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WEEKLY ECONOMIC COMMENTARY

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# Economy Holding Up Among Domestic & Global Challenges

As Florida residents coped with Irma-induced power outages and those in South Texas continued the messy cleanup from Harvey, we were reminded of a man-made disaster that struck in the Northeast – but really was felt all across the nation. On the 16th anniversary of 9/11, the city of New York observed several moments of silence; and relatives read the roll call of those lost in the terror attacks.

Market events pale in comparison to these disasters, both natural and unnatural. For the average citizen, sometimes the only way to fight back is to carry on. Investors have kept their eyes on economic and earnings fundamentals as the market navigates the traditionally challenging late-summer period.

**THE EXPANSION & BULL MARKET: OLD, OR WELL-AGED?**

With economic recovery (begun in June 2000) and the bull market (begun in March 2009) both within shouting distance of their decade marks, stock investors are on heightened alert for signs of erosion in the former and valuation imbalances in the latter. As for valuation, the S&P 500 has roughly flattened out below 2,500 over the past two months, range-trading in the 2,425-2,475 band. Stocks have stayed between 2% above to flat with fair value, based on our Fisher inflation-adjusted value.

Since 1960, no bull market has peaked before rising 8%-17% above fair value – and that is excluding the extreme value excesses preceding the 2000-2002 bear market. Assuming five-year centered earnings, interest rates and inflation remain roughly at current levels, and based on the historical trend since 1960, this bull could begin to top out somewhere around 2,650 to as much as 2,865 on the S&P 500. Reaching new heights is not a given, and we think the S&P 500 can find support, if needed, in the 2,400 range.

As suggested above, the underpinnings of a long-running bull market become increasingly important as valuations begin to stray toward and even above fair value. Earnings, which grew in low double-digits in the first half, must keep moving forward. Interest rates cannot stray too far in either direction, and inflation needs to remain in its cage.

For all these inputs to perform as needed, the economy must remain in a growth trajectory. Since World War II, nine prior expansions have averaged 63 months in duration; the current expansion is already over 98 months old. For this expansion to show off, rather than showing its age, the monthly data must remain vital.

**THE ECONOMY CHUGS ALONG**

September began with somewhat disconcerting news on the labor front. Nonfarm payrolls rose 156,000 in August, well below the three-month trend of 185,000 but in line with the Argus economics forecast of 150,000. Payroll growth in July and June was also revised moderately downward. While hiring as usual was led by professional services and health care, the core industrial economy grew as mining, construction and manufacturing were all higher. The U3 unemployment rate ticked higher, to 4.4% from 4.3% The more comprehensive U6 unemployment rate was steady at 8.6%, down sharply from 9.9% a year ago and not far from 10-year lows. Average hourly wages rose were up 2.5% over the past year.

August appears to be the seasonally trickiest month to forecast; Bloomberg reports that the consensus overestimated August jobs growth for a seventh consecutive year. August payrolls also tend to be revised higher. At this stage of the economic cycle, we expect to see more readings in the 150k-175k range than in the 200k+ range

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The ISM manufacturing data for August suggests that job gain in core industrial areas are no anomaly. The Institute for Supply Management reported that its PMI (purchasing managers) manufacturing index for August expanded at the fastest pace in six years. The group's gauge of factory employment reached its highest level since June 2011 (for diffusion indexes, readings above 50 signal expansion, while readings below 50 signal contraction).

The manufacturing employment diffusion index surged to 73.1, the highest since November 1997. A similar manufacturing gauge in Europe is also showing faster growth in traditional factory jobs. The ISM's non-manufacturing survey was similarly positive, though its reading of 53.9 missed the consensus forecast of 57.0. Even so, 15 of 17 non-manufacturing industries surveyed reported growth in August.

Consumers appear to have been buoyed by rising factory employment and job prospects. The University of Michigan's consumer sentiment index rose to 96.8 in August from 93.4 in July. While that number too missed consensus, consumer sentiment reached a three-month high, as consumers remained calm amid North Korea's sabre rattling and the controversial march in Charlottesville. U Michigan consumer sentiment has been higher during the first eight months of 2017 than in any year since 2000, according to the report's authors.

U.S. factory orders in August posted their biggest drop in three years, after posting strong growth in July. Backing out the volatile transportation sector, factory orders rose 0.5%. Orders for non-defense capital spending excluding aircraft, regarded as an indicator of business spending plans, slipped 0.1% month over month; but that came after an upwardly revised gain of 1.0% in July.

Earlier, investors digested the revision in 2Q17 GDP growth to 3.0%, from an advance reading of 2.7%. Economists broadly believed that generating sustainable 3.0% GDP growth in the U.S. economy will be highly challenging given two current realities: the demographics of an aging and increasingly conservative baby boomer cohort; and subpar productivity, which is being hampered by demographics and shifts in the composition of the work force. On that basis, second-quarter productivity growth of 1.5% was certainly encouraging. Within the productivity aggregate, unit labor costs edged up 0.2% and employee hours rose 2.5%. But output rose 4.0%.

**CONCLUSION**

Summer economic data discussed above did not include any impact from Hurricanes Harvey and Irma. Those storms will certainly impact conditions going forward. As shown by storms such as Sandy and Katrina, the post-storm phase will reflect the absence of regional commerce. That will be particularly true of vital areas such as refining and port operation in the Houston area and among Gulf rigs and refineries. The national economy will also feel ripples from sudden cessation of activity in South Texas and Florida.

Already, Houston is rebuilding; and Florida, which was spared potentially much worse impacts, will soon follow. Rebuilding a city the size of regional Houston will require an army of electricians, masons, plumbers, carpenters, drywallers and laborers, along with countless railcars and truckloads of materials. Hundreds of thousands of vehicles will need to be replaced.

The two consumer segments that experienced a summer pause – housing and automotive – are about to get a storm-driven jolt. Whether surging regional demand will be enough to compensate for moderating demand elsewhere is the big question for Autumn 2017.

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