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WEEKLY ECONOMIC COMMENTARY

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Ready for EPS Breakout: Our Monthly Survey of the Economy, Interest Rates, and Markets

The S&P 500 in 1Q17 logged its best first quarter since 2013 and its best overall quarter since 2015. The solid first-quarter showing came amid continued Washington turmoil as the Trump administration tried to push through its change agenda, only to run into the reality of Washington gridlock.

The new team in Washington can focus on their fiscal policy plans without excessive worry about economic underpinnings. The consumer has been positive for years, and small business confidence is increasing. The housing economy continues to defy expectations. The industrial economy is also sending positive signals.

We believe that the upcoming first-quarter results will give investors reasons to cheer. As we detail below, modest top-line growth and margin expansion, combined with easy prior-year comparisons, particularly in the energy sector, should drive double-digit EPS growth in 1Q17 and over the remainder of the year.

THE ECONOMY, INTEREST RATES, AND EARNINGS

The final reading on 4Q16 GDP followed a familiar pattern in which the last revision showed the strongest number in the series. Quarterly GDP growth was revised up to a final 2.1% from a preliminary 1.9% gain. Despite the slight increase in the final quarterly reading, final full-year GDP growth for 2016 stayed at 1.6%, consistent with the preliminary report.

Although 2.1% GDP growth in 4Q was down from 3.5% in 3Q, the PCE price index ticked higher, to 2.0% in 4Q from 1.5% in 3Q. This inflation indicator is on the Fed's radar and likely contributed to its aggressive dot plot for 2017, which calls for at least three rate hikes.

Real GDP growth drivers in 4Q16 included contributions from personal consumption expenditures, which rose to 3.5% in 4Q from an earlier 3.0%; private inventory investment; residential fixed investment; and state and local government spending. These were offset by lower federal government spending, an unfavorable imports-exports balance, and weak capital spending.

With 2017 now well underway, the focus has shifted to the 1Q17 advance GDP report due later in April. We think positive signals on taxes and infrastructure from Washington could lead to momentum in corporate capital spending. Consumers and small businesses are also likely to sustain their optimism.

Here is how Argus sees the outlook for GDP taking shape in the early part of the year. We look for GDP growth in the 2.5% range for 2017, down slightly from our earlier estimates. We look for a PCE in the 2%-3% range, with consumer spending potentially losing momentum as rates gradually rise. Gross domestic investment should also grow in the 2%-3% range, led by mid-single-digit growth in residential investment. In terms of nonresidential fixed investment, we look for capital spending growth in the low 2% range all year. Exports are expected to swing back to positive, but given the strong dollar, imports could be a net negative for GDP. We look for government spending to increase in the 1% range at the state, local and federal level, although the timing of defense spending is a wild card.

For 2018, we are also modeling GDP growth in the 2%-3% range, though we will further refine our estimate as 2017 progresses. Our assumption is that President Trump's programs will have a bigger impact in 2018.

A year ago, interest rates were falling across the board, as the likelihood of a 2016 rate hike seemed to recede. Rates

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have also declined recently, though not quite so precipitously. Investors appear resigned to the prospect of at least three rate hikes in 2017, the first of which took place in March.

Currently, the broad trend in longer-dated maturities is down. The three-month yield, however, has worked higher and now stands at 0.75%, compared to 0.69% last month and 0.21% last year. Treasury yields at two-year, five-year, 10-year and 30-year maturities are all higher than they were a year ago. But these yields are all down from last month. The 10-year has slipped to 2.34%, down from 2.6% as recently as mid-March. The 30-year yield has come back under 3%.

The strengthening in very short-term yields and the concurrent pullback in longer-dated maturities has led to a moderation in the yield curve. Any time the yield curve shows signs of flattening, economists mull the risk of recession. That is a term we have not heard much in the past few years, as concerns about inflation have moved to the forefront.

We see limited risk of recession given strong underlying fundamentals in the economy. These include relatively full employment, with the recent unemployment rate at 4.5%; rising wages, which are increasing consumer buying power; strong housing fundamentals; and positive signs from the industrial economy and from overseas.

Even talking about the "R" word reminds us that growth fears are never too far away. For the near term at least, we remain more concerned about pipeline inflation pressures.

The first-quarter earnings season gets underway in mid-April with the release of results from the major money-center banks. The key to the 1Q17 earnings season is that nearly all sectors face easy comparisons against a tumultuous prior-year quarter. Energy comparisons in particular are positioned to swing from very difficult to very favorable.

We are modeling quarterly EPS growth of 12.7% for 1Q17 in what may be one of the easier quarterly comparisons of the year. We then look for continued double-digit growth for 2Q17, when results are reported beginning in July. EPS growth could moderate slightly in the back quarters of 2017, but should remain well above the preceding three-year trend of flat to slightly up-or-down earnings.

