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U.S. ECONOMIC AND MARKET REVIEW—MARCH 2017

"Don't worry, be happy" seemed to be the motto of global equity markets in February. Brushing aside a bumpy start to Donald Trump's presidency, worries about Europe's political future and the prospect of a Fed rate hike in March, the S&P 500 rose +3.7% last month, alongside similar gains in European and many emerging markets. This optimism found support in solid economic data and improved earnings numbers. But valuations have risen steadily to a point where some caution is warranted.

U.S. economic momentum remains positive. The ISM Manufacturing and Non-Manufacturing indices rose further into solid expansion territory (57.7 and 57.6 respectively) in February, with manufacturing recording its strongest reading in over two years. Red-hot readings on new orders (65.1 and 61.2) suggest they will stay there. Actual orders for core capital goods—and important gauge of business investment—stumbled a bit in January, but have been recovering from last year's slump. Manufacturing output was up a modest +0.5% from a year ago.

Measures of U.S. consumer confidence are at or near cycle highs. Initial jobless claims fell to a new 44-year low in February, giving consumers the security to go out and spend. Retail sales surged +0.4% in January, up +5.6% from a year ago, though some of this gain was due to a rebound in gasoline prices. (Higher gas prices have helped bring inflation level with hourly wage gains at +2.5%, taking the air back out of the tires of real wage growth.) There is also real concern that auto loans have grown precipitously, and auto sales—which have been strong—could feel the pinch. Stripping out gas and auto sales, core retail sales are still up a vigorous +4.4%, year-on-year. Housing is also rebounding from last year's slump with existing home sales (+3.8%), new home sales (+5.5%) and new housing starts (+10.5%) all up in January, compared to a year ago.

The spike in the U.S. dollar, following the election, has been a headwind to output growth, channeling much of the growth in U.S. domestic demand abroad. Though the dollar gave back some of its rise in January, and held stable in February, the U.S. trade deficit in goods widened in January with exports falling −0.3% and imports rising +2.3%. The prospect of pushback on stimulative policies, from a strong dollar, is an important factor to keep in mind going forward.

Corporate earnings have rebounded significantly from their energy and materials-led downturn last year. Operating earnings per share (EPS) for the S&P 500 were up +22.5% in 4Q16 from the same quarter a year before, and all but 2 out of 11 sectors (industrials and telecom) saw earnings rise, year-on-year. More recent momentum, however, was less impressive. EPS in Q4 was down −1.6% from Q3, and all but 3 out of 11 sectors (health care, IT, and real estate) saw earnings decline quarter-on-quarter.

That means the latest rally—the S&P 500 has risen +11% since Election Day—has outpaced recent earnings growth and driven valuations steadily higher. The 12-month trailing P/E ratio for the S&P 500 stands at 22.2x operating earnings and 24.8x reported earnings, valuations typically reached near the end of a market cycle. The equity risk premium (ERP) has fallen from 6.3% just before the election to 5.4% now. That's still above the historical average of 4.1%, but the gap that so favored equities a few months ago has narrowed considerably, and higher share prices, or higher interest rates, could narrow it further.

As long as earnings hold steady, the base effect from consigning last year's energy and materials slump to the past should bolster the 12-month trailing figure, which means valuations may not be quite as stretched as they appear. There might well be some hidden upside to the market, even at current performance levels.

We can also imagine a number of scenarios that could trigger a temporary correction in the market, following its latest rally. A renewed drop in oil prices is one. In recent months, OPEC production cuts intended to bolster prices have been met with a rebound in U.S. shale drilling. Rising output has spilled over into rising inventories, even as rising fuel prices have started to put a dent in demand. It's entirely possible that a new oil glut could pull the rug out from under earnings, much as it did last year.

What we don't see is a recession around the corner, or a reason for the Fed to raise rates more aggressively than expected—the two things that could reverse the positive direction of the market in a more lasting way. The economic data, on balance, is encouraging. Inflation is close to the Fed's 2% target. Vigilance is justified, but pessimism is not. Perhaps a better motto for the market should be: "Do worry, be happy."

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