CRAWFORD
INVESTMENT COUNSEL
-EST. 1980-

Economic & Market Environment

Third Quarter 2017

THE FIRM'S OUTLOOK: SUMMARY AND CONCLUSION

THE ECONOMY

» Four major elements of economic activity are currently constructive:

- Real Gross Domestic Product (GDP)
- Employment
- Inflation
- Interest Rates

Positive trends within these components suggest continued expansion of the economy. Stress points or economic extremes seem to be absent, suggesting a low probability of recession over the near-to-intermediate term.

» The Trump economic agenda is moving more slowly than expected. Through tax reform, infrastructure spending and less regulation, the Administration hopes to return economic growth to more traditional levels, or greater. These initiatives will be challenged by structural impediments.

» The interest rate cycle has turned. The Federal Reserve (Fed) has now effected its fourth interest rate increase and is signaling one more increase in 2017. The expected rate for federal funds still resides at only 2% at year-end 2018. Longer-term interest rates have yet to be effected by increases in short-term rates.

STOCKS AND BONDS

» Investor enthusiasm for Trumponomics has waned somewhat as specific progress has not been forthcoming. Fortunately, the corporate-profit cycle has turned up, providing support for rising stock values. Valuation measures on stocks are mixed, but it is difficult to make the case that they are cheap.

» Bond yields have stabilized as Trumponomics enthusiasm has faded and economic growth and inflation remain low. 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.

ECONOMIC HEALTH CHECKUP: THE BIG FOUR LOOK O.K.

GROSS DOMESTIC PRODUCT

The basic measure of the economy's output of goods and services continues to expand slowly, but consistently, at 2% or lower annually.

EMPLOYMENT

Only 4.3% of the working population is now unemployed. This low figure is tempered by a very low participation rate. Growing employment means more money in workers' pockets, and fuels consumption.

INFLATION

Low and stable inflation improves confidence and preserves purchasing power of consumers. Headline inflation is only around 2%, and core measures are even lower.

INTEREST RATES

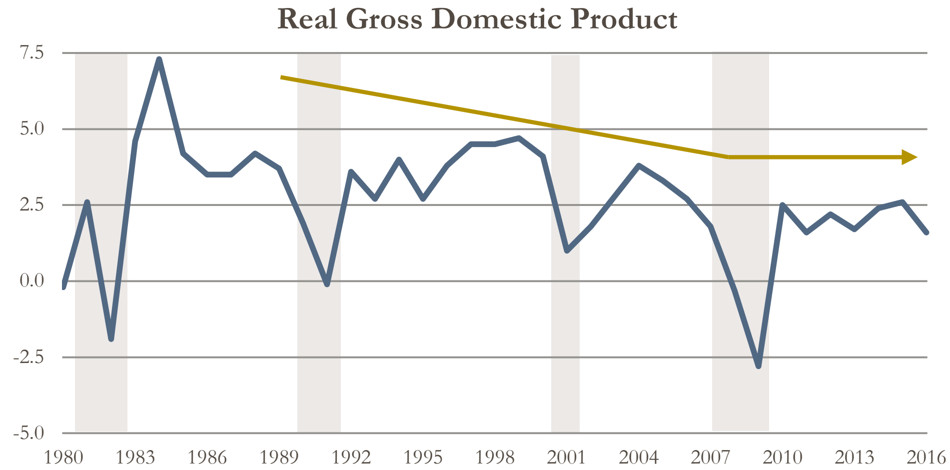
Low and stable interest rates encourage borrowing which in turn stimulates economic activity. Widespread expectations of higher rates have been frustrated thus far.

» The Big Four economic factors form the basic structure of the overall economic environment. If they are all in a favorable or improving trend, business and investment conditions should be constructive.

