Market **Insights**

Economy | **Capital Markets**

Q1 2018

Economy

As the new year began, the synchronized global expansion, which shifted into high gear late last year, was intact and appeared sustainable. The U.S. expansion will become the second longest on record this month. In certain respects, we are witnessing a Goldilocks-type period, not only for the U.S., but for the global economy. Growth across most of the world economies is running modestly above trend. Meanwhile, inflation risks are only slightly higher than average and still relatively tame. However, this equilibrium is at risk of being disrupted. Central banks around the world have begun tightening monetary policies and a strong dose of domestic fiscal stimulus is taking hold due to the recent individual and corporate tax cuts. While solid growth is a near certainty for the remainder of 2018, the sustainability beyond the next few years is in question, considering the potential for heightened market volatility if growth underdelivers, inflation picks up or geopolitical tensions accelerate.

In the U.S., the recent tax cuts have boosted consumer and business spending power. At the same time, unemployment claims have fallen to an almost five-decade low. Economic growth appears on track to accelerate to around 2.5-2.8 percent for 2018. While still slightly below its long-term average, it is much improved from a few years ago. Along with tax cuts, households are benefitting from intensifying labor scarcity, which has directly translated into higher wage growth. Further, households have reduced their savings rate, thereby transferring these gains directly into consumption. Business demand is also improving, helped by a combination of strengthening "animal spirits" and rising capacity constraints.

The latest composite Institute for Supply Management (ISM) index, which comprises both manufacturing and non-manufacturing sectors, spiked to the highest level since 1997. In particular, the manufacturing sector showed a sizeable increase in new orders, which hit a cyclical high recently. Supplier deliveries also showed a healthy increase, but a retracement in the employment component could reflect that the short supply of labor is becoming a more acute issue in several industries. The ISM surveys are meaningfully correlated with economic growth, and these latest results imply an acceleration in growth for the year ahead.

This relatively healthy environment and positive growth trend has led to an uptick in inflation, which has not gone unnoticed by the Federal Reserve. Newly elected Fed Chairman Jerome Powell appears a bit more hawkish than his predecessor, but he will be cautious not to stifle the economy. In mid-March, the Federal Reserve lifted short-term interest rates for the fifth time since December 2015. At least two additional rate hikes are anticipated over the course of this year and possibly two in both 2019 and 2020. Further, the unwind of years of Quantitative Easing, in which the Federal Reserve's balance sheet became bloated with U.S. government debt, is just starting and could further pressure interest rates in the coming years.

While the economic environment remained positive and inflation relatively calm, the combination of action taken by the Federal Reserve along with rising geopolitical tensions and newly enacted tariffs on a few of our trading partners, led to heightened volatility in the capital markets during the quarter. For instance, the S&P 500 jumped 7.5 percent through January 26, then proceeded to fall 7.7 percent from that high point to the end of the quarter. Other major domestic and international equity indices followed a similar pattern. In the bond market, U.S. Treasury yields spiked higher, with the 10-year bond yield up about 0.5 percent for the quarter. In general, investors' risk appetite waned a bit, which produced flat to negative returns across most sectors of the bond market.

Looking forward, after nearly a decade of economic expansion, the U.S. economy appears to be on a self-sustaining path for the near future. The employment environment is very solid, consumer confidence is soaring, and retail sales are picking up. However, with the ever-improving jobs market and stronger economy, wage inflation is expected to rise further as the year progresses. The recent corporate and individual tax cuts should add fuel to the economic growth engine and provide additional support for corporate earnings, which are expected to rise about 15 percent for this year. Amidst these many positives, we are mindful of the growing risks that could disrupt world economies and markets, including: trade wars, rising interest rates and geopolitical tensions. In this environment and after many years of above-average investment returns, we continue to take a slightly more conservative view on the markets. We view domestic equities as fully valued, while many international and emerging market equities appear to have more upside. In bonds, rising rates will likely continue to depress long-dated and government-related security returns, which is why we favor bonds with lower duration and more diversification across the credit spectrum.

As always, investing in the capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive risk-adjusted portfolio returns to our clients. Should you have any questions, please do not hesitate to reach out to your financial adviser.

Capital Markets

The yield on the 10-year U.S. Treasury bond jumped higher during the quarter on fears of rising inflation and expectations that the Federal Reserve will continue to hike short-term interest rates. Most sectors of the fixed-income market posted modest declines through the first three months, with longer duration assets posting the worst returns. Domestic equity returns were quite volatile, with returns ending the quarter flat to negative for the year.

Market Index Performance(%)
As of March 31, 2018

	1st QTR	YTD	1 Year	Annualized 3 Year
S&P500	-0.76	-0.76	14.06	10.76
Dow Jones Industrial	-1.96	-1.96	19.51	13.47
Nasdaq Composite	2.59	2.59	20.98	14.35
Barclays Aggregate Bond	-1.46	-1.46	1.21	1.20
Citigroup BIG Corporate	-2.26	-2.26	2.75	2.34
MSCI World	-1.15	-1.15	14.25	8.60

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.

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	4.10%	6.12%	**Represents the number of unemployed persons as a percent of the labor force**	Near historic lows
Consumer Price Index	2.20%	4.10%	**Represents changes in prices of all goods and services purchased for consumption**	Trending modestly higher
U.S. Capacity Utilization	77.66%	80.30%	**The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime**	Higher recently
Gross Domestic Product⁺	2.60%	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	2.74%	6.41%	**Yield on the current 10 year treasury bond**	Has increased over the past year
Annual Housing Starts	1,236,000	1,437,000	**New privately owned housing unit starts annualized rate**	Steadily rising

*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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