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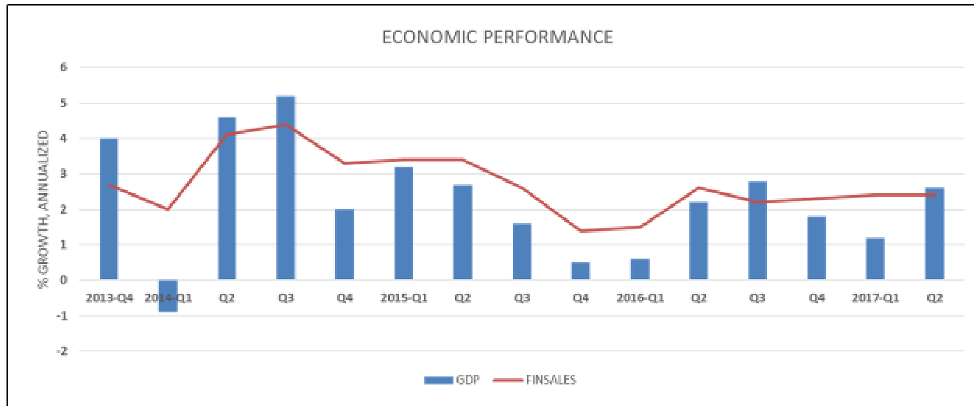
Advocacy Investing®

NEW MARKET HEIGHTS

- **Economic growth accelerated to 2.6% (annualized) in second quarter 2017**
- **Oil prices rebound as OPEC commits to output reductions**
- **Robust labor markets as the economy adds 209,000 jobs in July**
- **Fed balance sheet normalization to begin "soon" but, future benchmark interest rate increases could be delayed by underperforming inflation**
- **The global cyclical recovery gains momentum**
- **The defeat of the ACA repeal/replace—Washington's policy gridlock intensifies**
- **Equity markets hit new highs in July and early August as the S&P500 nears 2,500**

Economic Acceleration: The economy accelerated in the second quarter 2017 (2Q17) after two quarters of soft growth, with output rising at 2.6% (annualized, first estimate) from 1.2% in 1Q17—the average growth for 1H17 was 2.0%. However, this was not a breakthrough, just a return to the trend growth of the previous few years—the economic growth rate averaged 2.11% over the previous nine quarters. The main driver of growth was Private Consumption Expenditures (PCE), which accelerated to 2.8% in 2Q17 from 1.9% in the previous quarter. Non-residential Fixed Investment, Net Exports and Government Spending also contributed to growth, while Residential Fixed Investment (in the red for the first time in three quarters) and shrinking Inventories proved to be drags on economic activity. (The only positive factor in the case of Inventories is that they were shrinking at a slower pace). Final Sales (which represent economic growth ex Inventories and Imports) rose by 2.4%. Note that there will be two revisions to these numbers over the balance of 3Q17.

Figure 1: Economic Growth Picks Up



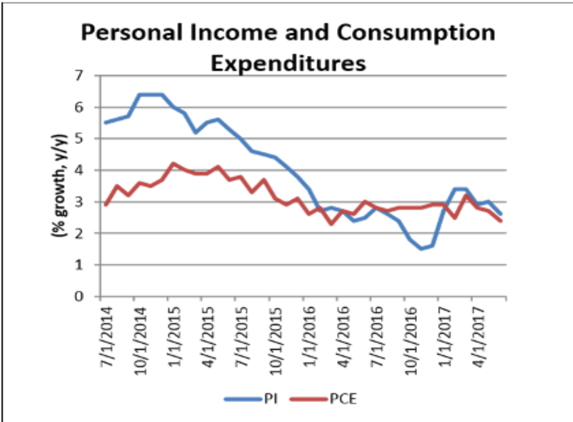
Stronger Industry, Weaker Households: The data releases show a strengthening in the goods sector. Industrial production and Manufacturing increased by respectively 0.4% and 0.2% month-on-month (m/m) in June, while Durable Goods jumped by 6.5% m/m. However, the latter number was distorted by a large aircraft orders delivery, and Durable Goods ex-transportation rose by only 0.2% m/m. The same issue distorted Factory Orders, which increased by 3.0% m/m in June. Survey data underscored the improvement. Early-month surveys were somewhat softer, but still at respectable levels: the Empire State Index fell from 19.8 to 9.8 in the last month, while the Philadelphia indicator declined from 27.6 to 19.5 over the same period. Late-month surveys confirmed the trends. The ISM-Manufacturing index fell slightly to 56.3 at the end of July from 57.8 a month earlier, the Markit PMI-Manufacturing rose slightly from 52.0 to 53.2 over the same period, and the broader Chicago PMI fell from 65.7 to 58.9.

