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# U.S. ECONOMIC AND MARKET REVIEW—DECEMBER 2015

Despite uneven corporate earnings, unsettling terrorist attacks, and an ever-more likely Fed rate hike, investors in U.S. equities held their nerve in November. The S&P 500 Index gained +0.1% and ended the month up +1.0% year-to-date, outperforming the MSCI World Index, which fell –0.2% in November, down –0.5% year-to-date. While European stocks rose in anticipation of more ECB easing, those gains were all but cancelled out by a –4% drop in the Euro. Emerging markets, weighed down by deepening downturns in China and Brazil, fell –2.5% in November, down –13.5% year-to-date. While returns for U.S. equities are perhaps disappointing against the backdrop of the past five years, the U.S.—aside from the complex case of Japan (up +10.4% so far this year, in dollar terms)—has lived up to its billing as the least-dirty shirt in the laundry basket. An understanding of the key drivers for this mixed picture, as we have outlined over the past two years, has proven a useful roadmap for investing.

In the midst of a slow and steady US economy, there continues to be great dispersion between sectors, with clear winners and losers, as a result of the rebalancing of the world's economy. While resources and manufacturing remains weak, retail, consumer, real estate, jobs and wages are growing apace. Despite a number of sectors that face specific challenges, we do not foresee an imminent recession, and a successful Fed rate hike could actually help reduce concerns about the fragility of the economy. While the market is priced fairly richly by most measures, this economy's heart is not about to stop beating, although some expectations may have to come down to more realistic levels.

U.S. economic growth for Q3 was revised upwards from +1.5% to +2.1%. However, the boost came entirely from a reduced drawdown in inventories. The inventory to sales ratio for all businesses has risen noticeably over the past year, to its highest level of the post-2008 recovery. While the main drivers of domestic demand remain relatively resilient, this overhang poses a potential drag on future growth.

Manufacturing, which has been a weak spot all year, presented a mixed picture. Industrial output fell –0.2% in October, for the second month in a row, up a mere +0.3% from a year ago. But new factory orders rose +1.5% from September to October, led by a +2.9% surge in durable goods orders, including a +1.3% increase in core capital goods. This encouraging data, however, seemed to be contradicted by the ISM Manufacturing index which, after losing momentum all year, fell into outright contraction (48.6) in November, for the first time in three years, suggesting the producers surveyed are doubtful about a rebound.

As in past months, the retail and service side of the economy presents a far more positive picture. Retail sales rose again in October, and excluding gas stations, are up a solid +4.1% from a year before. In November, auto sales came in for a third straight month at 18.2 million/year, a

12-year high. Consumer confidence surveys and the ISM Non-Manufacturing index have moderated a bit, but remained strong. This year's housing recovery has lost some of its momentum, with sales and new starts easing back from earlier months' highs, but—in contrast to the rest of the economy—housing inventories remain tight. Construction spending in October was up an impressive +13.0% from last year, with residential construction up +16.6%.

The November employment report confirmed that, despite its handicaps, the U.S. economy keeps chugging along. Job losses in resources and manufacturing were more than offset by gains in construction and retail. Overall, the economy added 211,000 new jobs in November, higher than expected, while prior month revisions added another 35,000. While the labor participation rate (62.5%) is the lowest it's been since the 1970s, to some extent this is due to an aging population. Rising wages (up +2.3% from a year ago), record-low new unemployment claims, and a falling ratio of job openings to job seekers all indicate a tightening labor market, which likely will persuade the Fed to begin raising interest rates later this month, in order to slow the pace of job creation to the rate the workforce is actually growing. When this happens, the U.S. economy will have to rely more on productivity gains, than on idle resources, to drive continued growth.

On the international scene, the terrorist attack in Paris, the bombing of a Russian airliner, and the shoot-down of a Russian fighter jet by Turkey all drove home the fact that Syria's civil war has become a destabilizing force, well beyond its borders. Based on history, one would expect a conflagration in the Middle East to trigger a spike in higher oil prices—as it did with the Yom Kippur War (1973), the Iranian Revolution (1979), the first Gulf War (1990), and the War on Terror (2001-8). Yet this time, oil prices have fallen by more than half. That's because the proxy war in Syria hasn't disrupted oil supplies, but has led its oil-producing sponsors into a price war which, while not accounting for the initial price drop, has intensified and prolonged it. The surprising effect has been to push down energy costs, while forcing key energy producers to draw on their savings to prop up continued consumption, a rebalancing act that generates both winners and losers across the global economy.

The disparate effect of cheap energy, and other commodities, is well hidden in the "average" corporate earnings data. After-tax U.S. corporate profits fell –3.2% in Q3, up just +1.4% from a year ago, but a breakdown of the S&P 500 reveals that the very same trends that are ravaging some segments of the economy are buoying others. A stronger dollar (up +3% in November) will draw a further divide between firms that enjoy pricing power, and those lacking it. The S&P 500, on average, is richly priced at 20x operating earnings (trailing).

All of which reinforces our consistent message, these past many months, that global rebalancing is having a mixed impact across sectors and geographies. In this type of environment, especially one with relatively muted results, smart investors will avoid the temptation to focus on the indices but rather will turn toward active managers who do the hard work that is required to look within the indices to generate returns in what has become, for now at least, a sideways market.

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