Economic & Market Environment

Second Quarter 2017

The Firm's Outlook: Summary And Conclusion

THE ECONOMY

- Viewed comprehensively, we believe the economy appears to be on sound footing.
  - Growth is slow, but inflation and interest rates are also low
  - At 4.7% unemployment, the economy is nearing full employment
  - Stress points or economic extremes are absent, suggesting a low probability of recession over the near-to-intermediate term.
- The Trump Administration has ambitious goals for the economy. Through tax reform, infrastructure spending and less regulation, they hope to return economic growth to more traditional levels, or greater. These initiatives will be challenged by structural impediments.
- Soft economic data, including surveys of confidence and expectations, is currently signaling stronger growth, but hard data has yet to confirm it.
- The interest rate cycle has turned. The Federal Reserve (Fed) has now effected its third interest rate increase and is signaling two more increases in 2017. Their expected rate for federal funds still resides at only 2% at year-end 2018.

STOCKS AND BONDS

- Investors have greeted Trumponomics with enthusiasm, taking stocks to new high levels. Failure to pass a new health care law threatens to delay or limit tax reform and could lead to investor disappointment. The expectation is that pro-business policy will result in higher corporate profits in the future.
- Near term, the corporate-profit cycle appears to be turning up on its own, and this augurs well for stocks in 2017.
- Bond yields have moved higher, reflecting federal funds increases and the fear that Trumponomics could be inflationary. As the Fed continues to normalize interest rates it is likely that bond yields will drift higher, but in our opinion, not dramatically so.
- Risk is a permanent feature for equity and fixed income investors. Slower overall economic growth makes the economy and markets vulnerable to shocks. Uncertainty around the new administration and its policies may increase volatility in financial markets. We continue to advocate high quality stocks and bonds as the best means of managing risk.

The Economy: The Fed Speaks

“The simple message is the economy is doing well.”

Janet Yellen
March 15, 2017

- The above quote was made in justification of the most recent Federal Reserve increase in federal funds.
- Growth is still slow, but imbalances and excesses are absent.
- It reflects the belief that the current economic cycle can continue without interruption.
- Because the economy is doing well, stocks have been rising and bond yields are increasing.

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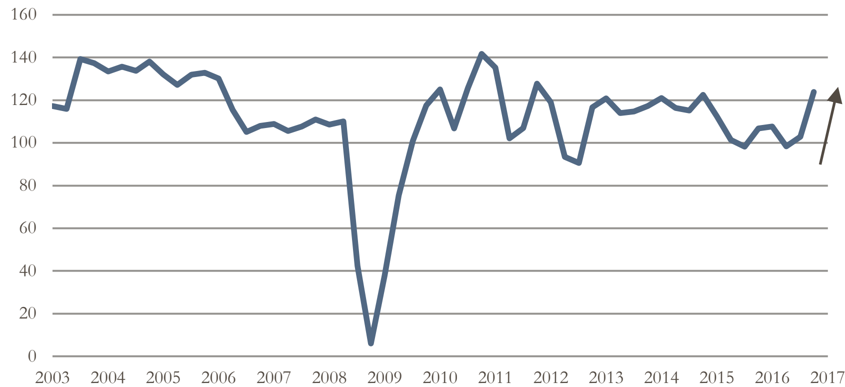
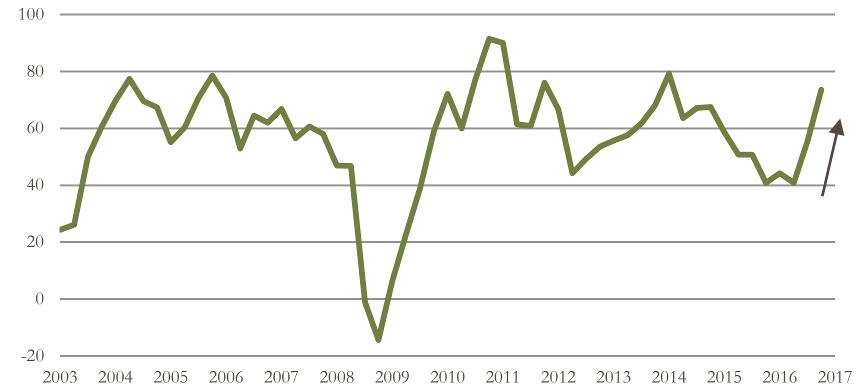
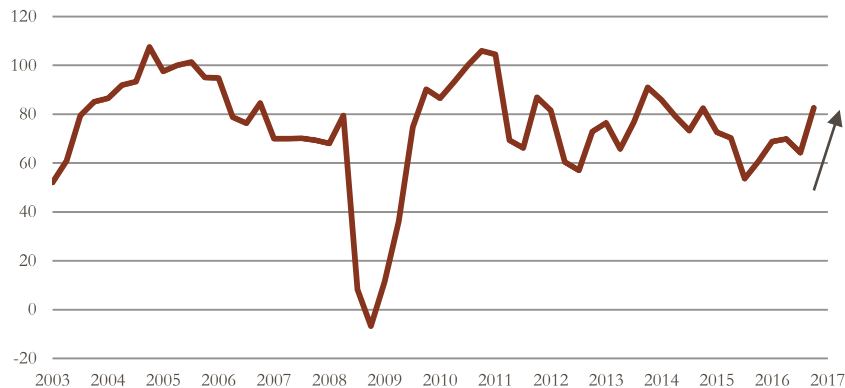
THE U.S. ECONOMY: CORPORATE LEADERSHIP IS OPTIMISTIC



