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U.S. ECONOMIC AND MARKET REVIEW—SEPTEMBER 2017

U.S. markets finally caught a case of the jitters in August, with the S&P 500 selling off by −2% in two sharp swings, before rallying at the end of the month to recover all of its losses. Volatile sentiment was soothed—as we anticipated—by a stream of steady economic and earnings data, almost in defiance of the political storms in Washington, D.C. and real storms on the Gulf and Caribbean coasts.

GDP growth for Q2 was revised upwards from +2.6% to +3.0%, with both consumption and business investment seeing stronger results. The third quarter is also off to a promising start. Industrial output is back from last year's slump, to its strongest level in over two years. Excluding volatile aircraft orders, which surged in July, durable goods orders rose +0.6% in July, up a confident +5.6% from a year ago, while orders from core capital goods—a key indicator of business investment—rose +1.0%, up +3.9% from last July, to their highest level in over a year and a half. The ISM Manufacturing Index for August rose +2.5 points to 58.8—solid expansion territory. The new orders gauge held above 60 for the third straight month, suggesting that momentum will continue. The Non-Manufacturing Index, which rose to 55.3, is showing similar strength.

Consumer confidence rebounded in August, close to its post-election highs. The −0.2% sag in June retail sales was revised upwards to +0.3%, and July sales surged a further +0.6%, up a solid +4.2% from a year ago. Consumer spending as a whole was also up +4.2% from last July. While the +156,000 jobs gained in August fell shy of expectations, that's still a pace that should continue to be supportive of steady consumption growth. And the ISM gauge for hiring in manufacturing is the strongest it's been in six years.

There are a few notes of caution that deserve our attention. Auto and housing sales—usually key sectors—have been in a deepening slump for the past few months. New home sales in July were down −8.9% from last year, and new housing starts were down −5.6%, while auto sales in August fell to their lowest rate in over three years. The economy's overall inventory-to-sales ratio has begun climbing again, while consumers are buying more by saving less (3.5% of disposable income in July, down from 5.1% a year ago). Higher inventories and lower savings may signal greater confidence, but they also imply greater risk if things slow down.

Most of the positive data we've cited precedes the impact of Hurricanes Harvey in Texas and Irma in Florida, which caused many billions in local property destruction and are expected to shave −0.3% off GDP growth in Q3. Harvey shut down a quarter of U.S. refinery capacity, and produced a jump in gas prices at the pump. Initial jobless claims in Texas spiked by +50,000, much as they did in the Northeast after Hurricane Sandy in 2013. These effects are expected to be temporary, however, and may even give economic activity a boost in early 2018 as rebuilding efforts get underway. They do not change our basic economic outlook.

The continued flattening of the yield curve—the 10-year U.S. Treasury fell −15 basis points in August, even as the 90-day note rose +55 basis points—suggests widespread doubt that a sudden uptick in growth or inflation will put the Fed under pressure to hike interest rates. Both the standard Consumer Price Index (CPI) at +1.7%, and the Fed's preferred PCE gauge at +1.4%, remain below its long-standing target of a 2% inflation rate, and Congress has yet to demonstrate its ability to pass tax cuts or other measures that could spur higher growth. Reduced expectations of Fed tightening, along with improved

outlooks overseas, pulled the U.S. Dollar down another −0.6% in August, on a broad trade-weighted basis, for a year-to-date decline of −7.5% (from its 14-year high at the start of the year). A less expensive Dollar has helped stabilize the U.S. trade balance, and increase the Dollar value of U.S. corporate earnings abroad, but it has also given a sizeable boost to the value of non-U.S. assets in Dollar terms. Germany's DAX Stock Index, for instance, is up +18.6% so far this year in Dollar terms (compared to just +5.0% by its own measure) due to the Euro's +13.0% rise against the Dollar.

The S&P 500, in contrast, has seen total returns (including dividends) of +11.9% since the year's start. These gains have been driven not by higher valuations, but by higher earnings. Earnings per share for Q2 rose +5.9% from the previous quarter, up +18.7% from a year ago. Out of 11 sectors, all but three (energy, utilities, and real estate) saw earnings gains over the first quarter, and all but two (materials and real estate) saw gains over a year ago. (After-tax corporate profits for the economy as a whole were also up +8.1% in Q2, from the year before). As a result, the trailing P/E ratio for the S&P 500 has remained steady at around 21x operating earnings for the past year—elevated, to be sure, but with the equity risk premium still hovering at 5.0%, less expensive than avoiding equity risk.

Coming days will undoubtedly bring headlines of more storm clouds, both real and figurative. But the underlying data show a U.S. economy that should continue to grow and provide support for this market.

September 12, 2017

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