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OUTLOOKS

April 2017

ECONOMIC OUTLOOK

Summary

As we begin the month of April, it's appropriate to ask ourselves, how is the U.S. economy performing compared to expectations from the beginning of the year? The answer would likely be, encouraging but not up to some of the lofty prognostications put forth by the growth bulls. The Atlanta Fed GDPNow Forecast started Q1 2017 projecting GDP growth at around 2.5% and ended the quarter in the low 1.0%'s. That may sound bad, but when you consider the seasonal bias toward weak Q1's in prior years, it will likely be better than similar quarters of the last few years.

One thing to keep in mind while reviewing our economic performance is that we are beginning the ninth year of this economic expansion and lots of "pent up demand" has been satisfied. In addition, goods and services are generally well supplied and many markets continue to face strong discounting headwinds. Incentives for car and truck sales reached a cyclical peak over the last few months and Amazon continues to disintermediate the entire bricks and mortar retail chain. The supply of goods and services continues to outpace final demand, thus perpetuating the disinflationary backdrop consumers have enjoyed the last few years.

Therefore, it would make intuitive sense that economic growth should gradually improve with more market and business friendly policies. Business leaders and investors were probably too optimistic about the prospects for rapid legislative victories and tax reform in the New Year. Therefore, we will need to see the Republican Party actually propose and pass legislation that can become the kindling for quicker economic growth and that hasn't happened yet. Signing Executive Orders and rolling back regulations unilaterally is a start, but the real fundamental building blocks needed for faster structural growth (health care and tax reform) have yet to see the light of day.

Positives

ADP Employment Report averages above 250,000 new hires over last two months

Conference Board Consumer Confidence hits highest level since year-end 2000

Personal Consumption up, at a 3.5% annual rate in Q4 2016

Negatives

Real Average Hourly Earnings flat Year over Year

Capacity Utilization at 75.4% is well below the cycle high of 79.16% reached in November 2014

Car and truck sales in March come in at 16.53 million units annualized vs 17.3 million expected

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EQUITY OUTLOOK

Summary

First quarter 2017 equity performance was positive across many indices; a dramatic change from the same period in 2016. Led by the rebound in the growth sectors of technology (+12.5%), consumer discretionary (+8.5%) and health care (+8.4%) the S&P 500 gained 6.1% in the quarter.

Gains weren't restricted to just U.S. markets; the rest of the world's equities performed as well and in some cases better than the U.S. The developed markets gained 7.3% (MSCI EAFE) while developing markets rose 12.7% (MSCI EEM).

Much attention has been paid to the potential positive impact of the Trump tax and regulatory agenda to the bottom lines of corporate America. We have commented here on the market moves since the election based on an expected boost to corporate profits. Time will tell the reality of any legislative action from Washington along these lines. An early read on Republican solidarity isn't clear and measures of political uncertainty are high.

However, we can't overlook the fact that economic conditions around the globe have been improving in a synchronized manner. Global data such as leading indicators, manufacturing indices, confidence and yield curves all point to accelerating economic growth outside of the U.S. centric view.

This is quite a change from recent history, which saw economic growth, such as it was, feeble at best at sub 2% annual rate, and confined almost exclusively to the U.S. of emerging economies, China and India stand out as the exceptions to contracting economies generally.

Since performance in these market sectors has lagged that of the U.S. for several years now, the valuations of these markets in the absolute and especially relative to the U.S. prices are attractive: enough so to reduce the underweight position in our clients' portfolios.

It may be that a synchronized, late cycle global economic recovery may be sufficient to drive earnings and equity markets higher throughout the rest of 2017. It would be ironic that if by year's end economic growth, inflation measures and market levels set the stage for ramped monetary tightening.

Positives

Jobs report and consumer confidence point to expansion in U.S.

Global economic data positive

Negatives

U.S. valuations no longer inexpensive

Unknown

Policy agenda success?

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FIXED INCOME OUTLOOK

Summary

After months of tranquility, in early March bond yields finally broke out to the upside of their recent trading range as investors anticipated an increase in the overnight lending rate at the mid-month's meeting of the Federal Reserve's Open Market Committee (FOMC). Coming just three months after the previous increase, Fed officials appear quite motivated to remove their significantly accommodative monetary policy that has been in place since the financial crisis. Economic optimism, steady job gains, rising core inflation and increasing stock prices have certainly given them the cover to do so. After starting the month at a yield of 2.39%, the 10-year Treasury note peaked at 2.63% on March 14, the day before the Fed meeting.

Immediately after the meeting, yields dropped sharply as investors were relieved that there were no statements in the press release or the following press conference that would make them believe that rate increases would be more than the three times in 2017, nor were there any defined plans to begin to reduce the Fed's enormous $4.5 trillion balance sheet. The Fed Chair emphasized that this rate hike did not reflect a reassessment of their economic outlook or of the appropriate course of monetary policy. We agree with her statement and believe this rate hike reflects a confirmation of their assessment and their desired course of monetary policy.

Later in the month, rates plunged right back to their starting level when the Trump administration and Republican-led congress where unable to even bring a "repeal and replace Obamacare" bill up for a vote. The missteps, missed opportunity and division within the Republican Party have caused many investors to question their ability to get through any of Trump's pro-growth agenda. Certainly bond investors are betting that radically different tax and trade policies are less likely than before the health care debacle. Overall, the yield curve ended March within a few basis points of where it started the month.

We still believe that rates should rise modestly over the course of the year, but the timing has likely been pushed back until the new administration can deliver on some of their campaign promises for new growth initiatives. Escalating tensions with North Korea and Russia, and even with our major trading partners like Mexico and China, will add an additional element of uncertainty to the outlook. For the next few months, short rates could be the part of the curve that is likely to trend higher.

Positives

Inability of the new administration to implement its pro-growth initiatives

Increasing global tension and the "go it alone" approach to North Korea

The possible further fracturing of the European Union with a "Frexit"

Negatives

The Fed is on course to raise rates two more times in 2017

Increasing Federal budget deficit and additional Treasury borrowings

Animosity with large foreign purchasers of U.S. Treasury debt

Unknowns

Trump administration's ability to enact tax reform

Populist and nationalist movements increasing around the world