# WEEKLY ANALYSIS

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# USA : End of PE growth will weigh on S&P 500

**Difficult to sustain US growth exceeding +3%. Pressures on corporate margins. Flattening of the yield curve. End of PE expansion. Caution on the S&P 500.**

## Key points

- Difficult to sustain US growth exceeding +3%
- Upturn in inflation could be the surprise of the year
- Flattening of the yield curve
- Rise of the dollar after three years of consolidation
- Two more rate hikes in 2018
- Likely pressure on the evolution of corporate profits and margins for multinational companies
- Effects of tax reform already anticipated
- Likely disappointments in overall profit growth of the S&P 500
- Contraction of multiples during the interest rate rise phase
- Probable consolidation of equity prices

## Difficult to sustain US growth exceeding +3%

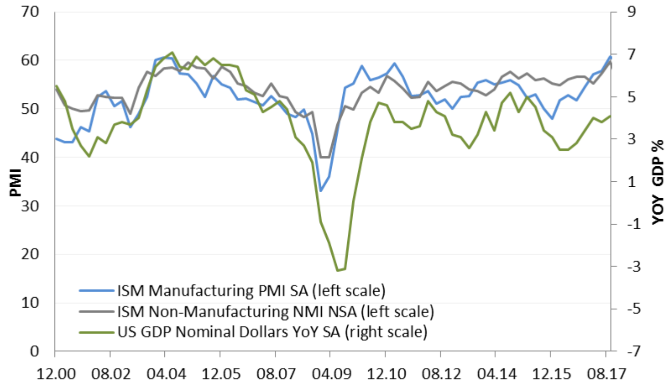
**The US economy will likely close out 2017 with annualised growth of around +3% in Q4, in line with our forecasts at the beginning of the year. Still recently we evoked the likely strengthening of US growth, carried by private consumption, investment and exports, which will likely remain positive factors as 2018 kicks off.**

**The growth target set by the Federal Reserve was +2.4% in 2017 – a result that will likely be achieved thanks to the upturn observed in the second part of the year. We still believe that a +2.6% GDP growth rate for the year is likely.**

Leading indicators clearly point to increased economic activity at the end of the year and in the beginning of 2018. Most economic indicators suggest that the current uptrend will persist. First, US consumers should take comfort in the flow of positive economic news and the ever more favourable situation of the job market. An increase in personal income will likely provide a lasting boost to household consumption in 2018.

With regards to investment, recent economic developments have had an impact on levels of production capacity, which will undoubtedly trigger new investments in a rather favourable context for corporate margins. Economic conditions in the US seemed to have settled into a relatively high rate of growth of +3%. Nevertheless, it is interesting to note that since 2000, the US economy has only very rarely recorded two consecutive quarters of annualised growth over +3%.

**GDP and PMI**




*Sources: Bloomberg, BBGI Group SA*

Thus, the current rate may not be sustainable over the long term in 2018, even if the White House economic advisors' estimates point to the expected long-term impact of the tax measures that were recently passed. Nevertheless, it is likely that the introduction of new tax measures will indeed be positive for economic growth, although it is difficult to assess the effects that are already truly visible in 2018.

It is likely more reasonable to table on a continuation of the current trend in the next quarters, supported by factors already at play. All this without forgetting the possible negative effects on GDP growth of the Fed's key rates normalisation policy and the increase in long-term rates, which will most likely intensify in 2018, taking into account economic fundamentals and the risks of a rise in inflation. Expectations are now high and will likely only be met if US consumers play their part.