Our 2017 forecast for S&P 500 earnings is $134, up 12% for the year. We look for high-single-digit growth in 2018, with most quarters rising in the 6%-8% range. There are numerous wild cards in the 2018 EPS outlook. These include the potential for worsening inflation; higher interest rates as the Fed seeks to cap pricing pressures; potential tax cuts, infrastructure investments, or other stimulative fiscal policy measures; and a further rise in geopolitical tensions, which have lately been on the boil in Syria, North Korea, and other hot spots.

DOMESTIC AND GLOBAL MARKETS

The stock market barely budged in March. On a capital appreciation basis, the S&P 500 was flat; you had to go out 3 or 4 decimal places to see that stocks were fractionally lower. Including dividends, the S&P 500 was up 0.12% for March.

While the broad market was little changed, there were some interesting currents beneath the surface. The Nasdaq pulled further ahead and the DJIA pulled closer to the S&P 500. Growth stocks widened their outperformance relative to value stocks. Despite the technology-fueled showing in the Nasdaq, the Russell 2000 continued to underperform; in fact, this small cap index lost almost 200 basis points in March and is now barely positive for 2017.

As yields for most bond maturities sank last month, the concomitant rise in bond prices helped the Lehman US Aggregate bond index push to a nearly 1% year-to-date gain after being slightly above breakeven a month earlier. With stocks showing signs of resuming their uptrend, we would not count on bonds to sustain recent strength.

Technology is now up more than 12% in 2017, as investors continue to play acceleration in the digital economy. Other sectors with a winning hand thus far in 2017 include healthcare, materials, utilities and the two consumer sectors, discretionary and staples.

Although crude oil prices have been held mostly in the $50-plus range, the energy sector is down in mid-single-digits for the year. The decline in telecom reflects the relentless price wars in data that have impacted Verizon and AT&T, which together comprise the bulk of the sector weight.

Calendar 2016 featured frequent sector leadership shifts on a quarter-over-quarter basis, which led to inconclusive trends for the full year. By contrast, 2017 has shown clear leadership returning to two of this bull market's favorite sectors, discretionary and healthcare, now joined by technology. We currently see a high likelihood that risk-on and economically sensitive sectors will lead in 2017 – although if we learned anything last year it was how quickly and completely sector leadership can change.

One of the big stories in 2017 is that technology continues to eat the market. In March, the sector grew to 22.1% of S&P 500 market weight, up 60 basis points from the prior month. Technology is now well above its historical band of 15%-20% of market weight. As the digital economy permeates every aspect of the consumer and business economies, we likely need to set new targets in which technology represents as much as one-quarter of S&P 500 sector weight in a few years.

The only other sector that grew last month was consumer discretionary, up 20 basis points to 12.3%. What drove

this growth? Amazon and Tesla, a pair of companies that, while not "officially" tech companies, certainly embody the rapid transitions underway in the digital age. We note that the consumer discretionary sector was able to grow both month-over-month and year-over-year despite the worsening crisis for traditional retailers.

Financial services lost the most ground last month, shedding 40 basis points. But this sector is still well ahead of where it was a year ago. Prior to the breakout of real estate, the combined financial services and REIT market weighting last year was 15.6%; at present, the combined weighting is 17.3%. Healthcare, which declined 40 basis points from the prior year, has slipped below the 14% level, though it did have a good first quarter. Last month, Senior Analyst David Toung identified attractive valuations in Healthcare, as investors have come back only grudgingly and not enough to make up for past weakness.

We see good values in both healthcare and financial services. At a time when market pundits are calling stocks overvalued, we would look for bargains in these two beaten-down sectors, with many high-quality names available at depressed prices.

As in the U.S., global stock market performance showed little change last month, but again with some interesting undercurrents. On a theme-basis, BRIC stocks extended their outperformance; this group is now up a bit more than 7% for the year, rising about a percentage point from the prior month. Consistent with weakness in energy, our basket of natural resources nations – which includes Canada, Russia and Brazil – is up just 2%.

The average for the four Americas bourses in our table is a gain of 6%, which is roughly consistent with the gain in the DJ World Index. Mature nations collectively are market laggards, up less than 5% year-to-date. If investors regain their enthusiasm for energy, we would expect leadership to shift toward the resource economies.

CONCLUSION

We think the upcoming earnings season could provide a distraction from the Trump administration's lack of progress on its agenda. With Congress now in recess, the key item greeting returning lawmakers late in April will be a spending authorization to prevent a government shutdown. We expect a rare bipartisan effort to ensure smooth resolution of this issue.

We also note that stocks tend to do well during the spring earnings season. Since 1980, the S&P 500 has appreciated 1.7% on average between the April 15 and May 15. If that were an actual month, it would score somewhere between the second and third best of the year.

The market has appreciated in 22 of the 37 mid-April to mid-May spans since 1980, for a not-great winning percentage of 59%. But when stocks rise between mid-April and mid-May, they rise sharply, logging an average 4.1% gain. There is a limited correlation between stock performance and earnings performance. That said, we expect a good stock showing this time because strong earnings are on tap for 1Q17.

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