

At its June meeting, the Federal Open Market Committee (FOMC) agreed to raise the federal funds target rate to a range of 1.00% - 1.25%. The FOMC's consensus expectation is that the target 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. Another form of tightening is expected to begin as the Federal Reserve (Fed) begins unwinding its balance sheet starting in the second half of this year. In June, committee members stated that the plan is to begin the tapering at a rate of \$4B per month in MBS and \$6B per month in Treasuries, increasing in subsequent months. The Fed has a mixed bag of key drivers for decision making. The unemployment rate dropped to a 17-year low of 4.3% in May and bounced back to 4.4% in June, indicating that tightening is appropriate; on the other hand, core Personal Consumption Expenditures (PCE), the Fed's preferred measure of inflation, slipped to 1.40% YOY in May. The Fed has been dismissive of the sluggish inflation, believing it to be transitory. Giving a heavier weight to unemployment figures than inflation, the Fed has signaled its intent to raise target rates once more this year. Overall, we expect a tightening credit environment as monetary policy will likely be less accommodative.

Gross Domestic Product (GDP) growth rate estimates for 2017 cluster tightly around the 2% mark. We have a slightly more optimistic outlook than the consensus. Despite tightening, monetary policy is still rather accommodative; payroll numbers grew faster than expected in June (179k vs. 220k); wages grew at a healthy 2.5%; and consumer and business confidence indices are also performing well. Combine these factors with pro-growth fiscal initiatives of less regulation, health-care reform, and tax cuts, our estimate of growth for the rest of 2017 is 2.3%. As the Trump administration's policies have time to pass through legislative hurdles and take effect, we believe the growth rate for 2018 will be higher than the 2.2% consensus at 2.5% or perhaps more if the White House has more success getting bills passed.

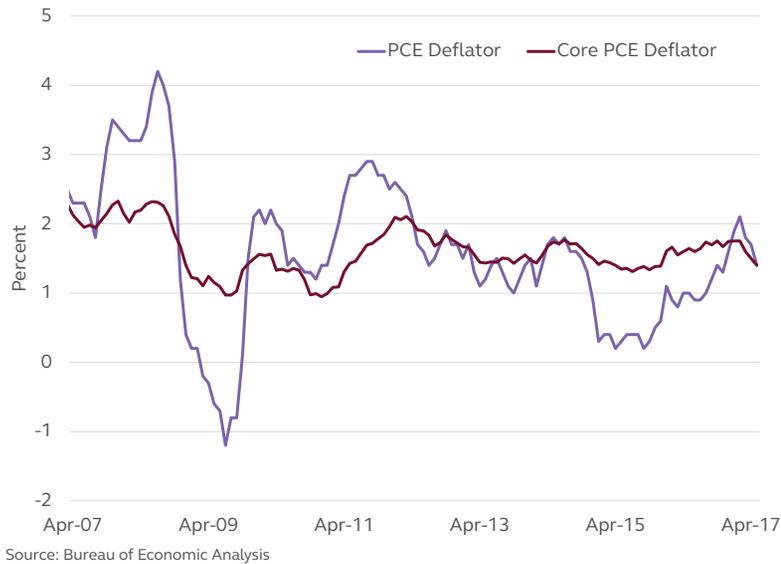
We expect primarily external risks to the US economy. Political and economic issues are looming with China whose debt levels have ballooned recently to over 250% of GDP, which led Moody's to reduce China's rating from Aa3 to A1 in late May. The rapid increase in debt was expected to maintain growth rates in the country, but has led to growing concerns about China's ability to service the debt. On the political landscape, the US has been relying on China to help with defusing the escalating tensions with North Korea, which has not been successful. China has been insisting that the level of its influence has been exaggerated, and other factors continue to inflame the situation. The US has been considering both highly targeted, narrow sanctions against specific Chinese companies, and broader-based sanctions against China. These actions have the potential for knock-on effects given the large trade volume between the US and China.