Consumer confidence remained steady, with the Conference Board index rising from 117.3 to 121.1 over the month of July, and the more subdued University of Michigan-Reuters index falling from 93.4 to 93.1 between mid and end-July (and 95.1 at end-June). However, lagged data was less positive. Personal Income was flat in June, while Personal Consumption Expenditures slowed to a 0.1% (m/m) growth pace and retail sales fell by 0.2%. The auto sector was the hardest hit; despite increased incentives, sales of the top 6 auto manufacturers fell by 2.6% year-on-year (y/y) in June—sales of light vehicles continued to slump. The services sector softened somewhat, but remained in expansionary mode. The ISM-Non-Manufacturing fell from 57.4 at end-June to 53.9 at end-July, while the Markit ISM-services rose slightly from 54.2 to 54.7 over the same period.

The trade deficit narrowed to $43.6 billion in June, as exports rose by 1.2% m/m and imports fell by 0.2% m/m. The dollar recovered slightly in early August after being battered for most of

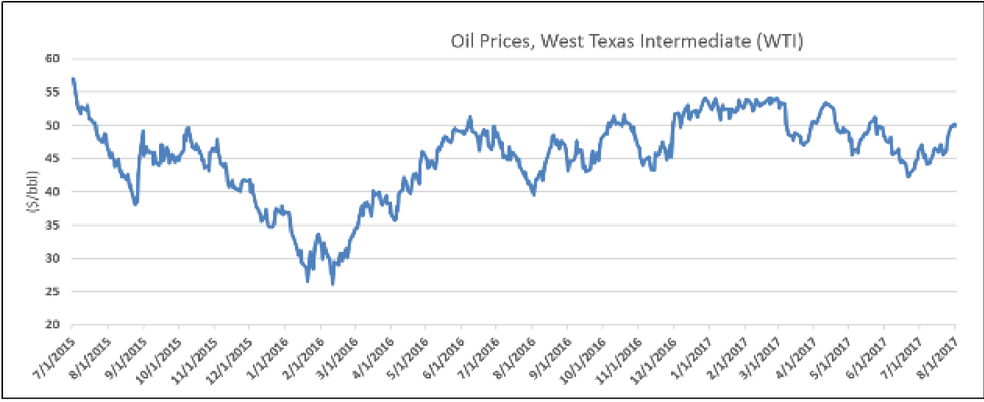
2017. The dollar index (DXY) had lost 2.6% in July, and 8.9% in the first seven months of the year.

Figure 2: Household Caution



The housing market was steady, with new Home Sales and Housing Starts up and Existing Home Sales flat in June. Prices cooled somewhat. The Case-Shiller 20-city index fell by 0.4% m/m in May (+5.7% y/y). Construction Spending dipped by 1.3% m/m in June after a 0.3% increase the previous month.

Figure 3: Oil Prices Surge

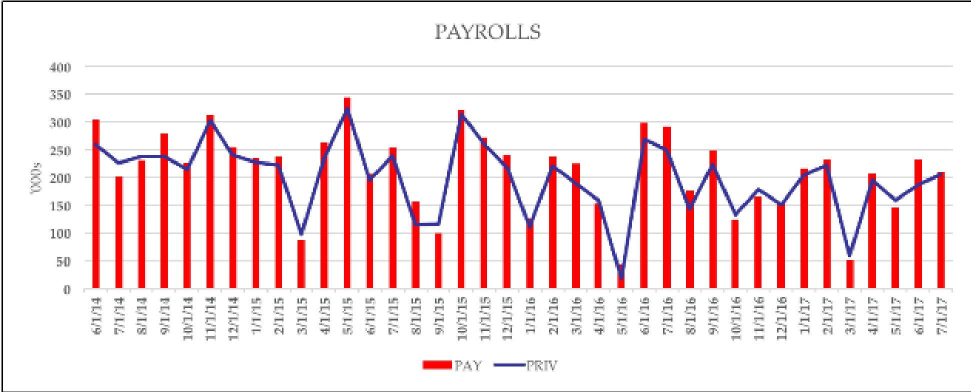


Oil Prices Close in on 50: Oil's fortunes have improved in July, with oil prices (West Texas

