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OUTLOOKS

August 2017

ECONOMIC OUTLOOK

Summary

The trend of mixed economic reports continued in July with the standout on the upside being the labor market reports. For the three months ended in July, payrolls have expanded by an average of 195,000 jobs, higher than the latest 12 month average of 180,000. It is estimated that a gain of 100,000 would be sufficient to absorb the new entrants into the labor force, so with the higher growth, the unemployment rate has continued to move lower and at 4.3% is near the lows seen before the financial crisis and great recession. Continuing claims for unemployment insurance are near the cyclical lows seen in other strong labor markets over the past 30 years. The last time continuing claims were lower was in 1973 when the U.S. population was about 35% smaller than it is today.

Ironically, even with the labor market exhibiting exceptional strength by almost any measure, retail sales continue to be weak and auto sales have rolled over from the historic high levels seen late last year. Tapping into the mindset of the consumer is a challenging task as even two of the most commonly followed consumer sentiment reports have seen a significant divergence in their trends over the last 12 months or so. While the Conference Board, an independent business membership and research association, reports that consumer confidence is moving upward and making new highs, the University of Michigan's survey indicates that confidence has been flat for the past couple of years. Business optimism remains elevated but has been rolling over the past five months as the hopes for health care and tax reform fade.

Late in the month, preliminary calculations for GDP for the second quarter were released along with the final revision of the first quarters report and the annual revision of the past three years. The second quarter's rate of growth came in slightly lower than expected at 2.6% and the first quarter's growth rate was revised downward to 1.2%. The average of these puts the year at the same average growth experienced over the last 15 years, 1.9%. This is slower than the 2.2% average experienced since the recovery began in the fall of 2009 and a long way from the 3% to 4% growth touted as the target from the Trump administration. Until real progress is made on tax reform and an infrastructure plan, it is unlikely that the overall level of GDP will break through to a substantially higher trend rate of growth.

Positives

Employment gains continue to be strong and unemployment is near cyclical lows

Business confidence and some measures of consumer confidence are high

The weaker U.S. dollar will spur exports and attract foreign travelers

Negatives

Personal income has not been growing much more than the rate of inflation

Construction spending declined 1.3% month-over-month

Car and truck sales continued to sag in July even with incentives running high

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OUTLOOKS

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EQUITY OUTLOOK

Summary

U.S. equity markets pushed to record levels again in July, with the Dow closing at 21,891, the S&P 500 at 2,470 and the Nasdaq at 6,348. Year-to-date percentage gains range from low teens to mid-twenties for the major indices.

Thus far, markets have been powered by growth sectors including technology, discretionary and health care. For the month of July, a rebound in telecomm (+6.4%), tech (+ 4.3%) and a bounce in energy (+2.5%) led prices higher. Laggards included health care (+0.8%), staples (+0.8%) and industrials (+0.06%).

Better than expected second quarter corporate earnings, stable and low inflation, and a stalemate in Washington combined to fuel investors' appetite for risk assets. Don't forget the adage, "Markets dislike change."

More importantly, from a global perspective, expectations for improved profitability are showing up not only in the U.S., but to a larger degree in international markets. Following a global slump, spurred by the collapse in oil prices in 2015, estimates of corporate profits in both emerging and developed countries are on the rise.

To emphasize the point that earnings expectations matter, investors have taken notice, driving the MSCI EAFE index of developed countries up 17.09% this year and emerging (MSCI EEM) up 25.49%.

So what next? At the risk of sounding Pollyanna-ish in this outlook, balancing slowly improving global economics, low and stable inflation, steady global monetary policies and barring an extraordinary geopolitical event, markets should continue to discount improving economic conditions. But always with the caveat that short-term corrections are inevitable.

This continues to be a market no one loves.

Positives

Steady monetary policies globally

Good employment opportunities

Negatives

Geopolitical frictions

Lack of trade policy clarity in Washington

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FIXED INCOME OUTLOOK

Summary

After extreme moves over the past three months, Treasury note yields were little changed during July even as the Federal Reserve further discussed plans to begin the process of shrinking its enormous balance sheet that was acquired to support the economy and the markets following the financial crisis and ensuing recession. For the first time this year, the 2-year Treasury note actually declined on a month-over-month basis while the 10-year traded in a tighter range and ended just a basis point lower at 2.29%. The long end of the curve steepened as well as the 30-year bond increased almost 7 basis points to end July at a yield of 2.90%.

The Fed is likely to formally announce, after the September 20 Federal Reserve's Open Market Committee (FOMC) meeting, the beginning of the process to remove some of the extreme monetary policy accommodations. The term for this initiative is Quantitative Tightening (QT) and it may be announced to begin on October 1. QT involves the liquidating of government securities held on the Fed's balance sheet and is the opposite of Quantitative Easing (QE), which was the buying of government securities in order to lower Treasury yields and stimulate the economy after already setting the overnight rate close to 0%.

In outlining the timing and amounts of this runoff, the Fed has put on its "kid gloves". The preliminary indications are that balance sheet reductions will begin at $10 billion a month, and increase by another $10 billion per month every quarter, until they reach a maximum runoff of $50 billion a month. So even at the maximum rate, they expect to shrink their balance sheet at a pace of $600 billion per year. That's if everything goes well, the markets cooperate and the economy continues to grow at a solid pace.

The private sector will need to absorb this additional supply, over and above regular debt financing that takes place each month. Since QE was designed to lower longer-term interest rates, which it is generally credited in doing by up to 1%, it stands to reason that QT should have the reverse effect. Their intentions have been well-telegraphed for a number of months now, so one could also reason that the markets have priced in the additional supply and that there are other significant reasons for rates to stay in the current range. Aging population demographics and inflation that continues to be below the target rate are often credited with the new paradigm in yields. No one, including the Fed, knows how it will impact the U.S. and global markets and economies but they can always change course if the circumstances warrant.

Positives

- Fed's commencement of QT has been well-telegraphed to the market
- The U.S. has the highest yield of any large high-quality developed country
- Inflation remains below the Fed's target level

Negatives

- Investors need to go out more than five years to get a yield higher than inflation
- Wage pressures could emerge with unemployment near cycle lows
- Additional supply with QT and higher deficits could pressure yields higher

Unknowns

- The reaction of the world to a nuclear-capable North Korea
- Rising tensions between the U.S. and Russia, China, Mexico, Germany,.....

Expanding Possibilities