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ECONOMIC & MARKET UPDATE

For the first half of the year, stocks and bonds have moved in different directions, but not materially so. Year-to-date returns from major equity indexes range from marginally positive to breakeven to slightly negative. Bond returns remain in slightly negative territory, reflecting higher Federal Reserve-induced interest rates.

> As is often the case, in the current environment, significant uncertainty attends the process of making monetary policy. Today, with the economy strong and risks to the outlook balanced, the case for the continued gradual increases in the federal funds rate remains strong and broadly supported among FOMC participants.
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> Jerome Powell, Chair of the Federal Reserve
> June 20, 2018

Few things are more important to investors than the level of interest rates, for it suggests much about expected returns for bonds and stocks and has major implications for the state of the economy. The Federal Reserve (Fed) has been raising the federal funds rate since late 2015 and is committed to further increases. As a result, there is keen interest in how high interest rates are likely to go. Chairman Powell speaks of the uncertainty of making policy currently. What he is referring to is the apparent conflict between an almost fully-employed economy and the lack of significant inflation. According to the Phillips Curve, one of the more prominent economic indicators, wages and inflation should be rising since unemployment is at levels not seen since the 1960s.

In speaking of the uncertainty that attends the process of making monetary policy today, Chairman Powell is in fact admitting to the possibility of policy mistakes. Mistakes can occur either because rates are increased too aggressively and therefore choke off economic growth, or the pace is too deliberate and inflation suddenly surges, leaving the Fed behind the curve. Somewhere in between lies the perfect path, an elusive one, and policymakers find themselves walking a fine line trying to accommodate the dual mandate of full employment balanced with moderate inflation.

We believe the extent of increases in federal funds, and subsequent increases in longer maturity interest rates as well, will be determined by two factors: the rate of growth in the economy and the rate of inflation and inflation expectations. Let's look at current and expected growth rates in the economy, as well as where inflation is and where it might wind up.

ECONOMIC GROWTH: The good news is that the U.S. economy is currently experiencing accelerated growth. Real Gross Domestic Product (GDP) is now reported to have risen 2.75% over the past four quarters, well above most estimates of its long-term trend. The unemployment rate of 3.8% is forecasted by many to fall to the mid 3% range and remain there for an extended period. The Atlanta Fed's GDPNow model is currently estimating second quarter GDP at over 4%. Finally, recently enacted fiscal stimulus is being felt in a positive way and should add to domestic demand over the next few years. All this is good and is a welcome contrast to the trend rate of 2% growth since the end of the Great Recession.

Looking to the longer term, enthusiasm over the current strong growth should be constrained, for, as we have noted in the past, two significant factors will be working to limit high rates of GDP growth. Sustained economic growth comes from two sources: population and immigration growth that produces new workers for the labor force and increased productivity. Both trends are slow or slowing. Demographics only change gradually over long periods of time. With regard to productivity, it is hoped that one of the desired results of the recently passed corporate tax reduction will be more investment in plant, equipment, and technology which should lead to improved productivity. The Fed itself, as well as the International Monetary Fund, foresees potential U.S. economic growth over the longer term at around 1.8%. But for now, our growth has improved, and this will play a key role in Fed policy on interest rates.

INFLATION AND INFLATION EXPECTATIONS: The rate of inflation has been in steady decline for almost forty years, beginning with Paul Volker's war on inflation in the early 1980s. While there have been temporary or cyclical uptrends in inflation, for the most part it has been in steady decline over this period. Even in the face of unprecedented zero rates of interest for some seven years, as well as quantitative easing, inflation has barely budged from its long-term trend.

The long trend towards lower inflation reflects a world in which deflationary forces have prevailed. Among these forces are technology and automation, globalization, the loss of negotiating power as labor union membership shrank, and others. Monopsony appears to have become more prevalent, a result of greater concentration among companies. Monopsony occurs when a large buyer controls a larger proportion of the market and drives prices down. All of these factors have fed into a basic supply/demand dynamic wherein the world's ability to produce goods and services far exceeds the demand for those goods and services. Any such imbalance will inevitably lead to price constraint.

Against this backdrop, the Fed considers it desirable to see its favored inflation gauge, Real Personal Consumption Expenditures (PCE), at a 2% level. They see this target as high enough to avoid the dangers of deflation yet low enough to provide competitive balance within the economy. Currently, PCE is in the high 1% range and is moving in the direction of the target. A key factor to monitor in the inflation discussion is wage gains. The above-mentioned Phillips Curve suggests that as unemployment decreases, wages should increase, leading to higher inflation. However, this has not happened yet, possibly reflecting some of the deeply embedded deflationary forces in the economy. But if and when wages begin to rise at a more rapid pace, we should expect the Fed to start moving more aggressively to be sure the inflationary effects will be limited.

POSSIBLE OUTCOMES: As conditions develop, the Fed will have to make choices. We see several potential outcomes. The first is the most desirable but probably the least likely to occur. Wouldn't it be nice if the Fed could engineer a perfect landing so that inflation is maintained at 2% in such a way that economic growth could continue at an acceptable rate and this long economic recovery/expansion could go on for many years? The history of Fed policy suggests this is not likely to happen. There are just too many moving parts in the economy. Steering it solely on the basis of monetary policy with all its time-leads-and-lags makes it well-nigh impossible to achieve the perfect outcome. However, this is not to say that the outcome has to be bad. More likely is some combination of Fed policy and secular trends that sustains growth and maintains low inflation in a reasonable fashion, recognizing that a recession will occur at some point. Importantly, all recessions do not have to be as devastating as the Great Recession. Mild recessions, while never pleasant, can serve the purposes of restoring balance, removing excesses, and allowing economic fundamentals to reassert themselves.

INVESTMENT IMPLICATIONS: Our discussion of the problem of making monetary policy at this time, as suggested by Chairman Powell, implies that risks are rising the farther we go into this cycle of recovery/expansion. The risks include the fact that the recovery/expansion is aging every day, and economic growth is running above potential, which may presage more aggressive action by the Fed. We are not forecasting extreme risk, but things economic have been pretty good for a long time, and we do know that interest rates are rising. We just do not know how far they will rise.

From our perspective, we would hope for restraint on the part of the Fed, since we believe so many of the deflationary forces of the past are still embedded in the economy. This informs our view of the future of interest rates more than anything else. It suggests further increases in interest rates, but only moderately so. If the benchmark ten-year U.S. Treasury yield can be contained at less than 4% in this cycle, a reasonable assumption in our opinion, that would limit damage to bond portfolios and would allow companies a lot of room to continue operating their businesses well and rewarding stockholders with higher earnings, dividends and stock buybacks.

If risks are rising, it is incumbent upon us to maintain our strong emphasis on quality. We expect to remain fully invested throughout the coming period, in line with portfolio policy guidelines, while continuing to focus on quality and the sustainability of the underlying businesses.