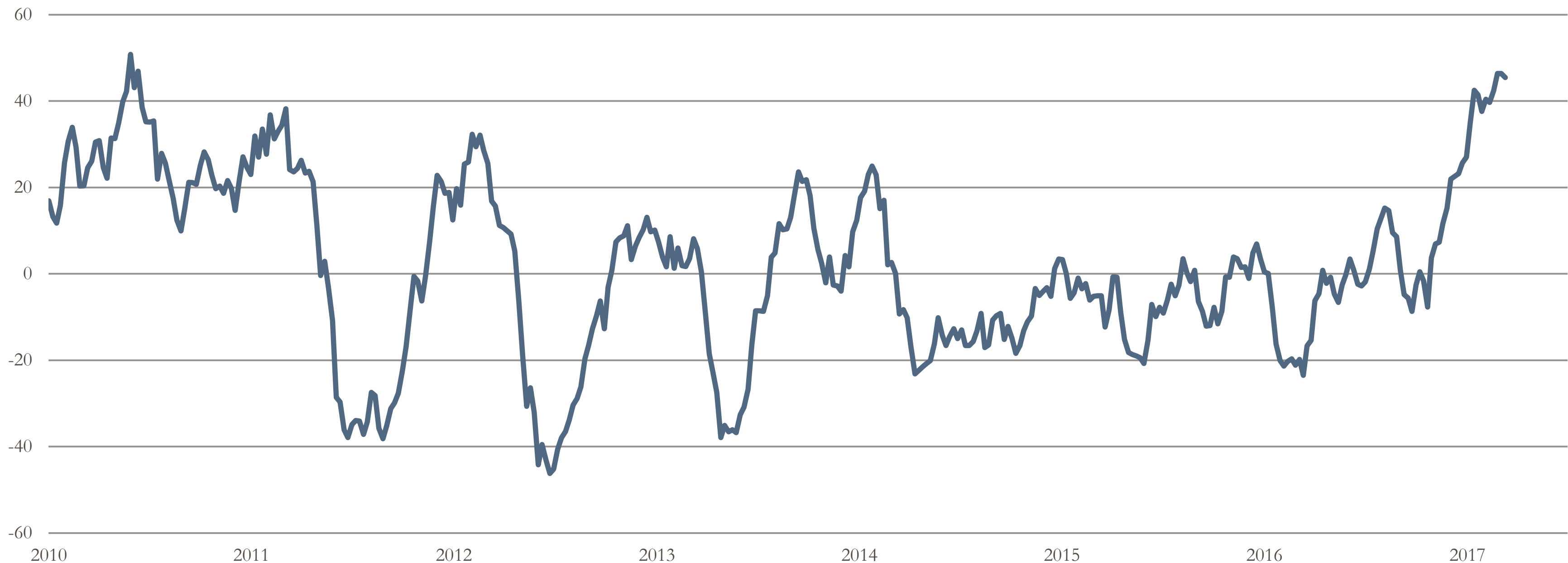




- Surveys of CEOs indicate sharply improved confidence over recent months.
- Improved sales, more hiring, and greater capital spending would suggest faster economic growth and improved earnings, all good for stock valuations.
- Optimism in corporate leadership needs to be converted to reality. Time will tell if action follows their intentions.

