Economic Summary

Morley
Capital Management

During the first quarter of 2017, the Federal Reserve's (Fed) Federal Open Market Committee (FOMC) met twice. The federal funds rate was left unchanged in January which raised speculation that a rate hike would occur in March. The FOMC did not surprise the market when it raised the rate to a range of 0.75% to 1.0% at the March meeting. The hike was accompanied by a suggestion from the members' dot plot that the rate will increase to 1.375% by the end of 2017, 2.125% by the end of 2018, and 3.0% by the end of 2019. Unemployment and inflation are focus points for the FOMC as it considers the timeline of future rate hikes. The U-3 rate, the most widely used measure of unemployment, dropped to 4.5% during the quarter, falling within the Fed's target range. The core personal consumption expenditures (PCE), the Fed's favored measure of inflation, was up 1.75% YOY in February bringing it ever closer to the Fed's 2% target. The recent levels of these measures should give the Fed leeway to raise rates two more times in 2017.

The Fed expects economic growth of 2.1% in 2017; the median estimate showed the economy expanding 2.1% in 2018 and 1.9% in 2019. US consumer confidence has spiked since the election. Republicans now control the White House, Senate, House of Representatives, and the majority of governorships, leading markets to believe that conservative, pro-business policies will be put in place, which should lead to higher growth. That said, after the failure of President Trump's health care bill, it appears the markets have concluded these policy implementations are not a given. The lack of Democratic support and discord within the Republican Party have complicated policy making; however, we believe the pro-business environment will survive and lead to higher growth. It will take time for these policies to be implemented, so we look for growth of 2.3% in 2017.

Major risks to the US economy continue to come from external shocks. The economic slowdown in China still tops the list, though it appears that the country's economic growth has stabilized and the Chinese government has gradually reduced its growth target, which may lead to a cut back in what has been significant debt expansion. The risk of trade wars between US and China has receded somewhat as the first meeting between President Trump and President Xi Jinping seemed to go better than expected. The spotlight also now shines on the threat of military escalation in Syria and the potential for military action against North Korea. We will see if President Trump was able to convince China to put pressure on North Korea. On a final note, the rise of populism in Europe could cause the breakup of the European Union (EU). We believe the major countries in the EU will remain for now, though populist influence may lead to restrictions on immigration.

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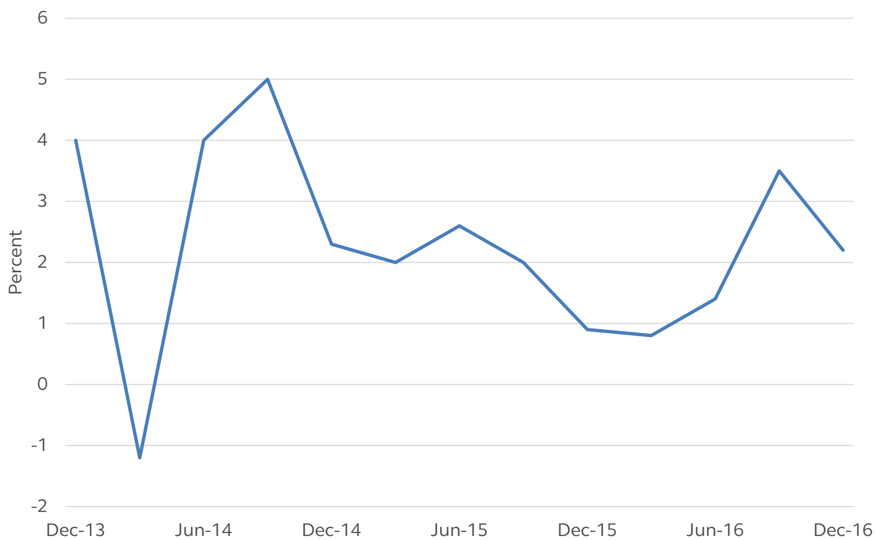
Gross Domestic Product



