ARGUS®

WEEKLY ECONOMIC COMMENTARY

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Strong Quarter Despite June Stutter-Step: Our Monthly Survey of the Economy, Interest Rates, and Markets

During the first half of 2017, the S&P 500 appreciated 8.2%, while the DJIA rose 8.0%. Including dividends, both indices delivered 9.4% total return for the first half of 2017. For all of the second quarter, the S&P 500 index appreciated 2.6%, which was a comedown after 5.5% appreciation in the first quarter. That was slightly better, however, than average second-quarter appreciation (since 1980) of 2.42% on the S&P 500.

The indices have plenty of time to build on their gains — but first they need to make it intact through the summer months. The third quarter is pretty much a dead-money time, with an average capital decline of 0.12% since 1980; the total return including dividends is less than 1%. The fourth quarter brings it home strong, however, with capital appreciation of 4.55% on average between 1980 and 2016.

Second-quarter S&P 500 earnings are on path for low double-digit growth in the coming weeks. Still, a lot can happen between now and year-end to disrupt what has been, overall, a good stock market performance in the year to date.

THE ECONOMY, INTEREST RATES, AND EARNINGS

Despite a positive backdrop in terms of earnings growth, consumer spending, and low unemployment, the final 1Q17 GDP report reflected 1.4% growth. Persistently weak GDP growth underscores the challenge of driving sustainable 3% GDP growth in an economy undergoing significant digital disruption and experiencing drags from low productivity growth and aging baby boomers.

Despite two upward revisions, 1Q GDP growth was down from 2.1% in 4Q16. The most-significant upgrade was to real personal consumption expenditures. PCE rose 1.1% in the final report, not the 0.6% in the preliminary report or the 0.3% in the advance report. But that is still down from full-year 2016 average PCE growth of 2.7%. Durable goods continue to drag, while services growth was okay.

Non-residential fixed investment, seen as a proxy for capital spending, was up 10.4% in 1Q17 – good, but down from the preliminary reading. Along with growth in structures, this measure was driven by growth of 7.8% in spending on equipment and 6.4% in spending on intellectual property products. Exports were up 7% in 1Q17, while imports increased a lesser 4%, meaning trade was net contributive to GDP growth.

We should get at least a modest rebound quarter in 2Q17, but the trend has been weakening. The Federal Reserve of Atlanta's GDPNow forecast has dipped to 2.7%, sliding in increments from 4.0% as recently as June 1. The New York Fed's forecast is a gloomy 1.9% for 2Q17 GDP.

We continue to model full-year 2017 GDP growth in the 2.0% to 2.5% range. With oil coming down, imports should remain subdued and potentially grow less than exports. The industrial economy is showing positive signs, but will need to sustain growth. Consumers may resume new-vehicle spending with the new model year, but scarce supply continues to impact the housing economy; automobiles and housing are vital to overall consumer spending.

For 2018, we reiterate our GDP forecast in a broad 2%-3% range, though we are currently shaded toward the low end of that range at about 2.25%. Where the final number falls is (at least partly) dependent on the president's ability to drive fiscal stimulus from tax reform and infrastructure spending next year.

The major trend change in 2017 to date has been dollar weakness; the dollar is down about 6% year to date against major trading partner currencies. The weak dollar is hurting commodity prices, which risks understating industrial

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economy activity. The good news is the euro would not be strengthening unless industrial activity were picking up in Europe.

That may partly explain the rebound in Treasury yields. For most of the year, the yield on the 10-year and longer-dated bonds have drifted down, hitting a closing low of 2.15% in mid-June after reaching 2.6% in March. But the long yield has come back, reaching 2.31% as of June 30.

Two-year and five-year Treasury yields have each gained about 10 basis points in the past month. The two-year yield is at 1.38%, while the five-year is at 1.89%. As long-term rates have moved higher in the past two weeks, rates at the short end have also edged higher. The three-month bill is now at 1.03%, compared to 0.96% one month ago. St. Louis Fed President James Bullard in a recent speech suggested that the Fed might not need to act again this year unless economic activity picks up. Even so, the Street continues to anticipate at least one more rate hike by the end of 2017.

Given stronger movements at the upper end of the rate spectrum compared with the lower end, the yield curve no longer appears to be losing its slope. This is encouraging economists, who associate yield-curve flattening with heightened recession risk. We also see limited risk of recession, given strong underlying fundamentals in the economy. These include full employment, rising wages, cheap gas, and positive signs from the industrial economy and from overseas.

Following a successful first-quarter earnings season, we are largely keeping our EPS estimates for 2017 and 2018 intact. First-quarter 2017 EPS grew 14%, slightly ahead of our 13% forecast and well ahead of Street expectations in the 9%-10% range.

Argus continues to forecast EPS growth of 13% for 2Q17. Earnings leaders in 1Q17 were mainly economically sensitive groups such as Industrials, Technology, and Consumer Discretionary. We also saw good growth in "wealth in the ground" sectors such as Materials and Energy. We expect these sectors to continue to lead in 2Q17.