Source: Business Roundtable – CEO Economic Outlook Survey (Data through: 3/31/2017)
Please see the last page for important disclosures.

The Global Economy: Also Doing Better



» The Global Economic Surprise index measures reported economic data relative to forecasts of the data. When data comes in above expectations, the index rises.

» After bottoming early in 2016 it has been rising erratically, but in recent months has risen sharply, indicating an improving global economy.

» This Index has been a good barometer of stocks, as they tend to rise in concert with the Index.

Source: Bloomberg (Data through: 3/10/2017)
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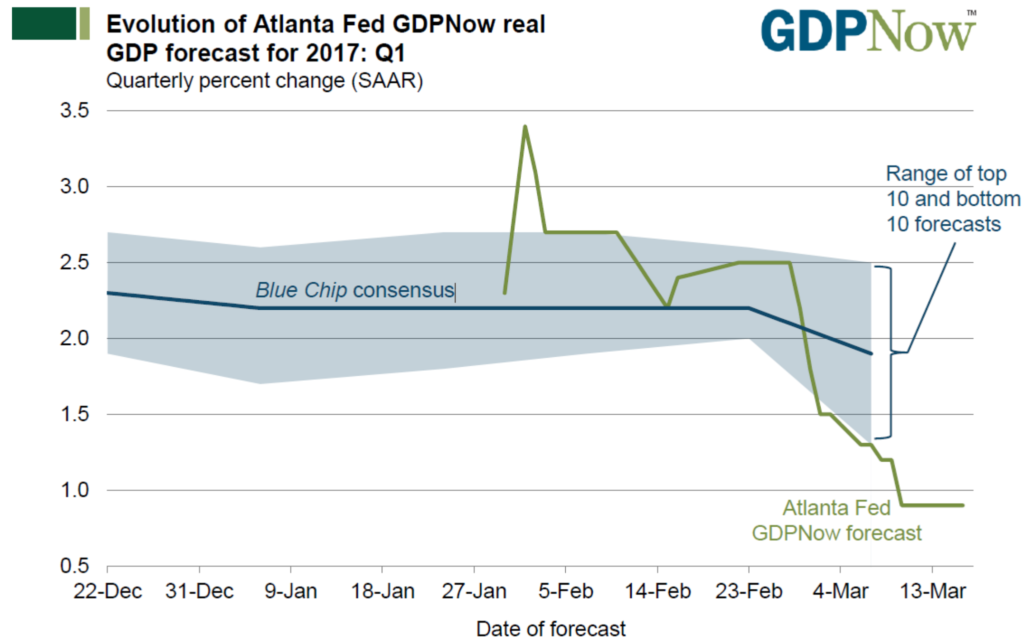
The U.S. Economy: First Quarter Forecast



- GDP Now, from the Atlanta Fed, is forecasting GDP growth of around 1% for the first quarter of 2017. This seems at odds with overall indications.
- In recent years there has been a seasonal tendency toward lower GDP growth in the first quarter. Perhaps this accounts for the expected low number.
- Since the economy has been growing slowly at around 2% for the entire recovery, a GDP growth number of 1% would be of concern.

