Economic Summary

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At the August meeting, the federal funds rate remained unchanged after the Federal Open Market Committee (FOMC) agreed to leave it at the current range of 1.00% to 1.25%. The dot plot was unchanged from last quarter, with the exception of a 25 bp drop in 2019, suggesting that the rate will increase to 1.375% by the end of 2017, 2.125% by the end of 2018, and 2.75% by the end of 2019. The Federal Reserve (Fed) expects the US economy to grow by 2.4% in 2017 and 2.10% in 2018 compared to the median Bloomberg estimate of 2.2% in 2017 and 2.3% in 2018. We believe it will take time for the pro-business policies of the Trump administration to be implemented, though when enacted, will lead to stronger US growth. We expect economic growth of 2.5% in 2018; and may raise our forecast if the new administration is successful in enacting more of its policies.

Two primary measures the Fed has been watching closely as they consider monetary policy are inflation and unemployment. The Fed's preferred measure of inflation, the personal consumption expenditures price index, excluding food and energy (core PCE deflator), was up 1.3% YOY in August, still below the Fed's 2% target. The unemployment rate remains near a 17-year low at 4.2%, falling below the Fed's median target, though it believes this is transitory. Consequently, we expect the FOMC to raise rates a third time in 2017. FOMC Chairwoman Yellen's term expires in February of next year; we expect President Trump to select someone with a less interventionist policy, like Kevin Warsh, a former member of the Federal Reserve Board, rather than reappoint Janet Yellen.

The country's economic recovery is the third longest in US history, exceeding eight years; key drivers, including its slow pace, should allow growth to continue. Central banks around the world appear to be reaching the conclusion that the deflationary cycle is over and that it is time to start removing some monetary accommodations. Consumer and business confidence continue to increase along with payrolls and wages. Pro-growth initiatives of less regulation and tax cuts would stimulate the economy, though, major initiatives have not passed yet. Tax reform may be on the table with close votes on either side. Wealth is likely to continue to increase for home and stock owners.

China continues to be a primary risk to the US economy. A slowdown in China's economy could occur if it is unable to service the significant debt which was caused by its stimulus measures in the quest to maintain the country's growth rate. The US is also leaning on China to control North Korea's nuclear ambitions. The US could pressure China through sanctions, though, unlike Russia which is weak economically, China has the world's second largest economy, potentially making a trade war very costly.

President Trump's appointment of the next FOMC Chair may pose some risk to the US economy. A faster increase in rates than what the market is anticipating could lead to a growth slowdown and unwinding leveraged positions could lead to shocks in the economy.

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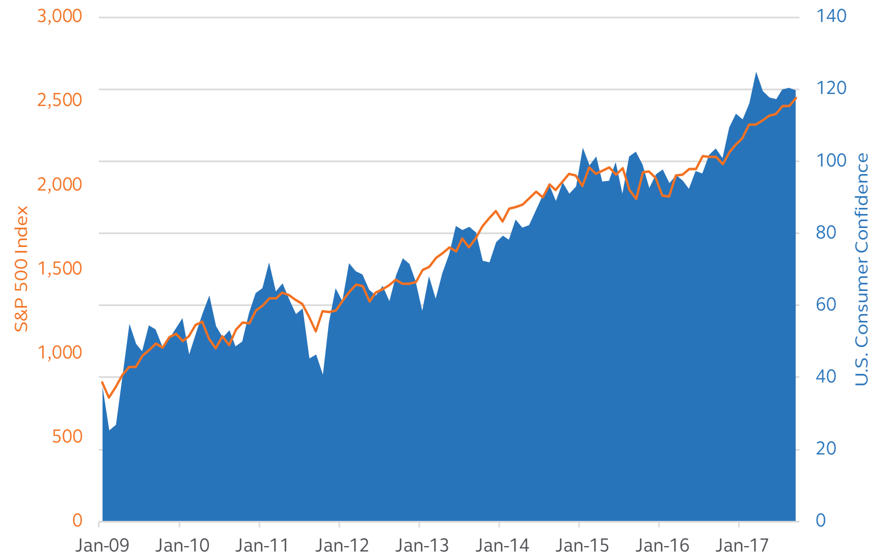
Consumer Confidence



