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WEEKLY ECONOMIC COMMENTARY

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More of the Same after Eventful August: Our Monthly Survey of the Economy, Interest Rates and Markets

During August, the stock market was little changed. Beneath seemingly placid waters, momentous events were occurring. The nation was first transfixed by the events in Charlottesville, collectively thrilled by the total eclipse, and then heart-broken by the disastrous flooding in the Houston area.

Simultaneously, global geopolitical tensions ratcheted higher as North Korea went further and further into rogue nation status. September, meanwhile, lurks as the worst market month, as measured (as we do) since 1980 or even if looking back more than 100 years.

We may see more tumult in September, particularly as Washington works to raise the debt ceiling, pass spending bills, approve a fiscal 2018 budget, and possibly address tax reform. Despite all that transpired in an historically lousy stock market, August squeezed out a win just as the month was coming to a close. Before assuming September is going to be a downer, let's see how the market plays out across the month.

THE ECONOMY, INTEREST RATES, AND EARNINGS

Investors cheered the revision of 2Q17 GDP to 3.0% in the preliminary report, from 2.6% in the advance report. Amid mixed signals from Washington and worsening geopolitical conflict particularly with North Korea, the report reminded investors of the underlying health of the broad domestic economy. Part of second-quarter strength was a rebound from a downwardly revised 1.2% for 1Q17; and Hurricane Harvey represents new challenges ahead. Still, getting GDP growth in the 3% neighborhood is essential to sustaining earnings growth, which we regard as the key determinant of stock market valuation and appreciation.

The 2Q17 GDP report had something for everyone to like, featuring growth in nearly every category. The headline event was the recovery in personal consumption expenditures, which rose 3.3% in the quarter after growing 1.9% in 1Q17. This included 8.9% growth in durable goods spending; that category declined fractionally in 1Q17 mainly on the sudden slowdown in new vehicle spending. Non-durable spending also perked up.

Non-residential fixed investment grew 6.9%, and within this measure – seen as a proxy for capital spending – spending on equipment rose 8.8%. That is a positive sign that companies are investing in operations. With the housing market cooling, residential spending declined 6.5%, after growing 11% in 1Q17; we do not see this reversal as indicative of a major trend change.

Exports were up a healthy 3.7%, more than double the 1.6% gain in imports; trade was thus contributive to GDP growth. Private inventory investment was positive, though this can detract from future quarters. Government spending slipped to a fractional negative in the preliminary report from a fractional positive in the advance report. Federal spending was positive, led by defense, while states and localities were a net negative to GDP.

Hurricane Harvey, potentially the most expensive storm that ever slammed the U.S., will have a mixed impact on overall growth this year. As shown by storms such as Sandy and Katrina, the post-storm phase will reflect the absence of Houston's commerce, particularly nationally vital areas such as refining and port operation, and a broad enough impact on local consumer spending that it will be felt at the national level. In the recovery phase, however, rebuilding a city the size of regional Houston will jazz multiple industries – particularly residential and commercial construction – for years. That also will be felt in national GDP.

At least until we can better assess the impact of Harvey on second-half GDP, we continue to model full-year 2017 GDP growth of 2.0%-2.5%. Year-to-date weakness in the

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dollar should keep the export trend favorable going forward. With oil coming down in price, based on the latest Harvey impacts, imports should remain subdued and potentially grow less than exports.

The industrial economy is showing positive signs, but will need to sustain growth. Harvey will provide a lift to new vehicle spending in the Southwest; otherwise, consumers do not appear overly excited about the new model year. Scarce supply continues to impact the housing economy. We have reiterated that 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 President Trump's ability to drive fiscal stimulus from tax reform and infrastructure spending next year.

The rebound in Treasury prices has been a steady feature in the year, reflecting a variety of contributors. Weak dollar is part of the picture. The failure to enact meaningful fiscal stimulus means that deficits are little changed, which in turn means that Treasury bond issuance is flattish. Amid worsening global tensions with North Korea, Treasury demand is strong from safe-haven investors.

