ARGUS®

WEEKLY ECONOMIC COMMENTARY

February 13, 2017

# Not So Fast: Our Monthly Survey of the Economy, Interest Rates, and Markets

The Trump presidency, which started with massive can-do energy, is encountering the reality that comes with our federal government structure. The selective travel ban on seven majority-Muslim nations has now been at the very least sidetracked. The sense that Obamacare would be repealed within weeks of the inauguration is now fading; anxious House members from the president's own party are now splitting semantic hairs over the difference between "replace" and "repair." The promised assault on Dodd-Frank is underway; but so far, the White House can only point to a "pause" in implementing the new DoL fiduciary standards, which were supposed to start in April.

More substantive changes are equally running into reality. The system of checks and balances written into the Constitution, regarded as a huge inconvenience by change agents on the left and right, is designed to prevent our laws and regulations from lurching wildly with every shift in leadership. In major areas such as tax policy, immigration and government infrastructure spending, the process of pushing through significant change is designed to be cumbersome, tedious, and (at least partly) bipartisan.

## THE ECONOMY, INTEREST RATES, AND EARNINGS

In the president's favor, his administration begins with the economy not fully humming but not hurting either. Real gross domestic product slowed to 1.9% in 4Q16, after growing at a 3.5% rate in 3Q16. The 4Q16 GDP number, though approximately in line with expectations, was a disappointing reminder of how hard it is to get this economy to grow at 3% despite a fully employed workforce and still-tame inflation. It also offered a worrisome preview of what a too-strong dollar can do to the imports-exports balance.

Personal-consumption expenditures advanced 2.5% in 4Q16, down from 3.0% in 3Q. Consumer spending on non-durable goods picked up quarter over quarter; but consumer durable-goods spending declined. Residential investment improved from a weather-impacted third quarter, reflecting housing recovery in October through December. Total spending on non-residential structures in the fourth quarter increased 2.4%, up from 1.4% in 3Q16.

On the downside, exports took a dive, falling by 4% in 4Q after growing by 10% in the third quarter. Imports, which are subtractive to GDP, rose to 11% growth in 4Q from less than 1% in 3Q16.

Government spending also weighed on GDP, as weaker defense spending pulled down total federal government spending by more than 1%. The new administration has promised an aggressive investment in the military and infrastructure, but those programs may take months or quarters to work their way through Congress.

Our outlook for GDP growth for 1Q17 is in the 2.6%-2.8% range. We look for growth in the 2%-4% range for personal-consumption expenditures and growing momentum in corporate capital spending. With the dollar already moderating off its highs and holiday spending finished, we expect exports to swing back to positive in 1Q17; exports and imports should be in better balance in subsequent quarters.

Residential construction could demonstrate normal seasonal softness in 1Q17 before rebounding in the spring. We look for corporate capital spending to begin to perk up. Government spending is a long-term positive, but tough to call in the near-term.

For the full year, we are modeling GDP in the 2%-3% range. We will provide further refinement to our estimate as the year progresses and we are able gauge the impact of President Trump's programs.

*(continued on next page)*

Bond yields, which surged in the weeks following the election and in advance of Fed's December rate hike, have now achieved a level of stability (or at least a tightened trade within ranges). The 3-month bill yield, at just under half a percent, is reflective of the two quarter-point rates hikes enacted in December 2015 and December 2016. Yields in the middle of the curve, including the two-year and five-year notes, are little changed from a month ago.

The benchmark yield on the 10-year has followed its spike to 2.6% and retrace to 2.3% with a leveling-out in the 2.40%-2.45% range. One notable move in the past month has been the 30-year yield, which has pushed back above 3.0%.

Stock charts show how far the market has come from a year ago, when the sky appeared to be falling. Certainly, no one knew how much further oil prices might fall; but oil had found its bottom. The panic in January-February 2016 turned out to be a good time to (bravely) buy Energy sector stocks. Oil prices rose steadily from trough levels, and interest rates began to follow by late in 2016.

The Fed has pledged an increasingly restrictive monetary policy, and that program is already underway. Although President Trump has pledged to ramp-up fiscal stimulus, he is learning that Washington moves at glacial pace amid our system of checks and balances. Impediments to the president's agenda likely keep market rates of interest from running away.

Where do bond yields go from here? We expect them to move higher, but in waves punctuated by retracements. While our forecasts call for yields to move above current levels six months from now, retracement and then stabilization over the past month suggests that investors are hedging their bets on the fixed-income market. In short, we expect rates to move higher only gradually

We have made revisions in our S&P 500 earnings estimates for 2016 and for 2017 and modeled preliminary earnings for 2018. We look for 2016 earnings to reach $119.00, down slightly from our earlier forecast of $119.75.

We have not made any additional changes, but we can report that 4Q16 earnings are coming in about as expected. With more than one-third of S&P 500 constituent companies having reported results, calendar 4Q16 earnings on a share-weighted basis are up 5.0% from 4Q15. Companies posting positive annual comparisons are growing EPS an average 12%, but companies posting negative annual comparisons are declining an average 24%.

