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WEEKLY ECONOMIC COMMENTARY

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Onward Into 4Q: Our Monthly Survey of the Economy, Interest Rates and Markets

Stocks had a very good August to cap a very good summer. For a second year in a row, Wall Street's oldest mantra, "Sell in May and go away," proved toothless. The calendar is providing lots of other technical reasons to like the stock market heading into the fourth quarter, traditionally the best time to be in stocks.

August and September collectively were strong, which is usually a harbinger of a better-than-average 4Q stock market. The market was up in double digits after nine months, which is consistent with full-year outperformance compared with the full-year average since 1980. The market experienced healthy rotation in September, both on a sector basis (laggard Energy outperformed) and on a size & style basis (small-caps roared while large-cap cloud stocks took a breather). And the quarterly win streak for the S&P 500 stretched to eight quarters.

Such a positive technical set-up can lead to investor enthusiasm and greed – resulting in the complacency that sometimes precedes a correction. We see the stock market's underpinnings as being fundamentally sound, however.

GDP growth topped 3% in 2Q17, and hurricane-recovery activity could juice job-creating areas such as construction. Recent data releases on construction spending and ISM manufacturing are sending positive signals on the consumer and industrial economies, respectively. Earnings are growing faster than they have since 2012. The market is not cheap, but it is not terribly stretched either.

THE ECONOMY, INTEREST RATES, AND EARNINGS

The final revision to 2Q17 GDP brought growth to 3.1%, from 3.0% in the preliminary report and 2.6% in the advance report. Some of the second-quarter strength reflected a rebound from a downwardly revised 1.2% for 1Q17. There are fresh challenges ahead to 3Q17 GDP as the U.S. mainland and Caribbean territories recover and begin to rebuild from Hurricanes Harvey and Maria. Hurricane effects aside, sustaining GDP growth in the 3% neighborhood is essential to growing earnings, which we see as key to stock market appreciation.

The slight improvement in the final number relative to the preliminary report reflected slightly better private inventory investment. Overall, the 2Q17 GDP report featured growth in most areas excluding housing, and was led by recovery in personal consumption expenditures. PCE rose 3.3% in the quarter after growing 1.9% in 1Q17. This included 7.6% growth in durable goods spending. Non-durable spending grew more than 4%. PCE represented 61.7% of core demand, above the 10-year average of 60.5% in a clear sign of consumer spending momentum.

Non-residential fixed investment grew 6.7%, 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. Amid an unseasonably weak spring housing market, residential spending declined 7.3%, after growing in double digits in the two preceding quarters. Housing data remained sub-seasonal but generally improved across the summer; we look for a modest uptick in residential investment going forward.

Exports were up 3.5% in 2Q17, more than double the 1.5% gain in imports; trade was thus contributive to GDP growth. Nonfarm private inventory investment was more contributive to 2Q17 GDP than earlier estimated, rebounding from a sharp decline in 1Q17. Government spending remained fractionally negative in the final report, pulled down by state and local.

Given the widespread devastation of the recent hurricane season, we expect some negative impacts to be felt in

(continued on next page)

3Q17 GDP. The post-storm phase will reflect the diminished output from Houston's refining and port operations, along with curtailed consumer and business activity in Florida, Puerto Rico, the Virgin Islands, and other U.S. territories. As shown by storms such as Sandy and Katrina, however, the rebuilding phase will drive tremendous activity across multiple industries – particularly residential and commercial construction – that will be reflected in national GDP for multiple quarters if not years.

We continue to model full-year 2017 GDP growth in the 2.5% range. The industrial economy is showing positive signs. Year-to-date weakness in the dollar helps industrial companies and exports, although recent oil price strength could cause a leveling out in the export-import balance. The ISM's purchasing managers' index for manufacturing companies reached its highest level since 2004 in September, with production, new orders, hiring, and new export orders all on the upswing.

Even though consumer spending growth has moderated, the U.S. consumer is in good shape. The hurricanes will provide a lift to construction activity and new vehicle spending in the South and Southwest. Construction in particular is labor-intensive rather than capital-intensive, and recovery efforts will directly benefit consumer paychecks. Construction spending in August rebounded to 0.5% monthly growth after tumbling 1.2% in July. And, as Chris will discuss in a few moments, we are looking for a strong holiday season, in what should be a reaffirmation of consumers' confidence in the economy and in their own prospects.

For 2018, we forecast GDP growth in the 2.0%-2.25% range, while modeling activity toward the low end of that range at about 2.1%. The final number is at least partly dependent on President Trump's ability to drive fiscal stimulus from tax reform and infrastructure spending in 2018. On the downside, we expect higher interest rates to negatively impact activity next year. We are also factoring in the potential end of the bull market next year, which would reduce overall economic activity even in a soft-landing scenario.

In a topsy-turvy year for Treasuries, yields have seesawed up and down. Movements in interest rates have been driven by the latest interpretation of economic indicators or the latest comments from Fed officials. With the year-end moving into sight, Fed hawks appear to have won the day; the FOMC appears likely to hike in December regardless of any wobbles in near-term data; and as a result, interest rates are again on the rise.

Economists and pundits have forecast the great unwinding in the bond market times past counting, so investors would do well to remain skeptical. Recent comments from New York Fed President Bill Dudley, seen as a covert spokesperson for Chair Yellen's policy, pointed to the high likelihood of a final rate hike in 2017 and perhaps more to come in 2018. In a recent speech, Dudley stated that "temporary, idiosyncratic" factors that had restrained inflation were now fading. He also said that the weak dollar and strengthening growth in overseas economies should support slightly-stronger-than-trend U.S. economic growth. Resultant higher wage growth raises the risks for inflation, which it is the Fed's job to counter.

