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WEEKLY ECONOMIC COMMENTARY

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GDP's Nice Surprise Punctuates Earnings Season

The stock market, known for some bad Octobers (most notably 1929, 1987, and 2008) delivered a down October for 2016, as the S&P 500 sank by 1.8%. Since 1980, the S&P 500 has averaged a 1.44% gain in October, so this year's performance was something of an outlier.

Investors may be tempted to blame the raucous and bitter presidential election campaign for the October dud, but we think the problem is with the consumer. After leading the U.S. economy for the past 4-5 years, the U.S. consumer appeared suddenly cautious in summer 2016. Housing starts, new home sales and existing home sales were erratic; new vehicle sales, which had been surging, hit a soft patch. Consumer confidence slipped off its highs, perhaps reflecting concerns about the deep divides that the election had revealed; people may also be realizing that the many years of 200K monthly job gains could be winding down.

We assume the U.S. consumer has hit pause rather than stop. And, though it may be hard to believe, this nation has weathered more acrimonious presidential elections. While those are suppositions or opinions, investors trade on facts. And the facts of the third-quarter 2016 GDP report, while not universally positive, are sufficiently good to lift the market's spirits once it gets its head out of the election. Companies are also wrapping up a better-than-anticipated 3Q16 EPS season, and have so far signaled that 4Q16 earnings season should be strongly positive.

3Q16 GDP: A PUSH FROM INVENTORIES

The advance report on 3Q16 gross domestic product, released on 10/28/16, indicated that the U.S. economy grew at a 2.9% rate in the July-September period. This was a nice step up from the 1.4% growth rate recorded in 2Q16. The Commerce Department distinguishes between the increase in real GDP, relative to a baseline of zero, and the acceleration in GDP, relative to the baseline of the prior quarter's growth rate (in this case, 1.4% in 2Q16).

The Commerce Department's Bureau of Labor Statistics (BLS) attributed the increase in real GDP to positive contributions from personal consumption expenditures, exports, private inventory investment, federal government spending and non-residential fixed investment. These positives were partly offset by negative contributions from residential fixed investment, an increase in imports (which detract from GDP), and state and local government.

The BLS attributed the acceleration in 3Q16 GDP relative to 2Q to an upturn in private inventory investment, an acceleration in exports, a smaller decrease in state and local government spending, and an upturn in federal government spending. These were partly offset by a smaller increase in PCE and a larger increase in imports. Other highlights of the advance GDP report included a 3.6% increase in current-dollar disposable personal income and a 2.2% increase in real disposable personal income. The savings rate held steady at 5.7%.

In terms of the details, the 3Q GDP report balanced positive surprises with some negative data points. The 2.1% gain in personal consumption expenditures (PCE) was modest and – with the exception of 1Q16 – the softest reading in that category since 1Q14. Consumer spending on non-durable goods swung to negative in 3Q16; that is consistent with our equity analysis of categories such as restaurants, groceries and hotels.

Non-residential fixed investment – regarded as a proxy for capital spending – grew 1.2% in 3Q16, building on the

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1.0% gain reported in 2Q16. Prior to 2Q16, this category had been negative for three quarters; the economy's long-term health is tightly tied to corporate capital investment. While the rebound in overall capital spending is welcome, corporate investment in equipment declined for a fourth straight quarter.

Residential investment in 3Q16 posted a 6.2% decline, on the heels of the 7.7% pullback in 2Q16. While some economists pointed to harsh weather and flooding particularly in the Southeast across mid-year, it seems clear that consumers nationwide paused in their housing searches across the middle months.

Exports jumped 10%, a sign that businesses are growing more comfortable with the new normal of a strong dollar. The export surge more than compensated for the 2.3% rise in imports. Government spending swung to a net positive, after declining in 2Q16.

The stock market has not made a lot of progress over the past two years, but neither has it declined; that signals a fairly even distribution of market bulls and bears. That may be one reason why the stock market has not made much of the most positive quarterly GDP number since 3Q14. In the pre-election frenzy, U.S. investors also appear to have overlooked a very good consumer spending number (up 0.5% in September) and strengthening trends in non-defense capital goods orders excluding aircraft.

Argus Chief Investment Strategist Peter Canelo notes that the U.S. was not the only region to surprise economists with its GDP reading. During 3Q16, UK GDP rose 2.0%; and even in the Eurozone, GDP increased 1.5%. Peter also notes that worldwide (with the exception of Brazil), purchasing managers' indexes are signaling increased industrial activity.

Some investors and economists dismissed 3Q16 GDP growth as inventory-driven. Inventories rose sharply in the quarter, adding an estimated 0.6 percentage point to overall growth. This volatile category had declined for three straight quarters. We note that distributors, who have access to advanced demand-tracking tools, are not blindly building stockpiles; they are responding to an anticipated late-year demand surge.

3Q16 EARNINGS: POSITIVE, FINALLY

As of 10/31/16, approximately 308 companies, or just under 62%, of S&P 500 companies had reported calendar 3Q16 results. In aggregate, earnings for these companies are up 1.0% as measured by share-weighted change. On a market-cap weighted basis, earnings are up nearly 9%, signaling (no surprise) that larger companies are relatively outperforming their smaller peers in an uncertain global economy.

Backing energy stocks out of reported companies to date, share-weighted earnings growth for 3Q16 is 5.1%. The percentage of energy companies that have reported is roughly in line with the percentage of overall companies that have reported; this suggests limited chance for a "November surprise" of negative energy earnings pulling the overall change back into the negative column.

Financial Services earnings, which were negative to 1Q16 and 2Q16 earnings, have been positive to 3Q16 earnings. Healthcare is the best-earning sector to date; only about half of S&P 500 healthcare companies have reported. Based on this and other elements of our sector analysis, we think S&P 500 earnings could be up from 1.5% to as much as 2.0% when the final numbers are tallied.

Whereas 3Q15 represented a reasonably tough comparison, 4Q15 is considered an easy comparison, given that normal seasonal strength largely failed to materialize last year. Based on the easy comp as well as positive trends from the consumer and industrial economies, Argus looks for 4Q16 EPS to growth at a high-single-digit to low-double-digit rate. Assuming continued stability in currencies, commodities and energy prices next year, we look for overall 2017 EPS to rise in low-double-digit percentages.

CONCLUSION

When the market was rising between 2009 and 2014, we pointed to the close correlation between S&P 500 index price trends and S&P 500 earnings trends. The stock market has not done much in the past six quarters; and it has been six quarters since S&P 500 quarterly earnings grew on a year-over-year basis. With 60% of companies having reported, it now appears highly likely that the S&P 500 has finally broken its trend of down EPS quarters.

The swing to positive EPS growth in 3Q16, and a more convincing rise in 4Q16 earnings, may not in itself be enough to break the bull-bear logjam that has stalled the broad market. As noted above, we are seeing signs of economic revival – particularly in the global industrial economy. The combination of rising earnings and increasing global economic activity could be the one-two combination required to trigger typical year-end strength in the stock market.

Jim Kelleher, CFA,
Director of Research