In other words, down earnings are declining at twice the rate at which up earning are rising. As Energy earnings swing to positive, and assuming the preponderance of companies already reporting double-digit growth can maintain that trend, earnings could be positioned to grow at low-teens percentage growth rates for several quarters.

For that and other reasons, we are modeling 2017 EPS to grow about 13% year over year, to $134.00. Our preliminary outlook for 2018 is EPS growth of 7.5%. Assuming 2017 EPS comes in as modeled, that would put 2018 EPS around $144.00. We expect the effects of infrastructure spending and tax cuts to impact earnings in 2018 rather than in 2017.

**DOMESTIC AND GLOBAL MARKETS**

On average, our aggregate of major domestic indices is up 2.3% year to date, which is 60 basis points better than it was early in January. For the year to date in 2017, less-seasoned names are out in front of blue chips. The Nasdaq is on top, followed closely by Wilshire Growth. The Russell 2000 is not confirming — somewhat surprising, as U.S.-facing small caps might seem the "conservative" choice over global-facing large caps if a series of trade wars breaks out.

Ranking the blue chip indices, the DJIA lags the S&P 500, but neither has done much this year. The Lehman bond index is fractionally positive but should be challenged to build on that slight gain, particularly if we see a new round of higher interest rates.

Compared with one year ago, stocks are in great shape. When we took our snapshot in mid-February 2016, the indices were down on average by 11%. The bottom for many stocks was reached on February 11, 2016 — which represented a more than two-year low in the S&P 500.

In 2016, several "wealth in the ground" sectors were among the top performers, including Energy and Materials. Financial Services made a tremendous late-year sprint, while Industrials paced the gains in commodity sectors. The "odd man out," meaning the defensive sector that rallied with risk-on last year, was Telecom — which we believe rose as domestic vendors shut down their subsidized phone plans and limited their unlimited data plans.

The new year has brought a rapid shift in leadership. The change is even more dramatic compared with the market a year ago, when only ultra-defensive yield sectors were positive. Telecom, up 9% last year at this time, is down 4% in 2017 to date. Growth sectors that were down in double-digits YTD in February 2016 — including Technology, Consumer Discretionary and Financials — are now all up in high- to mid-single-digits in 2017.

Energy is down year to date on dollar strength that is providing a reason to harvest last year's sector profits. We would take advantage of current weakness to make selective additions in the Energy sector.

The rally since the election has generally favored risk-on and economically sensitive groups. Despite awakening fears of inflation, the rally has not fully favored commodity sectors. Energy and Materials ran up strongly last year, making them tempting targets for profit taking. Additionally, the strong dollar has pushed down commodity and energy prices, creating wariness among some investors.

In the past month, the sectors gaining the most market weight have been Technology and Consumer Discretionary. The sectors surrendering the most market weight in the past month include Energy, Materials and Financial Services.

On a year-over-year basis, however, the Financial Services sector (excluding Real Estate) has gained nearly two points of sector weight. Healthcare was hardest hit, losing a percentage point of weight year over year on multiple policy concerns. While the drug-pricing and ACA drama has been playing out in loud headlines, quietly investors have been disengaging from Consumer Staples; this sector has also lost a percentage point of market weight in the past year.

Technology may need to retrace here, as it could be growing faster than justified by industry fundamentals. Silicon Valley is now at war with the Trump administration over immigration and visas. Given this backdrop, we would maintain a market weight in Technology.

In terms of global stock markets, last year's winners were the resource economies, followed by the BRICs; mature economy markets were the worst performers. We are seeing some of the same trends playing out this year that we saw in 2016.

BRIC nations are out in front with an average 5.3% gain, even though the year is just five weeks old. The Americas nations are up nearly 4%, mainly on Mexican strength. Commodity nations are okay, up 3% in 2017.

Mature economies are lagging, with a gain of less than 1% so far. Some of last year's global winners are subject to profit taking. Russia in particular has moved out of leadership. Geopolitics could have something to say about global market performance this year.

**CONCLUSION**

The post-inaugural parade is running into traffic, as it always does. True stimulus takes time: tax cuts if enacted will impact 2018 income, not 2017; and government-sponsored infrastructure investment could struggle to get through a GOP Congress that castigated Obama for deficit spending.

Executive action can get faster results, but (except for de-regulation) risks being subtractive rather than additive to growth. If shutting down ACA takes 10% of the population out of the healthcare economy, two percentage points could be shaved from GDP. Trade tariffs sound satisfying, but risk slowing growth and costing jobs.

The stock market has bought into the new agenda without thinking through the process. Investors may not have reckoned on the real timeline for change.

Stocks had a few minor corrections, in November and June of 2016, but not a real bone-jarring selloff since January-February. Stocks are overdue for a shakeout, regardless of who is in charge in our capital. The market may get a mid-year wakeup call, particularly if the inertia persists and disappointment sets in. As long as economic and earnings fundamentals remain intact, we would view any correction as an opportunity to buy on weakness.

Jim Kelleher,
Director of Research