ARGUS®

WEEKLY ECONOMIC COMMENTARY

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April Showers Bring Earnings Flowers: Our Monthly Survey of the Economy, Interest Rates, and Markets

After a meandering March, in which stocks barely budged, April featured a strong resumption in the bull trade. The month began with a sub-par jobs reading for March; included a report of anemic 0.7% GDP growth in the January-March timeframe; and featured ever-hotter rhetoric out of North Korea.

So what changed the market move to positive? In a word, earnings. S&P 500 earnings from continuing operations were up more than 15% for calendar 1Q17, the best performance since 2011. With easy comparisons ahead for at least the next three quarters, and with formerly laggard sectors such as energy swinging to positive, overall earnings growth should continue at a double-digit cadence through year-end at least.

The market's inability to look away from Washington finally was rewarded during April. The GOP's ability to get repeal-and-replace though the House restored confidence in other aspects of the President's agenda. Granted, healthcare reform could look at lot different or even stall in the Senate. For now, investors like the fact that the agenda moves on to clearly stimulative measures such as tax reform and infrastructure spending.

THE ECONOMY, INTEREST RATES, AND EARNINGS

The advance reading on 1Q17 GDP provided a sobering reminder that, even in an economy near full employment and with corporate earnings growing, getting the broad economy moving remains a heavy lift. GDP is often weak in the first quarter of the year; since 2013, 1Q GDP has 0.2%. While many of those quarters have included horrendous winter weather, the winter of 2017 was relatively mild.

Consumers drive two-thirds of the U.S. economy, and consumers closed their wallets in 1Q16, with particular aversion to big ticket spending. Personal Consumption expenditures rose a tepid 0.3% in the first quarter, which was the weakest PCE reading in more than seven years. While services spending growth was an okay 1.5%, spending on durable goods fell 2.5%. This reflected the rapid cooling automakers are experiencing in vehicle sales. Another deep negative was government spending, which was down 1.7%.

There were some positives in the report, including a 10.4% increase in non-residential fixed investment, which is a proxy for capital spending. Exports were up a healthy 5.8%, rebounding for a 4.5% decline in 4Q16 and outpacing 4.1% growth in imports. Residential fixed investment grew nearly 14% as the housing economy roars ahead.

We continue to model GDP growth in the 2.5% range for the remaining quarters of 2017. Given the weak 1Q reading, full-year growth will likely lag 2% once again, as it has for over a decade. In coming quarters, we look for a rebound in consumer spending. With oil coming down, imports should remain subdued and potentially grow less than exports. We are modeling government spending to be in the 1% range at the state, local and federal level, although timing of defense spending is a wild card.

For 2018, we continue to forecast GDP in the 2%-3% range, with plans to provide further refinement to our estimate as 2017 progresses. Our assumption is that President Trump's fiscal stimulus programs on taxes and infrastructure spending will have a bigger impact next year.

After an extended drift downward in rates across most of 2017, rates finally resumed their upward climb in mid-April. At the low end of the yield spectrum, rates are all higher

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than they were a month ago and a week ago. The three-month yield now stands at 0.77%, compared with 0.66% last month and 0.25% last year. Two-year Treasury yields are also higher than last month. While higher than they were last week, the 5, 10- and 30-year yields remain lower they were a month ago, before yields hit bottom on 4/18/17.

The net impact of these modest movements is not much change in the yield curve, which remains a bit flatter than we would like to see. Any time the yield curve shows signs of flattening out, economists worry about recession. Although recession is not a major concern, the exhaustion in consumer spending we saw in 1Q17 certainly bears monitoring, particularly if it recurs in 2Q17.

We continue to see limited risk of recession, given strong underlying fundamentals in the economy. These include relatively full employment, with the recent 4.5% unemployment rate; rising wages, which are increasing consumer buying power; strong housing fundamentals, which we will discuss momentarily; and positive signs from the industrial economy and from overseas. Our bigger current fear is inflation, but there too the economic signals have not been too worrisome.

The first quarter earnings season has delivered as promised, and then some. Going into 1Q17 EPS season, which got underway in the second week of January, Argus Chief Investment Strategist Peter Canelo called for 12%-13% EPS growth, better than the 9% consensus call. The reality has been better than even our aggressive forecast. With more than three-quarters of companies reporting, EPS growth has exceeded 15%. The last time EPS grew in double digits was in mid-2014. And the last quarter in which EPS grew more than 15% was 3Q11. Recall that in 2011, the S&P 500 was coming off the recovery year of 2010, when earnings rose 48%; and the government's stimulative mechanisms, such as "cash for clunkers" and first-time homebuyers credit, were still in place.

We forecast a continuation of the double-digit growth trend for the remaining three quarters of 2017. EPS growth could moderate slightly in the second half of 2017 but should remain well above the preceding three-year trend of flat to slightly up or down earnings.

While the bias in EPS is likely higher, for now our forecast for full-year 2017 S&P 500 earnings from continuing operations is $134, which would be up 12.6% for the year. We look for high-single-digit growth in 2018, with first half 2018 quarterly EPS growth in the 7%-8% range giving way to second-half quarterly EPS growth in the 6%-7% range. . Looking that far out, there are a range of possibilities in 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.