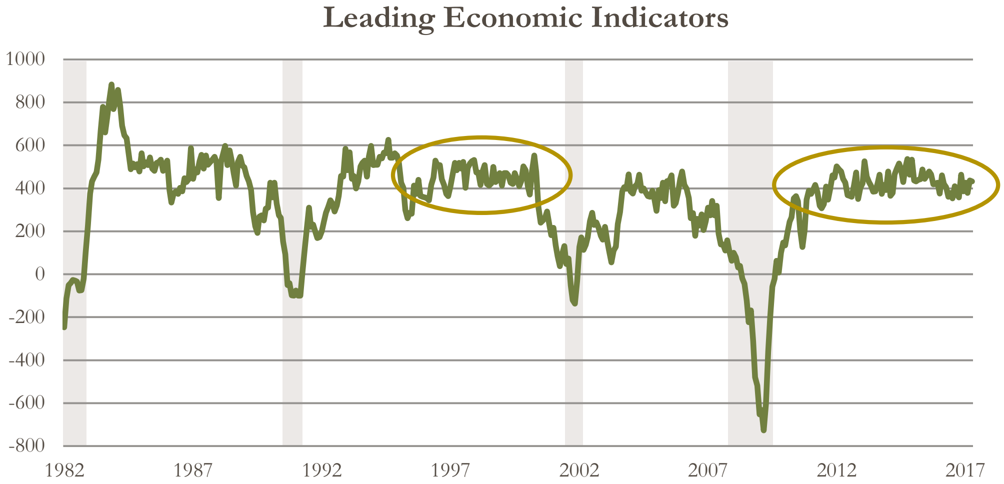
» Each of the Big Four remain in favorable trends, to a greater or lesser degree. Economic growth is stable, but remains low.

» There are many other economic issues that are important in the larger picture, but a focus on the health of the Big Four should be instructive for investors.

The Economy: Real Growth Should Continue



Real Gross Domestic Product, Percent Change from Preceding Period, Annual, Not Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 2016)

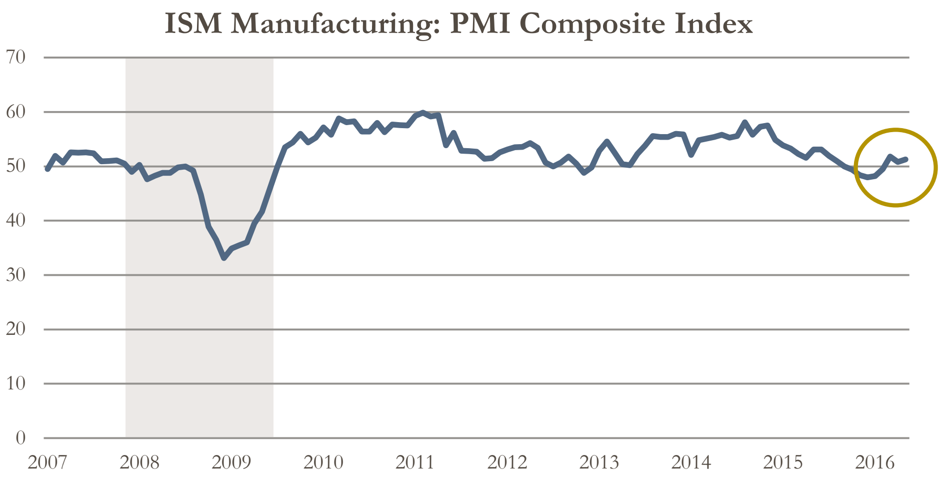


Leading Index for the United States, Index Nov 1982=100, Monthly, Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 4/1/2017)

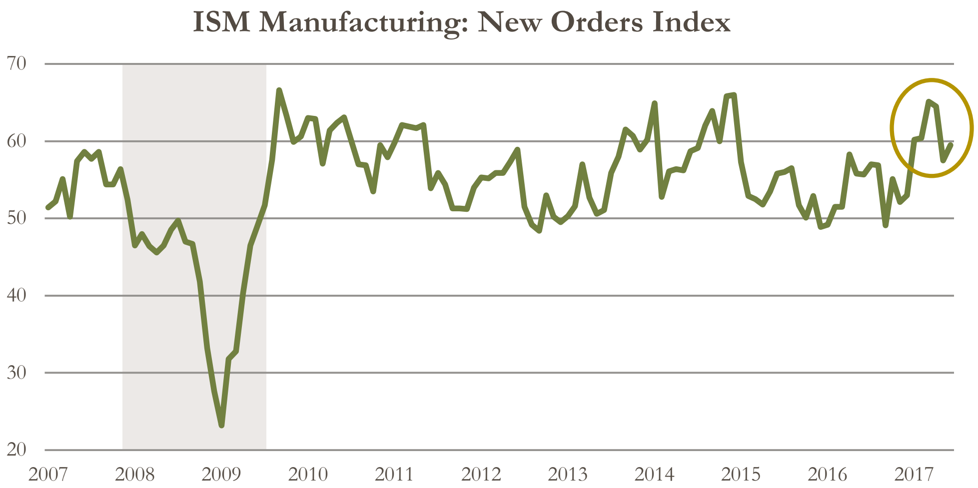
- Although Real Gross Domestic Product (GDP) has been in a slowly declining trend for years, it has stabilized in the vicinity of 2%. We expect this positive trend to continue, and we see no recessionary tendencies at this time.

