicious stock selection, as opposed to hitching a ride on a rising index.

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