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ECONOMIC UPDATE - THIRD QUARTER BOUNCE

Buoyed by solid consumer spending, stronger exports and positive though still sluggish business investment, the US economy accelerated during the third quarter which ended last Friday. However, the quarter's bounce will only bring overall GDP gains for the year back in line with the modest 2.1% pace of expansion we have experienced for the last seven years. Estimates now put third quarter economic growth at a 3.0% rate following gains of an upwardly revised 1.4% in the second quarter and only a 0.8% gain in the first three months of 2016.

Looking into the numbers, business inventory drawdowns have been a drag on growth for five consecutive quarters at a time when the broader economy, notably employment, has been expanding. We believe this inventory liquidation cycle is unlikely to have persisted into the second half of this year. Another drag on growth in 2015 and earlier this year was business investment which finally turned positive in the second quarter. Outlays for intellectual property, including software and research and development, rose at the fastest pace in nearly a decade despite the strong dollar and uncertainty surrounding the US election, which may be holding down these outlays.

So following last quarter's bounce, what are the *leading economic indicators* we follow closely telling us about economic growth this quarter and into 2017? Here is a quick rundown:

- The *Institute for Supply Management's (ISM) manufacturing index* for September rebounded after unexpectedly shrinking a month earlier, underscoring uneven progress for this sector and suggesting the weakness in August was likely a temporary setback. The ISM's index advanced to 51.5 from August's 49.4 reading. A reading above 50 signals growth. Importantly, new orders and production swung to expansion last month, indicating prospects are gradually improving across manufacturing. At the same time, factories continued to focus on becoming leaner by trimming inventories. The ISM new orders gauge jumped to 55.1 from 49.1 the prior month, the biggest increase since March. Other groups improved in September while still signaling contraction. For example, the measure of factory inventories edged up to 49.5 after 49 in August, while order backlogs increased to 49.5 from 45.5 the prior month. On balance, the composition of the report was encouraging.

- *The Institute for Supply Management's (ISM) non-manufacturing index* rose sharply as American service companies expanded in September at the fastest pace in almost a year, returning the economy's largest segment to a steady growth path following a slump in the prior month. The ISM non-manufacturing index jumped to 57.1, the highest reading since October 2015 and the largest month-to-month increase on record. August's reading of 51.4 was the lowest in more than 6 years. Measures of employment and orders led the advance, which signal businesses that account for about 90% of the economy see sufficient demand to keep expanding. This report, combined with the September ISM manufacturing report, suggest the August slowdown in both indices probably overstated softness in the economy.

- *Construction spending* declined 0.7% in August and earlier months were revised down as private residential construction slipped 0.3%, private non-residential construction fell 0.4% and public construction declined 2.0%, to the lowest level since March 2014. Monthly data on construction spending have been very erratic but the longer term trend has been disappointingly flat. While spending on new multi-family homes has been strong, new single family homes are barely gaining.

- *Consumer spending,* which accounts for over two thirds of GDP, was little changed in August as income growth cooled. The August result followed a 0.4% advance the prior month. The data are consistent with projections consumer purchases will produce a smaller but still respectable contribution to economic growth this quarter after the strongest quarterly advance since 2014. While large jobs gains and healthier finances are underpinning household spending, further advances in outlays await larger increases in paychecks.

- *Orders for US durable goods* were little changed in August while shipments of capital equipment declined for a fourth straight month. The latest reading for bookings of goods meant to last at least three years followed a 3.6% advance in July. The important measure of *sales of non-defense capital goods excluding aircraft,* used in calculating GDP, declined 0.4% in August. The declines in shipments of those goods indicate equipment investment may weigh on economic growth for a fourth straight quarter. While household demand is providing some relief for manufacturing, factory customers are still contending with high inventories relative to sales, and overseas markets remain tepid.

- The number of first time *applications for unemployment benefits* has been holding near its lowest level since mid-April, providing further evidence of a strong labor market. The four week moving average of initial jobless claims of 256,000 as of September 24 was 8.0% below that of last year. Continuing jobless claims filed during the last week of September were 6.5% below those of a year ago. These figures indicate employers are leery of dismissing workers as the labor market tightens.

- *Consumer confidence* rose to 104.1 in September, the highest level since the last recession, on optimism regarding the labor market. The Board's measure of consumer expectations for the next six months climbed to 87.8, the highest since October, and the share of those who said jobs were plentiful rose to 27.9, the highest since July 2007. The survey bodes well for consumer spending which has cooled after a robust second quarter. The assessment of the availability of jobs is consistent with data showing vacancies at a record high nationwide, suggesting wages could see further gains.

Parsing these and other indicators we get a mixed picture of the outlook for US business. Jobs data, a lagging indicator, remains strong. With both ISM reports now in hand, the softness we saw in August is increasingly looking like an anomaly. On the other hand, construction, auto sales and consumer spending have sputtered a bit. The Federal Reserve Bank of Chicago National Index which draws on 85 economic indicators was minus 0.55 in August verses 0.24 in July. September figures are not yet available. A reading below zero indicates below-trend growth in the national economy. Interestingly, 19 of the 85 monthly individual indicators made positive contributions while 66 indicators deteriorated. And importantly, both our firm's proprietary <u>Economic Model</u> and the <u>Leading Economic Indicators</u> (LEI) are signaling continued expansion over the next 6 - 9 months.