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Inflation



Highlights

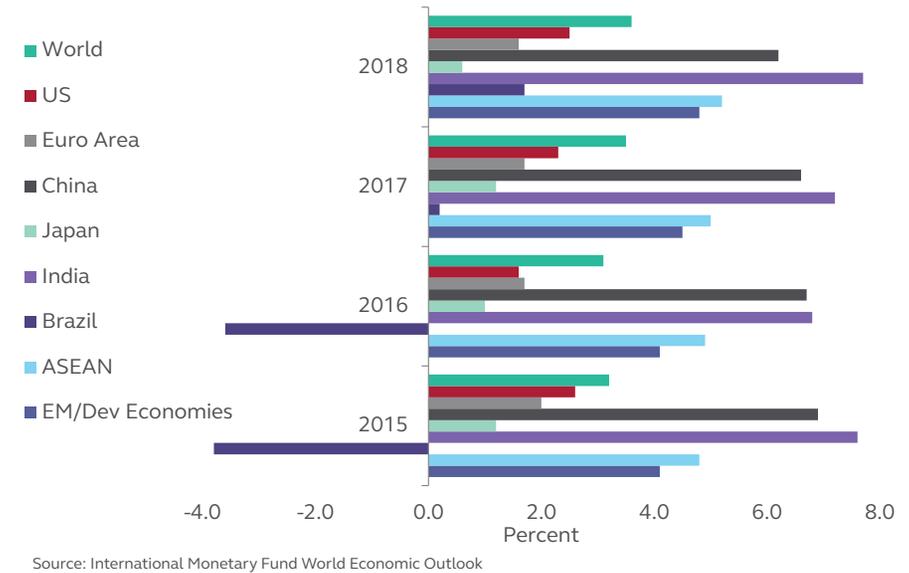
The Fed's most closely watched inflation indicator, the core PCE Deflator, remains well below the 2% policy target. The broader measure, the PCE Deflator, which includes energy and food prices, has also moderated, primarily influenced by falling energy prices.

According to the Arouba Term Structure of Inflation Expectations released by the Federal Reserve Bank of Philadelphia, market expectations for inflation have fallen and the slope of the break-even curve has flattened indicating that near-term and longer-term inflation expectations are more aligned than before.

Outlook

The latest FOMC meeting minutes indicate that recent weakness is expected to be transitory and that inflation would stabilize around its 2% objective over the medium term. Expectations for further strengthening of employment conditions lead us to believe the Fed will continue to gradually remove accommodation including one more 0.25% increase in the federal funds rate in 2017. Additionally, the pick-up in economic growth in the second half of this year should prompt it to begin the gradual balance sheet reduction in 2017.

Global Growth



Highlights

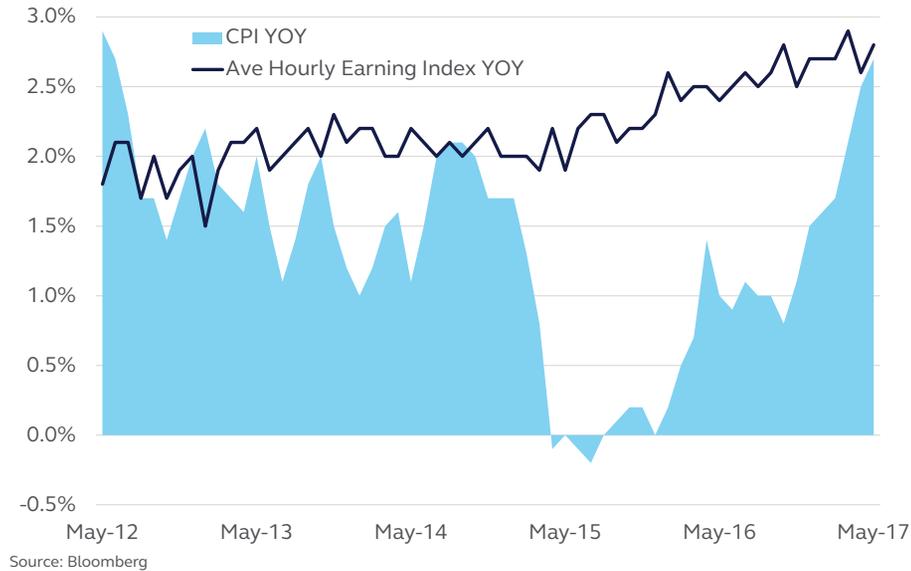
Global growth is expected to increase from 3.1% in 2016 to 3.5% in 2017 and 3.6% in 2018 according to the International Monetary Fund. The greatest improvements are expected in emerging and developing economies at 4.1% for 2017 and 4.8% in 2018, with the highest growth expected from India and China.

