Economic Summary

Morley Capital Management

The Federal Open Market Committee (FOMC) agreed at the March meeting to raise the federal funds rate by 25 bps to a range of 1.50% to 1.75%. The dot plot suggests the median funds rate will increase to 2.105% by the end of 2018, 2.9% in 2019 and 3.4% in 2020.

Some disconnect between the Federal Reserve (Fed) and the Trump Administration exists on the topic of economic growth. The Fed raised its growth expectations by 0.2% to 2.7% for 2018; the Administration believes its policies can boost the growth rate beyond 3%. The median Bloomberg estimate shows the economy expanding by 2.8% in 2018 and 2.4% in 2019. Gross Domestic Product (GDP) growth was revised up to 2.9% for the 4th quarter, down slightly from 3.2% in the 3rd quarter. Inflation, measured by core personal consumption expenditures (PCE), which excluded food and energy, was 1.80% YOY in February, still below the Fed's target of 2.0%. The unemployment rate is at a 17-year low at 4.1% after 313,000 jobs were added in February. We expect a strong economy combined with moderate inflation to encourage the FOMC to raise rates at least two more times during 2018.

The current U.S. economic expansion will hit 106 months in April, the second longest on record. Several recent government actions should keep the economy growing: the government provided significant fiscal stimulus to the economy in the form of tax cuts for businesses and most individuals while monetary stimulus is gradually being reduced. Additionally, the U.S. Congressional budget deal adds approximately $300 billion in government spending over the next two years; and reduced regulations are contributing to business confidence.

With the tax bill behind him, President Trump turned his attention to trade; the Administration is simultaneously negotiating with several countries. A deal with South Korea was completed without any interruption to trade. The market showed signs of apprehension over the NAFTA negotiations, though the Administration is suggesting an agreement could be reached in the coming weeks. China, the world's second largest economy, has a $375B trade surplus with the U.S. consequently, a major trade war could significantly affect the global economy. The tariffs that the Administration placed on China unsettled the markets; we expect more market and potentially economic volatility as the negotiations continue. We do not underestimate the challenges China would face in economic reform, though, we remain optimistic that an agreement will be reached without major disruption to the markets because both countries have too much to lose. North Korea is facing pressure from China to participate in negotiations that, if failed, could increase the risk of military action.

Domestic policy tightening measures, raising rates and reducing the Fed's balance sheet, pose two-sided risk to the U.S. economy. The financial system could experience disruption if levered positions unwind too quickly due to rates rising too rapidly; conversely, if monetary policy retreats too slowly, inflation could rise rapidly.