Intermediate, WTI) surging by almost 9% to over $50/barrel (bbl) for the first time since May 19th—oil prices have risen by 17% from their 2017 year-to-date (ytd) low of $42.74 on June 22nd. The price swing has pushed the oil markets into a bullish stance—with oil futures above their 200-day moving average for the first time since mid-May. Several factors underlie the price resurgence. First, a sharp fall in US crude oil and gasoline inventories, coming after a long period of inventory accumulation. Second, more aggressive cutbacks of crude production by OPEC, in particular Saudi Arabia, with similar commitments from other major OPEC members. However, the oil price gains might be short-lived. It is estimated that another 1.0-1.5 mbd of production need to be removed from the market to achieve some degree of price stability. However, US shale production has increased by almost 1 million barrels per day (mbd) since the end of last year, to 5.475 mbd, and US crude production overall is expected to continue to increase over the balance of the year. Furthermore, OPEC discipline has been difficult to maintain in the past, and Russia is under significant economic pressure and therefore unlikely to rein in oil production. Oil prices slipped under $50 in the first week of August.

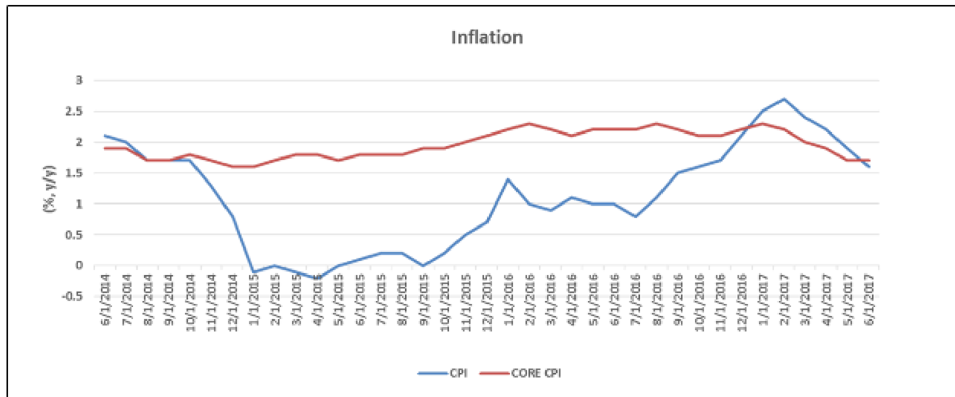
Robust Job Gains Continue: July payrolls came in strong, with 209,000 new jobs (205,000 for the private sector). Aggregate revisions for the previous two months totaled 2,000, which brought the three-month average to 184,000—compared to 187,000 monthly average ytd. The job gains were broad. The goods sector added 22,000 positions (manufacturing +16,000; construction, +6,0000; mining, flat), private services and government created respectively 183,000 and 4,000 jobs. Average weekly hours were flat at 34.5 and average hourly earnings increased by 0.3% m/m. In combination, this lead to a 5.9% (annualized) increase in the labor earnings proxy. The separate household's survey was equally positive. The labor supply increased by almost 350,000, increasing the labor participation rate to 62.9%, unemployment (U3) fell slightly to 4.3%, and the unemployment and underemployment rate (U6) was stable at 8.6%.

Figure 4: <u>Payrolls</u>



In another indication of labor market strength, weekly initial jobless claims have been below 300,000 for 125 consecutive weeks, the longest stretch in 30 years.