Core inflation rates in developed economies remain below central bank targets and economic slack persists, particularly in the US and Euro area. Headline inflation measures are expected to wax and wane with energy prices which have been more volatile than the norm.

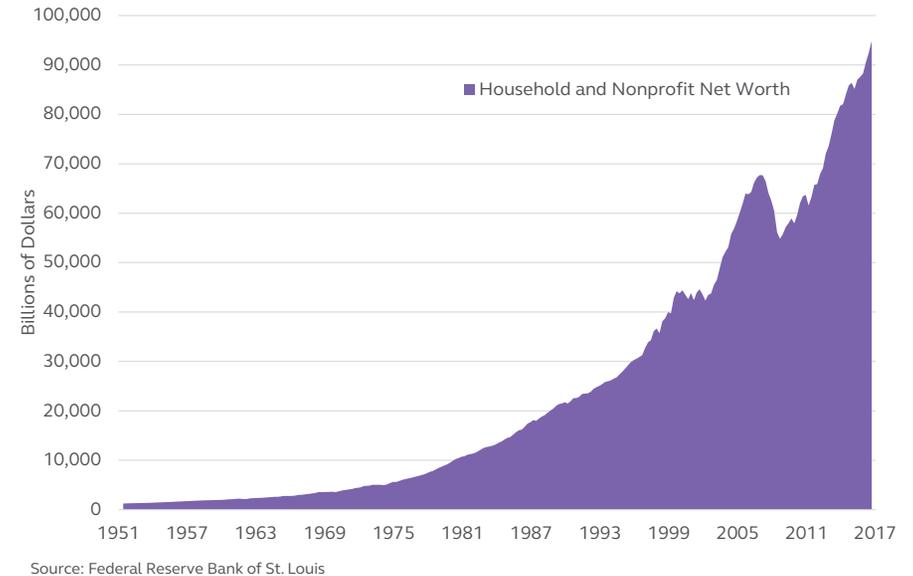
Outlook

Notwithstanding moderate inflation expectations, central banks seem inclined to gradually remove accommodative monetary policy. In the US, the FOMC considers a continued gradual removal of monetary policy accommodation to be appropriate. Economic performance has reduced deflation risks in Europe and Japan, permitting the respective central banks to consider tapering their quantitative easing programs.

US Wages



Household Net Worth



Highlights

Non-farm payrolls increased by 222,000 jobs in June, exceeding expectations of 175,000. This report was clearly better than the 138,000 reported for May, though, revisions added 47,000 more jobs to the preceding two months. Despite the strong jobs number, the unemployment rate increased by 0.1% to 4.4%, as more people entered the workforce. The participation rate, the percentage of the US population that is either working or actively seeking work, increased slightly to 62.8% from 62.7% a year ago.

Average hourly earnings increased 2.8% YOY in June, only slightly above the Consumer Price Index (CPI) growth rate of 2.70%, seemingly squeezing income as inflation increases.

Outlook

The Fed relies on the Phillips curve which describes an inverse relationship between unemployment and inflation so that as the unemployment rate drops, inflation will increase. Wages have not risen as fast as expected from the model. We don't believe the Phillips curve takes into account the global nature of our economy and the substitution of technology for labor, making it less relevant in today's economy; therefore, we believe that the unemployment rate can go lower without pushing up inflation through wage gains.

