



Creative Global Investments

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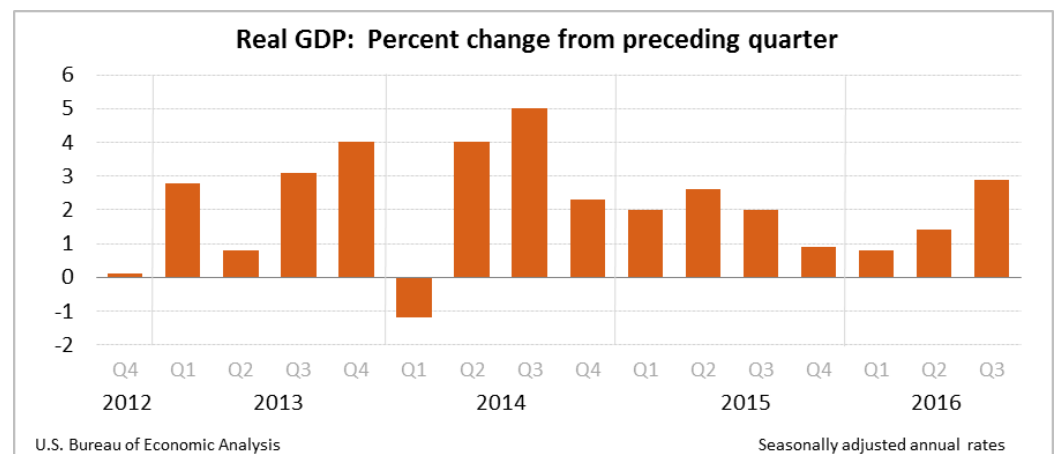
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Questionable Momentum for Third Quarter GDP Won't Matter to The Fed, but It Will for Investors

The better than expected 2.9% annualized gain in third-quarter GDP will provide all the justification that the Fed needs to raise rates in December. The voting members of the FOMC must be feeling more confident in their more positive economic outlook at their last meeting. Still we see no advantage to the Fed hiking rates in two days at the November FOMC meeting directly in front of Friday's nonfarm payroll report, next week's presidential election and the further potential complications from the OPEC meeting on November 30th and the Italian referendum on December 4th. The revised third quarter GDP will be released on November 29th.

The advance report on third quarter GDP supports our long-held view that the U.S. economy and the broader influences of the global economy don't justify a rate hike now or in December, but the Fed is caught in a trap of its own making. The Fed has no choice but to raise rates in December to maintain credibility and save face.



Many observers will place a more positive spin on this report than deserved by the data, perhaps due to the sharp acceleration from the lackluster 1.4% growth in the second quarter. However, real GDP was up just 1.5% year-over-year in Q3 compared to the 1.3% rate in the prior quarter. With real GDP growing at around 2% over the past few years, this last quarter's annualized growth rate still resembles a car stuck in first gear. In our judgment, it is too early to say with conviction that the headwinds faced by the economy have been overcome. While we're seeing early signs of stabilization in the industrial and energy sectors, it's certainly premature to declare a bottom in global trade. Much of that first half weakness was a result of an inventory buildup that has only slowly been worked off. The lingering effects on business investment from the collapse in commodity prices has also dragged down the economy. However, unlike some recent periods, which showed uneven gains, the growth in the third quarter was broad-based, with most industries advancing. For the second quarter in a row, trade was a net positive, adding almost a point to growth as exports shot higher.

The consensus forecast for third quarter real GDP growth was 2.5%, which had begun to creep up based upon the release last Wednesday of more positive trade figures for September. (The widely watched GDPNow forecast from the Atlanta Fed was revised up to 2.1%). The biggest contributor to the upside surprise to growth was a 10.0% surge in exports. Net exports contributed 0.83% to the third quarter's growth (the biggest contribution since 2013). Approximately three-quarters of that rise was due to a surge in

soybean exports. China ramped its purchase of soybeans from the US after a la Nina-induced drought hurt the harvest in Brazil. Most pundits view this as a one-off event and that those export volumes will disappear in the fourth quarter, negatively impacting quarter-over-quarter growth. While we agree with the one-off characterization, the qtr/qtr decline may not be as sharp as many believe since the strong soybean exports have continued into October. After being a sizeable drag on growth for the preceding five quarters, inventories added a further 0.61%.



The quarter's surge in exports has also caused many observers to erroneously conclude that the strong dollar is no longer weighing on exporters. Nevertheless, while overall exports added 1.2% to GDP growth, without the spike in soybean exports it would have added only 0.3%. We suspect that essential food purchases in the face of reduced alternative sources of supply offer little proof that exports have overcome the trade headwinds of a stronger currency. In our view, the much smaller adjusted 0.3% rise in exports is more indicative of the headwinds faced by dollar-based exporters.

