SILVERCREST
ASSET MANAGEMENT GROUP

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The S&P 500 advanced +2.3% in October. That rather staid statistic disguises what was in fact a very wild ride: an unnerving -5.6% plunge (-7.4% from the market peak in mid-September), followed by a sharp +8.4% rebound which propelled the market to new record highs. It was not an experience for the faint of heart.

Throughout the market downturn, we argued that we saw no reason for a sustained drop in U.S. share prices. In particular, we took issue with the widespread belief that slowing growth in China and Germany heralded the onset of "global deflation" that would sink the U.S. recovery. To the contrary, we argued that a slowdown in excessive capacity expansion by these chronic surplus countries is welcome and long overdue. The result will be cheaper input prices (such as oil) and better markets for U.S. goods—both of which will help, not hurt, the U.S. economy.

Bull markets climb a "wall of worry," but based on history, are only brought to an end by at least one of two things: Fed tightening or a recession. We see no evidence that either of these is imminent. Real GDP grew at +3.5% in 3Q14, stronger than the +3.1% expected. For the first time in years, all of the main components—consumption, business and residential investment, government spending, and net exports—contributed positively to GDP growth. Yet core PCE inflation, at +1.5%, remains well below the Fed's +2% target. Monetary easing in Europe and Japan should exert a downward pull on U.S. interest rates as well as strengthen the U.S. dollar, further reducing price pressures. The result is a U.S. economy that has room to keep growing, without the Fed having to pull in the reins.

From a purely statistical standpoint, Q4 growth may disappoint. A big fiscal year-end surge in defense spending, which added 0.7 ppts to Q3 GDP growth, is unlikely to be repeated; when spending levels drop back to normal in Q4, it could shave an equivalent amount from quarter-on-quarter growth. We are less convinced by arguments that the strong dollar will damage the U.S. economy in more substantive ways. Although a widening U.S. trade deficit in September lends some support to these concerns, cheaper imports—including cheaper prices at the gas pump – should help boost consumer purchasing power as well as cut costs for industry. The ISM Manufacturing Index for September certainly showed no sign of weakness, surging to 59.0 (from 56.6 in September), with new orders rising 5.8 points to a red-hot 65.8. In other words, the deteriorating economy investors are worried about is, so far, a lot more speculation than fact.

Meanwhile, corporate earnings continue to improve. By October 31, with 363 of the S&P 500 companies reporting, Q3 earnings were up +7.2% year-on-year on revenue growth of +3.9%. As a result, even with share prices hitting new record highs, the S&P 500 trailing 12-month P/E ratio has risen quite modestly to 17.6x, from 17.2x at the start of the year. As we have repeatedly noted, U.S. stock market gains this year have been driven mainly by improved profit performance, not soaring valuations. In terms of total return (including reinvested dividends), the S&P 500 (+11.0% year-to-date) is outperforming the MSCI World ex-US (-0.6% YTD) and Emerging Market (+4.0% YTD) indices by far, but U.S. equity valuations, at least on average, remain firmly rooted on solid ground. Several companies are tempering their earnings estimates for Q4, bringing them closer in line with our own, more cautious projections for the year. We see this as a reassuring sign of more realistic expectations, rather than a reason to rattle the confidence that, so far, has served us well.

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