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ASSET MANAGEMENT GROUP

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The U.S. stock market's steady march upwards in July might seem at odds with the uncertainty and discord dominating the headlines in Washington. But they reflect an underlying confidence in the economy that, by and large, is supported by the latest data. And until a clearly identifiable threat comes along to shake that confidence, we see this positive trajectory continuing.

U.S. GDP growth for Q2 came in, as expected, at +2.6%, a welcome relief after a sluggish first quarter (+1.2%). Consumer spending, in particular, perked up after a Q1 slowdown—which itself looked a lot worse at first than it turned out—growing a dependable +2.8% and contributing +1.9 points to GDP. While consumer confidence has fallen off slightly from its post-election highs, it remains solid. Those confident consumers have shown themselves willing to spend a greater part of their income, pulling the personal savings rate down from 5.1% a year ago to 3.8% in June. The addition of +209,000 jobs in July should help continue to support consumption growth.

Nevertheless, not every number in the consumer economy is coming up positive. Retail sales saw a second straight monthly decline in June, falling −0.2%, pulling down year-on-year growth to +2.8%. Once-hot auto sales have cooled off, as concern grows over aggressive subprime lending practices. Residential construction fell by −6.8% in Q2, shaving −0.3 points off economic growth, the most glaring weak point in the latest GDP report. The problem with the housing market isn't so much that it's pulling down the rest of the economy, but that it's had a hard time taking off for more than a quarter or two, despite relatively low inventories. It should be pulling more weight.

Business investment grew +5.2% in Q2, on top of a +7.2% spike in Q1, but for a second quarter held off adding anything to inventories. Factory orders surged +3.0% in June, driven mainly by aircraft sales, but even excluding aircraft, durable goods orders were up +6.1% in Q2, compared to a year ago. Orders for core capital goods—a key indicator of investment—were up an encouraging +5.0% over last year's slump. Both the ISM Manufacturing and Non-Manufacturing survey indices took a step back in July (to 56.3 and 53.9), but remain in solid expansion territory. Their forward-looking New Orders sub-indices also turned it down a notch, but still signal continued expansion ahead.

Government outlays rose slightly (+0.7%) in Q2, boosted by a +5.2% increase in defense spending, but hopes of the Trump Administration initiating a major fiscal stimulus this year have dwindled. That, along with the fact that the PCE price index was nearly flat (+0.3%) in Q2, reduces pressure on the Fed to raise interest rates. The result is a continued decline in the U.S. dollar, which (on a broad trade-weighted basis) has fallen nearly −7% from its 14-year high at the beginning of the year. A weaker dollar, in turn, has stabilized the U.S. trade balance, which—in contrast to shaving −1.6 points from GDP growth in Q4—added +0.2 points for the second straight quarter. In other words, what one hand (stimulus) gives, the other (dollar exchange rate) takes away, and what the first takes, the other gives back, keeping growth range-bound.

The weaker dollar has given a boost to stocks in Europe and Japan, transforming their fairly flat performance in July into moderate gains, at least in dollar terms. It's given a turbo-boost to emerging markets, whose (dollar-denominated) MSCI index is up +25% year-to-date, as concerns about dollar tightening recede. We share the market's confidence in India (+23%) and Brazil (+14%) as reform measures take hold, but less so that China (+37%) has truly turned a corner. In contrast to soaring Hong

Kong-listed shares, the far more mixed performance of domestic shares—the Shenzhen Composite is down −5%, while the ChiNext tech index is down −12%—hint at the difficult transition and mounting debt burden China continues to face, despite (and in part, because of) the government's latest stimulus efforts. Russia, of course, is the one major market that is down (−11%) this year, because of its dependence on oil revenues and exposure to sanctions.

The stabilization in oil prices continues to support U.S. corporate earnings, compared to last year, but Q2 earnings growth is much broader than that. With 84% of the S&P index reporting, operating earnings per share (EPS) are expected to rise +7.7% over Q1, up +20.7% from a year ago. Out of eleven sectors, all but three (including energy) are expected to see positive earnings growth over last quarter, and all but one (materials, down −1%) are up year-on-year.

So while the S&P 500 index rose +1.9% in July, and has delivered total returns (including dividends) of +11.6% so far this year, the 12-month trailing P/E ratio has held steady around 21x operating earnings for the entire past year. These are rich valuations, but the market's rise, these past 12 months, hasn't outpaced the recovery and growth in earnings. We continue to keep a close watch on the equity risk premium (ERP), which has narrowed from 6.3% last October to 5.0% in July, its lowest level in three years, but still well above its long-term historical average of 4.1%, implying that at current share prices, equity risk is still being well rewarded, though not quite as generously as before.

Many commentators have expressed concern that the market has grown complacent, and could be riding for a fall. We are keenly aware of the need to pay vigilant attention to possible risks, to avoid being surprised. But based on the data we have seen, throughout this year, the risks we can identify do not appear imminent. In contrast, investors would have paid a high price to stand on the sidelines. This is not the cynical—and infamous—reasoning that "as long as the music is playing, you've got to get up and dance" (as the then-chairman of Citigroup said to justify holding dubious assets right up until their crash in 2008). As we see it, the music is playing for a reason. And until that reason changes, leaving early makes little sense.

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