Source: Bloomberg

Highlights

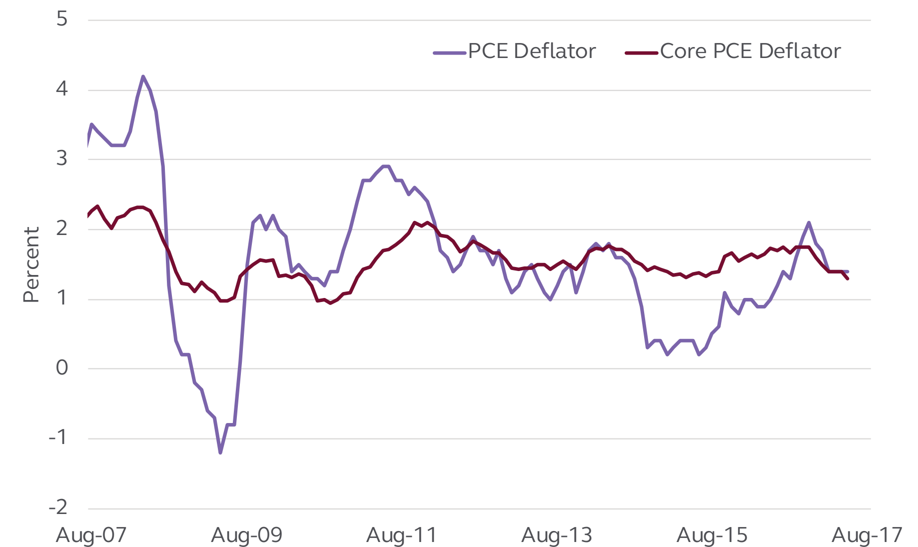
Consumer confidence in the US remains near 16-year highs despite recent oscillation, driven in part by uncertainty surrounding hurricanes Harvey and Irma and the political environment in Washington DC.

Americans generally have a favorable view on the overall economy, including their employment and income prospects. This favorable view largely reflects strong declining unemployment rates, which are at pre-financial crisis lows, and a US stock market at all-time highs.

Outlook

Favorable consumer confidence typically points toward higher future household spending. With household spending accounting for roughly 70% of Gross Domestic Product (GDP), increased outlays have a notably favorable impact on the economy.

Inflation



Source: Bureau of Economic Analysis

Highlights

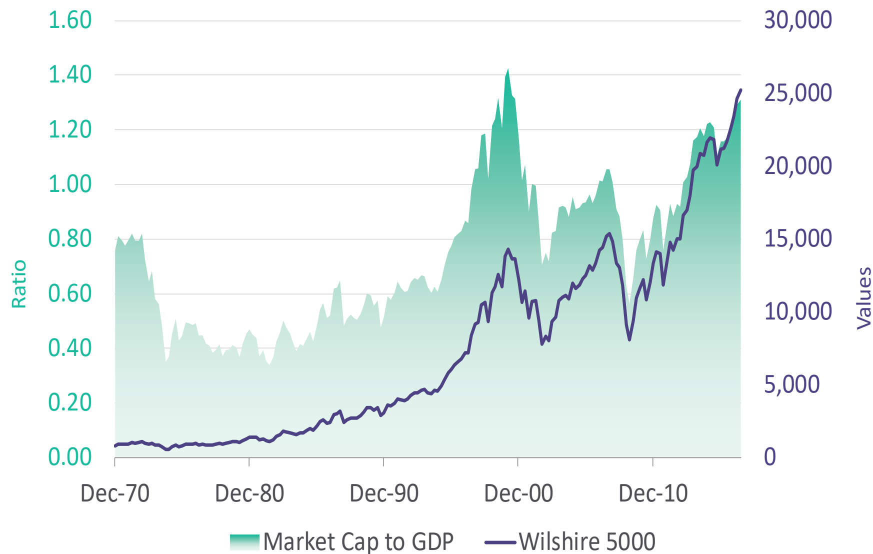
The PCE and the core PCE, excluding food and energy prices, have moderated. The core PCE, the Fed's most closely watched inflation indicator, continues to report price increases well below the 2% policy target, most recently 1.3%.

Near-term Consumer Price Index (CPI) expectations have fallen significantly, though break-even inflation rates project slightly higher, yet modest, inflation of just above 2.25% out 10 years.