DOMESTIC AND GLOBAL MARKETS

After a largely flat March, stocks moved ahead in April. On a capital appreciation basis, our composite of domestic stock indexes is up 6.9% for the year, after being up 4.6% year-to-date as of the end of March and 4.5% year-to-date as of February-end.

As usual, there were some interesting and in some cases counter-intuitive movements. For example, the Lehman aggregate bond index rose, which is associated with declining yields. Yet traditionally more-defensive areas, such as value stocks, barely budged.

Instead nearly all the stock appreciation was in growth and risk-on areas. The Nasdaq, up about 14%, pulled further ahead. Growth stocks up about 12%, widened their outperformance relative to blue chip indexes while leaving Wilshire Value (up 3%) in the dust. The S&P 500 and the DJIA moved up but, in the 7%-8% range year-to-date, are well below Nasdaq and large-cap growth.

Another counter-intuitive trend, given the rally in Nasdaq, is the deep lag by Russell 2000. Investors remain under invested in small cap. While Russell 2000 did move up last month, it has almost no chance of catching up with Nasdaq, which is over 1,000 basis points ahead year-to-date.

Consistent with the pattern of recent years, we are seeing greater dispersion among the sectors in terms of relative performance. Within the S&P 500, which is up in the 7%-8% range for 2017, a handful of sectors are up in double digits, while two sectors are down in high single digits. In this kind of environment, we recommend trading within existing positions over whole-position trades; this includes selling strength and buying weakness among high-quality and trusted names in your portfolio.

Technology is up 17% in 2017, as investors continue to play acceleration in the digital economy. Health care and consumer discretionary are also up in low double digits.

In the second tier of sectors that are beating or matching the market are materials, industrials, staples, and utilities. Financials are up in low single digits. At the other end of the spectrum, Telecom and Energy are down in high single digits.

Energy continues to get hammered, particularly with crude oil prices last month slipping from the low $50s to the upper $40s. Ironically, energy delivered the strongest sector earnings during 1Q17 season. The decline in telecom reflects the relentless price wars in data, which have impacted Verizon and AT&T — which together comprise the bulk of sector weight.

The stock year 2016 also featured frequent leadership shifts. Although 2017 leadership to date remains with economically sensitive sectors, we learned last year how quickly sector leadership can change.

April showed a continuation of the predominant theme whereby information technology continues to gain relative sector weight at the expense of pretty much every other sector. During April, the Information technology sector grew to 22.5% of S&P 500 market weight, up 40 basis points in the past month – and that is after a month in which technology added 60 basis points from February to March. Technology is now so far above its historical market weight bands of 15%-20% that a new set of bands in the 17%-25% range is likely appropriate. As the digital economy permeates every aspect of the consumer and business economies, technology could come to represent as much as one-quarter of S&P 500 sector weight in a few years.

Consumer discretionary increased 20 basis points in April to 12.5% market weight after rising by a like amount in March to 12.3%. Once again, it was the technology-sensitive companies in this sector, including Amazon and Tesla, that are rallying along with other digital age names. Retailers, media and housing have also shown strength within this diverse sector, and that is helping overcome the poor showing by traditional retail stocks.

Financial services stabilized in April after a rough March; the stability likely reflects the fact that interest rates may have found a floor. Financial services is still well ahead of where it was a year ago. Healthcare, at a 13.9% weighting, is still well down from 14.7% a year ago and peak readings above 15%; but at least it has staunched the bleeding.

We continue to see good values in both healthcare and financial services, and also in parts of technology despite its strong run. At a time when market pundits are calling stocks overvalued, we would look for bargains in two beaten-down areas with many high-quality names available at depressed prices.

Similar to what happened with U.S. stocks, stock performance worldwide moved, higher in April after little change in March. While the U.S. may seem to be in the midst of a nice leg higher, in fact the S&P 500 lags the DJ World index by more than a percentage point year-to-date.

On a theme basis worldwide, BRIC are up over 7%, but that's where they were a month ago. Russia continues to drag on this group.

Other themes have moved ahead, meanwhile. The average for the four Americas bourses in our table is a gain of 7.5%. Mature nations collectively are up 7.5% year-to-date, making a quick 250 basis points move on the anticipated Macron victory in France. UK is a laggard as the reality of Brexit sinks in.

Consistent with weakness in energy worldwide, our basket of natural resources nations – which includes Canada, Russia and Brazil – is up 1.6%, after being up 2% at the end of March. Should investors regain their enthusiasm for energy, we would expect leadership to shift back toward the resource economies. Given the current direction in oil prices, however, we see more weakness ahead.

CONCLUSION

The asset markets are finally beginning to de-couple from events inside the beltway in Washington. That usually happens a few months after a presidential election. Assets have been yoked to Washington a bit longer this time, given the substantive change promised by the president. We saw what may be a final echo of this linkage last month, as stocks rallied and bond yields climbed following the successful repeal-and-replace vote in the House of Representatives.

Going forward, stocks are going to have to succeed on their own merits. The earnings season, which was a nice April driver, is winding down and will be immaterial by mid-May. The absence of unambiguously good earnings news may contribute to the challenges the market typically faces as May gives way to June. While we would be mindful of "Sell in May," axioms do replace an investment strategy. We would remain long this market, which appears to have a few more legs to go.

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