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ECONOMIC UPDATE – FED QUANDARY: INFLATION

Economic indicators we monitor show the US economy, now entering its ninth year of expansion, growing moderately and still creating jobs at a healthy clip, but unable to gain additional momentum beyond the 2% rate of GDP growth of the past 5 years. As we have previously pointed out, unfavorable demographics and lack of productivity improvement remain powerful headwinds to a more rapid rate of economic expansion absent the enactment of a fiscal stimulus agenda.

Payroll growth in the recently released June employment report stands out as the best economic news so far this year. Job gains have averaged 180,000 per month, down only slightly from the average in 2016 and well above the pace that would be sufficient to provide jobs for new entrants to the labor force. The unemployment rate has fallen about ¼ percentage point since the end of last year and, at 4.4% in June, is more than 5 percentage points below its peak in 2010. A broader measure of labor market slack, the so called U6 unemployment rate, which includes workers marginally attached to the labor force and those working part-time who would prefer full-time work, has also fallen this year and is now nearly as low as it was just prior to the recession. It is also encouraging that jobless rates have continued to decline for most major demographic groups, including African Americans and Hispanics.

Although real GDP increased at an annual rate of only 1.5% in the first quarter, more recent indicators point to a rebound in expected growth in the second quarter to about 2.6%. Household spending, which was weak early in the year, has picked up in recent months, supported by job gains, rising household wealth, and generally favorable consumer sentiment. In addition, business fixed investment, largely in the energy sector, has turned up this year after having been soft in 2016. And strengthening economic growth abroad and a weaker US dollar have provided important support for US manufacturing production and exports. The housing market has continued to recover gradually, aided by the ongoing improvement with labor market and mortgage rates which remain at relatively low levels. All in all, we have an economy growing steadily, though only at a moderate pace.

FED QUANDARY: INFLATION

Consumer prices, as measured by the Federal Reserve's favorite gauge, the personal consumption expenditures index (PCE) increased 1.4% over the 12 months ending in May, up about 1 percentage point from a year ago but a little lower than earlier this year. Core CPI Inflation, which excludes food and energy prices, has also edged down in recent months and was 1.7% in June, a couple of tenths below the year-earlier reading. These recent lower readings on inflation present the Federal Reserve with a quandary as the two metrics they follow most closely (i.e. unemployment and inflation) are sending conflicting signals about the urgency of additional rate increases. The low unemployment rate portends a tightening of the labor market, arguing for further interest rate increases to prevent the economy from overheating. However, inflation has fallen farther below the Fed's 2% target in the past 3 months, suggesting borrowing costs should remain low to strengthen price pressures.

The recent inflation weakness appears to be more broadly based than it did only a few months ago. The rate of increase in housing costs has fallen as rising inventories of newly built apartments have weakened owners' pricing power. Likewise, growing inventories of used cars are weighing on sales prices. Structural changes at retailers which face growing competition from online sellers, are forcing traditional retailers to cut prices to maintain their market share.

While the Fed has not abandoned their expectation that the inflation weakness will prove transitory, they have acknowledged there may be more going on than a series of idiosyncratic pricing declines. Further inflation weakness could delay the Fed's plan to normalize rates.

OUTLOOK

A number of high-frequency leading economic indicators underpin our forecast for a continuation of the gradual expansion of the US economy. For example:

- *The Institute for Supply Management (ISM)* June reading of 57.8 showed *manufacturing*, on solid footing, powered-up to the fastest pace in nearly three years, with robust advances in production, orders and equipment, indicating a firming in the economy. Readings above 50 signal continued expansion. Most importantly, the ISM's gauge of new orders increased to a 3-month high of 63.5 from 59.5 in May and the employment index climbed to the second–highest level since 2011.

- The *ISM's non-manufacturing index* picked-up from 56.9 to 57.1, near the top of its recent range. Business activity edged higher from 60.7 to 60.8, while new orders rose from 57.7 to 60.5. Readings above 50 signal continued expansion.

- Fewer Americans are applying for *jobless aid*, as the number of people seeking benefits has stayed near historic lows. Applications are a close indication of layoffs. Employers are holding onto workers in the expectation business will continue to improve. Jobless claims have come in below 300,000 for 123 consecutive weeks, the longest such stretch since 1970, when the US workforce was much smaller.

- *Consumer confidence*, though below its recent highs, remains firm reflecting rising stock and home prices.

- *Housing starts and permits* jumped in June, a positive sign for the balance of the year. Importantly, housing permits came in well above expectations.

- Interestingly, the average *FICO score* in the US recently hit an all-time high of 700. FICO scores can be used to determine who qualifies for loans and the rate of interest that consumers pay on credit cards, car loans and mortgage loans. FICO scores can range from 300 to 850. High FICO scores support borrowing for cars and homes.