- Leading economic indicators are one of the better indicators of economic health. They continue to suggest future growth. Note how they have declined precipitously prior to and during previous recessions.

The Economy: Manufacturing Is A Key Element



ISM Manufacturing: PMI Composite Index
Source: Data 360(Data Through: 5/1/2016)



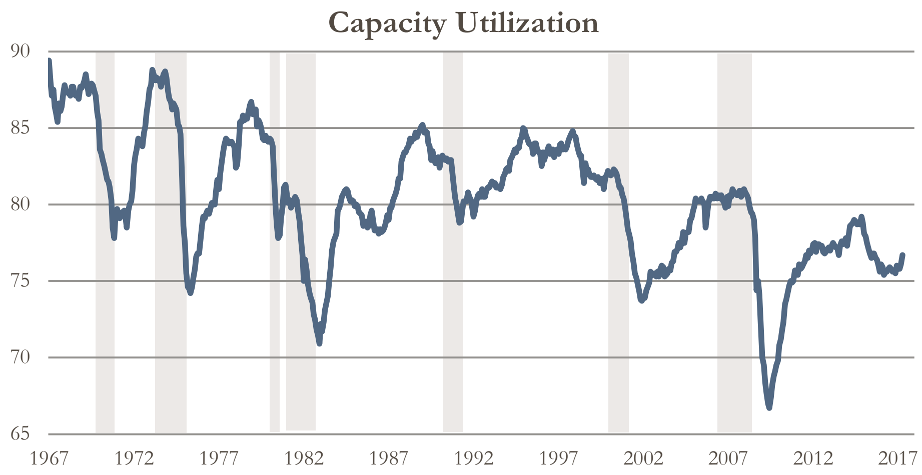
ISM Manufacturing: New Orders Index
Source: Investing.com (Data Through: 6/1/2017)

» Although the service sector of the economy has become larger, manufacturing remains a bedrock element of economic health.

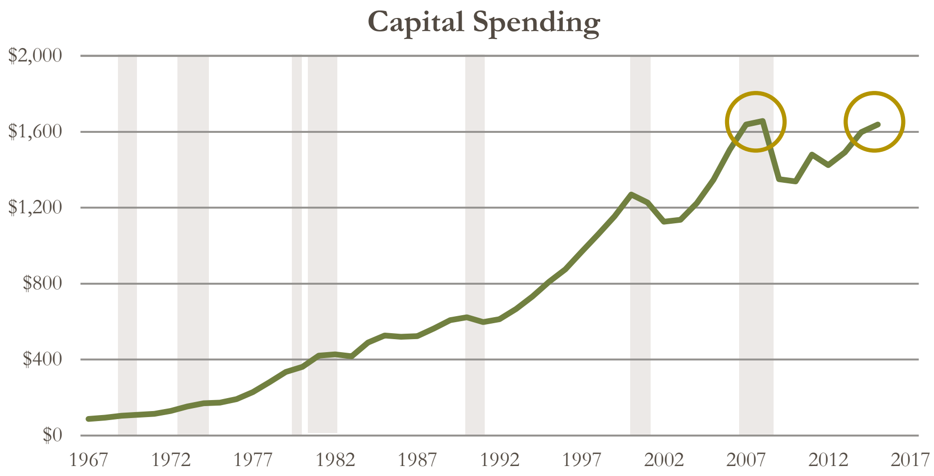
» Recent trends in new orders for manufacturing and actual manufacturing are encouraging.

» Manufacturing is a cyclical component of the economy, and thus suffers greatly in recessions. Trends have been relatively stable since the last recession.