Highlights

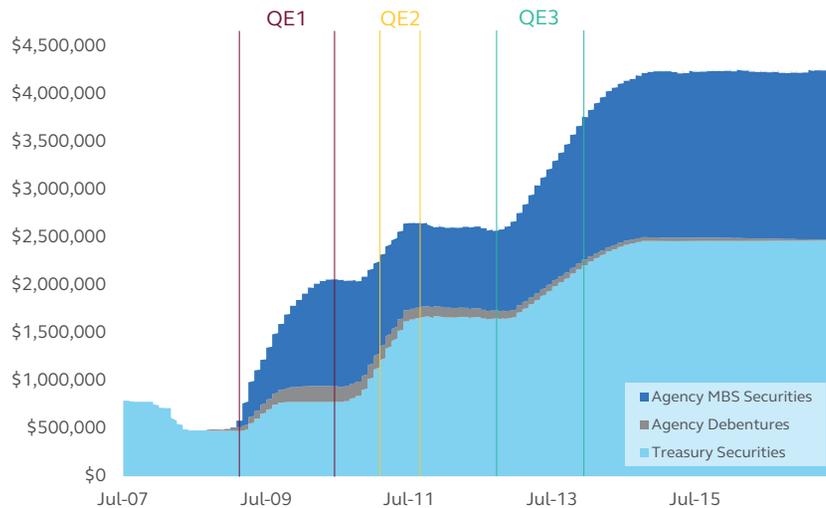
The Fed reported that the net worth of US households and nonprofit organizations increased to \$94.84T in the first quarter of 2017 from \$92.81T the previous quarter. This represents an increase in net worth of \$7.59T from 2015 and \$10.65T from 2014.

The increase was driven by a \$1.3T gain in corporate equities and a \$500B increase in the value of real estate. Household debt grew by 3.2% as consumer credit expanded at a rate of 5% and mortgage debt rose at a rate of 3%.

Outlook

The continued increase in net worth is a positive sign for the economy, improving consumer and business confidence. It also provides additional spending and borrowing capacity.

Fed Balance Sheet



Source: Federal Reserve

Highlights

At the onset of the financial crisis the Fed's balance sheet consisted of \$790M in Treasuries, of which 80% matured within 5 years. As a result of the subsequent quantitative easing (QE) programs, the size and composition of the balance sheet has changed considerably over the past decade.

Under QE1, the Fed added over \$1T in Agency MBS to its balance sheet. The Fed further attempted to drive down long term borrowing rates via \$600B in outright Treasury purchases (QE2) as well as by swapping \$400B of short maturity debt for longer debt under Operation Twist in 2011. The Fed's holdings swelled to the current level of \$4.2T in QE3, comprised of 58% Treasuries and 42% MBS. As a result of QE and Operation Twist, the percentage of securities on the Fed's balance sheet maturing within 5 years is now only 35%.

Outlook

At its June meeting, the Fed announced a set of gradually increasing caps on the amounts of MBS/Treasuries it will allow running off its balance sheet each month: \$4B/\$6B respectively, stepping up quarterly until reaching \$20B/\$30B. Given the Fed currently holds \$1.8T MBS and \$2.4T Treasuries skewed towards longer maturities, many years will pass before its balance sheet declines meaningfully, leaving a good amount of policy accommodation in place.

Leading Index



Source: Federal Reserve Bank of St. Louis

Highlights

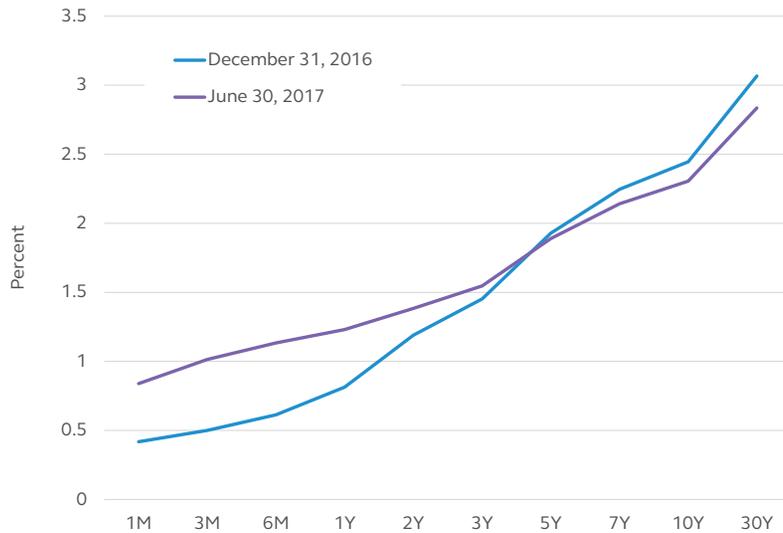
The Leading Index of the United States, compiled by the Federal Reserve Bank of Philadelphia, is a compilation of individual state indices which track such things as initial unemployment insurance claims, state-level housing permits, the ISM manufacturing survey, and the spread between 90 day and 10 year Treasuries. Over the past 5 years, the Index has settled in a range of 1.39% and 2.04%.

