SILVERCREST
ASSET MANAGEMENT GROUP

# U.S. ECONOMIC AND MARKET REVIEW—NOVEMBER 2016

All eyes may be anxiously on the U.S. presidential election, but the U.S. economy keeps chugging along—which informs our market view far more meaningfully than the latest political headline. While nervous investors pulled the S&P 500 back −1.9% in October, Q3 GDP surpassed expectations, growing by +2.9%, and S&P 500 earnings continued a healthy rebound, for the third straight quarter, from last year's energy and materials-led slump.

One of the most striking differences from last year is the trade balance. Throughout 2015, the U.S. dollar rose by over +10%, helping to shave −0.7 points off annual GDP growth by widening the trade deficit. This year, the dollar's stabilization first steadied, in Q1 and Q2, and then narrowed the trade gap, adding +0.8 points to Q3 growth as exports surged by +10%. Import prices, which plunged −16% from July 2014 to February 2016, have also steadied, restoring some pricing power to U.S. firms at home and abroad. A more moderately priced dollar also boosts the value of U.S. corporate earnings abroad, which had come under serious pressure.

The dollar's stabilization is a direct result of the Fed's patience in raising interest rates. With headline PCE at +1.4% in Q3, and core PCE at +1.7%—both below the Fed's 2% target—the Fed is under no immediate pressure to raise rates to combat inflation, and has demonstrated its willingness to wait. Some see the recent decline in the bond market as an indication that expectations for future inflation are on the rise. The fact that wages rose +2.8% in October compared to a year before—the highest rate so far in this recovery—just as deflationary pressures from the rising dollar and falling oil prices are receding, could lend further weight to such views. That pace is still rather low by historical standards, however, and in any event, the Yellen Fed sounds inclined to let the economy "run hot" rather than risk pressing the brakes too hard.

The stabilization in oil prices, in the $40-50 range, has helped restore somewhat shaky business confidence and investment. The number of active U.S. oil & gas drill rigs has steadily increased in recent months, and orders for new mining and drilling equipment, which collapsed an astounding 98% in the past two years, have begun to recover. More broadly, business investment grew at +1.2% in Q3, but was still down −1.2% from a year before, in real terms. Inventories added +0.6 points to Q3 growth, after five straight quarters of destocking, perhaps suggesting a pick-up in business confidence. But with inventory-to-sales ratios still highly elevated, we expect excess stockpiles to continue posing a curb on growth. And with capacity utilization at a mere 75%, businesses remain reluctant to add more. Orders for core capital goods fell −1.3% in September, down −4.3% from a year ago.

Despite this caution, most companies surveyed by ISM in October, in both the manufacturing and much larger non-manufacturing sectors, report that they continue to see business grow, supported by a solid stream of new orders. Consumer spending grew by a modest +2.1% in Q3, dented by a weak August. But retail sales rebounded by +0.6% in September, with core sales (excluding autos and gas) up +3.4% from a year ago. Auto sales surpassed expectations in

October, rising +2.8% to an impressive rate of 18.3 million/year. The steady addition of 161,000 new jobs in October, plus 44,000 more in prior month revisions, should continue to support consumption growth. Nevertheless, consumer sentiment surveys show people growing increasingly concerned about the job market's future outlook, which has pulled consumer confidence down a bit from its previous highs this year.

Housing, which was a significant source of strength throughout 2015, has stumbled lately. Residential investment fell −7.7% in Q2 and −6.2% in Q3, its worst showing since 2010. The reasons are a bit hard to decipher, because the data is somewhat conflicting. New home sales in Q3 were up a striking +23% from a year ago, but median prices fell −3.8% from the prior quarter, and were flat year-on-year. Existing home sales fell −2.2% in Q3, and prices have fallen for the past three months in a row. Although housing inventories remain relatively tight, new housing starts fell −1.8% from Q2 to Q3, down −1.6% from a year before. While homebuilding is a relatively small sector, and only shaved −¼ point from Q3 growth, it has a strong multiplier effect on supplier industries and on related consumer purchases, and its latest downturn merits our close attention.

Contrary to many headlines, large-cap corporate earnings are recovering rather vigorously from last year's slump, which was concentrated almost entirely in two sectors: energy and materials. With 85% of the S&P 500 having reported for Q3, operating earnings per share (EPS) is expected to rise +12.6% from the previous quarter, up +13.8% from a year before. Together with recent price decline, that would bring the 12-month trailing P/E ratio down from a peak of 21.4x at the end of June to 20.9x at the end of October. Seven out of 10 sectors in the S&P 500 are expected to see earnings rise compared to Q2, and eight out of 10 compared to a year before. While consensus EPS has come down dramatically from what we always considered unrealistic heights, the Q3 results put earnings on track to meet Silvercrest's much more conservative projection for 2016.

There are certainly challenges, and potential pitfalls—election uncertainty being high on the short-term list—but we are a great deal less anxious about where the market is at, or the U.S. economy is headed, than many appear to be at the moment. If the U.S. election, like the Brexit vote, takes an unexpected turn, it may well have important long-term implications, but we recommend responding to facts, not emotion, and avoiding the immediate overreactions—positive or negative—that are sure to follow.

November 7, 2016

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