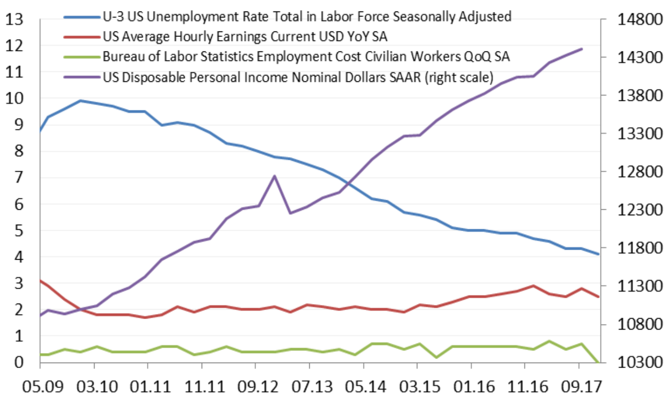
Nevertheless, our forecasts for H1 remain optimistic, and we believe that an economic growth rate close to +3% will likely persist for a while before subsequently dropping.

## Upturn in inflation could be the surprise of the year

The latest inflation figures published in November (+2.2%) pointed to a stabilisation of price indices slightly above the Federal Reserve's targeted +2%. The yoy rise of the index excluding food and energy (+1.7%) was slightly below expectations and still under 2%. This shows that inflation has clearly struggled to gain greater momentum in H2 2017, despite statistics that indicated accelerating economic growth in the US. Nevertheless, the central bank is not showing any signs of worry or impatience, noting instead that temporary factors have for the moment held back an increase in prices.

Nevertheless, the strength of the economy and an unemployment rate at a 16-year low will almost certainly trigger tensions and price increases enabling inflation to exceed the set targets.

**Unemployment, Disposable Income, Labour Costs, Salaries**

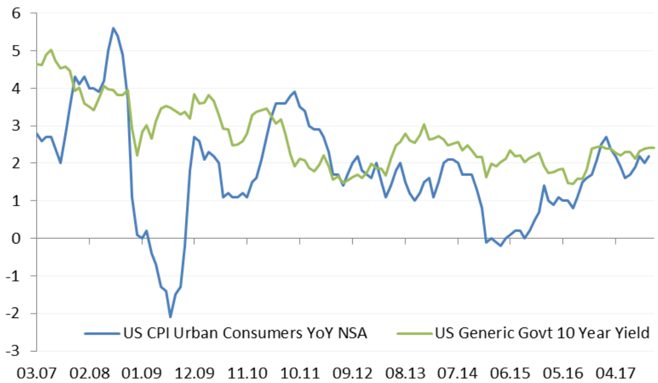



*Sources: Bloomberg, BBGI Group SA*

Pressure on wages is slow to materialise despite a continuously improving job market. Contrary to theory, inflationary pressures are still weak, while the unemployment rate has steadily dropped to a historic low of 4%, de facto approaching its full employment level.

Nevertheless, the Fed remains relatively serene and convinced that the relation between employment and inflation still exists, even if it appears that the Phillips curve is for the moment clearly flatter than before. Import prices have surged 3.7% yoy mainly due to the increase in oil prices in November. This trend will likely continue in 2018 with the upswing in business activity. Forecasts for expected inflation have progressed at the end of the year, reaching +2.7% yoy and +2.4% on a 5 to 10-year time horizon. Inflationary pressures were limited in 2017 and mainly linked to external factors. In the US as in most economies, rising inflation was indeed triggered by the increase in crude oil prices that began in 2016 and continued to have an effect in 2017 – a year that was marked by successful policies carried out by central banks to put a stop to deflation and to bring the rate of inflation back towards their targets generally set at 2%.

**Inflation and 10-Year US Treasury Bonds**




*Sources: Bloomberg, BBGI Group SA*

Thus, inflation has returned to a "normal" level, while employment has improved and tensions on the job market have yet to appear. A series of surprises could mark 2018 owing to multiple factors acting in combination. Indeed, the macroeconomic environment will likely be conducive to wage negotiations and pressures on commodity prices, supporting an increase in production and consumption prices.

