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WEEKLY ECONOMIC COMMENTARY

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Strong Data/Fed Comments Revive Rate-Hike Fears

The market sold off on 8/16/16 after New York Fed President Bill Dudley suggested that the Federal Reserve could hike rates as soon as September, this amid signs of strengthening data and pricing pressure. A parcel of strong economic data released the same morning acted like a Greek chorus to emphasize the Fed governor's words.

While the Federal Reserve has 12 regional banks charged with carrying out day-to-day operations, the New York Federal Reserve bank holds a special place (as well as more gold than can be found in Ft. Knox or most nations). Thus, when the New York Federal Reserve president speaks, the words carry unusual weight.

Despite clear signs of a strengthening economy and multiple opportunities to raise rates, the Fed has opted to sit on its hands time and again. Early in 2016, the Fed repeatedly remained neutral because of fears that any rate rise would spike the dollar and further damage weak emerging economies. As the year progressed, the Fed also failed to hike following a weak May payrolls reports (since reversed) and the surprising Brexit vote. If it so chooses, the Fed can equally point to soft earnings growth and weak 2Q GDP as further excuses for inaction.

Still, the Fed can't stay on the sidelines indefinitely, particularly if pricing pressures really do begin to build. Amid signs of gathering economic momentum and rising consumer prices, investors need to prepare a more-active Fed.

We believe investors have become tired of the tepid to non-existent stimulus provided by ultra-low rates; and they've become genuinely fearful that negative interest rates could trickle into our economy from Europe or Japan. In short, we think the market would adapt almost seamlessly to rising rates, at least during the early part of a rate-hiking cycle.

FED KINDLING, DATA BONFIRE

On 8/16/16, in an interview on Fox Business News, New York Fed President Bill Dudley stated his view that the Federal Reserve could raise U.S. interest rates as soon as next month as evidence builds of wage gains amid a tightening labor market. The regional Fed president said, "we're edging closer to the point in time" where raising rates becomes appropriate.

Just by calling a mid-September rate hike "possible," President Dudley spooked the markets and may have shifted economists' forecasts for the timing of the second hike in the current cycle. Prior to Dudley's comments, according to Reuters, traders saw just a 12% chance for a rate hike at the 9/20/16 FOMC meeting. Traders see a higher likelihood for a hike after the election at the December FOMC meeting. Yet the Fed has stood pat so many times since the first rate hike in December 2015 that even a December hike was seen as only 50% likely.

One data point that caught investors' attention not long after Dudley's comments was the consumer price index (CPI), though not the monthly number. The all-items CPI for July was unchanged from June, the first flat showing in five months. Excluding food and energy, prices inched up 0.1%. But over the past 12 months, CPI excluding food and energy increased 2.2%. While that was down slightly from the 12-month increase of 2.3% reported in June, it is still above the Fed's annual inflation target of 2.0%. With both parts of the Fed's mandate fulfilled (2.0% inflation and sub-6% unemployment), the Fed risks uncorking inflation should it remain on the sidelines.

Additional data released in mid-August painted a picture of clear economic acceleration out of the summer and

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into the fall. Housing starts for July increased to a seasonally-adjusted annual rate (SAAR) of 1.211 million homes, from an already-robust 1.186 million SAAR in June. U.S. home construction in July accelerated to the fastest pace in five months, and more homes were under construction during July 2016 than in any month since 2008. One of several data points dragging on 2Q16 GDP was residential construction; the starts report suggests that category will strongly return to growth in 3Q GDP.

Industrial production in July rose 0.7% month over month, handily topping consensus expectations for a 0.3% hike. The July jump, which follows a (downwardly revised) 0.4% gain in June, included gains of 2.1% in utilities, 0.7% in mining, and 0.5% in factory production. While utilities were likely responding to one of the hottest months on record, the gains in factory and mining activity also showed acceleration from June growth. Capacity utilization finished at 75.9%, not yet indicative of a full-capacity economy — but inching toward it.