Source: Federal Reserve Bank of Atlanta
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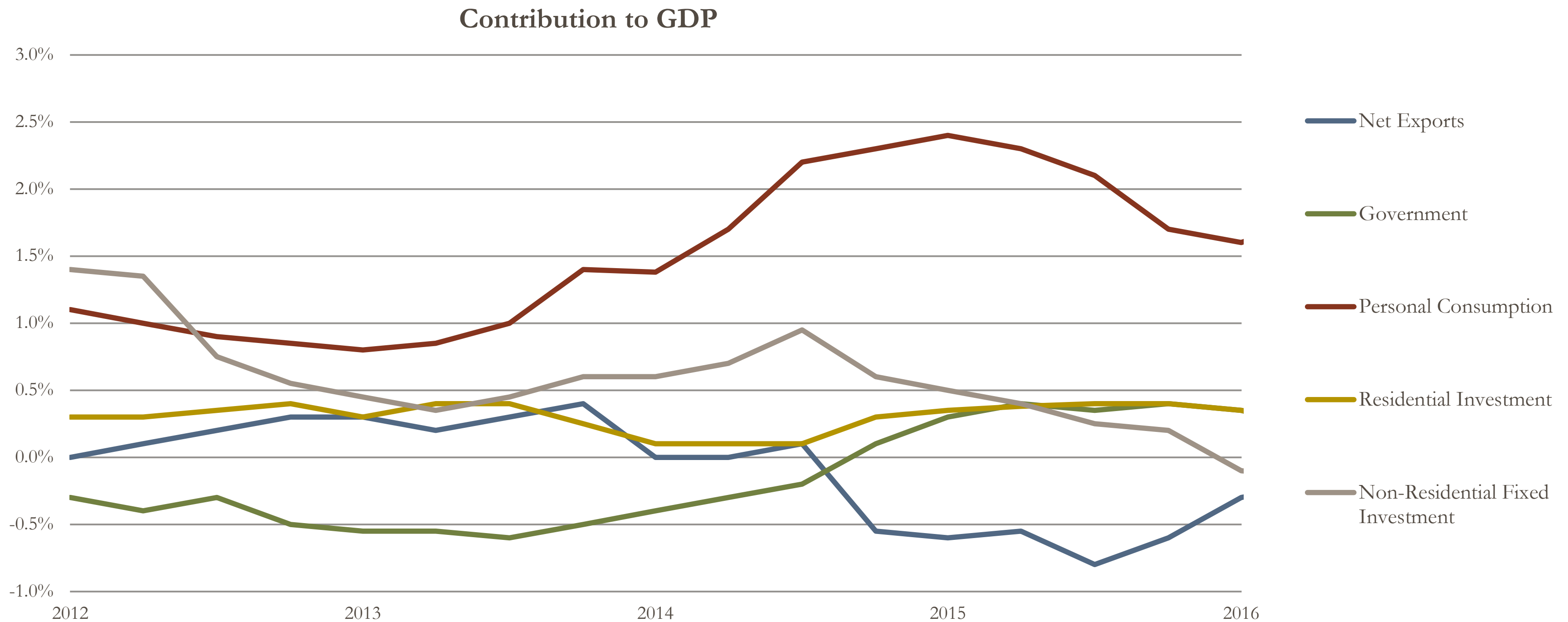
The U.S. Economy: Who Contributes And How Much?



- Of the five contributors to growth in real GDP, Personal Consumption is by far the largest.
- The other four, Net Exports, Government, Residential and Non-Residential Fixed Investment, hover just above or just below zero. Ours is definitely a consumption economy.
- Non-Residential Fixed Investment, which is largely capital spending, and Government have the greatest potential to boost real GDP growth.

