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U.S. ECONOMIC AND MARKET REVIEW—AUGUST 2015

The U.S. economy saw a modest recovery in the second quarter, as the multiple headwinds it faced in a challenging first quarter eased, but did not disappear. GDP grew by +2.3% in Q2, up from a revised +0.6% in Q1. Corporate earnings also rebounded, following recent stumbles, but have struggled to regain last year's mid-year heights. As a result, U.S. share prices have continued to tread water.

A pause in the dollar's steady climb provided some relief in Q2. Exports recovered +5.3%, after falling -6.0% in Q1, while imports rose +3.5%, down from +7.1%. In contrast to Q1, when net exports shaved nearly 2 percentage points off GDP growth, trade contributed +0.1 points in Q2. The relief may prove temporary, however, as the dollar bounced back +2.4% in July, approaching its earlier high. A widening trade gap in June, with exports softening -0.1%, hints at further challenges from a strong dollar.

While the dollar revisits earlier highs, oil is revisiting earlier lows, falling -19% in July. Both are weighing on the industrial economy. Business investment fell -0.6% in Q2, down from +1.6% in Q1—both a far cry from the +9.0% growth experienced in Q3 of 2014. Industrial production rose +0.3% in June, after two months' decline, but is only up a dismal +1.5% from a year ago. Durable goods orders rose +3.4% in June, better than expected, after falling in April and May, but were still down -2.8% from a year ago. Strip out transportation, including aircraft, and orders are down -4.5% from last June.

The ISM Manufacturing Index slipped -0.8 in July to 52.7, lower than expected, with new export orders down -1.5 to 48.0, their fifth contractionary reading in the last seven months. While new orders rose by 0.5 to 56.5, the strongest reading of the year, backlog orders saw their sharpest drop in three years, to 42.5. The ISM Non-Manufacturing Index, in contrast, surged by over 4 points to 60.3, its highest reading in 10 years. New orders, at 63.8, and backlog orders, at 54.0, both show significant momentum in the service sector of the U.S. economy, with 15 of 18 industries reporting growing business.

Consumer confidence remains near post-crisis highs, but actual spending patterns are mixed. Personal consumption grew +2.9% in Q2, up from +1.8% in Q1, but well below the last three quarters of 2014, when the growth rate never fell below +3.5%. Retail sales fell a disappointing -0.3% in June, after a strong surge in May, and after several months of decline in Q1 are up just a paltry +1.4% from a year ago. Auto sales, on the other hand, reached a sizzling annual rate of 17.6 in July, matching the post-crisis record set in May. Consumer demand continues to be supported by steadily rising employment, with new weekly jobless claims at their lowest levels since early 2000.

One area of particular strength, which was missing-in-action last year, is housing. Residential investment rose +6.6% in Q2, adding +0.2 points to GDP growth. Existing home sales rose +3.2% in June, up +9.6% from a year ago, making it the strongest month since February 2007, with transaction levels comparable to pre-bubble monthly sales in the early 2000s. New home sales fell -6.8% in June, after several strong months, but were still up +18.1% from a year ago. Housing starts rose by +9.8% in June, up +26.6% from the year before. The market for new homes is a far cry from pre-crisis levels, but is showing welcome signs of improvement.

Barring a new budget impasse in Washington over funding for Planned Parenthood—not likely, but possible—we expect government fiscal policy to remain relatively benign: neither a big drag nor a big contributor to GDP growth. A recovery in the latest inflation figures—the PCE index rose +2.2% in Q2, the fastest rate since early 2012, while core PCE (excluding food and energy) rose +1.8%—together with steady job gains, suggest that the Fed will raise interest rates by 25 bps sometime in the Fall. Absent clear wage pressure from a tightening labor market, however, we expect the Fed to remain patient in following up with further rate hikes. Additional QE overseas, along with global growth concerns, should prevent long-term interest rates from rising too abruptly.

The S&P 500 index gained 2.0% in July, mainly on relief that Greece and China did not completely unravel, putting it up 2.2% year-to-date, with total returns of 3.4%. Operating earnings per share (EPS) for the S&P 500 appear set to rebound +10.3% in Q2, after falling -12.8% over the previous two quarters, putting them -3.0% short of where they stood a year ago. That means the P/E ratio continues to be a bit stretched at 19.0x operating earnings and 21.6x reported earnings, and will likely remain so for at least the next quarter. The relatively tepid performance of the S&P 500 index, however, disguises a growing disparity in performance among stocks and sectors. Gains this year have been heavily driven by two sectors in particular, health care and retail (including several star tech names), which are both trading at a 20% premium to the rest of the market. The bull market isn't over, but the emphasis has clearly shifted from riding the index to selecting the right stocks.

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Patrick Chovanec
Managing Director, Chief Strategist