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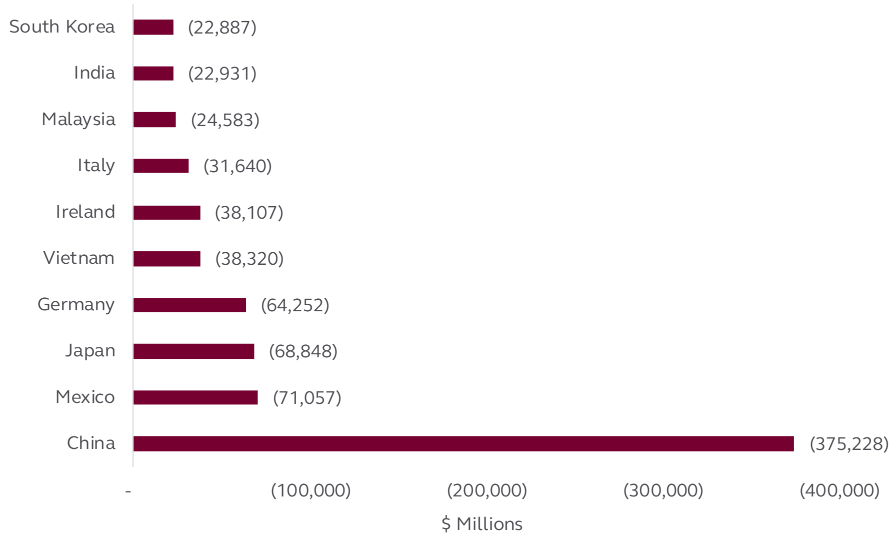
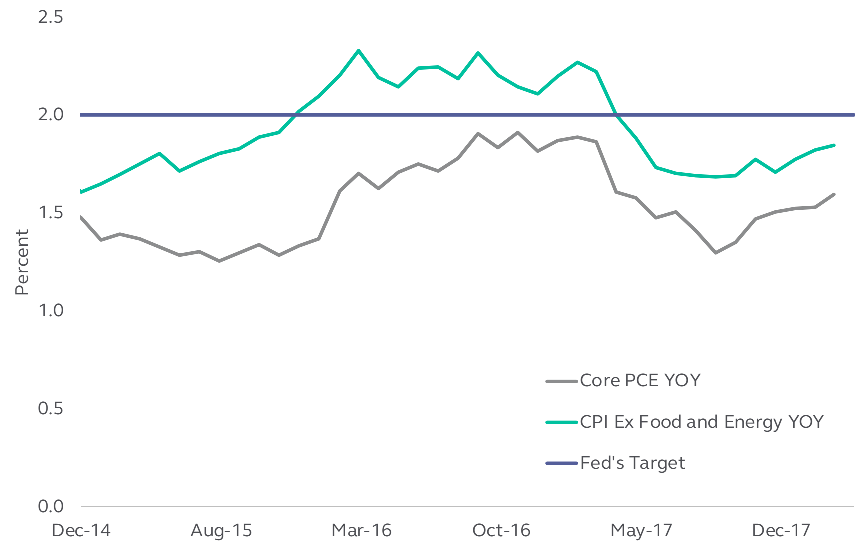
Trade Deficit



Source: The U.S. Census Bureau

Inflation



Source: Bureau of Economic Analysis, Bureau of Labor Statistics

Highlights

In 2017 the U.S. had a trade deficit with China in goods of $375B, a net of $505B imported and $130B exported. President Trump is focused on reducing America's large trade deficits and is hoping to reduce the trade deficit with China by $100B.

Under Section 301 of the Trade Act of 1974 the U.S. has initiated action with the World Trade Organization to address China's unfair technology practices. The U.S. has also identified $50B of products upon which a 25% tariff will be applied following a public comment period. The Chinese government responded with a threat of its own 25% tariff on $50B of U.S. exports to China, including soybeans and certain aircraft. President Trump responded by threatening to escalate the dispute with tariffs on an additional $100B of imports from China.

Outlook

The direct GDP headwind from a trade war with China would offset the positive impacts from the 2017 Tax Cuts and Jobs Act. Additional downside could also result from complicated global supply chains, depressed business and consumer confidence, and stress felt by certain more intensely impacted businesses. For example, U.S. farm prices and exports could fall significantly due to tariffs. Even U.S. auto manufacturers, who export very little to China, would likely see a drop in demand from patriotic Chinese customers in exchange for highly profitable U.S. brands like Buick and Cadillac which are manufactured in China via joint ventures.

Highlights

Two measures of inflation, the core Consumer Price Index (CPI) released by the Bureau of Labor Statistics and the Fed's favored measure, the core PCE, are designed to reveal inflation trends without volatility related to changes in food and energy prices by measuring prices consumers paid for goods and services.

The Fed has set a target of 2% for the core PCE, a rate it believes will lead to sustained growth. The rate has been running under the Fed's target since April of 2012, falling to a low of 1.4% during the middle of 2017 and increasing gradually to 1.8% in February 2018.

