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U.S. ECONOMIC AND MARKET REVIEW—MARCH 2018

Concern over the prospect of rising inflation and interest rates pulled U.S. stocks into a −10% correction by early February—their first major sell-off after two years of steady gains. As we anticipated, however, solid corporate earnings reports helped the market soon find its footing with the S&P 500 recovering enough to end the month up +1.5% from year's end (overseas equity markets in Asia and Europe saw a very similar downturn and recovery). For the moment, the outlook looks encouraging with the Atlanta Fed projecting +3.5% and the New York Fed +3.0% GDP growth for Q1. But a handful of more equivocal data points, as well as new worries over a possible trade war, could cause markets—both here and abroad—to remain focused on potential downside risks.

U.S. consumers remain confident, buoyed by a solid job market. The Conference Board's Consumer Confidence Index surged to 130.8 in February, its highest level since November 2000, with only 14.7% saying jobs are hard to get, down from 16.3% in January. Spending, however, has not matched sentiment: retail sales fell −0.3% in January, their biggest decline in 11 months, while a once-sizzling December was revised downwards from +0.4% to zero. As a result, year-on-year sales growth declined from +5.4% to a still respectable, but much less impressive, +3.6%. While incomes rose +0.4% in January, more of that money stayed in consumer's pockets, boosting the personal savings rate from a 10-year low of 2.5% in December back to 3.2%. Sales of both new and existing homes also stumbled in January, though new housing starts were up strongly (+7.3% y/y) and industry sentiment, as measured by the NAHB Housing Market Index, remains quite positive.

Businesses have displayed a similar caution. After a strong rebound all last year, orders for core capital goods—a key indicator of business investment—slipped for a second month in a row, though it remains up a solid +6.3% from a year ago. More broadly, durable goods orders fell −3.7% in January, though they too remain up +6.8% year-on-year. Nevertheless, the economy is still clearly in expansion mode across a broad range of sectors. The ISM Manufacturing Index rose to 60.8 in February, a 13-year high. And while the ISM Non-Manufacturing Index declined slightly to 59.5, that is still a very strong reading. Both continue to report a steady stream of new orders, which should keep momentum going in the months ahead.

Drill deeper into the ISM surveys, however, and it becomes clear that part of what's driving these strong numbers is growing backlogs and rising prices. Respondents across many industries report tightening supply chains and, in some cases, shortages of key inputs. These pressures have not worked their way into consumer prices yet: the PCE price index, the Fed's preferred inflation gauge, is up just +1.7% year-on-year, still below its 2% target. But CPI grew at +0.5% in January, its highest monthly rate in nearly five years, and the Producer Price Index (PPI) has been hovering just below 3%. In his first congressional testimony, Jerome Powell, the new Fed

Chair, indicated he is keeping his eye on inflation and intends to raise rates at a slow but steady pace—likely at least three, maybe four times this year.

Despite these expected Fed rate hikes, the 10-year Treasury yield remains, for now, below 3% and the latest correction in share prices makes equity valuations still look fairly attractive by comparison. After narrowing steadily for the past year, the Equity Risk Premium—the additional return investors can expect, over the long term, for taking equity risk—has widened again, slightly, to 5%. The 12-month trailing P/E for the S&P 500 has come back down from 23.0x operating earnings at the peak of the January rally back to 21.7x, just slightly above the level it has held for the past two years. Given the likely boost to after-tax earnings this year because of the corporate tax cut, that multiple probably makes more sense than usual, and will likely come down a bit as those tax savings are realized.

A trade war could change that positive outlook. President Trump's surprise announcement, on March 1, that he will impose a 25% tariff on all steel imports and 10% on all aluminum imports raises serious concerns and could have a negative impact on the U.S. economy and markets in three ways. First, the immediate price shock on two key inputs that affect a wide range of industries comes at a sensitive time in the business cycle, with companies and their investors already increasingly anxious about rising prices and tightening resource constraints on growth. Second, the normally friendly U.S. trading partners, like Canada, Mexico, and the E.U., are already discussing retaliatory measures designed to wreak maximum political and economic damage on the U.S. in turn.

Third, the proposed tariffs represent a sharp new turn in U.S. policy, one that could seriously undermine the global rules that, however imperfectly, protect freer trade. Unlike previous tariffs targeted at specific countries to punish specific unfair practices, or deal with temporary emergencies, these measures take aim at our closest trading partners, for overtly protectionist ends. The offered rationale—national security—is sure to be challenged fiercely at WTO and may open the door to other countries using the same excuse to adopt protectionist steps of their own. The President's subsequent statements—tweeting that "trade wars are good, and easily won", threatening the E.U. with auto tariffs, and tying the lifting of steel tariffs to Canada buckling to U.S. demands on NAFTA—reinforce concerns that he has a much broader assault on existing trade norms in mind.

At the time of writing, however, President Trump has yet to translate his words into action, and it is unclear what action—if any—he will end up taking. We have learned, over the past year, that this President often makes dramatic policy pronouncements, only to shift his position or kick the can down the road. He has threatened repeatedly that he is about to quit NAFTA, yet so far we have not quit and negotiations continue, despite several deadlines passing. In this case, like NAFTA, his proposed course of action faces substantial opposition from within his own party, and even from his top economic advisor. That said, we also recognize that he has a deeply held (and in our view mistaken) conviction, dating back several decades, that the U.S. loses from international trade and has nothing further to lose from greater confrontation. So, we cannot dismiss the risk of a destructive trade war breaking out, forcing us to downgrade our outlook for the U.S. and global economy. But neither can we predict that such a trade war is really around the corner.

The risk of a trade war, along with inflation and rising interest rates, casts a shadow of uncertainty over the market. That makes it all the more important to keep in mind the more positive indicators we are seeing that are signaling solid economic momentum, continued earnings growth, and attractive long-term returns for taking equity risk. There are potential headwinds, but there are also very real tailwinds, and both will play a role in determining how high this bull market can fly, and for how long.

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