The rise in bond prices and decline in bond yields had excluded one area, and that was very short-term money. Yields on the three-month Treasury bill, which is impacted by Fed Policy intensions, had continued to rise all year even as yields fell elsewhere along the curve. But for the first time, that trend has reversed, in a move that may signal what the market thinks is coming from the Fed.

The 10-year Treasury yield has moved out to the 2.15% level from 2.32% level a month ago and is 60 basis points or so below the 2.6% peak reached in March. Two-year yields continued down in the past month, although five-year yields actually edged higher.

The 30-month yield slipped to 0.96% at the beginning of September, from 1.11% at the beginning of August. This means that investor confidence in another rate hike has deteriorated meaningfully over the past month. Some of the drivers of this change in mind set are obvious. August nonfarm payrolls were the weakest in six months. And the consumer price index came in below expectations. Other factors may be more difficult to quantify. With thousands of Houston-area consumers needing to finance home construction and/or buy or lease a new car, is this really the best time to be raising rates?

We were disappointed that Fed Chair Yellen did not use the Jackson Hole meeting to sketch its timetable for "quantitative tightening," as it begins the task of unwinding its massive balance sheet. In our view, the reality of quantitative tightening could send yields higher once more as investor contemplate a potential massive rise in bond supply. If the Fed really is "done" for 2017, the absence of further rate hikes and modest early unwinding would likely about balance out, resulting in relatively stable rates.

S&P 500 earnings on a continuing operations basis grew a healthy 11% in 2Q17, building on strong 14% growth for 1Q17. Excluding Energy, which grew EPS by more than 250% year over year, total 2Q17 earnings would have been up 8.8%.

Beyond Energy, the best-earning sectors in 2Q17 included Information Technology, up 19%; and Materials, up about 10%. Notable individual industry winners during 2Q17 EPS season included Software, up 16%, and Semiconductors, up 44%, both within Technology; Oil, Gas, and Consumable Fuels, up 221%; and Professional Services and Transportation, both within Industrial and both up in mid-teen percentages.

About 72% of companies surprised to the upside in 2Q17, slightly better than the long-term average in the 70% range. Notably, the aggregate upside surprise was 4.7%, which is better than average. Sales trends were also a positive in 2Q17, with revenue increasing by about 5%. Even backing out the contribution from Energy, where revenue increased a sharp 15%, total S&P 500 sales growth ex-energy for 2Q17 was a healthy 4%.

The second quarter included no real currency benefit. That is about to change quickly for 3Q17 and the next few quarters after that, based on significant weakening in the dollar year-to-date. Corporate earnings should see a meaningful dollar-related tailwind beginning in 3Q17, strengthening in 4Q17, and carrying into 2018.

Despite the currency tailwind, we are not hiking our full-year estimates because of other puts and takes in various sectors. For now 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. We also 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. Infrastructure spending and tax reform are dead letters for 2017, but could positively impact 2018 earnings.

DOMESTIC AND GLOBAL MARKETS

Stocks on the S&P 500 finished August with a last-gasp win, forestalling a down performance in what is traditionally the market's second-worst month. September, unfortunately, is the market's worst month; but that is a problem for another day. During August, amid a barely budged S&P 500 – up 0.1% - we saw some of the early-year themes continuing to play out in other indexes.

The DJIA outperformed the S&P 500 and is now ahead of its slightly less blue chip cousin year-to-date. Leadership remains with Nasdaq and growth, both of which built on their early year advantage and both of which are now at or approaching 20% total return.

Small-cap (Russell 2000) and value continue to struggle, with both delivering total return that is less than half the broad market average year-to-date. The Lehman U.S. aggregate bond index has now pushed up to 3.3% total return, rewarding those investors who doubted that rates were about to race higher. However, the bond index was up nearly 5% at this time a year earlier.

