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U.S. ECONOMIC AND MARKET REVIEW—JUNE 2017

The U.S. economy kept plugging along in May, even as expectations for new policies—including tax cuts and infrastructure spending—that helped drive the post-election stock market rally kept getting kicked farther and farther into the indefinite future. The S&P 500 has seen a total return of +8.7% so far this year—nothing to be ashamed of—but take away the most popular tech stocks, and factor in the further decline in the U.S. dollar, and U.S. shares have visibly underperformed most non-U.S. markets. The flattening of the bond yield curve provides further indication that markets are tempering their growth expectations for the U.S. economy.

Nevertheless, hopes remain strong that Q2 will see something of a rebound—even as Q1 GDP growth was revised upwards from +0.7% to +1.2%. The Atlanta Fed currently projects +3.4% GDP growth in Q2 (down from +4.0% barely a week ago), while the New York Fed projects a more modest +2.2%. One key will be whether U.S. consumers remain as hesitant as they appeared to be, based on the GDP figures, in Q1. Consumer confidence cooled somewhat in May, from its recent highs, but is still quite strong. Personal income rose by +0.4% in April (up +3.6% from a year ago), giving rise to a similar surge in retail sales (up +4.5% y/y) and overall consumer spending (+4.3% y/y). But auto sales, weighed down by rising defaults on car loans, have stumbled this year, while new and existing home sales, as well a new housing starts, slowed noticeably in April, showing only meager gains from a year before.

Both the ISM Manufacturing (54.9) and Non-Manufacturing indices (56.9) indicate continued growth momentum, supported by a steady stream of new orders. While new factory orders wobbled a bit in April, falling −0.2%, they were +3.8% higher than a year ago. Orders for core capital goods—a key indicator of business investment that fell into a serious slump last year—are up a healthy +3.0%. Industrial output, which rose +1.0% in April, is up +2.2%.

Hiring, however, appears to be slowing. The number of non-farm jobs created in May (+138,000) was not terrible news, but together with downward revisions to March and April, it was a weak report, which pulled the average monthly pace of job growth, so far this year, down to +162,000, from +187,000 last year. It's important to keep in mind that a major intention of the gradual Fed rate hikes that began in December 2015 was to rein in the rate of job growth, as the economy approached full employment. But that also meant that higher wage growth, hopefully accompanied by productivity gains, would have to pick up the burden of driving continued growth in consumer spending. Neither, so far, has really materialized. Even though the unemployment rate has fallen to 4.3%, its lowest rate since 2001, year-on-year wage growth remains stuck at 2.5%, barely above the (still low) inflation rate. Labor productivity was flat in Q1, after rising just +0.2% in 2016.

The absence of inflationary pressure—both the headline and core PCE price indices remain below the Fed's target of 2%—gives the Fed room to remain patient in raising rates. Indeed, the flattening of the yield curve for U.S. Treasuries (the 90-day rate has risen +46 basis points so far this year, while the 10-year rate has fallen −24 points) suggests that while the Fed may hike rates again next week, the market does not expect much in the way of immediate follow-up. Certainly, the belief that Congress will act quickly to enact stimulative tax cuts and spending increases—which might boost both growth and inflation—has shifted to doubt, and for good reason. The diminishing likelihood that House and Senate Republicans can agree on a health care bill places serious procedural roadblocks in the path of passing tax cuts or anything else over Democratic opposition by the end of the year.

Those reduced expectations, along with stronger economic data abroad, have undercut upward pressure on the U.S. dollar, causing it to fall −4.2% since the start of this year (on a trade-weighted basis), back to where it stood before Trump's election. While a falling dollar helps relieve headwinds to exports, domestic pricing power, and the value of overseas corporate earnings, it has also boosted returns to foreign share markets in U.S. dollar terms. As a result, the MSCI Emerging Markets Index has risen +17.3% so far this year, while the MSCI Eurozone Index is up +19.3%. As well as the S&P 500 Index may have done, it has underperformed the MSCI World Index, which is up +10.6%.

The performance of U.S. markets, themselves, are highly mixed. The small-cap Russell 2000 index fell −2.2% in May, ending the month up just +1.0% year-to-date, while the tech-heavy Nasdaq rose +2.5% to hit +15.1%. Within the S&P 500, shares of companies with a high level of foreign exposure have gained +14.0% year-to-date (according to BAML), well above the index average. The earnings underlying the market's performance were also uneven. While quarterly operating earnings per share (EPS) for the S&P 500 were up +3.8% from Q4 to Q1, and up +20.9% from a year before, five out of 11 sectors actually saw earnings drop q/q. The range was also striking: earnings in energy rose +846.3% q/q (from a very low base), while real estate fell −25.1% and IT (ironically) fell −15.3%. After-tax corporate profits for the economy as a whole were up +12.0% in Q1, from a year ago, but declined −0.3% from Q4. All of this highlights the importance of sound bottom-up analysis to identify where value may lie hidden amid the gusts of sentiment sweeping the market. This is not an economy where a rising tide lifts all boats at the same time or rate and investors must be carefully attuned to the strengths and weaknesses that could drive uneven market returns going forward.

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