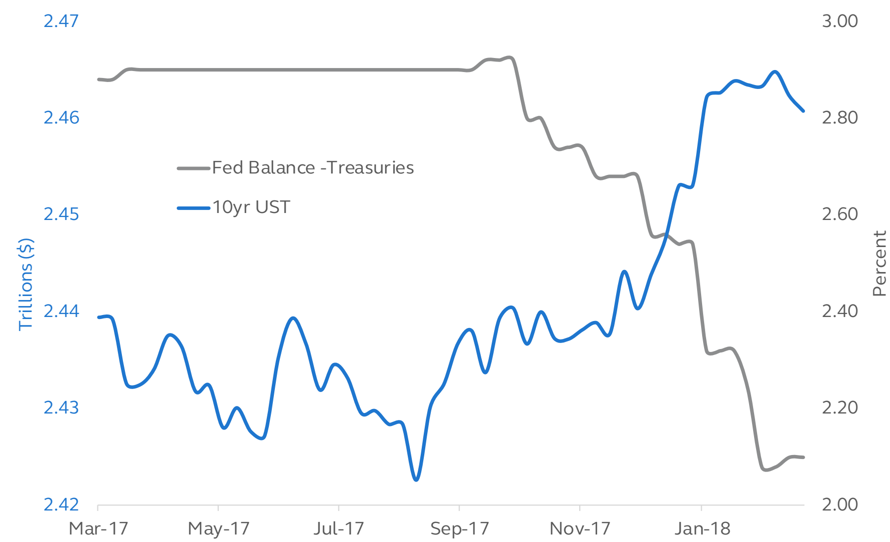
Outlook

The core PCE should remain slightly under the Fed's target during 2018. Faster economic growth tends to lead to an increase in inflation, though the U.S. is part of a global economy with global supply chains which mitigate price pressures in the U.S. Rent increases have been an area of concern in the recent past, though rent inflation has been slowing as builders have increased the supply of multi-family units. Trade wars could result in higher inflation, though we are not expecting significant trade wars.

Volatility

Source: Chicago Board Options Exchange and Merrill Lynch

Fed Balance Sheet



Source: Bloomberg

Highlights

With equity prices on a steady upward trajectory throughout 2017, the Chicago Board Options Exchange Volatility Index (CBOE VIX), an equity market volatility index, started the year near historical lows at 11. Volatility surged during the first quarter, however, driving the CBOE VIX to a peak of 37 in February before ending the quarter near 20.

Interest rate volatility, as measured by the Merrill Lynch Option Volatility Estimate Index (MOVE) also rose sharply during the quarter, peaking at 72 bps in February before closing near the average of 58 bps.

The surge in cross market volatility was driven by decreasing policy support from the Fed and concerns over the impact a potential trade war would have on global growth. The moves were amplified by the large number of funds utilizing systematic momentum trading strategies.

Outlook

With the European Central Bank (ECB) and Bank of Japan (BoJ) also scaling back quantitative easing later this year, we expect market volatility to continue to normalize after having been suppressed by coordinated central bank accommodation over the past several years. Uncertainty around the Trump Administration's policy agenda should further boost volatility, requiring investors to reprice risk assets to reflect this new normal.

Highlights

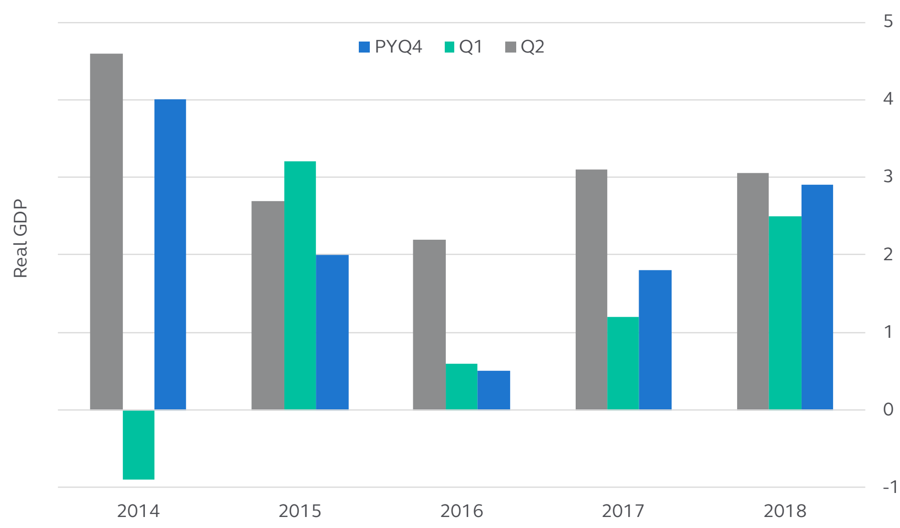
After six months there are signs that the Fed's program to reduce its balance sheet is beginning to bear fruit. Treasuries, making up roughly $2.46T of the Fed balance sheet in October 2017, show a clear downward slope to roughly $2.42T. However, for MBS, the picture is more complicated due to a mismatch of settlement, reinvestment and paydown dates. Although MBS holdings are slightly harder to examine, a downward trend is apparent as well, decreasing from about $1.768T in October to $1.761T to end the first quarter.