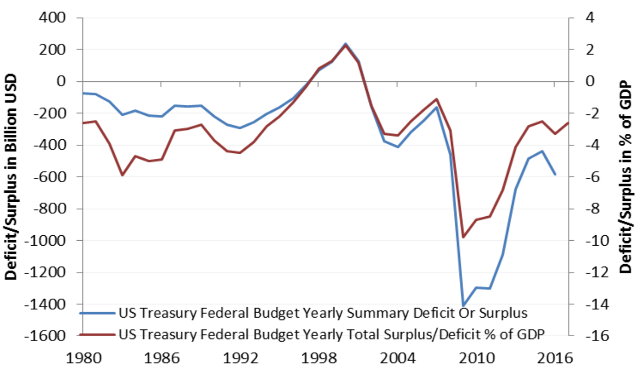
## Rate hikes and flattening yield curve

A return of inflation in a robust economic environment will likely see long-term nominal rates being adjusted once again in the next few months. After a few quarters of stabilisation, US long rates will likely be the first to kick-start the trend once again. Already several months ago, we noted that the adjustment in 10-year Treasury rates from 2.6% to 2.1% observed until the end of the summer was not at all compatible with our economic growth expectations in the area of +3% and with a normalisation of the Fed's regular monetary policy. We then believed that an increase in long rates would very likely be observed in the second part of 2017. This took the shape of an increase in 10-year rates from 2.1% to 2.5% as of 31 December. Thus, long-term rates are once again close to the highs they had reached in March and in the upper section of their fluctuation band for 2017. In H1 2018, confirmation of strong economic data will probably be accompanied by an increase in crude oil prices and commodities prices likely to trigger valuation adjustments in the interest rate markets. We believe that most maturities will be subject to a 0.5% adjustment in the next few months that will push 10-year Treasury rates above 3%.

## Rise of the dollar after three years of consolidation

US economic momentum will likely most often be superior to that of other developed economies in H1 2018. Consequently, the interest rate spread will likely widen further across the yield curve and benefit the greenback. In this environment, the weakness of the dollar in 2017 seems unjustified. The depreciation of around -10% of the trade weighted USD index against a basket of currencies erased almost half of the dollar's gains between 2014 and 2015. The value of the US currency will thus undoubtedly adjust in the coming months, unless expectations of deteriorating public finances linked to the tax reform start to prevail and hurt the dollar. Ultimately, our forecasts are positive and support an increase above 1 Swiss franc to the dollar.

**US Treasury Budget Deficit**

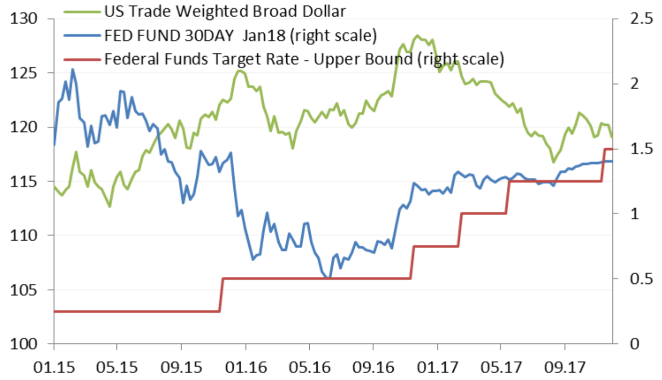



*Sources: Bloomberg, BBGI Group SA*

## Two more rate hikes in 2018

During its last meeting, the Federal Reserve proceeded with a further rate hike to 1.5%, as expected. New chair Jerome Powell will take office after the next meeting in January with no risks of significant change in the stated policy. Balance sheet normalisation will remain very moderate, not to say imperceptible. In parallel, the target for key rates (Fed Funds) will likely increase to 2-2.25% in 2018. FOMC members' analysis of the economic conditions and the state of the US economy remained relatively unchanged in December.

