Market **Insights**

Economy | **Capital Markets**

Q2
2017

Economy

After the first six months of the Trump administration, there remains many unanswered questions and growing concerns that anything of importance can't get addressed in this increasingly polarized political environment. Whether it's tax or regulatory reforms, infrastructure spending, border security or health care changes, the divisiveness in our nation's capital is palpable and potentially crippling to these agenda items. For investors, three big questions linger: Will Trump's plans eventually drive growth and inflation? Will the forces of technology and globalization slow under the new populism? Will the Federal Reserve continue to push interest rates higher?

Although widely disdained for its relatively weak growth and pay gains, the current economic expansion is about to complete its eighth year and may become the longest on record. A recent economic survey put those odds at 60 percent, with positive growth expected to continue at least through mid-2019. This would put the full expansion at 121 months, topping the 10 years of gains during the 1990s. At the start of the year, most experts were optimistic that the Trump administration would have some degree of success enacting a pro-growth economic agenda. The combination of sluggish economic growth and stagnant income gains along with Republican majorities in both houses of Congress appeared to provide a favorable environment to pursue an ambitious policy agenda. Now, some of this enthusiasm has been tempered. This is generally not due to a reassessment of economic fundamentals. Instead, it reflects the sharply reduced odds that any of the main pillars of Trumponomics will be successfully implemented. Most recently, first quarter Gross Domestic Product (GDP) came in at a meager 1.2 percent (annualized) rate.

By the numbers, the main drivers of growth remain generally intact: employment, housing and, to a lesser extent, domestic manufacturing. To begin, the nation's unemployment rate fell to a 16-year low of 4.3 percent. Further, the number of people working part-time who want a full-time job declined to a nine-year low, while the number of discouraged workers plunged to the fewest since 2007. Meanwhile, the demand for workers is quite robust but the supply of available and qualified workers is dwindling. A shortage of workers would make it harder for employers to fill vacancies, leading to slower payroll gains and higher wages. In fact, recent claims for unemployment benefit insurance are near a 40-year low, as employers struggle to find and retrain employees. In housing, the upward trend in new home sales over the past few years is mostly intact. However, there has been some signs of weakness. A recent report shows single-family home sales decreased 11 percent, while the median sales price of a new home dropped 3.8 percent from this time last year. The supply of homes rose to 5.7 months, the highest since September 2015. Still, the combination of relatively low mortgage rates, a robust jobs market and high home affordability should be enough to keep the housing sector growing and adding to economic growth. Finally, recent manufacturing activity posted the largest monthly gain in over three years in April. The details revealed broad strength, as production of most household and business goods rose, and the factory capacity utilization rate uptrend bodes well for future capital spending. May and June were more modest, however, as a slowdown in auto production highlighted some weakness. Tighter lending standards and higher prices led to a stall in auto production over the past few months.

The Federal Reserve continues to take notice of this relatively healthy U.S. economic environment. After more than seven years of unprecedented monetary accommodation (low interest rates), the Federal Open Market Committee on June 14 raised short-term interest rates for the second time this year and the fourth time since December 2015. It cited healthy labor market conditions along with modest inflation and growth as reasons to continue "normalizing" interest rates. Further, the Fed has indicated it is likely to begin unwinding its bloated balance sheet in the near future. Recall that in the aftermath of the credit crisis, the Fed stepped in and dramatically expanded its balance sheet by buying bonds in the open market to force interest rates on government and mortgage-backed bonds to historic lows. Now that economic conditions have stabilized, the Fed views it prudent to reduce its holdings. Investors are concerned that this action will ultimately result in higher interest rates and lower bond prices. Although possible, chairwoman Janet Yellen reiterated that the Fed will move gradually to keep interest rates low and not disrupt the capital markets.

Looking ahead to the remainder of the year, we continue to believe the economy will grow around 2-2.5 percent for the full year with still modest inflation and a robust jobs picture. Yet, as the economic expansion grows older across developed countries, and given the range of potential downside risks, we remain concerned that the global economy is driving without a proverbial spare tire. The Federal Reserve's policy measures might be insufficient during the next downturn, whenever it might materialize. Further, while the capital markets have handled this environment well, valuations in both domestic stocks and bonds are quite elevated relative to historical metrics. Any disruption in growth, earnings, policy measures or the Trump administration's agenda could significantly impact the direction of the economy and investment returns. With that, while there may be more room to run in risk assets, we are maintaining a slightly more cautious positioning across model portfolios. This does not imply we have raised our cash position. Rather, we continue to utilize alternative investments where appropriate and funds with a history of performing well in weak market conditions.

Capital Markets

The yield on U.S. Treasury bonds fell modestly after spiking higher the prior few quarters. Corporate and high-yield bonds produced solid results along with longer dated Treasury bonds. Larger domestic stocks and those tilted toward growth tended to outpace smaller stocks. Finally, international and emerging-market stocks returned some of the best equity returns for the quarter.

Disclosure: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.

Market Index Performance(%)
As of June 30, 2017

	2nd QTR	YTD	1 Year	Annualized 3 Year
S&P500	3.09	9.34	17.89	9.58
Dow Jones Industrial	3.95	9.35	22.12	10.99
Nasdaq Composite	4.21	14.76	28.40	13.11
Barclays Aggregate Bond	1.45	2.27	-0.31	2.48
Citigroup BIG Corporate	2.53	3.84	2.25	3.59
MSCI World	4.19	11.01	18.89	5.86

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	4.67%	6.16%	Represents the number of unemployed persons as a percent of the labor force	Continues to decline at steady rate
Consumer Price Index	1.90%	4.10%	Represents changes in prices of all goods and services purchased for consumption	Has jumped higher over the past year
U.S. Capacity Utilization	76.60%	80.35%	The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime	Has declined recently, but steady
Gross Domestic Product+	2.10%	2.80%	Total value of all goods and services produced indicates strength or weakness of the economy	Positive, slightly below average
10 Year Treasury Yield	2.33%	6.47%	Yield on the current 10 year treasury bond	Has increased over the past year
Annual Housing Starts	1,092,000	1,440,000	New privately owned housing unit starts annualized rate	Lower recently, but steady gains

*Average from 1966 to Present   + Annualized   *Source: Bloomberg*

Disclosures: Investments are not insured, and may lose money. Client should be prepared to bear the risks associated with investing.

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