The Economy: Plenty Of Room For Expansion



Capacity Utilization: Total Industry, Percent of Capacity, Monthly, Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 4/1/2017)



Total Capital Expenditures by Type for All U.S. Businesses
Source: United States Census Bureau

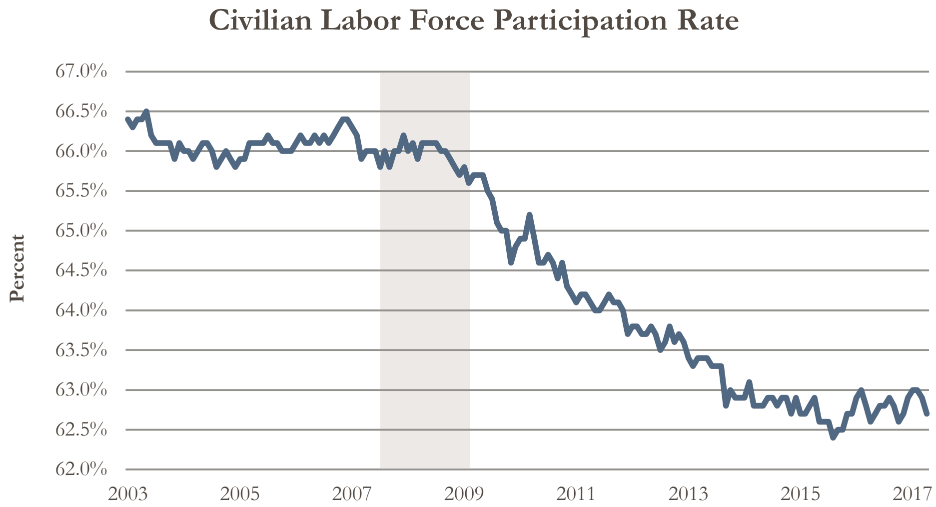
» Capacity utilization, at around 77%, is well below average, indicating there is still room for considerable economic expansion without creating significant inflation pressures.

» Capital spending, an important element in productivity, is only at levels of ten years ago. This is disappointing. Bricks and mortar expansion is unnecessary when spare capacity exists.

» One of the main goals of tax reform is to give companies incentive to invest capital for improved worker productivity.

EMPLOYMENT: THE BRIGHT SPOT

Unemployment Rate: Aged 15-64: All Persons for the United States©, Percent, Quarterly, Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 1/1/2017)



Civilian Labor Force Participation Rate, Percent, Monthly, Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 5/1/2017)

» The employment picture is strong. From its peak of 10% it now resides at 4.3%. This is a very healthy trend.

» Excitement over the unemployment rate must be tempered by the low participation rate. Only a little more than 60% of potential workers is now employed or seeking employment, down from 66% a decade ago.

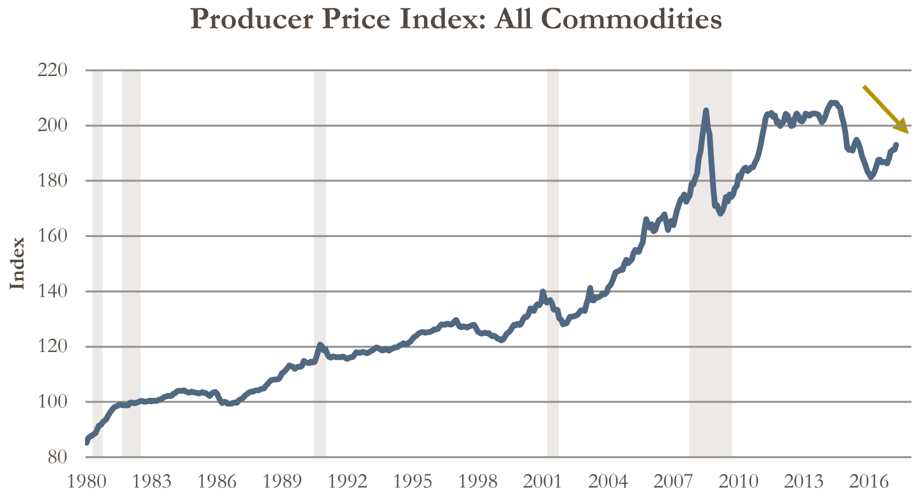
» The Fed counts the employment picture among the main support factors for raising interest rates.

