

ECONOMIC OUTLOOK

Summary

Tax cuts, regulatory rollbacks and government stimulus are having a noticeable impact on the U.S. economy and it showed with the latest GDP forecast for Q2 2018. It might not be the strongest or best economy we've seen in the last 50 years, but it's pretty good. 4.2% growth (annualized) for the initial measurement and it portends further gains ahead. But before we dig into some of the specific details, it's worth examining one of the Bureau of Economic Analysis's (BEA) revisions to prior periods and it was a doozy.

To begin with, the BEA found about \$3 Trillion in personal income, previously unreported from 2012 to 2018. Most of it was earned by contractors and small business owners. As a result, the saving rate, previously reported to have dropped from 6% in 2014 to less than 3% in 2017, was actually stable over that time at about 7%. Think of a higher savings rate as deferred consumption, the higher the number, the more potential spending available to the consumer. So instead of sub 3% savings rate coming into 2018, the consumer is flush with potential spending power at close to 7%, who knew? Nobody - until now.

The major point here is to be careful not to overanalyze any single economic data point that may be revised years into the future. But, it's also the only information we have to consider at a single point in time. Keep in mind, real-time economic data can be weaponized in today's polarized, hyper partisan environment that isn't changing anytime soon. So, soybean exports did boost Q2 2018 GDP by over 1% (ahead of tariffs) but inventories detracted over 1% to the

quarter and were expected to add 1%. When we try to tease out much of the "noise" in the quarter and the revisions, it leaves us feeling good about the prospects for a better than 3% Q3 GDP print, right before the mid-term elections and one might expect to hear something about that shortly thereafter.

Positives

Retail Sales up .5% for the month, but upwardly revised to 1.3% from .8% in prior period

Factory Orders and Durable Goods Orders were better than expected

PCE Core price index surprises to the downside 1.9%, 2.0% expected

Negatives

Housing Starts drop 12.3% for the month as higher rates curb new construction

Advance Goods Trade Balance ticked higher to – \$63.8 billion (deficit is a drag on growth)

New Export Orders contained within industry surveys are weakening (tariff fears?)

EQUITY OUTLOOK

Summary

Equity markets resumed their uptrend in July with positive earnings results outshining escalating trade friction. The S&P 500 rose 3.7% for the month, making July the best monthly performer since the correction in February of this year. High corporate earnings expectations led the way to the release of second quarter results, and companies were able to meet, and in many cases exceed, those lofty forecasts. The debate now centers on whether we are currently experiencing peak margins/earnings and what the full impact will be when the dust settles from the U.S. vs. China trade skirmish.

Strength in stocks was widespread with every economic sector in the S&P posting gains for the month. The most notable outcome from July was a rotation into value stocks and the relative underperformance of growth stocks. Over the last 12 months, the Russell 1000 Growth is up 22.4% and the Russell 1000 Value is up just 9.7% extending a prolonged period of relative outperformance by growth over value. It may be early to suggest that July's 4.0% return for value vs. 2.9% for growth is a sign growth is moving out of favor, but the pattern did accelerate as the month progressed. The underperformance from growth was highlighted by setbacks from a handful of technology leaders, particularly Facebook and Netflix. While we are not suggesting an immediate turn in the growth/value

relationship that began last month, we continue to believe the growth leadership is overextended and have been tilting portfolios towards value given current valuations.

With solid economic fundamentals and corporate America seemingly firing on all cylinders, stocks appear poised to continue moving higher. The global trade tensions and mid-term elections later this year do give us reason to take pause. However, both of these issues will have an eventual conclusion that could serve as a catalyst for equity markets going forward. We believe the risk reward characteristics remain positive for long term equity investors.

Positives

Valuations reasonable following recent earning strength

Consumer and business confidence remain elevated

Negatives

Inter-global economic relationships strained

Rising wages and input costs

FIXED INCOME OUTLOOK

Summary

Rarely does the bond market become so engrossed with two words. Bond investors seem to be obsessed with the implication of the two words “for now” when added to a standard positioning statement by Fed Chairman Jay Powell. During the Fed Chair’s semi-annual report to Congress, he twice stated that further gradual rate increases are consistent with the Fed’s mandate, “for now.” The addition of these two little words likely indicates that the Fed remains open-minded as to how high the overnight rate will actually go and what the neutral overnight rate actually is. Importantly, it illustrates that their fundamental beliefs evolve over time. About two and a half years ago the Fed thought that we would be ending 2018 at a 3.50% Fed Funds rates, so clearly the Fed’s Open Market Committee is not on autopilot and will adapt to new information.

The 2-year Treasury note yield continued to step steadily higher during July and ended the month up 14 basis points (bps) at 2.67%. Longer maturity rates traded in a relatively tight range until later in the month, then moved higher by about 10 bps. The 10-year note ended with a yield of 2.96%, up 10 bps, and the 30-year finished at a yield of 3.08%. The big movement of the month was in the investment-grade corporate bonds where spreads reversed a five month trend and declined by 12 basis points. Narrowing spreads helped corporate bonds deliver positive returns while Treasury bond returns were negative.

Like the Fed, bond market participants still expect two additional rate hikes this year, in September and December. After that, there is a divergence in what investors expect, as measured by the Fed Funds futures market and what the Fed expects according to

their dot plots. We have been saying for some time that we think the market is closer to correct than the Fed forecasts. If that is the case, short rates should still move a bit higher, and so could longer term rates, but we would be surprised to see the 10-year breach 3.25%. We have confidence that the Fed’s forecast will continue to adapt to incoming information and they will not push the economy over into a recession, “for now” at least.

Positives

Global synchronized growth story is under review

Core PCE inflation is finally back at the Fed’s target, but not above

Fed continues to adapt forecast of the long-term neutral overnight rate

Negatives

The second GDP growth rate was the highest in almost 4 years

Tariffs could lead to higher inflation in certain industries

Higher energy prices could cause overall inflation to escalate

Unknowns

Geopolitical pressures including trade and security