**Fed Funds, Key Rates and Trade Weighted Dollar**




*Sources: Bloomberg, BBGI Group SA*

Remarks regarding the possible effects of the tax reforms have been rather surprising, most of them finding the long-term effects of these measures to be relatively limited. The central bank's position on this matter seems particularly divergent from that of the White House, which considers the tax reform as a major and long-term factor boosting the GDP growth rate. At the moment, the Fed actually seems to view this reform as a short-term stimulus whose effects will remain limited in time. It also does not appear convinced of the reform's impact on consumption and has actually evoked the risk that listed multinationals will not increase their investments significantly, on the contrary opting to use the resulting cash-flow to implement debt reduction and merger and acquisition strategies.

With regards to inflation, it is likely that the Fed would like to see price indices grow at a slightly stronger and faster rate than the targeted 2%. However, it still seems convinced of future inflation trends. While hoping for an impact on wages triggered by the decline in the unemployment rate, the Fed undoubtedly considers that pressures will remain limited and pose few risks requiring the need for abrupt and unexpected monetary policy actions. The monetary policy will likely remain very clear in Q1 2018 with an expected 0.25% hike in Q2, which will then be followed in the last quarter by a further 0.25% increase.

## Likely pressure on the evolution of corporate profits

It seems that nothing will stop the rise of US equities. It is true that corporate margins are excellent and close to historical highs at around 10%. Profit growth was also satisfactory in 2017, and analysts expect a +11% increase in 2018 and +10% in 2019. The overall value of US corporate earnings has reached almost 10% of GDP against a historical average of 6.5% over the last 70 years. The distribution of wealth creation as represented by GDP has actually been more favourable for companies in recent years. The overall wage bill in 2017 represented 43% of GDP, significantly lower than the historical average of 47%. Recent developments in the job market point to likely future adjustments that will undoubtedly weigh on the level of corporate margins and profits. Labour costs represent between two thirds and three quarters of corporate expenditure; an increase in wages will thus have a significant impact on margins. Profit growth for multinationals may thus have peaked and ultimately be lower than expected in 2018, drawing closer to the economic growth rate.

The tax reform, which is so positive for corporate profits, may well be less significant for S&P 500 multinationals than for more domestic and mid-sized companies.

**S&P 500, Nasdaq and GAFA**


*Sources: Bloomberg, BBGI Group SA*

However, beyond the fundamental issue of profit growth, it should be noted that the rise in US equities was mainly triggered by a strong phase of multiples expansion.

While US stocks traded at less than 10x earnings in 2009, they are now trading at close to 18x earnings. Price/earnings (P/E) expansion phases are generally linked to periods of declining interest rates; conversely, in periods of rising rates, we tend to see the P/E ratio contract.

## Inflection point for multiples and for the S&P 500

In 2018, the normalisation of monetary policies and interest rates will likely mark a turning point in the growth of multiples. Indeed, it is probable that rising interest rates will put an end to the 10-year expansion phase, regardless of the evolution of corporate profits.

This P/E expansion, especially in the technology and digital sectors, has reached extreme levels similar to those observed in 2000 before the burst of the TMT bubble and the 50%correction in the global market. The valuation levels of these stocks and of GAFA in particular should at least act as a brake on their future development. The banking/financial sector, another S&P 500 heavyweight, may also face new difficulties in meeting expected results. Indeed, the current flattening of the yield curve is not a favourable factor for the evolution of their margins, which could lead to some disappointment. In 2018, energy will likely be one of the rare sectors that will truly be able to post exceptional profit growth rates. However, given the weight of the sector in the global index, this will not have the significant impact required to support global growth in market profits.

In conclusion, the rise of equity markets probably incorporates the favourable impact on profits that all have been expecting from the tax reform for over a year, although as we mentioned multinationals will undoubtedly feel the impact less than other companies. We believe that the two least expected effects at this time are those that may be triggered by the contraction of margins and of P/E ratios, which may well weigh on prices in 2018. Thus, we would advocate a more cautious approach as well as underexposure to US stocks in early 2018.

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