INFLATION: COMMODITIES ARE HELPING A LOT

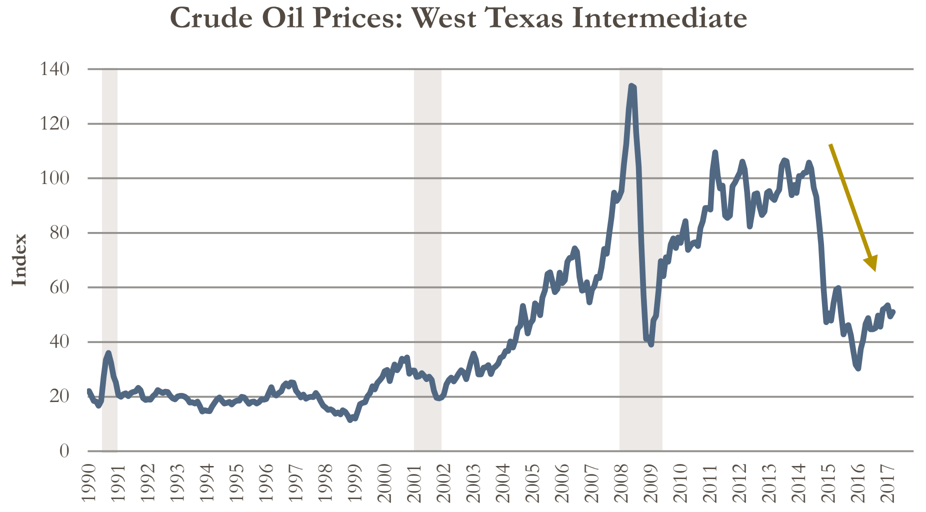
- Commodities play an important role in the overall inflation picture. They are a key component of input costs for producers, and in many cases directly affect consumer costs.

- Oil is in many ways the most important commodity because its price makes headlines, and so many consumers are affected every day by the price of gasoline.

- The dynamics of oil production have changed dramatically. Trading at roughly 50% of their peak, oil prices may have peaked on a permanent basis. If so, this augers well for future inflation, but is a threat to an important sector of the economy.

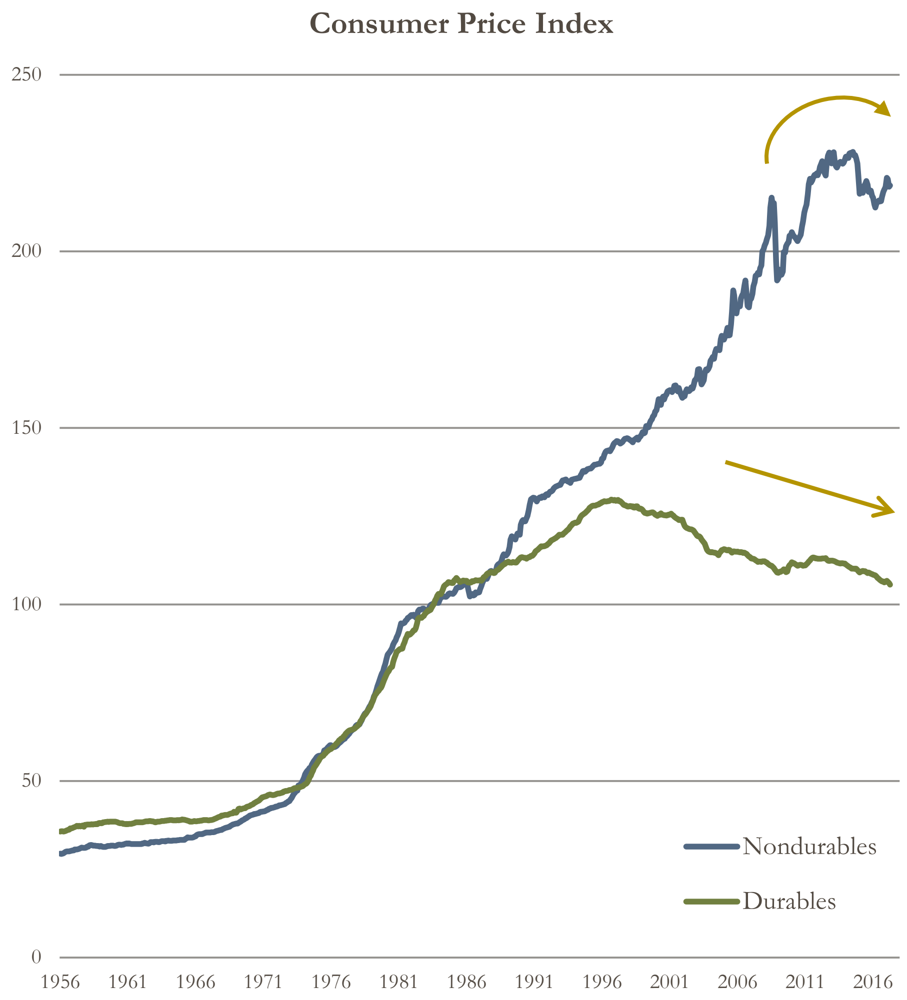


Producer Price Index for All Commodities, Index 1982=100, Monthly, Not Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 4/1/2017)