Thus, after a period in which rates (particularly at the low end) worked down from summer peaks, September has seen rates reverse and move higher once again. The three-month bill yield, which slipped under 1.0% in August, is now at 1.06%. While that is below the multi-year peak of 1.17% recorded in mid-July, the trend is plainly higher.

The middle maturities (the two- and five-year Treasury notes) are both up about 20 basis points just in the past month; and both are about 50 basis points higher than they were at this time one year ago. The 10-year yield strengthened across September, from 2.16% the beginning of the month to 2.33% at September's end.

By the beginning of 2018, we expect the three-month bill – a proxy for the Fed Funds rate – to be 1.35%, on its way to 1.50% by early spring. We look for the middle maturities to move up another 50 basis points, to the 2.0% range for the two-year and 2.5% for the five-year note. And we think the 10-year yield could get back above 3.0% for the first time since 2013 – a level that proved to be a "false alarm" for the 10-year yield.

Overall, we see interest rates rising and bond prices falling. But we are out of the business of predicting a great unwinding in bonds.

S&P 500 earnings on a continuing operations basis grew in low teen percentages for 2Q17, building on slightly stronger growth for 1Q17. Excluding energy, which grew EPS by more than 250% year-over-year, total 2Q17 earnings would have been up 9%.

Beyond energy, which is rebounding from the long slide into negative territory, the best-earning sectors in 2Q17 were economy-sensitive. About 72% of companies surprised to the upside in 2Q17, better than the long-term average in the 70% range.

The second quarter included no real currency benefit. That is about to change, 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.

Given some sector headwinds that could reduce the broad contribution from weak dollar, for now 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, to the $144 range. We look for the quarterly EPS to grow in the 7%-8% range in the first half of 2018. We expect that to give 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 get out in front of inflation; and a further rise in geopolitical tensions. Infrastructure spending and tax reform appear to be dead letters for 2017, but could positively impact 2018 earnings.

DOMESTIC AND GLOBAL MARKETS

During September, sector leadership shifted meaningfully away from year-to-date leaders such as information technology and healthcare, and toward out of favor areas including energy and financial services.

While the shift in sector leadership has been closely analyzed, investors appear to be paying less attention to a style shift that may be equally meaningful. During September, small-cap stocks surged, with the Russell 2000 nearly doubling its previous gain for the year to date.

The proposed tax reform floated by the Republican leadership would reduce taxes for all businesses. Large corporations with overseas exposure currently pay a blended rate that may already be below the business tax rate targeted in the GOP proposal. But smaller firms that do most business domestically would stand to see their income tax rates cut substantially, by 10 or more percentage points. The tax proposal is in its early days, and certain aspects of the plan – such as eliminating the state and local tax deduction – are being fiercely debated. But the business tax cut is generating less heat, suggesting its prospects for passage are good.

Also on the style front, value stocks rose at the expense of growth stocks in September. For the year to date, however, Wilshire large-cap growth, with a 20.1% gain, is way out in front of Wilshire large-cap value, with an 8.4% gain.

Among blue chips, the DJIA is holding about a one percentage point lead over the S&P 500. The Lehman US aggregate bond index lost ground last month and its full-year return is now more than 1,000 basis points behind our average for the major domestic equity indexes. Now on a sector basis during September, energy stocks surged as energy prices rose amid hurricane-related disruptions on the Gulf Coast. Financial services stocks also moved up as the Fed appeared to signal its intention to hike the Fed funds rate later this year.

In September compared to August, financial services and energy gained the most weight, while industrials, materials and telecom all gained slightly. Information technology, healthcare, utilities, and the two consumer sectors all shed weight.

September marked a significant shift in sector leadership; currently, we are uncertain if new leadership will persist into 4Q17. energy and telecom services, two beat-up sectors this year, got better in September – energy was up 8% and telecom up 3% - but not quite enough to move out of the full-year losers' column. Financial services also had a better-than-average September, rising about 5%, as the Fed clearly signaled that more rate hikes were coming.

With three quarters completed, information technology and healthcare are the two sectors that have appreciated 20% or more year to date. Even though internet and cloud leaders such as Facebook to Alphabet took a break in September, more mature tech names such as Cisco and Intel benefited from in-sector shifts.

Although so far in 2017, leadership 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.

Compared to one month ago, our aggregate of international stock markets appreciated by over 200 basis points in September – less that the U.S. market, but solid nonetheless. Our international basket is up about 700 basis points in the past three months.

Among our market themes, the BRIC basket is the clear leader with a 22% year-to-date gain, despite weak returns in Russia.

Brazil bounced back, helping both BRIC and our basket of resource-sensitive stock markets. Resource-sensitive stock markets were down 3% at midyear, about break-even at the end of July; up 6% at August-end, and up 9% at September-end.

Our Americas composite moved up 200 basis points month-over-month and now holds an annual 13% gain, vs. 6% at midyear. Mature economy markets rose sharply in September. Even so, stock-price momentum continues to shift to growth economies, including several too immature to be featured in our composite.

CONCLUSION

Why did investors change horses in mid-stream in September? Sector leadership changes were in response to a more aggressive signal from the Fed and to the rise in energy prices. Size and style changes likely tracked details of the emerging tax reform proposal.

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We are not predicting that this sector shift will carry over into year-end 2017. But sector shifts of this sort are good for bull markets, in that they reward patient investors in out of favor areas, stimulate healthy profit-taking among former leadership sectors, and generally encourage interest in the stock market.

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Investors