SUNPOINTE ILLUMINATIONS

Sunpointe Investments

MARCH 2018

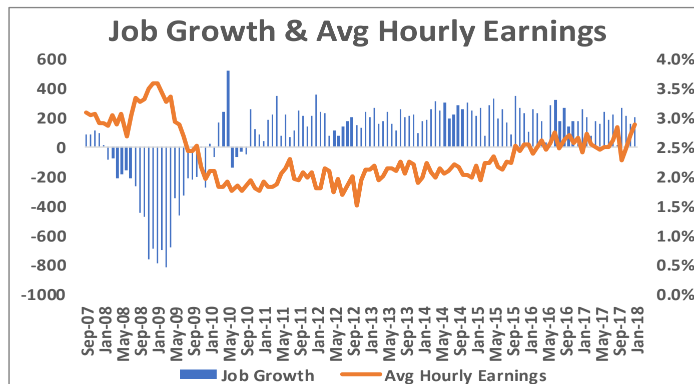
Strong employment report, but inflation/wage pressure remains elusive; retail sales/durable goods orders softened last month

The February employment report was very strong with 313K new jobs added to the economy (estimate was 200K). The previous two months were revised higher by 54K jobs and the unemployment rate held steady at 4.1% as more workers entered the labor force. The big surprise was the minimal 0.1% M/M rise in average hourly earnings which dropped the Y/Y rate back down from 2.9% to 2.6%. The labor market is looking tight and healthy although wage pressure moderated during the month and this continue to be an enigma. Inflation and wage pressure continues to be somewhat elusive and this should allow the Fed to maintain its cautious stance.

The ISM Manufacturing Index jumped to a 13-year high in February with a reading of 60.8 (up from 59.1 in January). While production and new orders fell slightly last month, they remain at strong levels and the surge in employment more than offset the weakness. Employment jumped from 54.2 to 59.7 in February, suggesting strong manufacturing hiring in the coming months. The U.S. manufacturing sector remains in solid shape, boosted by the weaker dollar, strong global economic growth and robust domestic demand resulting from recent tax/fiscal stimulus.

U.S. durable goods orders fell more than expected in January as the –3.7% headline number was worse than the –2% expectation. Orders for non-defense capital goods excluding aircraft, a closely watched proxy for business spending, dropped 0.2% after declining 0.6% in December. This marked the first back-to-back monthly declines in core capital goods since May 2016 and signals some weakness in business spending after robust growth in 2017. The soft headline number was driven by a significant decline in the volatile aircraft segment.

Retail sales fell 0.3% in January, the largest fall since February 2017. December's reading was also revised down to unchanged after initially showing a gain of 0.4%. Core retail sales were flat in January after falling 0.2% in December. Auto sales and building materials were weak in January and the overall report was negatively impacted by the widespread national flu outbreak. Certain elements of the economy appear to be on solid footing, but recent readings on durable goods orders and retail sales point to some slowing in consumer and business spending.



Source: U.S. Bureau of Labor Statistics

The Fed's preferred measure of inflation is the Personal Consumption Expenditures (PCE) Index because it accounts for substitutions in consumer goods unlike the more well know CPI Index. The PCE Index jumped 0.4% in January to an annualized rate of 1.7% while the core PCE Index rose 0.3% to an annualized rate of 1.5%. Core PCE has undershot the Fed's 2% target since 2012, but it is expected to rise this year as things like lower energy prices in 2017 roll off and as tight labor market conditions ultimately drive wage growth higher. CPI sits above the Fed's target so future readings will be crucial for determining the path and pace of Fed rate hikes.

Tax reform causes a surge in confidence; economy & earnings not the cause of recent market volatility

Tax cuts have boosted consumer confidence to a 17-year high. The Consumer Confidence Index surged from 124.3 in

January to 130.8 in February led by increases in both the present situation and expectations indices. Consumer confidence has remained robust since Trump was elected President, but it has not necessarily translated into stronger consumer spending. Spending has generally been in the 3% growth range over the past few quarters and an acceleration is unlikely given other hard economic data points that point to some weakness.
Recent market volatility has little to do with the underlying economy and corporate earnings. Economic growth continues to be solid across the board with the main concern being inflation/wage growth and how many rate hikes the Fed will implement in 2018. Corporate earnings grew 15% in Q417 and they are forecast to increase 18% in 2018 and 10% in 2019. The recent decline in the S&P 500 has brought the forward P/E multiple down to 16.7x which is above historical averages, but below the expected 2018 earnings growth rate. Strong earnings growth should provide support for market valuations.