Figure 5: 2% Inflation Remains Elusive



Fed Hesitation: The Federal Open Market Committee (FOMC) issued a neutral and non-committal statement at the end of its July 25th-26th meeting. The FOMC message was that the economy continues to grow at a moderate pace, with solid job gains, but that inflation continues to underperform, with the Fed's preferred indicator (Core PCE Deflator) remaining below the 2% Fed target. No interest rate action was expected at this meeting, and none taken. However, the FOMC message was that "balance sheet normalization" is expected to begin relatively soon—probably September. In effect, the Fed's accommodative stance is expected to prevail, with a very gradual reduction in its balance sheet. The FOMC statement also reiterated the Fed's intention to gradually raise the benchmark interest rate—one more rate increase likely this year, probably in December. The robust July jobs report has strengthened the case for staying the course. Nevertheless, Fed officials have also warned against policy uncertainties. In particular, the Fed is concerned about the potential for a budgetary impasse and failure to increase the debt ceiling in time to avoid a government shutdown. Such an outcome would derail the path of interest rates and balance sheet normalization.

The bond markets continue to soften, with the 10-year Treasury yield stabilizing around 2.30% and the yield curve continuing to flatten. The 10-year/2-year spread has fallen by 40 bp since the end of 2016 to under 1%.

Global Upswing: The IMF's message in its latest global economic forecast (World Economic Outlook, 7/24/2017) is broadly unchanged from its April version. The global economic recovery is gaining momentum and broadening in 2017, after a two-year slowdown. Global output is

expected to grow by respectively 3.5% and 3.6% this year and next. However, the IMF states that the projected composition of growth will be slightly different, with slower-than-anticipated growth in the United States compensated by faster growth in the eurozone, Canada, Japan and emerging markets.

Table 1: <u>IMF Economic Projections</u>

GDP Growth	2016	2017	2018
World:	3.2	3.5	3.6
G-7	1.7	2.0	1.9
US	1.6	2.1	2.1
Eurozone	1.8	1.9	1.7
Emerging Markets	4.3	4.6	4.8
o/w: China	6.7	6.7	6.4
World Trade:			
Volume	2.3	4.0	3.9

As far as the IMF is concerned, there are two major changes since its April report. First, prospects for growth-friendly policies in the United States have faded as policy paralysis has overcome the Trump Administration and the Republican-dominated Congress. Second, the ill-timed British election has undermined the likelihood of a smooth Brexit, leading to a sharp decline in business and consumer confidence and a broadly weaker UK economy (the latest GDP release for the UK shows a sharper-than-expected slowdown in the first half of 2017). More broadly, the shift from austerity to an expansionary policy stance by the major economies is happening at a slower pace than earlier expected.

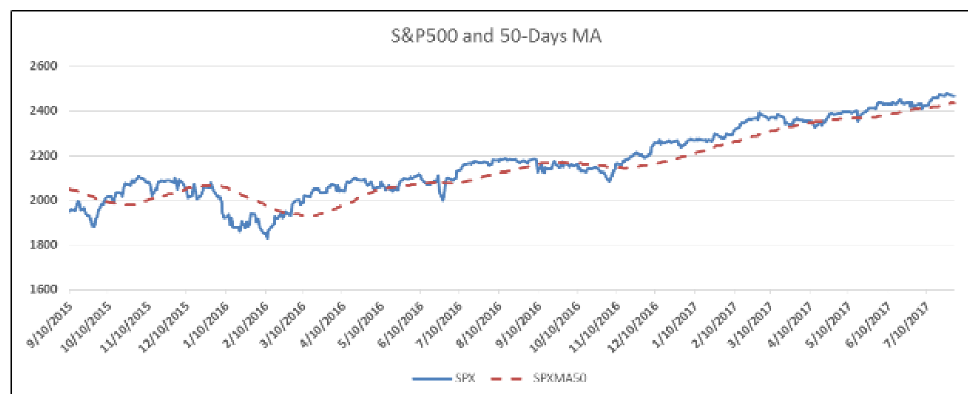
The IMF considers that the risks are balanced in the short-run, but shifting somewhat to the downside in the medium term. In particular, the IMF is concerned about an excessive pace of monetary tightening by the major central banks and the potential for greater trade tensions. In this context, the IMF has warned the European Central Bank about the risks of an early exit from quantitative easing. Nevertheless, recent data shows that the Eurozone cyclical recovery is well under way: the economy has been growing for 17 consecutive quarters, with output up by 0.6% (quarter-on-quarter) in 2Q17, unemployment is at a nine-year low of 9.1%, and indices of business confidence are at pre-2008 highs.