On balance, then, there have been signs of a net pick-up in business activity in September, and leading indicators generally remain positive. We conclude, absent an exogenous shock, the expansion will continue but at a modest pace, at or near the 2.1% rate of growth we have experienced over the past seven years.

<u>Fiscal Policy</u>

Since the global financial crisis of 2008, *monetary policy* has borne the burden of supporting aggregate demand, boosting growth and averting deflation in developed economies. *Fiscal policy* was largely constrained by large budget deficits and rising public debt, with many countries even implementing austerity programs to ensure debt sustainability. Banks adopted increasingly unconventional monetary policies by first cutting rates to zero and later introducing forward guidance, committing to keep policy rates at zero for a protracted period. Advanced countries also launched quantitative easing (QE), purchasing massive amounts of long-term government securities to reduce their yields. They also initiated credit easing or purchases of private assets to reduce the costs of private sector borrowing. More recently, several major central banks have driven interest rates negative.

These policies boosted asset prices and economic growth, while staving off deflation, but they are reaching their limits. Negative interest rates are crimping bank profits and their willingness to extend credit. As for quantitative easing, central banks, particularly in the Eurozone, may be on the verge of running out of bonds to buy.

Despite these measures, most economies remain mired in below-trend growth where monetary policy may well lack the tools to address it, particularly if tail risks -- economic, financial, political and geopolitical -- also undermine recovery. Should banks decide to reduce lending to the private sector, monetary policy may become less effective.

Under these circumstances, fiscal policy would be the sole effective macroeconomic policy tool left, and thus would have to shoulder the burden of countering recessionary pressures. Many economists agree that policy makers should not wait until central banks run out of ammunition. They agree that fiscal policy should be activated now as most advanced economies, thanks to austerity programs, have seen deficits and debts decline to the point where they now have room to boost demand at a time when government bond yields are at an historic low. Governments should be able to spend more and/or reduce taxes while financing deficits cheaply.

The good news is that the advanced countries of the G7 seem poised to begin to rely more on fiscal policy to bolster lagging economic growth. In the US, there will be some stimulus, regardless of whether Hillary Clinton or Donald Trump is elected next month. Both candidates favor more infrastructure spending and corporate tax reform.

The fiscal stimulus that will result from G7 policies of which we are aware will likely be very modest -- at best 0.5% of GDP of additional stimulus per year for a few years. Nonetheless, the measures undertaken or contemplated so far represent a step in the right direction. *For the US, absent additional fiscal stimulus, there is a good chance the economy will continue to be mired in sub-par growth for the foreseeable future.*

Central Bank Policy Bias

As Global GDP trends have stabilized in recent months, a somewhat more optimistic tone to central bankers' comments has emerged, and global policy bias has begun to shift. The Federal Reserve's Open Market Committee (FOMC) has been explicit in wanting to raise rates in December. The Bank of Japan (BOJ) has shifted away from purchasing securities towards yield targeting and the Bank of England (BOE) is viewed as unlikely to ease further. Media reports recently have noted that the Peoples Bank of China (PBOC) could turn away from an easing bias in 2017 (recently a number of Chinese cities have announced measures to cool local housing markets). Central banks are, in general, pushing back against negative interest rate policies (NIRP) given the damage this policy is inflicting on banks. In part, reflecting this change in policy bias, and a perceived upward tick in inflation expectations, interest rates have begun to rise. For example, the 3 month LIBOR rate has risen from 0.62% on June 24th to 0.86% today while the yield on the 10 year US Treasury has increased from 1.36% on July 8th to 1.72% currently. Just possibly we have finally seen the bottom of the interest rate cycle.

Equities

Since the July interest rate lows, the benchmark S&P500 stock index has returned about 4%. However, individual sector performance has varied considerably. During that period, the best performing equity sectors have been cyclicals tied to growth (technology +11%, energy +4% and industrial +2%) and benefactors of higher interest rates (financials +9%). Not surprisingly, the laggards have been sectors usually expected to underperform in a rising rate environment (utilities -10%, telecommunication -10% and staples -6%). We expect these trends to persist as investors continue to reposition their stock holdings to take advantage of the rising rate environment. Clients' diversified core equity portfolios under our management remain significantly exposed to these economically sensitive groups as well as to investments abroad including developed and energy markets. Stock portfolios remain fully invested as the US stock market, selling at 16.6 times expected forward earnings, is fairly valued and markets abroad remain undervalued.

Fixed Income

Fixed income portfolios under our supervision remain defensively structured, with principal protection as the overriding objective, in the anticipation of higher rates. Durations of fixed income portfolios under our supervision approach 1.

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