Source: Bloomberg (Data through: 1/1/2017)
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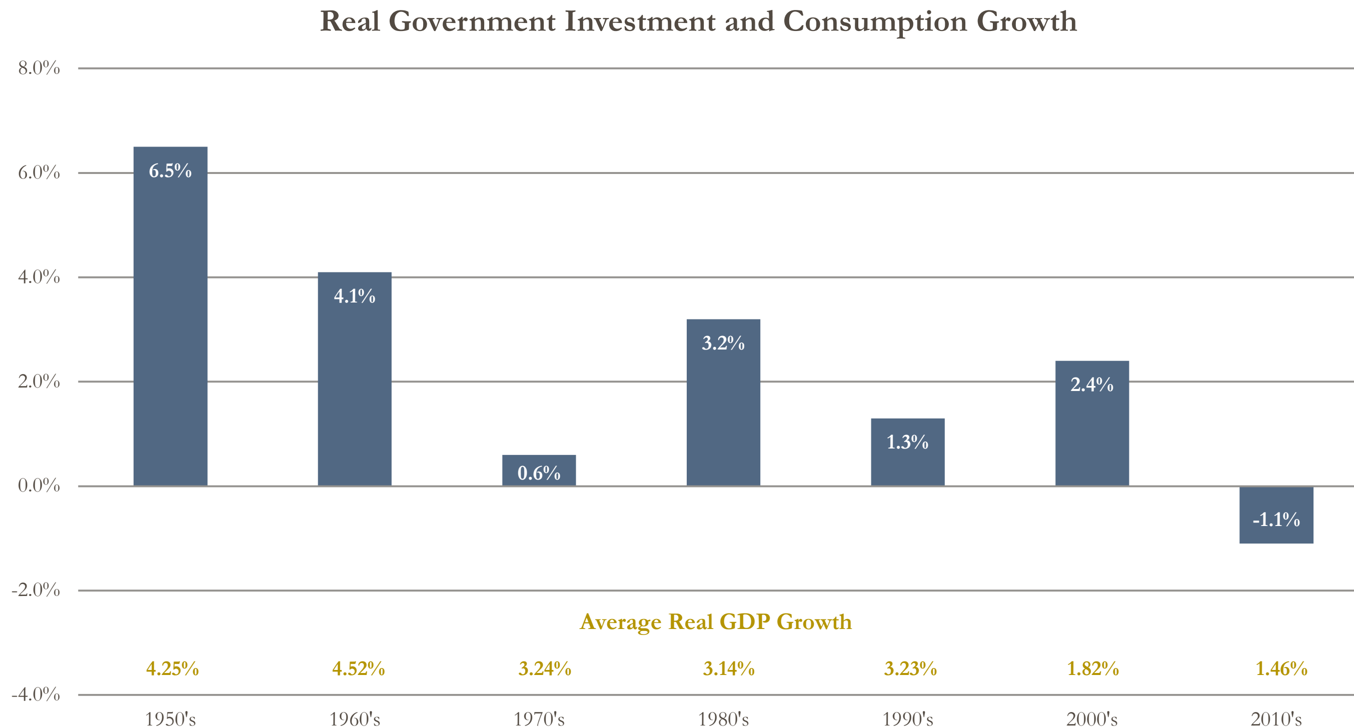
Want More GDP Growth? The Government Can Do It



- Real government spending has been trending down over the last 65 years.
- Note the correlation between government spending and real GDP: more government spending tends to increase real GDP growth, all factors being equal.
- Budget and debt concerns are a factor, but this display supports the case for infrastructure spending.

Bank Credit: Something To Worry About?

Total Bank Credit

Year	2012	2013	2014	2015	2016	Average Growth
% Increase	4.1%	1.2%	6.9%	7.3%	6.8%	5.3%

Month	November 2016	December 2016	January 2017	February 2017	Average Growth
% Increase	2.3%	-0.1%	2.5%	0.0%	1.2%

Consider:

» Bank lending is a major factor in generating economic growth.

» Fairly normal rates of growth in bank credit have occurred within the context of 2% average real GDP growth in the current recovery/expansion, until recent months.

» The sharp contraction in credit growth over recent months is concerning. If it continues at a low rate, it likely will not augur well for economic growth.