Source: Bureau of Economic Analysis

Highlights

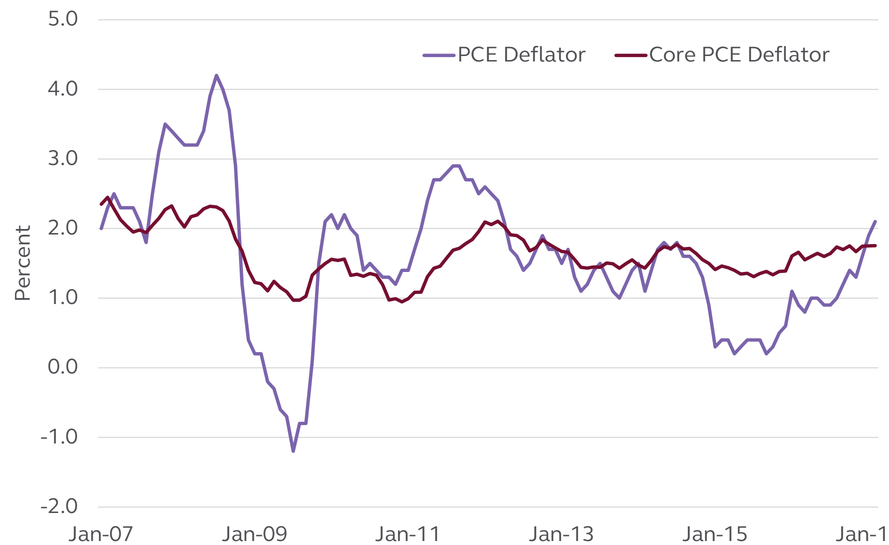
GDP growth slowed in the fourth quarter to 2.1% from 3.5% in the third quarter. The deceleration in the fourth quarter resulted from downturns in exports and federal government spending, an acceleration in imports and a deceleration in nonresidential fixed investment.

Real GDP, adjusted for inflation, increased 1.6% in 2016 compared with an increase of 2.6% in in 2015. Confidence has surged since the election in November and equity markets have rallied. The defeat of the health care bill and rising global tensions have caused the markets to stall. The Atlanta Fed has cut its forecast for first quarter growth to .6%. The New York Fed is looking for 2.8%.

Outlook

We expect growth to be stronger in 2017 than in 2016 due to a pickup in global growth and the pro-business policies of the Trump Administration. We have seen a seasonal pattern of weak first quarter GDP followed by a strong second quarter. We expect growth to pick up as the year progresses at a rate of approximately 2.3%.

Inflation



Source: Bureau of Economic Analysis

Highlights

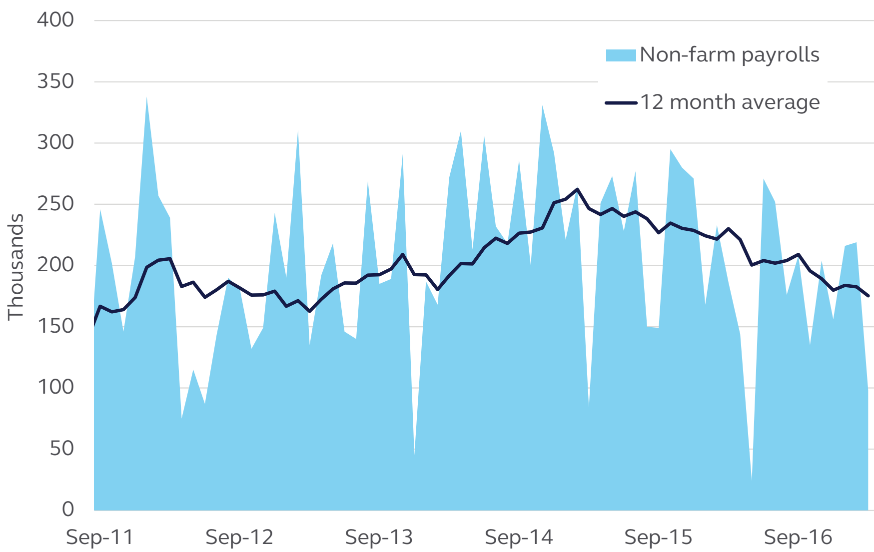
The core PCE, the Fed's most closely watched inflation indicator, rose 0.19% in February, and increased 1.75% year-over-year, approaching the Fed's target of 2%.

