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U.S. ECONOMIC AND MARKET REVIEW—DECEMBER 2016

The U.S. economy didn't change much in the past month, but the market narrative about where the economy is headed changed a great deal. Concerns about stagnant wages and an impending recession were replaced after the surprise election of Donald Trump by expectations of fiscal stimulus and rising inflation. Far from crashing in response to Trump's victory, as many expected, U.S. stocks rallied, with the S&P 500 rising +3.4% in November, the Dow Jones Industrial Average rising +5.4%, and the small-cap Russell 2000 surging +11.0%. The bond market broke in the opposite direction, with Treasury yields spiking abruptly. The challenge for investors is to keep these market moves in perspective.

Throughout the summer, we wrote about the U.S. economy being caught in a tug-of-war between resilient consumer spending and cautious businesses, willing to hire but reluctant to invest. The initial GDP figures for Q3 appeared to soften this picture somewhat, but more recent revisions show it persisting, with business investment nearly flat and consumption growing a solid +2.8%. Retail sales surged +0.8% in October, up a solid +4.3% from a year ago, and consumer confidence jumped in November, following the election, with the Conference Board's gauge reaching a new high for this cycle. The housing market also showed new signs of life in October, with existing home sales up +5.9% from a year ago, new home sales up +17.8% and new starts up +23.3%. Construction spending and housing prices are also indicating a modest rebound.

Whether this translates into renewed business confidence remains to be seen. Orders for core capital goods rose by +0.2% in October, but remain −4.3% below where they were a year ago. If businesses do choose to be more optimistic, there are certainly some grounds for it. Both the Manufacturing and Non-Manufacturing ISM surveys showed steady and accelerating expansion in November, at 53.2 and 57.2 respectively. After-tax corporate profits were up +5.2% in Q3, from the year before, after a−8.5% dip in 2015. A Trump stimulus, should it materialize, could help construction firms, equipment suppliers, and defense contractors, while a deregulatory push could give the banking and energy sectors a boost.

The main concern, once again, is a rising U.S. dollar. After a 10-month period of relative stability, the dollar has resumed its upward march, strengthening +3.3% in November on a trade-weighted basis to its highest point in 14 years, on the expectation that U.S. fiscal stimulus could push up inflation, causing the Fed to raise rates. The same expectations caused 10-year U.S. Treasury rates to rise sharply, from 1.8% to 2.4%, though it's worth keeping in mind that this is barely above where rates stood at the beginning of the year; it is more accurate to say the turn represents an end to this summer's record-setting bond rally than a collapse in the bond market. Although there is little sign yet that inflation has actually accelerated, steady job growth in November, which brought the unemployment rate down to 4.6%, does make it more likely that the Fed could see a prospective stimulus as inflationary, and resume raising rates. That could undercut liquidity in emerging markets, which pulled back −4.4% in November. A stronger dollar could also create renewed headwinds to

U.S. exports, domestic pricing power, and corporate earnings abroad, which could blunt the positive impact of any stimulus on growth.

The rise in U.S. Treasury yields, alongside the U.S. stock market rally, reduces the gap between risk-off and risk-on valuations we have frequently discussed. The equity risk premium has declined from 6.3% at the beginning of November to 6.0% at the end. That's still a highly favorable premium for equities, and far from being a reason for concern, highlights a case we've made before: that a large equity risk premium can act as a cushion for share prices as interest rates rise on rising growth expectations. That is what we're seeing right now. Of course, that growth has to materialize for the valuations to hold up. We remain alert to the potential risks as well as opportunities presented by a Trump presidency. In the meantime, however, we take assurance from the existing data, which shows the U.S. economy on track, and earnings steadily rebounding from last year's energy and materials-led slump. It validates our earlier determination not to take fright at every bump in the road, or whiff of uncertainty, that rattles markets, and keep both our hopes and our fears in perspective.

December 8, 2016

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