Source: Federal Reserve H.8 Statistical Release – 3/31/2017
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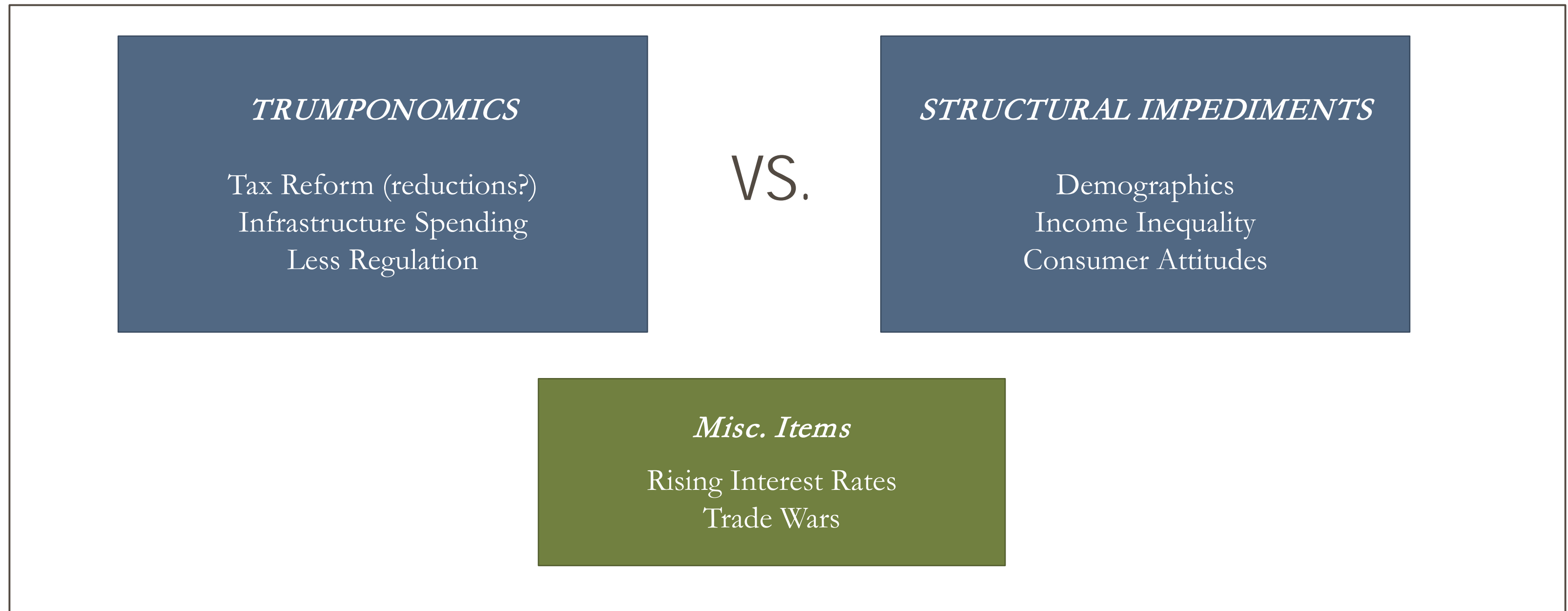
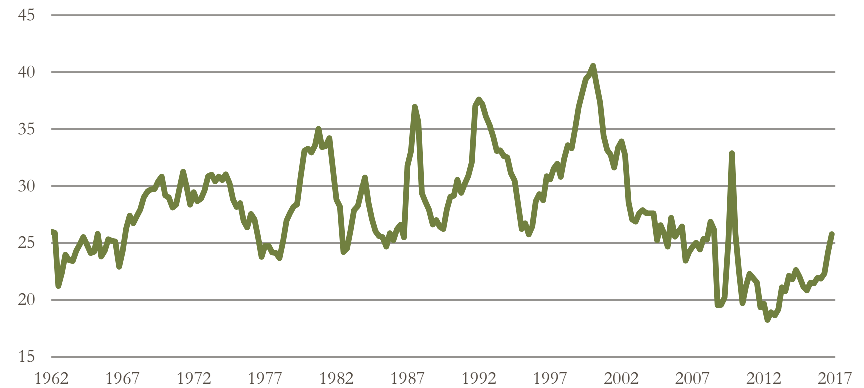
Trumponomics: Update



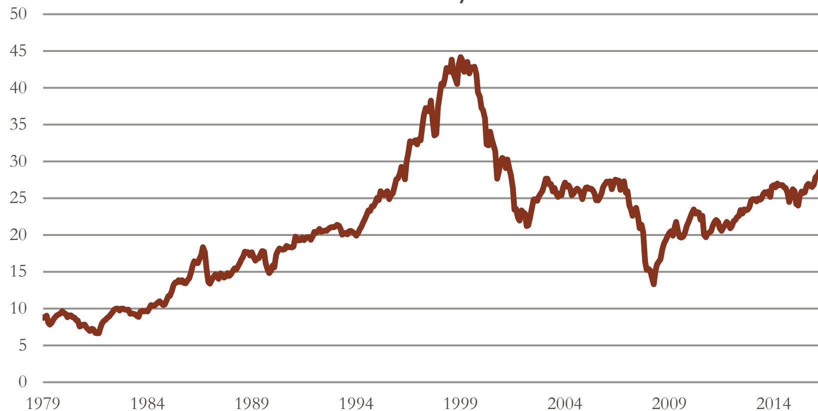
- Investors have given Trumponomics the benefit of the doubt since the election. The stock market has risen sharply and bond yields have increased.
- Concrete progress on tax reform and infrastructure spending has yet to appear. The failure to repeal Obamacare casts doubt on the ability to affect comprehensive tax reform.
- There has been some deregulation through executive order, but major reform such as unwinding Dodd-Frank does not seem likely at this point.
- Enthusiasm for Trumponomics has waned somewhat, as stocks have levelled off, bond yields have retreated, and the U.S. dollar has weakened.