The world's economies have moved away from the deflationary scare. In Japan, core consumer prices rose for the first time in more than a year in January, up 0.1% from a year earlier. Inflation has been moving closer to the Eurozone target of 2%. Eurostat reported in March that the annual consumer price inflation rate was 1.5%, down from February's four-year high of 2%.

Outlook

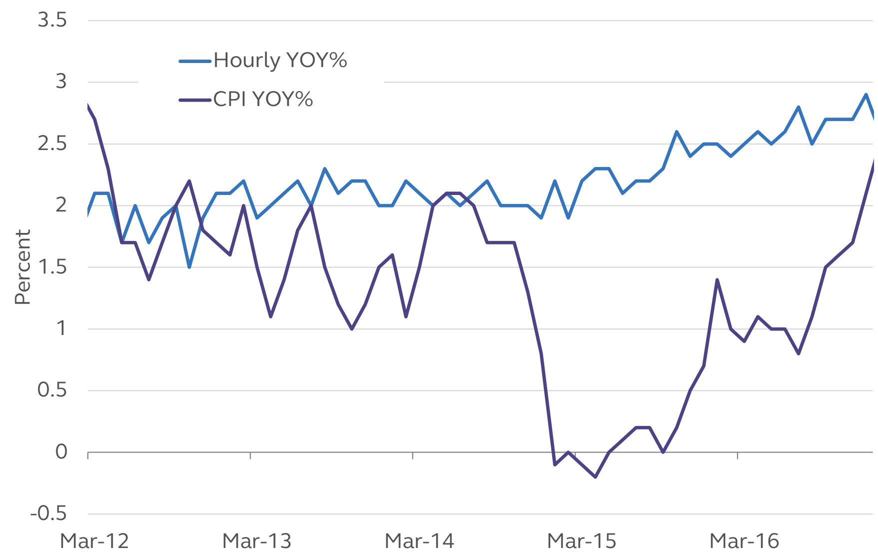
The increase in inflation worldwide combined with a growing US economy should push inflation toward the Fed target of 2.0%. The Fed is looking at the 2% policy target as balanced, meaning it will let inflation push above 2% at times.

Non-Farm Payrolls



Source: Bloomberg

US Wages



Source: Bloomberg

Highlights

Non-Farm Payrolls (NFP) has been a widely-watched metric to gauge the health of the US economy, the world's largest, as well as gain insight into the path of future fed funds rate hikes. The economy has generated positive NFP growth since the Great Recession in the late 2000s.

The NFP 12-month moving average indicates a decline in the number of new jobs added since 2015; the average has fallen to 175K, the lowest level since early 2014. March payrolls totaled just 98K, however most economists are attributing the poor headline number to seasonal effects. In addition, January and February NFP data both posted strong numbers of more than 200K.

Outlook

We expect an extended economic recovery. Job growth should continue at a good pace, though at a slower rate than we experienced coming out of the recession.