Crude Oil Prices: West Texas Intermediate (WTI) - Cushing, Oklahoma, Dollars per Barrel, Monthly, Not Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 4/1/2017)

Inflation: Don't Forget about Cheaper Durables



Consumer Price Index for All Urban Consumers: Nondurables, Index 1982-1984=100, Monthly, Seasonally Adjusted
Consumer Price Index for All Urban Consumers: Durables, Index 1982-1984=100, Monthly, Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 4/1/2017)

» Consumer inflation has been trending lower for years. Many do not believe this, as they forget that many durable goods such as TVs, computers, appliances, etc. have been deflating for the last 20 years.

» Nondurables peaked around 2011 and have also been declining since then.

» Consistent low inflation is good for consumers and businesses. It leads to improved confidence in both cases.

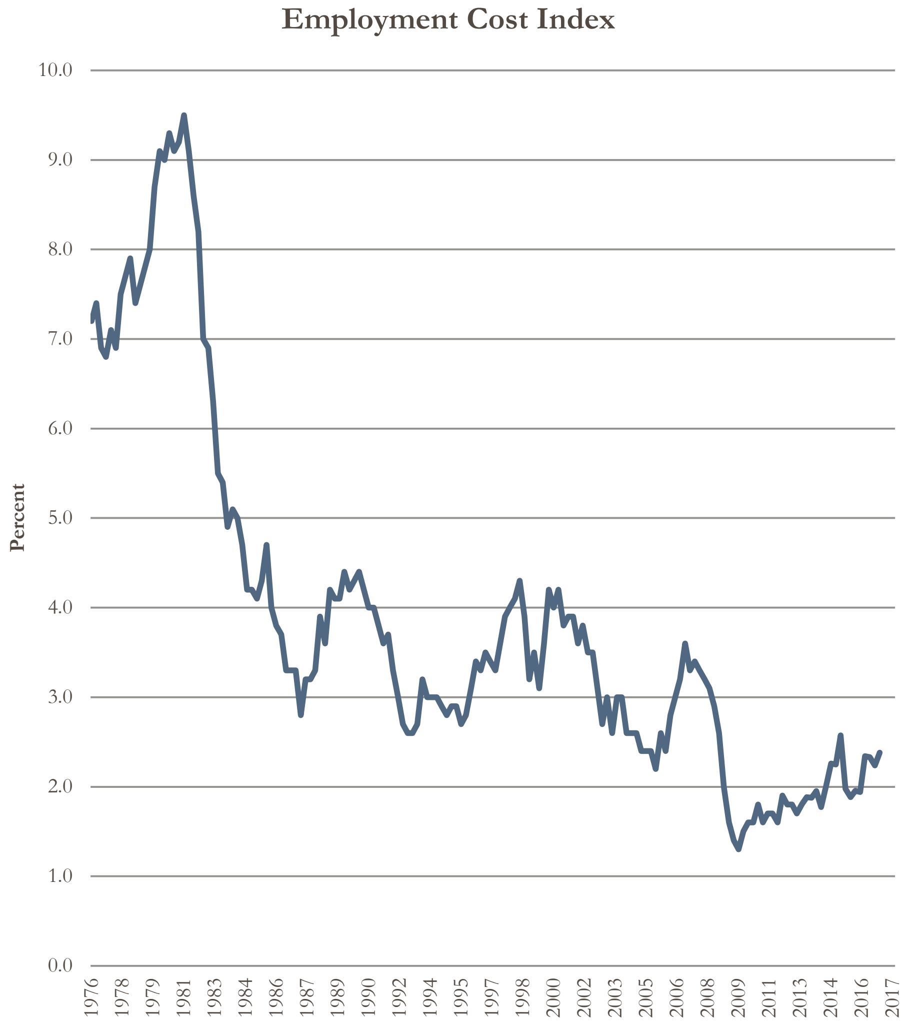
Inflation: Wages Are A Threat

» The Employment Cost Index is considered one of the best measures of wage growth.