2Q EPS POST-MORTEM

With 460 (92%) of S&P 500 companies having reported calendar 2Q16 results as of this writing, earnings for all companies declined 3.0% for the quarter. As expected, the near-final tally was worse than interim reports in the -2% range, given that Energy sector companies tend to be late reporters.

Excluding Energy, earnings for 2Q16 were up 1.5%. This adjusted positive reading is hardly cause for celebration. The S&P 500 has now recorded five consecutive down EPS quarters for the first time since 2008-09. Further, revenues for 2Q16 declined for a sixth straight quarter.

Worth noting is that 61% of companies reported higher earnings for 2Q, while 35% reported lower earnings. Companies reporting higher earnings averaged a 16% gain, while those reporting lower earnings averaged a 26% decline.

The list of companies reporting lower earnings was crowded with Energy, Materials, and Financial companies. All of those stand to benefit from easier comparisons in coming quarters, assuming that currencies, commodities, and energy prices can maintain their recent fragile stability.

As 2Q earnings seasons wraps and before earnings slip from investors thoughts for a few months, it is worth examining how 2Q results impacted the 3Q outlook. For calendar 2Q16, over 70% of companies reported earnings above the mean estimate. That increases our confidence that earnings growth can return in 3Q16, even though the Energy sector will remain a significant drag and Financial will also likely lag. We are modeling low- to mid-single-digit EPS growth for calendar 3Q16, which will begin reporting in October, followed by high-single to low-double-digit EPS growth in 4Q16 against easier comparisons.

THROUGH HOT SUMMER HAZE, A LOOK AHEAD

The summer has been a hot one in many parts of the country, and many investors are only now heading for beach, mountains or other vacation spots. Once Labor Day weekend is over, however, investors will ditch their beach chairs and turn to the serious business of crafting an investment strategy for the final quarter of 2016.

The bull market was challenged over the past year by corrections in August-September ’15 and January-February ’16. Those selling spasms unwound any remaining good feelings toward this bull market, already widely regarded as the “most hated” in history. The wave of disdain is just another wall of worry for the bull to climb, however. And soon, decisions about liking or trusting this rally leg will become moot.

Sometime late in September or early in October, the stock market reaches its “event horizon,” beyond which the counter-vailing tendency of the prior nine months is sucked in and succumbs to the prevailing tendency. In short, if the market is bullish through nine months, it gets extremely bullish in the final three months; and if bearish across nine months, it gets really bearish for the final quarter.

Since 1980, the S&P 500 through nine months has averaged capital appreciation of 5.5%. Given that the market since 1980 has averaged annual capital appreciation of 9.8%, it follows that a big part of the gain comes in those final three months.

For 10 of the 36 years since 1980, the S&P 500 has been down for the nine-month period; the average decline has been 13.1% over nine months. For those 10 years, the average capital decline for the full year has been 8.9%.

For 26 of the 36 years since 1980, the S&P 500 has been up for the nine-month period; the average increase has been 11.9% over nine months. For those 26 years, the average capital appreciation for the full year has been 17.0%.

In years in which the S&P 500 is positive after nine months, average capital appreciation for October-December is about 5.5%. In years in which the S&P 500 is negative after nine months, October-December is still positive; but the gain is more muted, averaging less than 4%.

As of mid-August 2016, year-to-date capital appreciation on the S&P 500 topped 6.5%; and total return including dividend was 8.3%. Assuming the stock market can hold its high-single-digit gain through the end of September, bearish money managers will need to change their investing strategy and go aggressively long, or risk delivering even-deeper under-performance to unhappy clients.

While much can intervene between now and December 31, including one of the more-dramatic and polarizing presidential elections in memory, Argus expects stocks to maintain their bullish tone into year-end. We would continue to focus on companies delivering real EPS and dividend growth, rather than those bobbing lazily on the rising tide of an accelerating stock market.

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