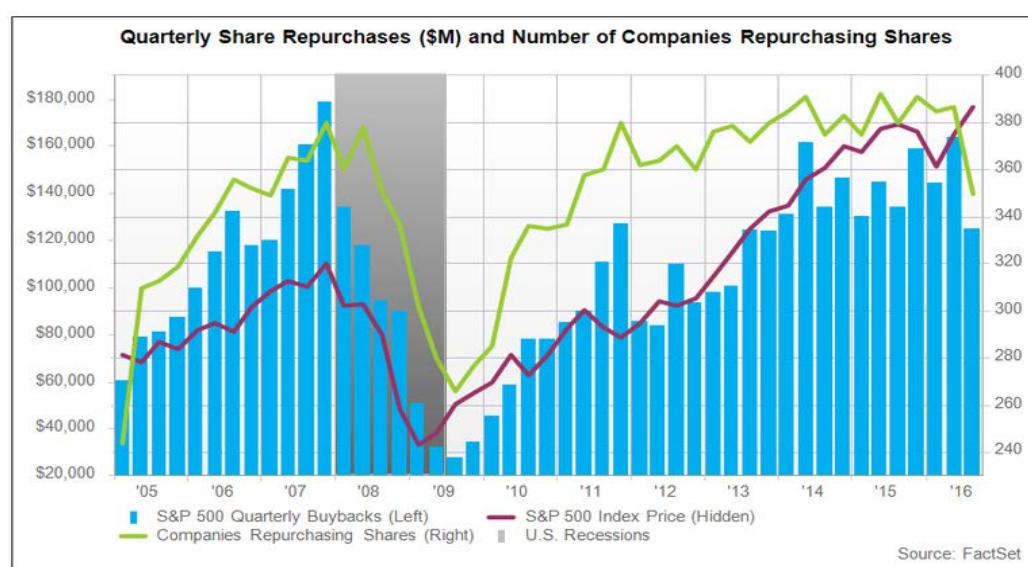
Consumer spending slowed from the second quarter by about half, but at 2.1% (consensus estimate was 2.6%) there are many who believe it was healthy enough to suggest that shoppers remained optimistic. However, the rise was just 1.5% y-o-y, which is the weakest increase in three years except for the prior quarter. We attribute this to the bigger bite that healthcare is taking out of household budgets. Separately, the University of Michigan revised its final reading on consumer sentiment in October down slightly to 87.2, most likely due to the presidential campaign rhetoric and attack ads that have become even more negative as Election Day approaches. This is not unusual for election years and we anticipate a solid rebound in sentiment once the election is over.

Aside from exports and inventories, the news was not nearly as encouraging as the headline number would lead one to believe. As previously noted, consumption growth slowed to 2.1%, residential investment contracted by 6.2% and equipment investment fell by 2.7%. The reduction in equipment spending [for the fourth quarter in a row] points toward lower productivity, which has been weighed down by the continued rise in employment. Companies are finding it less costly to hire workers than increase fixed overhead by investing in new equipment. Workers can be laid off to reduce costs given an increasingly uncertain political environment fraught with escalating regulatory challenges.

Job growth has been pushing income gains but without improved productivity, any improvement in consumer spending from higher income will eventually prove unsustainable since the ability to leverage becomes compromised as savings are exhausted. So, even if this morning's release of personal income (consensus estimate +0.4% vs. +0.2%) and spending (consensus estimate +0.5% vs. 0.0%) looks very strong, it doesn't provide a basis for sustained long-term economic growth without productivity gains.

In our October 25th Strategy Update, we observed that there had been a nascent rise in capital spending coincident with a significant decline in the number of companies buying back shares in the second quarter. We pondered whether we were seeing the first early sign that company managements are beginning to reallocate capital away from financial engineering to direct investment in their operations. We noted that, if confirmed, this had positive implications for the economy but might signal the removal of a pillar of support for higher stock valuations that have been in place since the start of the current bull market.

Early indications for the third quarter are that capital spending has continued to strengthen with non-residential structures investment rebounding by 5.4% (Spending on equipment continued to decline but at a slower pace than the prior quarter and the increased spending on structures may be a precursor to higher equipment spending), reflecting in part the upturn in drilling activity. The recent rebound in oil prices has been a catalyst for more economic activity among drillers and other energy producers. Federal expenditure also increased by 2.5%. This has been matched by share buybacks declining by another 6% from the previous quarter (-26% year-over-year) per S&P Dow Jones Indices.