» Wage growth is a threat to inflation for two reasons:

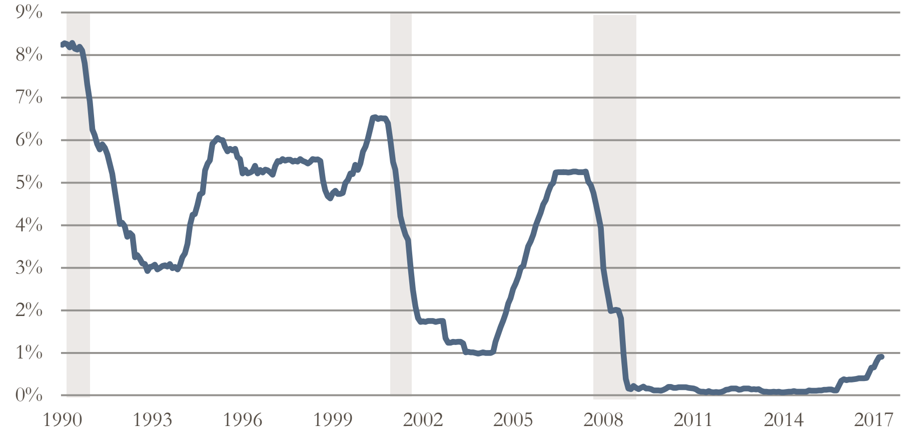
1. Higher wages give consumers more money to spend and this may push consumer prices higher
2. As companies are forced to pay higher wages due to a tight labor market, they will attempt to recoup this through higher prices.

» To date, wage growth remains well under control at about 2.5% annually. This seems at odds with a fully employed economy.

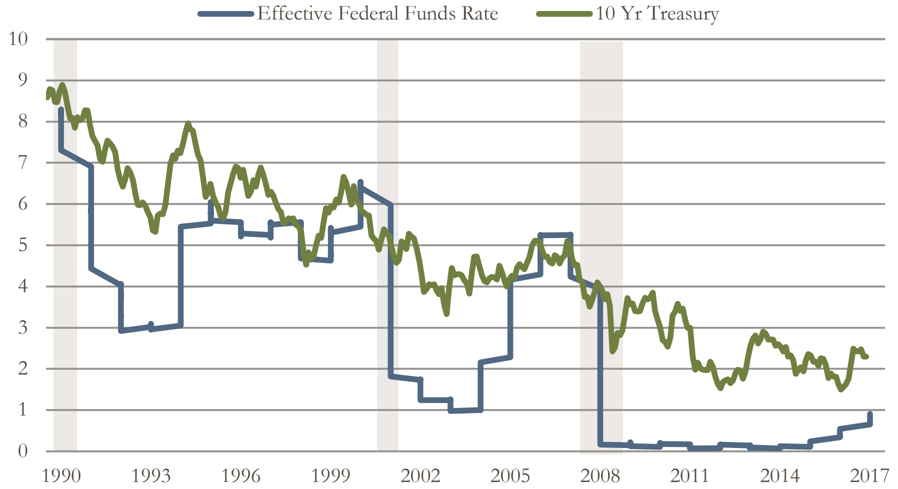


Employment Cost Index: Total compensation: All Civilian, Percent Change from Year Ago, Quarterly, Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 1/1/2017)

Interest Rates And The Bond Market: How High Can Yields Go?



Effective Federal Funds Rate, Percent, Monthly, Not Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 5/1/2017)



Effective Federal Funds Rate, Percent, Monthly, Not Seasonally Adjusted
10-Year Treasury Constant Maturity Rate, Percent, Daily, Not Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 5/1/2017)