Highlights

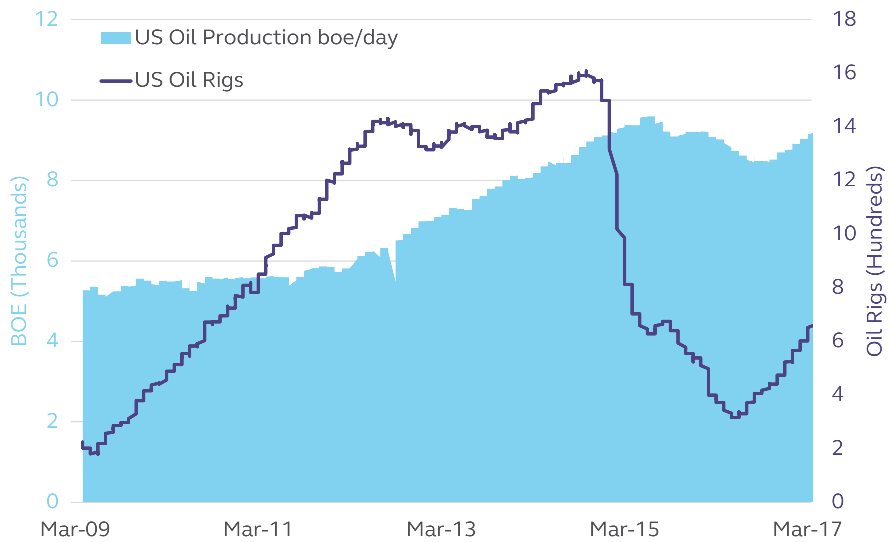
Nonfarm payrolls increased by 235,000 in February. The US unemployment rate dropped to 4.7% in February from 4.8% in the previous month. The number of unemployed persons was almost unchanged at 7.5 million while the labor force participation rate increased slightly by 0.1% to 63%.

The growth in wages has only recently exceeded the rate of growth of the Consumer Price Index (CPI). Wages rose 2.8% for the year ended February 2017 compared to 2.7% for the CPI. The slow increase in wages has been a drag for consumer spending.

Outlook

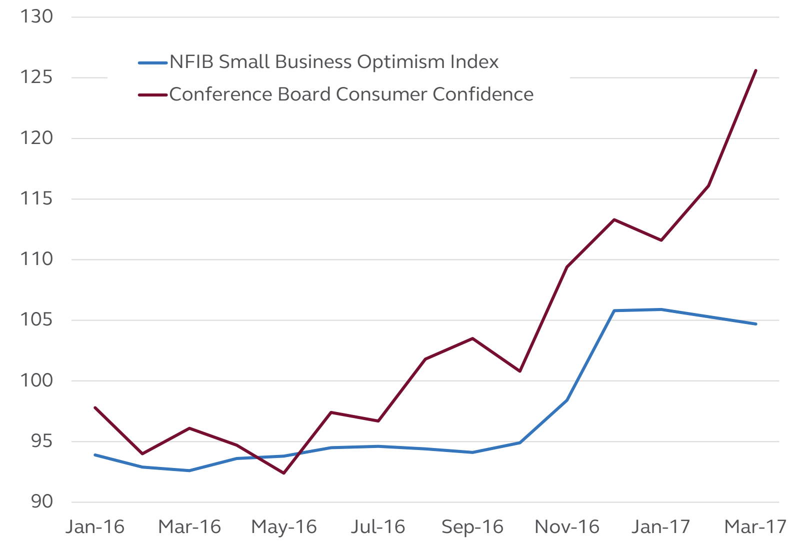
The theory is that as the unemployment rate drops, a scarcity of workers will push wages up. This relationship is muted somewhat by the global nature of the world's economies which has given rise to the populist view to take care of American workers first. We expect wages to grow at a rate of about 3% as the economy expands.

Crude Oil



Source: Bloomberg

Consumer Confidence



Source: Conference Board

Highlights

US oil production, particularly shale oil, remained robust in 2015 & 2016 even as oil producers curtailed capital expenditures.

Oil prices in the range of $50 – 55 per barrel have supported a strong increase in capital spending as reflected in the growing number of operating oil rigs.

Outlook

The increased efficiencies of oil rigs will drive further growth.

Therefore, US oil production will continue to increase, capping prices both domestically and internationally. We expect oil will remain in a price range of $50-55 per barrel for the near-term. The increased efficiencies of oil rigs will drive further growth.