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

We are reiterating our forecast for full-year 2017 S&P 500 earnings from continuing operations of $134, which would be up 12.6% for the year. There is a range of possibilities in our 2018 EPS outlook. For now, we continue to model 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.

Potential roadblocks to EPS growth include the potential for worsening inflation; higher interest rates as the Fed seeks to cap pricing pressures; and a further rise in geopolitical tensions. There are also potential positives that might impact 2017 and more meaningfully 2018 earnings, including possible tax cuts, infrastructure investments, or other stimulative fiscal policy measures.

DOMESTIC AND GLOBAL MARKETS

As of mid-year, the two blue-chip indices — the S&P 500 and the Dow Jones Industrial Average — were exactly equal with total return of 9.4%. Although the S&P 500 edged higher by about a half-point in June, indices with more of a growth bias backed down in the month. The Nasdaq and Wilshire Large-Cap growth indices both declined over a point and a half. Value stocks, meanwhile, gained from sector rotation; Financial and Healthcare stocks are well represented in value indices, supporting 100 bps growth in Wilshire Large-Cap Value.

The Lehman bond index lost ground as yields recovered into month-end. The Fed's determination to raise rates in June despite less-than-stellar consumer-economy data is sending a message to bond investors. Do not doubt the Fed's resolve to get out in front of inflation, regardless of the latest economic data points.

The S&P 500 advanced about 2.6% in 2Q17, slightly better than average 2Q capital appreciation of 2.4% on the index since 1980. In the final month of the quarter, however, there were some significant leadership changes that led to sharp revision in S&P Market Sector Distribution.

First up was the Technology sector train wreck, which drove down Technology's weighting in the index. From an all-time high of 23.2% at the end of May, Technology shed 90 bps and finished the quarter with a 22.3% weighting. That is still well above the historical band-top of 20%, a number we are unlikely to see again. We believe Technology investors were realizing profits, and we see no sign of a fundamental breakdown in demand for products.

The biggest gainer in the month was Financial Services, thanks to two distinct events. At mid-month, the Fed went ahead with its fourth rate hike of the cycle and its third within the preceding seven months. Then, near month-end, all the major banks passed their stress tests, which permitted them to increase their dividends.

Healthcare was another sector that rallied in June following details of the Senate's Obamacare replacement plan. Although the plan included significant reductions in Medicaid, the Senate kicked the can down the road on those cuts to as late as 2025. The Senate plan would also fund Obamacare exchange subsidies through 2019.

On a full-year basis, one notable pattern has been the widening gulf between the Consumer sectors. A year ago, Consumer Discretionary was about 200 basis points bigger than Consumer Staples. Now, with Discretionary expanding while Staples is contracting, the gulf has widened to 330 bps.

Reflecting the sector weighting changes we discussed earlier, the leadership shifts in June partly impacted full-year performance without knocking the leader off his horse. Technology remains the leading sector through mid-year, but shed about 400 basis points from year-to-date total return during June. Another economically sensitive sector that lost ground in June was Consumer Discretionary

The big gainers, as noted, were Healthcare and Financial Services. Industrials, Materials and Energy all edged higher. Gains in these commodity sectors were curious, given the weak dollar that negatively impacted commodity prices and the nearly 20% drop in oil prices as supply showed signs of outstripping demand. The biggest year-to-date performance swing is in Telecommunications, which was up 26% a year ago at this time and is currently down 11% year to date in 2017.

Although 2017 leadership to date remains with economically sensitive sectors, we learned last year how quickly sector leadership can change. In this environment (in which there is wide dispersion of returns and frequent leadership changes), we recommend trading within existing positions as opposed to making whole-position trades. This includes selling strength and buying weakness among high-quality and trusted names in a portfolio.

Compared to one month ago, our aggregate of international stock markets declined by about 70 bps in June. China reinforced its market leadership and was up 26% as of mid-year.

Our basket of resource-sensitive stock markets continues to struggle, weighed down by Russia's worsening decline. Our commodity basket was down 3% at mid-year after being down 2% year to date at the end of May. The BRIC basket was stable, as Russia's worsening stock-market performance was offset by accelerating strength in China.

Our Americas composite also held steady month over month, with a 6% gain. Mature economy markets lost 400 bps of year-to-date appreciation in June, as the reality of imminent Brexit slammed UK and Eurozone stocks. Stock-price momentum continues to shift to growth economies, including several too immature to be featured in our composite.

CONCLUSION

Based on average full-year returns on the S&P 500 since 1980, the market in 2017 has almost achieved its full-year objective. What should be a positive EPS season lies immediately ahead. A strong EPS season might provide the market with enough tailwind to tack on a few percentage points more gain.

After 2Q EPS season, the stock market slips into summer slumber. Fall is typically the time of the market's best performance. But that pattern could be disrupted if the consumer and industrial economy data fails to recover from early-summer softness. Another big risk would be frustration in Washington if the president's agenda remains stalled. In that case, we could see the bullish mood turn sour, prompting investors to take winnings off the table.

We continue to believe the earnings environment is positive and that the global economy remains healthy enough to support solid economic growth. We would continue to use any periods of uncertainty and retrenchment (such as in June) to establish or add to positions in blue-chip leaders.

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