In addition to these leading indicators of economic activity, both our firm's proprietary Economic Model and the Leading Economic Indicators (LEI) continue to point to expansion over the next 6 – 9 months despite some recent weakness in retail sales and inflation.

On balance, for all of 2017, absent a dose of fiscal stimulus, or an exogenous shock, we expect the US economy to expand at about the 2% rate of recent years. We expect the Fed will remove its accommodation at a measured pace with one more Fed Funds rate hike before year-end, likely in December, and a gradual shrinking of its $4.2 trillion balance sheet beginning in September. The 10 year US Treasury yield, currently 2.3%, could reach 3% by year-end. Despite its recent weakness, inflation is expected to drift up slowly but remain below Fed's 2% target this year. Corporate profit growth will be sufficient to support US equities at about their current level.

EQUITY INVESTMENT STRATEGY

Keep in mind, uncertainty always clouds the economic outlook. Today there is, for example, lack of clarity regarding when and how much inflation will respond to tightening resource utilization as the economic expansion continues. Possible changes in fiscal and other governmental policies here in the US and abroad represent another source of concern. In addition, while the prospects for global growth have improved somewhat this year, a number of our trading partners still face economic challenges. And central bank policies, now shifting away from extreme accommodation, can impact the outlook for economic growth and the valuation of various asset classes.

With no end to the current expansion in sight and business conditions abroad improving, we recommend clients maintain fully invested equity positions, in accord with their risk tolerances and liquidity requirements. Absent a serious domestic political shock or a disruption of global trade, we believe the risk of a recession to be low. Inflation is expected to remain below the Fed's 2% target, alleviating the need for the Fed to tighten aggressively. Even though the rate of corporate profit growth is likely to slow from the 15% pace of the first quarter, we expect the full year to deliver a gain of better than 7%.

Looking ahead, we expect moderate gains from stocks, in line with the growth of corporate profits. Returns from equities are likely to exceed those from high-quality fixed-income securities or cash. Stock market gains are not linear so 5-10%+ corrections in share prices are normal and should be expected from time-to-time.

Unlike past market cycles, where the risk to the economy was from the Fed needing to raise rates aggressively in order to curb inflation, the risk this cycle stems from the fact we have a less-than-unified government majority in Washington where it is increasingly likely expectations for stimulative tax reform and other fiscal measures will not be met in either time or magnitude.

As for domestic equities, performance for both the year-to-date and 12 months through mid-year, have been surprisingly strong. Investments domiciled abroad, which we have viewed as undervalued, have had notable bounces this year, outperforming their domestic counterparts.

	Total Return	
Domestic	Year-to-Date*	12 Months
Dow Jones Industrial Average	10.91%	19.91%
S&P 500	11.05%	16.04%
NASDAQ100	20.77%	28.54%
S&P Growth	15.87%	17.97%
S&P Value	5.61%	13.32%
S&P Small Cap Growth	5.44%	18.74%
S&P Small Cap Value	1.68%	17.32%
Foreign		
MSCI EAFE (Developed Markets)	15.97%	19.11%
MSCI (Emerging Markets)	23.10%	23.70%

***through 6/30/17**

Despite the strong overall market, S&P sector performance has shown some notable divergences with energy and telecom services underperforming.

	Total Return	
S&P Sector	Year-to-Date*	12 Months
Consumer Discretionary	11.61%	12.75%
Consumer Staples	7.57%	1.40%
Energy	-11.90%	-4.73%
Financials	7.84%	32.47%
Health Care	17.31%	9.97%
Industrials	11.52%	18.93%
Information Technology	22.36%	34.00%
Materials	12.13%	16.14%
Telecom Services	-12.51%	-14.34%
Utilities	8.68%	3.73%

***through 6/30/17**

While no longer cheap at 18 times forward earnings, US equities appear to be reasonably valued given the level of interest rates likely over the balance of this year. Energy, health care and financials remain attractive as areas of relative value in our view. Technology share prices appear reasonable given their earnings growth prospects. The aforementioned sectors are well-represented in clients' portfolios, accounting for about 50% of equity portfolio exposure. We continue to target foreign domiciled equities at up to15% of clients' equity portfolios.

FIXED INCOME

The Fed still plays an outsized role in determining interest rates, but given the steady expansion of the economy over the past several quarters, we've been somewhat surprised that market fundamentals haven't supported a more notable increase in intermediate-term rates. With the prospect of higher normalized interest rates in mind, bond portfolios under supervision remain conservatively laddered with high quality, marketable corporate obligations with maturities averaging twelve to eighteen months. Preservation of principal remains a key consideration in our fixed income strategy.

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