Highlights

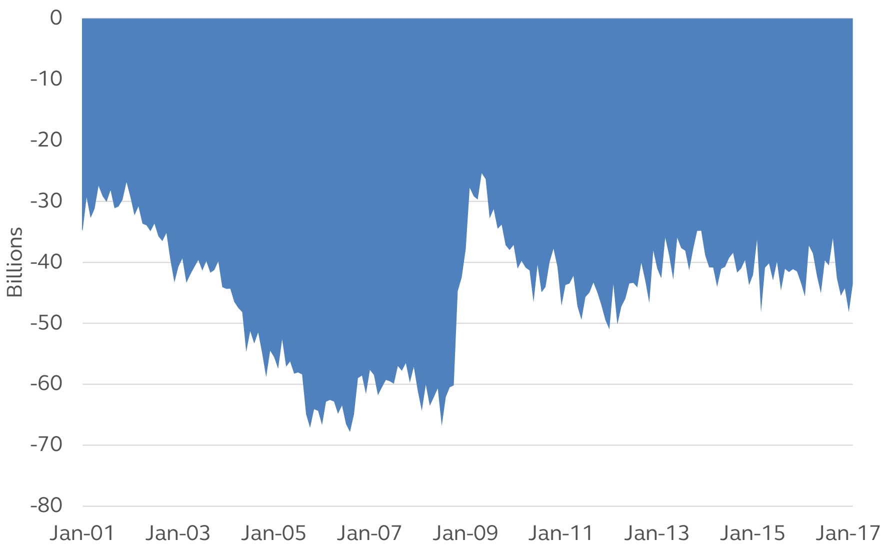
US consumer confidence surged in the first quarter of 2017; 125.6 reported in March was the highest level since Dec 2000, and was broad-based, showing consumer confidence in both the present situation and future expectations.

In addition to the consumer, business confidence is up as indicated by the March NFIB Small Business Optimism Index pre-election level of 94.9 has now risen to 104.7 at the end of the first quarter. It seems the Trump presidency has been a contributor to both personal and business confidence indicators.

Outlook

Confidence indicators should be combined with other factors if they are to be predictors of economic performance. These confidence indicators, in combination with improving investor confidence and low GDP levels in 2016, lead us to expect a moderate pickup in GDP data for 2017 at approximately 2.3%. We will track the confidence numbers closely going forward as the optimism around the Trump presidency has the potential to taper off, especially as timelines on pro-business agenda items like tax reform and infrastructure spending are unclear.

US Exports



Source: Bloomberg

Highlights

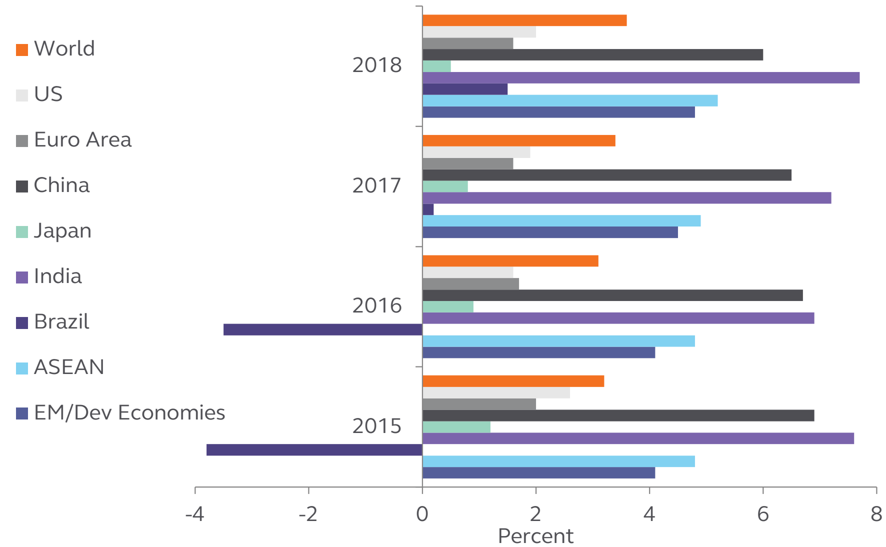
After posting the biggest trade deficit in nearly five years, $48.2B, in January, the deficit shrank to $43.6B in February. Exports increased to $192.9B in February from $192.5B in January. Imports decreased to $236.4B in February from $240.7B in January.

