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U.S. ECONOMIC AND MARKET REVIEW—DECEMBER 2017

The U.S. stock market continued to climb in November, with the S&P 500 gaining another +2.8%, for a total return (including dividends) of +20.5% year-to-date. While progress towards Congress enacting a tax cut bill by year's end may have given the market a boost, it also found support in a steady flow of positive economic data. U.S. GDP growth for Q3 was revised upwards from +3.0% to +3.3%, its best quarterly performance in three years, while the Atlanta Fed is projecting Q4 growth at +3.2%, and the New York Fed is estimating +3.9%. As long as that kind of tangible momentum continues, markets will set their less tangible worries aside and remain focused on the upside.

The U.S. industrial sector has nearly recovered from a painful 2-year slump, with production up a solid +2.9% from a year ago. Manufacturing output, in particular, surged +1.3% in October, up +2.7% from the year before. And that momentum looks set to continue, due to healthy new order books. Excluding volatile aircraft sales, durable goods orders are up a remarkable +8.1% from a year ago, to their highest level of the recovery so far. Orders for core capital goods, a key indicator of business investment, are up +9.3% from last year, to their highest level in three years. Meanwhile, though companies are adding to inventories, the inventory-to-sales ratio—which looked alarmingly elevated a year or two ago—has dropped back to its lowest level since December 2014. The ISM Manufacturing (58.2) and Non-Manufacturing (57.4) indices cooled a bit in November, from preceding highs, but remain in solid expansion territory, with survey respondents repeatedly using the word "strong" to describe current business conditions.

Consumers are remarkably positive as well. The Conference Board's Consumer Confidence Index surged in November to its highest reading in 17 years, while the University of Michigan's gauge remains close to its cycle high. Bolstered by steady job growth, confident consumers are offsetting less-than-impressive wage growth by digging deeper into their pockets, pushing the savings rate to its lowest level of the cycle (3.0%) in September. As a result, October retail sales were up an impressive +4.6% from a year ago. Two key areas that were sluggish earlier this year—autos and housing—seem to have picked up. Auto sales settled in at a healthy rate of 17.5 million/year in November, after a big post-hurricane replacement surge. While existing home sales and new housing starts are still below last year's levels, the numbers are improving, and new home sales in October were up +18.7% from a year ago.

So far, inflation remains under control. Consumer prices (CPI) are up +2.0% from last year, while the Fed's preferred PCE price gauge is up +1.6%, well below its 2% target. The market expects the Fed to raise its discount rate by another 25 basis points in December, and has priced it in, but steadier long-term rates reflect a recognition that the Fed is under no pressure to raise rates faster than it wants. Meanwhile, the price of oil and the U.S. dollar are both in the Goldilocks zone—neither too high, nor too low, to get in the way of continued growth.

Congress has made substantial progress towards enacting tax cuts. The House and the Senate have passed similar—but far from identical—bills that need to be reconciled before they can go to the President's desk. Both bills are complex, and could have disparate effects on different companies, industries, and kinds of investments. Cutting the headline corporate tax rate from 35% to 20%, as well as allowing immediate expensing of investments in new plant and equipment, could well boost many firms' after-tax earnings. But others could lose valuable tax shields, or face a big one-time tax on profits earned and held overseas. Investors may face new restrictions on how and when they must recognize capital gains, and some bonds may lose their tax-favored status. Investors will need to drill down to make sure they stay on the right side, and don't end up on the wrong side, of these tax changes.

The tax bill does not significantly change our near-term growth outlook for the broader U.S. economy. The fiscal stimulus it delivers, by adding upwards of $1 trillion to the budget deficit over 10 years, comes at an unusual point in the business cycle, when the economy is already nearing full capacity and the Fed is gradually raising interest rates. Any boost to demand is likely to encounter pushback from the Fed, and in anticipation of that, a stronger dollar, tempering growth. We saw this effect in 4Q16, right after the election, when bold stimulus talk boosted the dollar to a 14-year high, widening the trade deficit and shaving a full −1.6 points off GDP growth that quarter. Any moves to repatriate large amounts of overseas profits back to the U.S., which the tax bill encourages, could also put upward pressure on the dollar and check growth. The key to boosting growth at this stage in the cycle is fostering productivity gains, whose effects will only be felt over time.

The market may have rallied on the prospect of tax cuts, but it's being supported by earnings. Tax policy aside, corporate after-tax profits, across the economy, rose +4.9% from Q2 to Q3, up +10.0% from a year ago. Operating earnings per share (EPS) for the S&P 500 are up by a similar amount. That's why the trailing P/E ratio for the S&P 500 has held steady at 21x for over a year now, despite rising share prices—though given their latest gains, Q4 earnings will have to show continued improvement to keep up. It's worth recalling, though, that at the beginning of the year, when we argued in favor of staying in the market, we projected S&P 500 EPS for 2017 at $117. By year's end, even if Q4 shows no earnings growth from Q3, EPS will well outperform that at $122. Even if a modest correction is in the cards, the year's earnings performance has well justified our confidence, and investors' willingness to take equity risk.

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