As expected, that excess supply entering the market, without a change in the supply/demand curve structure, is putting upward pressure on interest rates. Although multiple factors can be attributed to the recent rise in both Treasury and mortgage rates, there is still a correlation between excess supply and the increase in rates over the same period.

Outlook

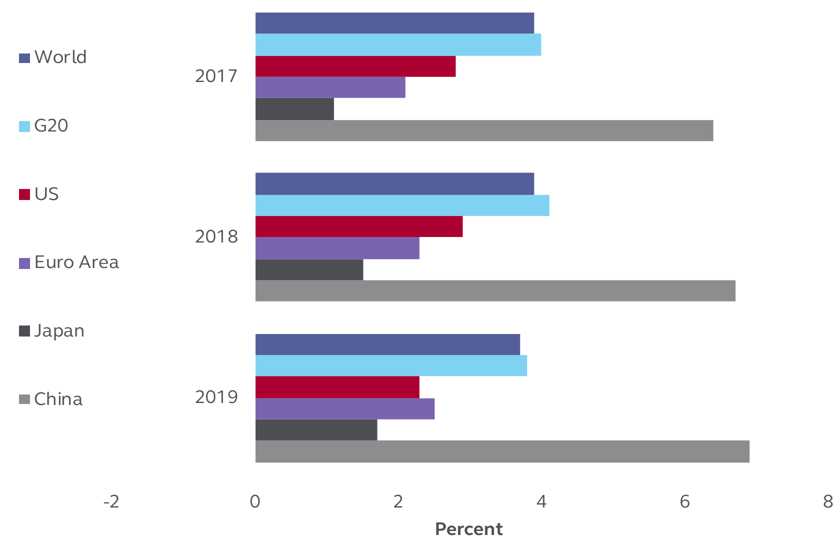
As the Fed balance sheet runoff continues to pick up its pace and the Treasury and MBS securities available for purchase increases, the private market (banks, GSEs, REITs, foreign investors, and money managers) will need to absorb that extra supply. As the private market's ability to absorb the excess wanes, investors will begin to demand lower prices, putting even further upward pressure on rates in the coming quarters.

GDP



Source: Bloomberg
Note: Q1/Q2 2018 consensus estimate

Global Growth



Source: OECD Economic Outlook, Interim Report March 2018

Highlights

Over the last four years, the economy has fallen into a pattern, where GDP growth slows from the fourth quarter to the first quarter and then rebounds in the second quarter. This pattern is again reflected in the Bloomberg Consensus forecasts for 2018.

It is possible that consumers take a break at the beginning of each year, though we believe a better explanation lies in the belief among economists that there are some issues with the seasonal adjustments that are causing the first quarter drop and the second quarter rebound.

Outlook

It is important to recognize this pattern and not predict the year based upon a slowing first quarter; we expect the pattern to continue in 2018 with a pickup in the second quarter. There are always risks that could disrupt this pattern, such as a trade war, though we are not expecting significant trade wars.

