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The Healthy US Economy and Markets

Concerning the Economy

The U.S. economy surged in 2Q18, with preliminary data showing +4.1% q/q SAAR GDP growth. While consumer spending was expectedly the largest contributor, some may be surprised that another component had an outsized effect: trade. A shifting trade balance contributed 1.1% to growth, compared to an expansion average of -0.3%.

So, what caused this? One possible answer relates to accounting: corporate tax reform has disincentivized U.S. multinational corporations from claiming excess business in overseas markets with lower tax rates. As a result, goods that were formerly leased to offshore affiliates are now sold directly from the U.S., boosting exports and decreasing the trade deficit, resulting in a one-time adjustment to GDP and a temporary boost to growth.

Moving forward though, expectations should be tempered:

- consumption likely has little room left to run, with most pent-up demand exhausted;
- inventory normalization should provide a boost to 3Q growth but contribute little thereafter, as inventory management systems continue to advance;
- rising mortgage rates and home prices should put pressure on housing; and
- business investment, while promising given strong corporate profits and a friendly tax code, will likely remain depressed so long as geopolitical uncertainty persists.

All in all, investors should remember that while the U.S. economy is healthy, it is not entering a new era of growth.

Concerning the Market

For starters, the reduction in the U.S. corporate tax rate from 35% to 21% is a real game changer. And the effects of the lower rate are only now just starting to be felt. This year will be the first full year of the lower tax rate, and firms are still adjusting to how much extra cash this lowered rate will produce.

Second, add in the repatriation holiday that is still underway and you have a recipe for plenty of excess cash on balance sheets. You'll have more profits hitting balance sheets just as firms are paying less in taxes on them.

Aside from these two reasons, some sleepy sectors are once again starting to get their acts together. Specifically, both energy and financial firms.

Thanks to rising rates (the 10-year Treasury), banks and other financial firms in the S&P 500 have increased their operating cash flows relative to debt levels over the past two years. Because of this, banks have finally been able to get the clearance from regulators to start raising their dividends. At the same time, after years of painful dividend cuts, rising energy prices and lower costs are benefiting energy sector firms. Like the financials, they now could start raising their payouts.

Overall, we are being patient in adding risk to client's portfolios given rising emphasis on trade negotiations, tightening employment conditions, potential for moderate inflation, threat of a government shutdown, and softening growth momentum in non-U.S. markets.