The broadly optimistic IMF report and other positive signals should be tempered by a number of considerations. First, while the eurozone is in the midst of a strong cyclical upswing, some of the structural issues of the eurozone remain unresolved. Among others, we can cite the Greek

debt crisis, the massive external imbalances between Germany and other eurozone members, and the still very high level of unemployment. Second, the medium-term impact of the simultaneous balance sheet normalization by the major central banks on financial markets is unclear. Third, the deepening political chaos in Washington does not bode well for the development and implementation of coherent economic policies. Fourth, while the markets have so-far shrugged off geopolitical risks, there is a real danger of expansion of old conflicts and the emergence of new tensions in both the Persian Gulf and North Korea, and more recently Venezuela, with major implications for oil markets and the U.S and global economy.

Policy Gridlock and Economic Momentum: The collapse of the Republican efforts to repeal and replace (or just repeal) the Affordable Care Act have cast even more doubts on the ability of the Trump administration and the Republican-dominated US Congress to actually implement any economic policy measures in the foreseeable future. The next few weeks of the body politic are likely to be consumed by the fiscal year 2018 budget (starting October 1st) and the likely battle over raising the debt ceiling and avoiding a government shutdown. In the absence of any policy measures, the economy is likely to continue on its own momentum, growing at 2.0-2.5% in 2H17, with downside risks coming from both household and business pullbacks.

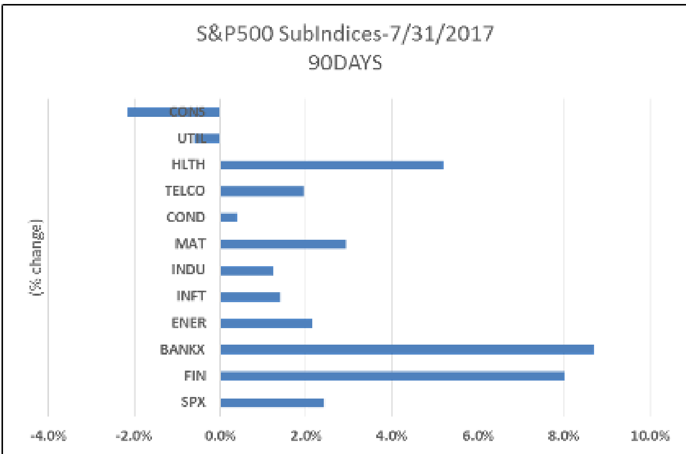
Figure 6: New Heights



New Heights: The financial markets were buoyant in July. The S&P500 gained 2.4% in July (up 10.3% ytd) to hit a new record of 2,475 on 7/27. Global indices also registered strong gains. The VIX index hit an all-time low. The MSCI-EAFE (advanced countries ex-North America) and he MSCI-EM (emerging markets) gained respectively 15% and 23% ytd. Leading sectors have been finance and banking, technology and energy. In particular, bank shares, driven by record earnings and prospects for financial deregulation, have soared. The markets continue to ignore the rising political risks, focusing on fundamentals. The main drivers of growth have been a

continued upswing in earnings, a weak dollar and a strong global economy, (the latter two have advantaged global corporations) and cost cutting. With about 84% of the companies reporting, 2Q17 top-line revenues and earnings of the S&P500 companies are estimated to have increased by respectively 5.5% and 10.4% y/y. This performance came after a very strong 15% rise in earnings in 1Q17—the only sector that showed an earnings decline in 2Q17 was Consumer Discretionary, while topline revenues of Consumer Staples were affected by weak consumer spending The Blue Chips have also been paying healthy dividends, expected to reach $109 billion in 3Q17, from $100 billion a year earlier. However, the underlying earnings picture is not as strong: 70% of earnings growth in 2Q17 has come from three sectors: tech, energy and finance. Considering that energy started from a very low base in 2016—Energy sector earnings more than tripled y/y—the earnings picture looks far shakier. Excluding Energy, S&P500 earnings growth fell to 7.0%. Furthermore, the weakening dollar has also been an important factor—studies show that every 1% decline in the dollar adds 0.5% to the rate of growth in S&P500 earnings. The dollar is likely to stabilize somewhat, reversing some of the potential earning gains.