Inflation continues to present challenges to U.K. policymakers; did the eurozone hit a speed bump?

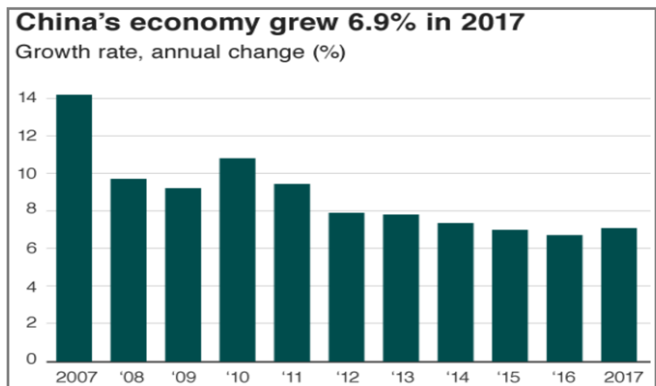
U.K. inflation remained stubbornly high in January at a 3% annual rate. This was unchanged versus December and above the 2.9% forecast. Inflation peaked at 3.1% in November 2017 and despite falling food prices, it has only declined slightly and remains above wage growth. Interest rates sit at 0.5% in the U.K. and the BoE has indicated its desire to raise rates more quickly to bring inflation back down to the 2% target. The BoE wants to raise rates more aggressively, but this may be a challenge considering mounting signs of slowing economic growth.

The eurozone economy may have hit a speed bump in February as rising prices may have impacted demand. The IHS Markit Composite PMI fell from 58.8 in January to 57.1 in February. January's reading was the best since June 2006 and a decline was likely after several months of strong activity. Growth was solid and broad based across the region and the current data suggest that Q1 GDP growth is in the 0.8-0.9% range. Inflation in the eurozone fell in February to 1.2% Y/Y from 1.3% in the previous month. Core inflation came in at 1% Y/Y and that remains well below the ECB's 2% target. Eurozone growth has improved, but inflation remains elusive and the ECB may need to keep its foot on the gas for a bit longer.

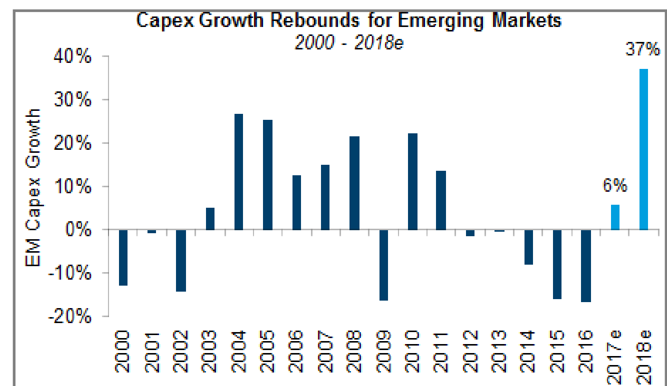
Chinese government sets a 6.5% growth target for 2018; capex growth returning to EMs

China set its 2018 growth target at 6.5% based on the annual National People's Congress session. The economy grew 6.9% in 2017 which was above the 6.5% target in place. The Chinese government expects growth to slow this year as they attempt to reduce risk in the overheated property and financial segments. Other initiatives announced include the cutting of taxes, reduction of the deficit from 3% to 2.6%, more restrained government spending and a boost to defense spending (8.1% from 7%).

After 5 years of declining capital expenditure (capex) growth for emerging markets, capex growth is forecasted to have turned positive. EMs finished 2017 with estimated capex growth of 6% and in 2018, EM corporations are expected to spend 37% more versus 2017. Infrastructure spending could be one area that boosts future capex growth. The significant increase could provide a nice tailwind for the asset class.



Source: Bloomberg



Source: Bloomberg, MSCI, Columbia Management