The Stock Market: Valuation

Source: Bloomberg (Data Through: 3/27/2017)



Sum of PE Ratio (LTM), 10 Year Treasury Bond Yield, Annual CPI Inflation
Source: Bloomberg, Federal Reserve Bank of St. Louis (Data Through: 1/1/2017)

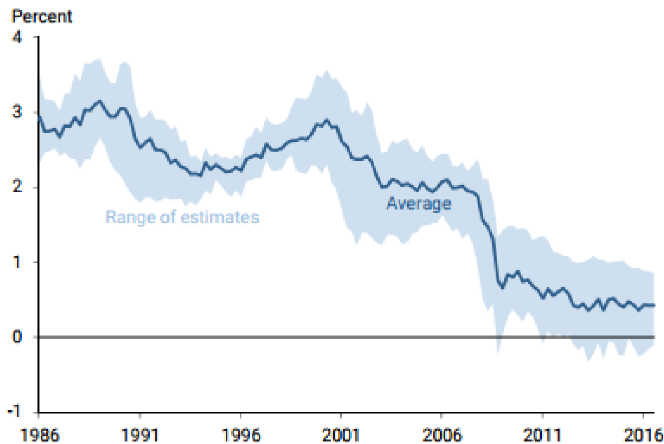


Source: Robert Shiller (Data Through: 3/27/2017)

- We present three stock valuation measures. Two, the S&P 500 and Shiller PE Ratios, signal overvaluation relative to their history.
- In contrast, the Environmental PE still indicates undervaluation, reflecting an environment of well-below-average interest rates and inflation.
- Stock prices are normally forward-looking, and currently are assuming faster economic and earnings per share growth. Overvaluation does leave room for disappointment.

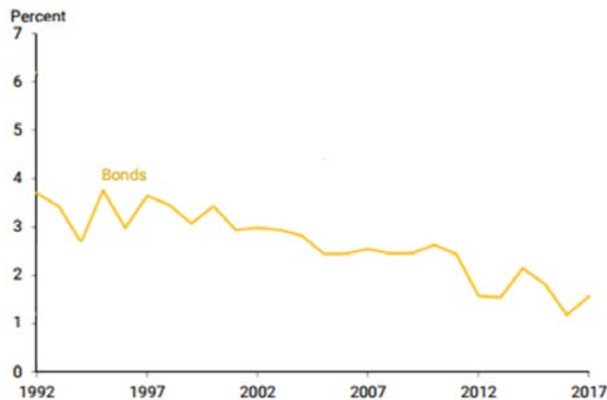
BONDS: HOW HIGH CAN YIELDS GO?

Estimates of the Natural Rate of Interest



Note: The five estimates are from Laubach and Williams (2003), Kiley (2016), Lubik and Matthes (2016), Johanssen and Mertens (2016), and Holston, Laubach, and Williams (2016)

Forecast of 10 Year Real Bond Returns



Note: Returns are deflated with SPF long-run consumer price index inflation forecast

» The natural rate of interest is defined as the rate at which savings and investment are balanced at full employment. But since the rate is unobservable, uncertainty surrounds this assumption.

» The San Francisco Fed is now forecasting a real natural rate of interest at approximately one half of 1%, or 50 basis points. This has implications for bond yields.

» It will be difficult for bond yields to rise too far above the natural rate without becoming a tightening force on the economy.

» These forecasts are in line with ours. We believe bond yields will trend upward, but the rise should be limited by the natural rate of interest as well as other structural impediments.

Source: Federal Reserve Bank of San Francisco (FRBSF) Economic Letter, Issue 2017-05 dated 02/21/2017; *Three Questions on R-Star*, by John C. Williams
Please see the last page for important disclosures.

Disclosure Statement

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