As the rich get richer among S&P sectors, the poor get poorer. The two sectors that are being left behind, Energy and Telecom Services, saw their underperformance worsen in the past month. Energy, which drew no benefit from delivering the best sector growth in 2Q17, struggled in August amid the Harvey induced disconnect between crude (declining) and refined products (rising).

While those sectors are down in double-digits year-to-date, every other sector except Financial Services and Consumer Staples are beating the market. So far this year, and with stocks little changed during August, the odd "barbell" leadership continues to prevail. On one side of this very uneven barbell are economy-sensitive sectors, including Technology, Materials, Consumer Discretionary and Industrials. On the other side are pure defensives such as Utilities and quasi-defensives such as Healthcare.

Although 2017 leadership to date remains primarily 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 your portfolio.

We have performed our normal quarterly rebalancing of our recommended sector weightings. For the fourth quarter of 2017 we have made the following changes. We have raised Financial Services to overweight from market weight. We believe the direction of market interest rates is upward. In our view the great unwinding of the Fed's balance sheet will act as a kind of quantitative tightening, even amid a slower pace of actual Fed rate hikes.

Simultaneously, we have reduced Consumer Discretionary to recommended market weight from recommended overweight. On top of the well-documented pressures on traditional retailers in this sector, insufficient home supply is creating a logjam in the housing sector, while the new model year has failed to trigger new vehicle buying. While demand for big ticket consumer goods falters, we expect consumer discretionary investors to focus in the leisure markets that we are highlighting.

We have also increased our recommended weighting on Telecom Services to market weight from underweight. In our view, the worst of the unlimited plan price wars has now rippled through the industry. At the same time, all carriers will likely benefit from the upcoming holiday season phone releases, led by Apple iPhone 8 and Samsung Galaxy Note 9.

Finally, we have lowered our rating on Consumer Staples to underweight from market weight. Investors are voting with their feet in this sector, recently reducing sector weighting to a multi-year low of 8.5%, below the low end of the historical 9%-13% band. Consumers who accepted generics when money was tighter are simply not returning to the brand names they grew up with.

Our recommended sector weightings are as follows:

* Over-Weight: Healthcare, Technology, Financial Services, and Materials.

* Market-Weight: Consumer Discretionary, Energy, Industrials, and Telecom Services.

* Under-Weight: REITs, Consumer Staples, and Utilities.

Compared to one month ago, our aggregate of international stock markets appreciated by over 300 bps in August – after doing the same in July. We continue to see a fairly wide dispersion of returns among our market themes during the month. China reinforced its market leadership in July, and is now up over 40% year to date. That helped the BRIC basket lead among market themes with a 20% year to date gain, despite ongoing bifurcation between commodity consumers (China and India) and commodity producers (Russia and Brazil).

Our basket of resource-sensitive stock markets is now in the best trend, but has far to go to overcome first-half weakness. Resource-sensitive stock markets were down 3% at mid-year and about break-even at the end of July; now the basket is up 6%.

Our Americas composite moved up 300 bps month over month and now holds an annual 12% gain, vs. 6% at mid-year. Mature economy markets barely budged in August after modest recovery in July. Stock-price momentum continues to shift to growth economies, including several too immature to be featured in our composite.

CONCLUSION

September is a challenging market month, no matter how long or how short the measurement period. September has averaged a 1.1% decline on the DJIA since that index's inception in the 1890s. On the S&P 500, September has been down an average 0.77% since 1980, and down 1.52% since the millennial turn in 2000.

But there is one group of Septembers that beats the odds. Beginning in 1980 on the S&P 500, we looked at year to date performance through August. We selected only those years in which the S&P 500 was up a least 10% by the end of August. We then looked at next-month performance for those years, and found that September averaged a gain of 0.4% for those years.

Even if investors use September as an excuse to rebalance or otherwise rejigger portfolios, we are still positive into year end. Remember that September is followed by the best three-month stretch of the year, namely October through December. Based on the economic fundamentals sketched above, we believe investors would do well to remain invested into year-end.

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