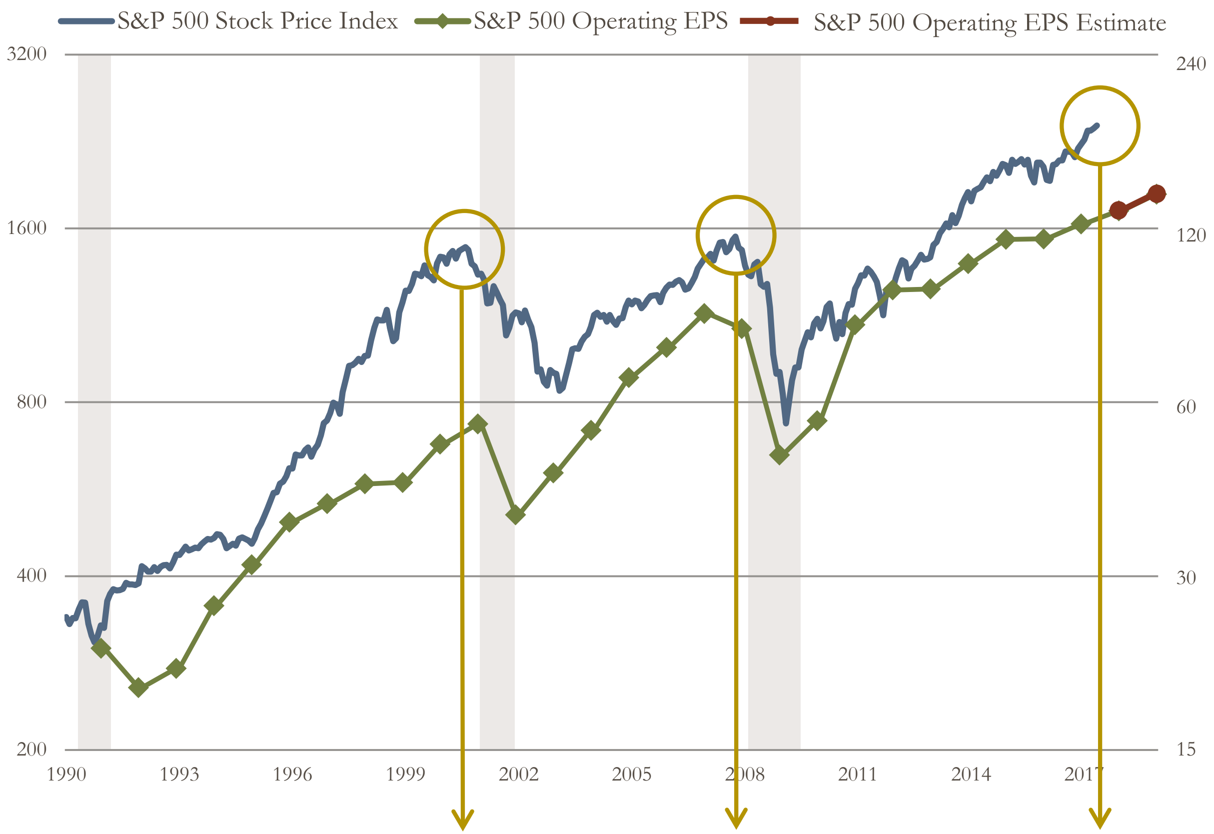
» In an attempt to "normalize" interest rates, the Fed has now increased its federal funds rate four times to 100-125 basis points. They project a peak rate of 3% in 2019 or 2020.

» Normally, increases in short-term interest rates lead to increases in longer-term interest rates. Thus far, longer-term rates are resisting. The spread between federal funds and the yield on 10-year treasuries is narrower than normal.

» This condition reflects investor perception of low inflation for the foreseeable future. The Fed may not be able to reach their federal funds goal if inflation expectations do not change.

» We expect gradual increases in longer-term bond yields if the Fed is able to follow their plan for federal funds, but such increases should be modest compared to history.

The Stock Market: Now At A Peak?



P/E	**24.0**	**16.1**	**18.0**
Yield	**1.1**	**1.8**	**1.9**
Federal Funds Rate	**6.5**	**4.5**	**1.125**
10 Yr. Treasury Yield	**6.0**	**4.5**	**2.2**

S&P 500©, Index, Monthly, Not Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 5/1/2017)
S&P Operating EPS, Calendar Year
Source: FactSet (Data Through: 2016, Estimates for 2017, 2018)

- The stock market currently resides at an all time high. Is it too high?
- The primary driver of stock prices is corporate earnings. These also reside at an all-time high.
- Valuation should be judged relative to history, but also relative to the overall economic environment, especially interest rates and inflation.
- We maintain that higher valuations are justified by lower interest rates and inflation.
- Notice that the last two peaks occurred just prior to recession. We do not expect a recession now or in the foreseeable future.

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