Highlights

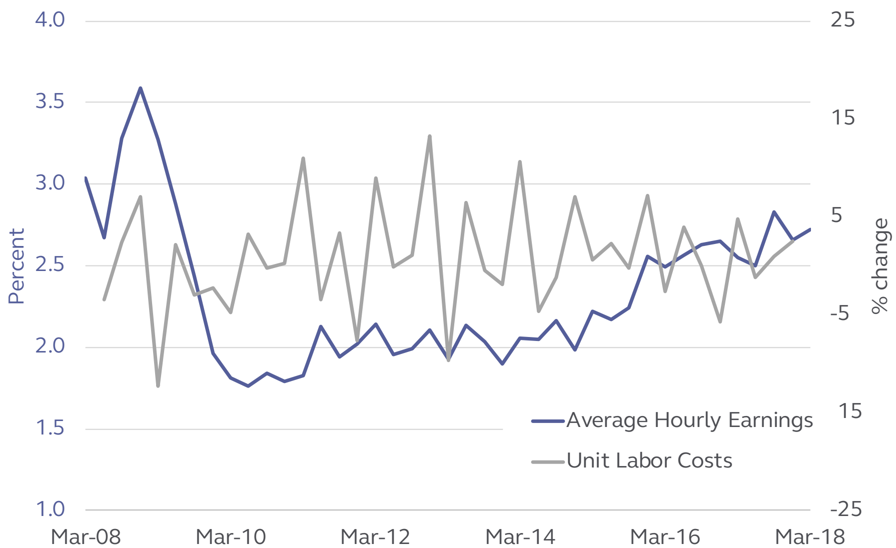
Global real GDP expectations have been revised higher across the board according to the economic outlook of the Organisation for Economic Development (OECD). The OECD predicts growth of 3.9% for both 2018 and 2019 which represents an increase of 0.2% and 0.3%, respectively.

India's economy is expected to grow by 7.2% this year and China by 6.7%, representing the fastest growing economies. U.S. growth is projected to be 2.9%, roughly consistent with our expectation of 2.8%. Euro-area growth is anticipated at 2.3% and Japan at 1.5%.

Outlook

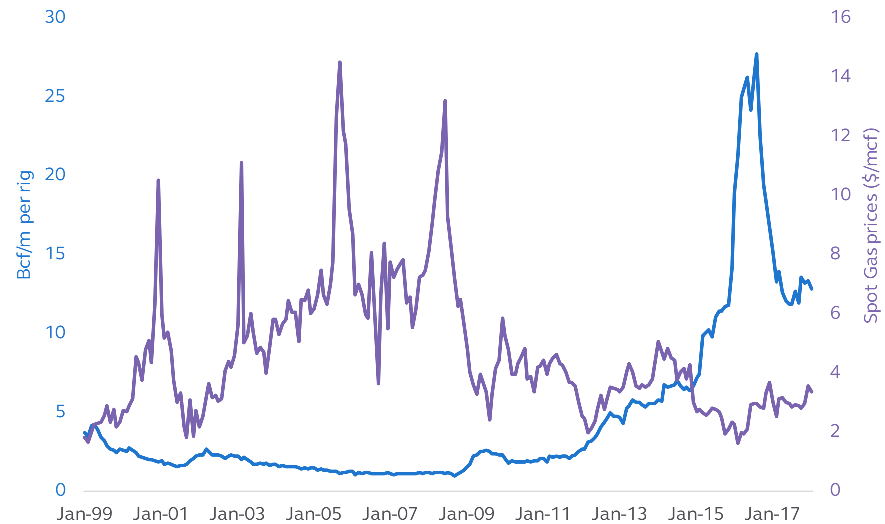
Strong investment and labor markets contribute to the global economy exhibiting broad-based strength and solid footing through 2019. That said, the pace of growth is modest enough that core inflation remains low, though, labor market strength has led to some increase in labor costs and shortage of skilled labor which may create some inflationary pressure from supply bottlenecks. Accommodative monetary policies are likely to diverge as the U.S. Fed continues its targeted path of policy normalization. The ECB may have an opportunity later in the year to begin gradually phasing out asset purchases. Continued below-target inflation in Japan will likely force the BoJ to continue its stimulative quantitative easing. Monetary policy error and the risk of U.S.-led trade wars present risks to growth in the form of reduced investment and jobs.

Labor Market



Source: Bureau of Labor Statistics

Energy



Source: U.S. Energy Information Administration

Highlights

When earnings increase, consumers have more spending power to grow the economy. Companies look to offset increased earnings by productivity gains, or they may need to raise prices or accept lower profit margins. Average Hourly Earnings growth has been running in the 2% range since the Great Recession of 2008-2009 and slowly picking up over the last two years to 2.7% in February.

