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There are times when the market's reaction is out of sync with reality. The latest sell off in U.S. stocks is one of those times.

Throughout July, the U.S. stock market felt like it was walking on eggshells, hitting modest new highs, but tentatively, as if everyone were holding their breath to find out what the second quarter numbers would reveal. We expressed some caution that Q2 corporate earnings needed to see real improvement in order to put some firmer support underneath what was, at that point, a 7% year-to-date rise in the S&P 500 index. When the GDP, employment, and earnings numbers arrived, the news was good, and largely allayed our concerns. However, the market reacted by taking a nosedive, erasing virtually all of the S&P 500's gains for the past two months. It was almost as though, having sold itself an encouraging story, the market stopped believing in it the moment it came true.

Come true it did. U.S. GDP rebounded strongly from its Q1 setback, surging 4.0% in Q2, and growth figures for the preceding three quarters were all revised upwards. Virtually every aspect of the economy strengthened in Q2, compared to the first quarter. Housing investment grew by 7.5% following two quarters of contraction. Business investment rose by 5.5%, up from a meager 1.6% in Q1. Spending by state and local governments rose 3.1%, as their fiscal condition gradually improves. A big surge in inventories, which added 1.4 percentage points to GDP growth, may be cause for caution: a similar build-up in inventories that boosted growth in 3Q13 created an inventory overhang that helped drag GDP down in 1Q14. Perhaps we should look at Q2 GDP as closer to 3.0% on a sustainable basis. In a similar vein, a 14% surge in consumer durable goods purchases, alongside a widening U.S. trade deficit, suggests that much-needed global rebalancing has yet to take place, and the world is still looking to the debt-laden U.S. consumer to drive demand, at home and abroad. Without unlocking and tapping into external consumer demand from creditor nations like China and Germany, we believe it will be very difficult for the U.S. economy to accelerate past 2.0-2.5% growth. These caveats, however, should not distract from the overriding good news the latest GDP numbers conveyed: that the Q1 slowdown was a temporary dip, not the onset of a new recession.

The July employment report, which showed 209,000 jobs created, fell slightly short of expectations, with the unemployment rate nudging upward to 6.2%. But even this, in a sense, was welcome news. The surge in Q2 GDP, together with an uptick in the benchmark PCE price index to 1.9% (just shy of the Fed's 2% inflation target), had many concerned that the Fed might be forced to tighten sooner than anticipated. More moderate job growth, along with flat real wages, suggests that such worries are premature. It was a Goldilocks report: cool enough to allay immediate inflation concerns, but warm enough – with job growth surpassing 200,000 for the sixth month in a row – to indicate that the U.S. recovery is still on track.

Corporate earnings for Q2, meanwhile, have come in strong. As of July 31, 361 of S&P 500 firms had reported, accounting for 78% of the index's market capitalization. So far, operating earnings per share (EPS) are up 8.9% over the same period last year, on 5% higher revenues. Unlike in Q1, where the year-on-year base effect gave the appearance of earnings growth, even though earnings had actually fallen from the previous quarter, the improvement in company performance is real this time. In past notes, we expressed some concern that rising share prices, combined with weakening quarterly earnings, implied that the market could find itself relying too heavily on rising P/E multiples if earnings didn't turn around. They did turn around, putting a much firmer foundation under share prices. As a result, the 12-month trailing P/E multiple (on operating earnings) for the S&P 500 has barely budged from 17.23 at the start of the year to 17.29 at the end of July.

So why the sell off? Many commentators point to the crisis in Ukraine, but this seems more like an excuse than a reason. We have argued since Ukraine first hit the headlines, in February, that whatever the geopolitical significance of growing tensions between Russia and the West, the impact on the economic outlook for the U.S. or even Europe would be minimal. We've seen no evidence that would prompt us to revise that view. We do hear lots of talk about a 10% correction ("the market is due for one"), and it's entirely possible, given the psychology of markets, that such talk could become a self-fulfilling prophecy. But even most short-term bears expect shares to rebound strongly from any correction, given palpably improving fundamentals.

The most plausible explanation may be that with Fed QE expected to come to an end in October, people are uncertain and anxious about what happens next. If we believed that the U.S. stock market was riding a QE-induced bubble, the end of QE would have us very worried. We do not believe that. A trailing P/E ratio of 17.3 (compared to a 25-year average of 18.9, and a long-term average of 15.4), with share prices rising in line with earnings performance, suggests a market with much firmer foundations. When interest rates do rise, a historically elevated Equity Risk Premium should help cushion the negative impact on stocks (in other words, as the economy gains strength, rising real interest rates should also reflect an improved outlook for investment returns overall, including stocks). Seen in this light, any further fall in U.S. share prices looks like a much-welcome buying opportunity.

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