Since its inception in 1982, each time the Index has fallen below 0.9% the economy has fallen into recession, without false-positives. The Index has ranged from 1.40% to 1.63% during 2017.

Outlook

We do not expect a recession in 2017 nor do we expect the Index to fall to the pre-recession level, rather we expect the economy to continue to expand throughout the year.

Yield Curve



Source: Bloomberg

Highlights

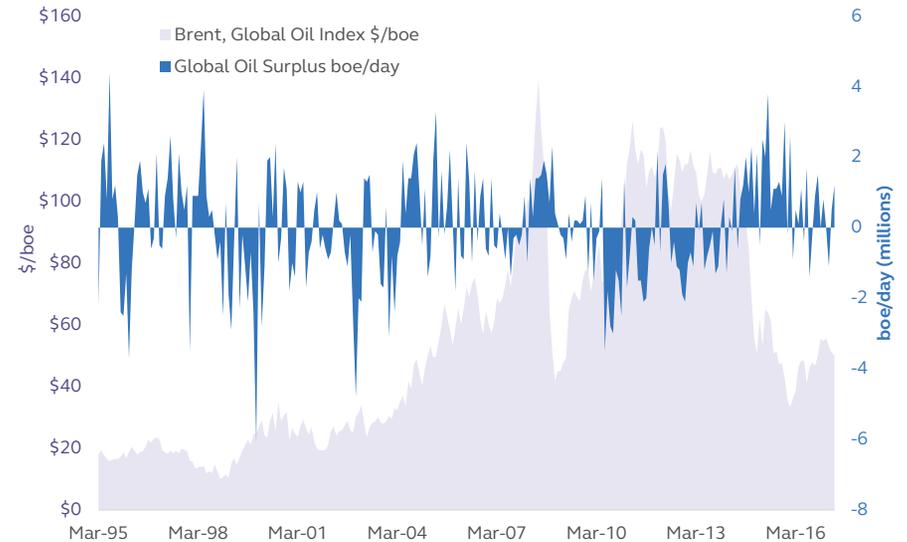
Throughout 2017, the US Treasury yield curve has flattened. The yield difference between the 2yr Treasury and the 10yr Treasury ended the second quarter at 92 bps, which is nearing the tightest spreads post the Great Recession. The Fed has continued its course of short-term rate hikes, with two hikes already seen in 2017, while weaker than expected economic data has dampened economic optimism and resulted in longer term rates to come down.

Historically, flattening yield curves have been an indication of pending recessions. Thus, close attention will be paid to the Fed throughout the second half of 2017 to see if its policy actions run parallel to economic realities and previously set expectations.

Outlook

Despite the flattening yield curve, we do not believe that a recession is in the near future. Over the next quarter, we think the yield curve may actually steepen slightly with the spread between 2yr and 10yr Treasuries widening less than 5 bps.

Oil and Gas



Source: Bloomberg

Highlights

Global oil production continues to exceed global demand.

Saudi Arabia's efforts to bring the market to equilibrium in advance of the IPO of its oil reserves have been somewhat successful as the surplus has narrowed.

Outlook

US oil production will continue to increase, capping pricing both domestically and internationally. Absent an unusual event, Brent Crude pricing, a major benchmark for worldwide oil purchases, is expected to stay within its current band of \$45-\$55 per barrel of oil equivalent until the market reaches more equilibrium.

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
	<p>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 smaller than expected. Increased growth will lead to higher interest rates. Major trade wars will be avoided, but there will be volatility around trade deals. Political turmoil around the Russian scandal remains, but does not directly touch the President. Core PCE will stay below 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. The recent drop in oil and commodities may lead to lower inflation and less capital spending. Soft landing in China. Europe continues to recover. North Korea is handled through diplomacy. Low global rates and the strong dollar make U.S. term rates attractive and mute their rise.</p>	<p>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 retains 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. 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.</p>	<p>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 approaches 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. European 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.</p>
GDP	2.30% in 2017, 2.50% in 2018	Below 0.50%	Greater than 3.50%
Change in Rates	2Yr 1.65%, 10Yr 2.60%	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

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