The U.S. Bureau of Labor Statistics calculates unit labor costs as the ratio of hourly compensation to labor productivity. Increases in hourly compensation tend to increase unit labor costs, and increases in output per hour tend to reduce labor costs. Unit labor costs have followed a pattern similar to earnings, though fairly contained, they have begun to increase, posting a 2.5% annualized increase over the 3rd quarter.

Outlook

As the unemployment rate drops there is pressure to raise wages to attract and keep workers. The U.S. is part of a global economy where China and India have large work forces; India has more than 10 million people entering the workforce each year. We expect wages to be contained around 3% annualized growth. Clear evidence that higher wages cause inflation does not exist, but there is evidence that higher wages are correlated with inflation.

Highlights

Significant technological improvements in shale gas extraction have increased production per rig from an average of 2.7Bcf/m (Billion cubic feet per month) to 12.8Bcf/m since 2012.

Absent a few days of weather-driven price spikes, natural gas prices have ranged between $1.9/mm btu and $3/mm btu (million British Thermal Units) since the end of 2014.

Outlook

Technological advancements have increased rig efficiency and lowered the cost structure of gas production. Low, stable prices and plentiful reserves make natural gas an attractive and competitive feedstock for chemical and electric power production. The outlook for prices remains under $3.00/mm btu through 2021.

Morley Capital Management

A macroeconomic outlook is prepared, offering a base case and two tail scenarios.

	Base Case (75%)	Tail 1 (10%)	Tail 2 (15%)
	Modest growth	**Prolonged weakness (w/high chance of recession)**	**Inflation / Stronger than expected growth**
	GDP growth forecast for 2018 is 2.80%. The world economy has been gaining momentum. The Trump Administration has fostered a pro-business climate. Reduced regulation and tax cuts are positive drivers for the economy. The $1.3 trillion spending bill will provide stimulus, but increase the deficit. Increased growth will lead to modestly higher interest rates. Potential trade wars make the headlines, but trade is managed without major disruptions. Political turmoil around Russia remains, but does not directly affect the President. Core PCE will stay below the Fed target of 2%. China grows in the 6% range. Europe continues to recover. North Korea is handled through diplomacy. Low global rates make U.S. term rates attractive and mute their rise.	The major risk comes from the world's second largest economy, China. A slowdown due to the significant debt that has built up in China reverberates throughout the world. The announcement of tariffs is the prelude to a trade war with China. Other trade wars develop in North America. This leads to a significant global slowdown. The slowdown spills into the U.S. economy. The current recovery is growing old and rising inflation and interest rates lead to a recession. Global conflicts and terrorism that disrupts growth presents another risk. The equity markets decline, reducing household wealth. The Fed raises rates too soon and must reverse course.	President Trump is successful in enacting his pro-growth policies. Trade negotiations result in increased and fairer trade. Growth surprises most economists and GDP growth exceeds 3.50%. China grows at a believable rate near 7%. The UK and EU come to amicable terms on the UK exit. Growth in the European economies improves to above trend. Japan's growth accelerates as monetary stimulus works. The threat of terrorist attacks is reduced and the Middle East problems improve. The North Korean threat is solved peacefully. The drop in the unemployment rate leads to rapid wage growth. The Fed is slow to react to inflation. The rise in interest rates does not damage the economy.
GDP	2.80% in 2018	Below 0.50%	Greater than 3.50%
Change in Rates	2Yr 2.75%, 10Yr 3.15%	Sharply lower / -150 bps (10Yr UST)	Sharply higher / +100 bps (10Yr UST)
Change in Curve	Curve flattens 2-10s	Bull flattener	Bear steepener
Volatility	Moderate	Higher	Higher

M2 Money Velocity (the nominal GDP/M2 ratio) is the frequency at which transactions are occurring between individuals in an economy and can be used to provide insight into whether consumers and businesses are saving or spending their money. This economic indicator includes the velocity of currency in circulation, savings deposits, CDs, and money market deposits and has been used as a barometer to the expected growth of inflation within an economy.