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U.S. ECONOMIC AND MARKET REVIEW—MAY 2017

The data on the U.S. economy that came out in April pointed in conflicting directions. GDP growth for Q1 slowed to +0.7%, its weakest in three years. But like the stock market, which held steady, we look at other, more encouraging data and question whether this stumble equates to a negative trajectory for the economy going forward.

The U.S. consumer is hard to figure out. The most striking aspect of the Q1 GDP figures was that consumption grew by a mere +0.3%, its slowest pace since 2009, when the U.S. was facing the fallout from the financial crisis and unemployment was nearing its peak. Yet through Q1 and into April, the two main surveys of U.S. consumer sentiment show confidence at or near its highest levels of the cycle. The GDP figures themselves indicate that disposable personal income rose a healthy +3.4% in Q1, but that the savings rate rose to 5.7%. So where are all those confidence consumers? The retail sales data suggests they are out spending. While sales slid in February and March, that came off a big bump at the end of the year, leaving March sales up a very solid +5.2% from a year before.

A few months ago, we noted that vigorous auto sales, which had given manufacturing much-needed support through its slump last year, had grown reliant on increasingly risky car loans, and could be vulnerable. Auto sales have fallen, to an annual rate of 16.9 million in April, and many in the industry expect further weakness ahead. Housing, in contrast, is seeing an upswing, with existing home sales in March up +5.9% from a year ago, new home sales up +15.6%, and new housing starts up +9.2%. Residential investment surged by +13.7% in Q1, adding half a point to GDP growth.

Business investment also surged by +9.4% in Q1, adding an impressive 1.1 points to growth. This was largely offset, however, by businesses pulling back on inventories, which shaved −0.9 points away from GDP. Still, businesses appear to be optimistic about the future. The ISM indices in April for manufacturing (54.8) and non-manufacturing (57.5) remain well in expansion territory, supported by a steady stream of new orders. Government numbers tell a similar story: March factory orders were up +5.8% from a year ago, while orders for core capital goods—a key indicator of investment—are up +3.3%, after a terrible slump last year.

Business continues to create new jobs. The April jobs report was important for one big reason: the March report was so weak, everyone wondered if it signaled a new, negative trend. It didn't. The U.S. economy added +211,000 new jobs in April, while new jobless claims remain near 40-year lows. Wage growth remains at a tepid +2.5%, which suggests, even with unemployment at a 10-year low of 4.4%, there is still room for continued job growth—which should help drive consumption growth—without fanning inflation.

The U.S. trade deficit stabilized in Q1, as the dollar fell back −3.0% (on a broad trade-weighted basis) from the 14-year high it hit in December. The dollar's post-election surge, in expectation of a big stimulus package from the Trump Administration, widened the trade gap and shaved −1.8 points off GDP growth in Q4. With those expectations now receding, the headwinds they generated have also receded, for the time being.

The price of oil has also fallen since the start of the year, by more than −10%, as U.S. shale has stepped in as the swing producer in the face of OPEC cuts intended to shore up the price. Cheaper oil should help U.S. consumers, as well as energy-poor regions like Europe and India, as well as keep inflation under control (with U.S. inflation hovering around its target of 2%, the Fed is under little immediate pressure to raise interest rates). But further weakness in oil markets could undermine earnings in the energy sector, which have only just recovered from last year's collapse in price.

With 84% of S&P 500 companies reporting, operating earnings per share (EPS) for Q1 are currently projected to grow by +5.5% over last quarter, up +22.8% over a year ago. That would put the current P/E ratio at 21.4x trailing 12-month earnings, close to the level it's held since last June. In other words, overall earnings growth—driven in large part by the rebound in energy—has kept pace with the post-election rally in the index. But within sectors, the record is more mixed, with only 6 out of 11 sectors showing positive earnings growth in Q1 compared to Q4. Selective stock picking remains important: one does not want to repeat the mistake of the economist who drowned in a river that was only a few feet deep—*on average*.

While the S&P 500 index has produced a +7.2% total return year-to-date, it has basically tread water the last two months, waiting for a signal on which way to jump. Last year we noted how different elements of the U.S. economy were waxing and waning out of sync with each other, coalescing neither in a real boom, nor an outright bust. We certainly see that in the latest data. One of the most consistent trends last year, however, was steady consumption growth contrasted with hesitant business investment, a pattern that appears to have reversed in Q1. Whether that reversal continues or not is something we will be keeping a close eye on.

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