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U.S. ECONOMIC AND MARKET REVIEW – JUNE 2014

The S&P 500 index is up 4% so far this year. If an investor had followed the popular advice being touted last month, to "sell in May and go away," he would have missed out on half of the year's gains. The U.S. stock market has climbed a wall of worry for over a year, from the "fiscal cliff" to the Fed taper to the government shutdown. The rapid rise in P/E multiples that provided a broad lift to the market last year are probably played out. Plenty of anxieties remain: the violence in Ukraine, the slowdown in China, the trend towards deflation in Europe, and a first quarter contraction in the U.S. This is not a "jump on the bandwagon" market. It is a market that requires steely resolve rooted in a coherent long-term view.

That long-term view, as we see it, is that the U.S. economy remains on track, even if this expansion looks very different from the kind we are used to seeing. The American consumer is neither willing nor able to drive domestic, much less global, growth by leveraging back up again. Instead, the U.S. is experiencing a production-led recovery driven by more competitive energy and labor costs, along with innovation. This translates into record-high corporate profit margins and more sustainable debt levels. It also translates into sluggish wage gains and weak corporate revenue growth. Domestic consumer demand can grow, but only in line with genuine productivity gains. The key to growing demand, and the economy, more rapidly is global rebalancing. Contrary to popular belief, the slowdown (or even an abrupt downturn) in China's investment boom will not hurt the U.S. economy, any more than the bursting of Japan's bubble did in the 1990s. The explosion in credit that fueled China's runaway growth went largely to build out capacity that only contributed to global deflationary pressures; reining it in will help relieve the supply glut and drive net demand for U.S. goods and services. Less of the wrong kind of growth from China is actually good news for the U.S. economy.

The latest data on the U.S. economy tends to support this more confident view. In particular, we've gotten a much better picture of what actually happened in Q1. The biggest (but least mentioned) dent to GDP growth came from a fall in inventories; without this, Q1 growth would have been positive. In a sense, the 1Q14 drop can be seen as a give-back for the excessive run-up in inventories that helped boost 3Q13 growth to 4.1%, and the removal of this overhang puts output on a much sounder footing. Another dent, of greater concern, came from a -1.6% decline in private nonresidential investment (a proxy for business investment). However, this figure was an improvement from the original estimate, and subsequent surges in commercial and industrial lending (+10.3% year-on-year in April) and orders for non-defense capital goods (+3.9% year-on-year in April) suggest a Q2 recovery. Residential investment saw a -5.0% slowdown in Q1 (less than first thought), but housing starts (+13.2%), new home sales (+3.8%), and existing home sales (+1.3%) all saw significant rebounds in April, compared to March. The U.S. trade deficit widened in Q1, reversing a trend that contributed to GDP growth last year. While some blamed China's slowdown, a more significant headwind is Europe's growing trade surplus with the U.S., which is helping to drive Europe's recovery in the

absence of internal rebalancing within the Eurozone. To some extent, then, the growth stories of these two regions are in conflict. On the positive side of the ledger, the mini budget accord (or at least ceasefire) reached earlier this year in Washington has, rather significantly, removed the federal government as a source of drag on the U.S. economy.

To be sure, the bond rally has continued. By the end of May, the 10-year Treasury yield had fallen below 2.5%, and long-term (20+ year) Treasury ETFs had gained over 12% on the year. There are various possible reasons for this: pension funds locking in their funding requirements under new regulations, short-sellers covering their positions, a shortage of long-term Treasury issuance due to a reduced federal budget deficit, continued QE purchases by the Fed (which due to the reduced deficit, has steadily risen to 73% of all net new Treasury issuance, despite tapering), anticipated easing by the ECB, worries (exaggerated, we would argue) about Ukraine, and worries (misplaced, we would argue) about the implications of a slowing China. But it's worth remembering that while some or all of these factors may be boosting bonds, they are also helping to maintain an unexpectedly low interest rate environment that should cushion some of the softer spots in the U.S. economy.

At the start of this year, we projected a 4.4% rise in the S&P 500 earnings per share to $112, which equated to a reasonably-priced forward-looking P/E ratio of 16.5 (or even lower, if excess cash were taken into account). With U.S. corporate profits up 5.3% year-on-year in Q1, despite a difficult quarter, we remain confident in the economy's ability to meet or exceed that projection. So while the 12-month trailing P/E ratio for the S&P 500 has risen somewhat, from 17.2 at the start of the year to 17.7 at the end of May, there appears to be further upside to U.S. equity, based solely on fundamentals.

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