The goods deficit with China decreased from $31.3B in January to $23.0B in February; imports decreased $8.6B, primarily from cell phones and apparel reductions. China accounts for approximately 60% of the annual US trade deficit.

Outlook

A trade deficit is subtracted in the calculation of GDP from the sum of consumption, government spending and investment, effectively reducing GDP. A major theme of President Trump's economic plan is reducing the deficit. He intends to renegotiate trade deals and focus on making trade fairer. A case could be made that Trump's tough talk on China has led to a more stable Chinese currency since the election. We believe a major risk to the economy is that trade negotiations deteriorate into trade wars.

Global Growth



Source: International Monetary Fund World Economic Outlook

Highlights

World output is expected to grow from an estimated 3.1% in 2016 to 3.4% in 2017 and 3.6% in 2018, according to the International Monetary Fund. The greatest improvements are expected in emerging and developing economies at 4.1% for 2017 and 4.8% in 2018 with highest growth expected from India and China.

Moderate inflation expectations should allow central banks to gradually remove accommodative monetary policy in places, such as the US, where the economy may have reached the natural rate of unemployment. In other economies, such as the EU, continued deflation risks may require continued monetary push. Either way, loose monetary policy may be losing its effectiveness to promote demand.

Outlook

For the US, where less accommodative monetary policy is combined with continued stagnant productivity, further increases in demand may depend on the Trump Administration's ability to deliver on the promise of meaningful and effective fiscal stimulus to offset the impact of higher policy rates. Given the large US role in global demand, these projections may be somewhat dependent on the effectiveness of US policies, while efforts toward trade protectionism may also present a risk to the growth outlook.

Morley
CAPITAL MANAGEMENT

A macroeconomic outlook 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 2017 is 2.30%. The world economy has been gaining momentum. Optimism has increased with the election of Donald Trump. The expectation is that he will push major positive business initiatives, such as tax cuts and reduced regulation. It will take time for legislation to be passed and the initial failure of health care repeal increased the markets skepticism. Tax cuts should be passed, although less than expected. Increased growth will lead to higher interest rates. Major trade wars will be avoided, but there will be volatility around trade deals. Core PCE will approach the Fed target of 2%.The Fed will raise rates three times in 2017. Rising interest rates and a strong dollar will provide headwinds to growth. Oil prices have rebounded, but should remain under $55 per barrel. Soft landing in China. Europe has a slow recovery and Brexit and other elections do not lead to a recession. Low global rates and the strong dollar make U.S. term rates attractive and mute their rise.	Tail risk has been reduced as the U.S. economy has rebounded and Republican control of the three branches of government should favor pro-growth policies. The Supreme Court should also regain its conservative majority. A risk is that the President can't get any of his major initiatives through Congress. He is seen as a weakened president and confidence falls. Another risk is the potential for trade wars. This leads to a significant global slowdown. Emerging market economies suffer as demand for commodities drop and the dollar strengthens. Elections in Europe cause disruption as France votes to leave the EU. 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, while not causing disruptions with his trade negotiations. The forecasts from his advisors proves true and growth exceeds their forecasts of 4%. Stimulus programs are effective and China grows at a believable rate near 7%. The UK and EU come to amicable terms on the UK exit. France and the other countries remain in the EU. 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 lessened. The drop in the unemployment rate leads to rapid wage growth. The Fed is slow to react to inflation. The rise interest rates does not damage the economy.
GDP	2.30% in 2017	Below 0.50%	Greater than 4.00%
Change in Rates	2Yr 1.70%, 10Yr 2.85%	Sharply lower / 150 bps (10Yr UST)	Sharply higher / +150bps (10Yr UST)
Change in Curve	Little change 2-10s	Bull flattener	Bear steepener
Volatility	Moderate	Higher	Higher