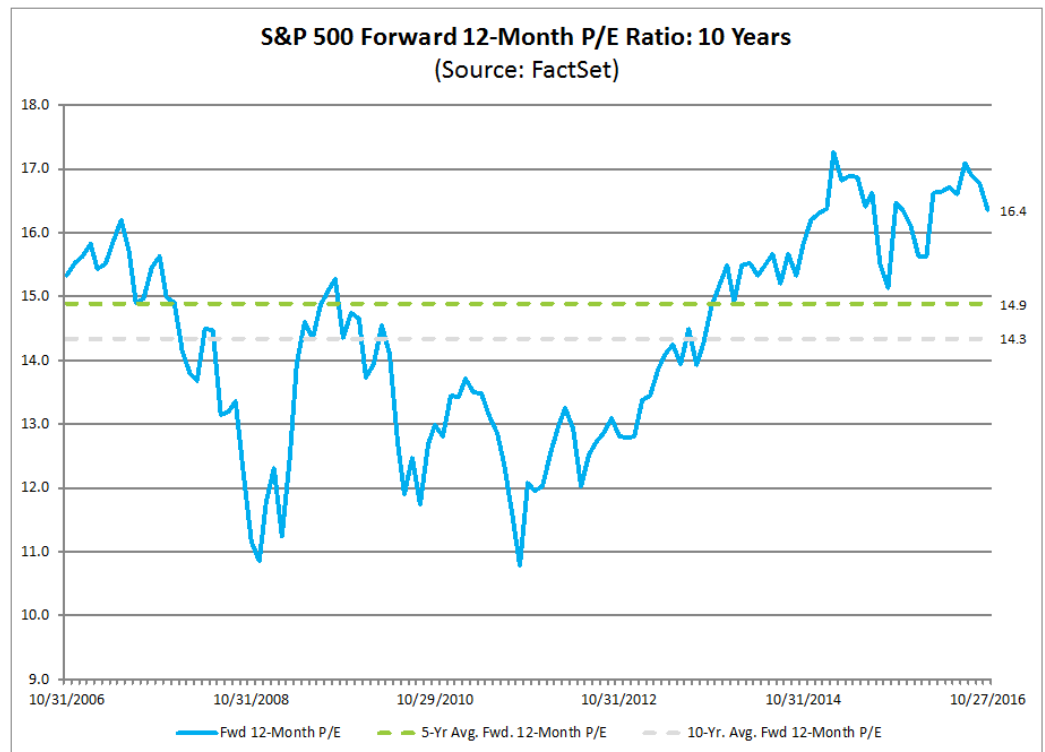


The key takeaway for investors is that two main drivers powering the stock market higher, monetary liquidity and share buybacks, are now fading in intensity as both are being reduced. One possible compensating factor could be the resurgent merger & acquisition activity that can remove shares from the market. The continued availability of low interest rate debt makes financing deals very attractive and provides a financial incentive that justifies transactions to be priced at meaningful premiums to market price. But, in our judgment, rising M&A activity alone is unlikely to support the market at current valuations.

Earnings must reassert themselves as a driver of share valuations. Per FactSet, the blended earnings growth rate for the S&P 500 in the third quarter is 1.6%, which is a substantial improvement from the consensus analyst estimate on September 30th for a decline of 2.2%. If sustained, this will mark the first time the index has seen year-over-year growth in earnings since Q1 2015 (0.5%). Unfortunately, management guidance to-date has delivered mixed signals. For Q4 2016, 36 S&P 500 companies have issued negative EPS guidance and 21 S&P 500 companies have issued positive EPS guidance.

Share valuations remain high but could still go higher. Again, citing FactSet the forward 12-month P/E ratio for the S&P 500 is 16.4. This P/E ratio is above the 5-year average (14.9) and the 10-year average (14.3). Analysts currently expect earnings and revenue growth to continue in Q4, projecting earnings growth of 4.6% and revenue growth of 5.2%. Both figures are reductions from higher levels at the start of the quarter. If Q4 sales and earnings growth exceed those of Q3, post-election investor sentiment could be buoyed as confidence takes hold that the downward quarterly revisions of the past two

years have come to an end. For 2017, analysts are projecting earnings growth of 12.0% and revenue growth of 5.8%. Although it appears a bit of a reach to us within the context of 1.8% real GDP growth forecast for next year, market participants may nonetheless price those expectations into their valuation models and support an elevated P/E ratio if the Fed reinforces and maintains its go-slow approach to rate hikes and any changes in Washington's fiscal policy are at least benign, if not stimulative. **In our judgment, nothing in the advance report on third quarter GDP should be interpreted as encouraging the Fed to assume a more aggressive approach to interest rates. Investors should pay attention and position portfolios accordingly.**



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