Figure 7: S&P500 Sub-Indices



The seemingly unstoppable equity bull market (the S&P500 has risen by 76% over the past five years) and the clear overpricing of the market has raised concerns about its durability. On a 12-months forward earning basis, the index P/E stood at 17.7, vs a 15.4 five-year average. Furthermore, looking at the past patterns, we see that since 1928, 5% corrections have occurred on average every ten weeks, vs. every 33 weeks since 2009. Similarly, 10% corrections have happened on average every 56 weeks, vs. every 75 weeks for the current run. However, history does seem to be a meaningful guide in this case. Nevertheless, while we can expect the market to maintain some momentum, it is vulnerable to event risk.

July Data Releases

Economic Data Releases-July 2017	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP(2Q17 % Annualized, First Est)	1.2%	2.6%	2.6%	2.2%	3.2%
PCE Deflator(%, y/y) Jun	1.5%	1.3%	1.4%	1.3%	1.4%
Core PCE Deflator (% ,y/y)	1.5%	1.4%	1.5%	1.4%	1.5%
CPI (%. m/m) Jun	-0.1%	0.1%	0.0%	0.0%	0.2%
Core CPI (%, m/m)	0.1%	0.2%	0.1%	0.1%	0.3%
Employment					
First Time Claims ('000) (Last week July)	245	244	240	235	247
Non-Farm Payrolls ('000), July	231	178	209	144	220
o/w Private Sector	194	175	205	151	205
Balance of Payments					
Trade Deficit $ billion) (Jun)	$46.40	$44.40	$43.60	$43.70	$47.00
Exports (% m/m)	0.4%		1.2%		
Imports (% m/m)	-0.4%		-0.2%		
Current Account Deficit ($ billion) 1Q17)	$114.0	$122.10	$116.80	$109.80	$128.80
Dollar Index-eom (Jul)	95.63				
Oil Prices-eom (WTI, $/bbl) (July)	$46.04		$50.14		
Industrial & Manufacturing					
Corporate Profits (y/y) 1Q17	11.5%		12.0%		
Empire State (Jul)	19.8	15.00	9.8	10.00	18.30
Philadelphia (Jul)	27.6	22.00	19.5	15.00	34.20
Chicago PMI (Jul)	65.7	61.0	58.9	58.0	63.0
Markit PMI Mfg (Jul)	52	53.2	53.3	51.9	53.2
ISM Mfg (Jul)	57.8	56.2	56.3	55.0	57.5
Industrial Production (% m/m, (Jun)	0.1%	0.3%	0.4%	0.1%	0.5%
Manufacturing (% m/m) (Jun)	-0.4%	0.2%	0.2%	-0.2%	0.4%
Durable Goods (m/m) (Jun)	-0.1%	3.5%	6.5%	1.5%	6.0%
Durable Goods, ex transp (m/m)	0.6%	0.4%	0.2%	0.2%	0.8%
Factory Orders (m/m) m/m (Jun)	-0.3%	2.7%	3.0%	0.9%	3.3%
Services					
PMI Services (Jul)	54.2	54.2	54.7	54.0	56.8
ISM Non-MFG (Jul)	57.4	56.9	53.9	55.0	57.6
Consumer Spending					
Retail Sales (% m/m) Jun	-0.1%	0.1%	-0.2%	0.1%	0.4%
UMich Consumer Sentiment (end-Jul)	93.1	93.1	93.5	92.0	94.0
ConfBd Consumer Confidence (end-Jul)	117.3	117.0	121.1	115.0	118.0
Personal Income (%, m/m) (Jun)	0.3%	0.4%	0.0%	0.2%	0.5%
Personal Consumption Expenditures (%, m/m) (Jun)	0.2%	0.1%	0.1%	0.0%	0.2%
Housing Market					
Housing Starts ('000) (Jun)	1122	1170	1215	1120	1200
New Home Sale ('000) (Jun)	605	611	610	590	630
Existing Home Sales (MM) (Jun)	5.620	5.580	5.520	5.500	5.690
Construction Spending (%, m/m) (Jun)	0.3%	0.5%	-1.3%	0.0%	1.0%
Case Shiller-20 (%, m/m) (May)	-0.2%	0.3%	0.1%	0.0%	0.7%
Case Shiller-20 (%, y/y)	5.7%	5.8%	5.7%	5.8%	6.0%

Dr. Pakravan has been a senior economic strategist in global financial markets for 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.

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