Outlook

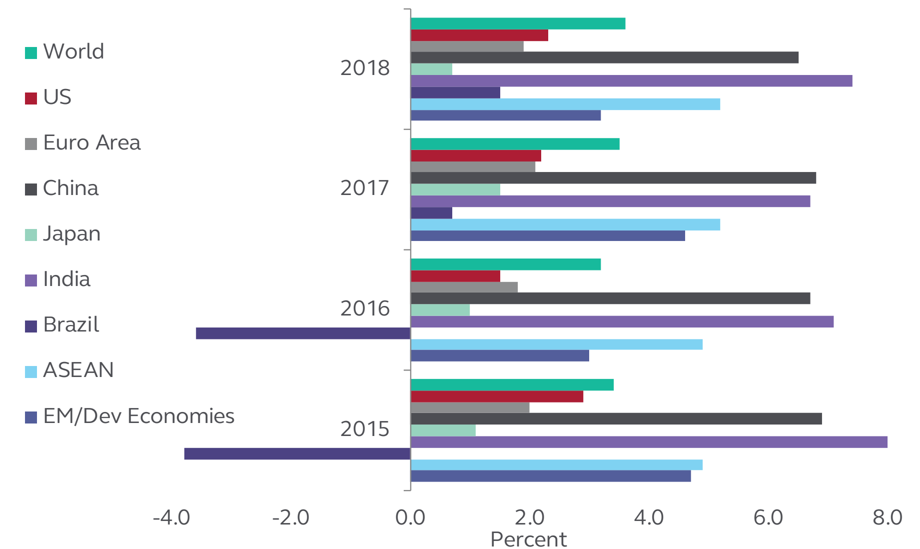
The Fed expects inflation to increase over the next couple of years and considers recent weakness the result from transitory factors. Combined with expectations for further strengthening of employment conditions, we believe the Fed will continue to gradually remove accommodation, including one more 0.25% increase in the federal funds rate this year.

Stock Market Capitalization



Source: Bloomberg

Global Growth



Source: International Monetary Fund World Economic Outlook, July 2017

Highlights

Often referred to as the Buffet rule, the ratio of corporate market capitalization (measured by the Wilshire 5000 Index) to the size of the economy, is considered one measure of equity valuation. By this measure, equities are at the high end of the valuation range.

One explanation for the higher valuation of equities is that rates are much lower now than they were during other peaks.

Outlook

From a valuation perspective, the equity market is vulnerable, especially if rates rise; the equity market can return to a lower valuation even with a stronger economy.

Highlights

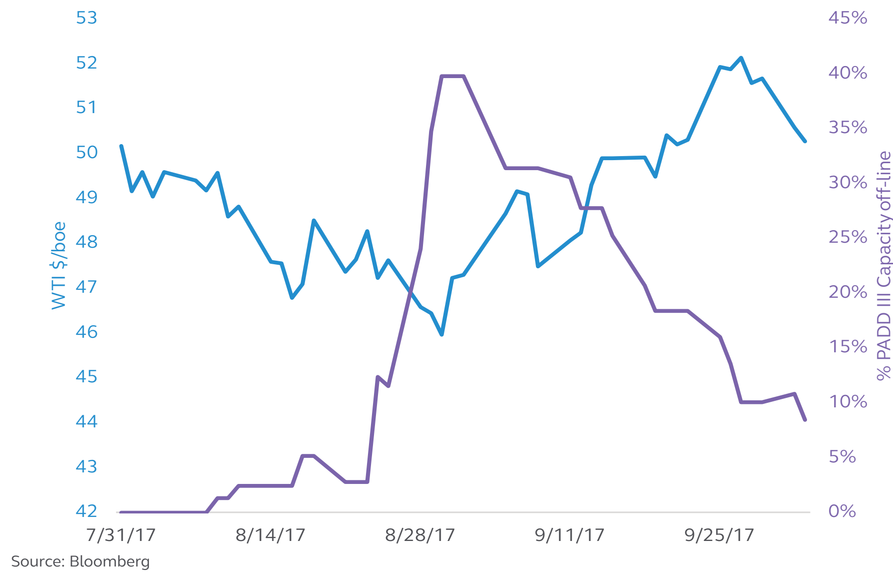
The International Monetary Fund projects that world economic output will continue to increase from 3.2% in 2016 to 3.5% in 2017 and 3.6% in 2018. Growth rates in many categories experienced upward revisions, most notably Europe, Japan, Brazil, and emerging market countries.

US growth expectations remain steady at 2.1%, though our base case looks for a slightly stronger 2.2% in 2017 accelerating to 2.5% next year.

Outlook

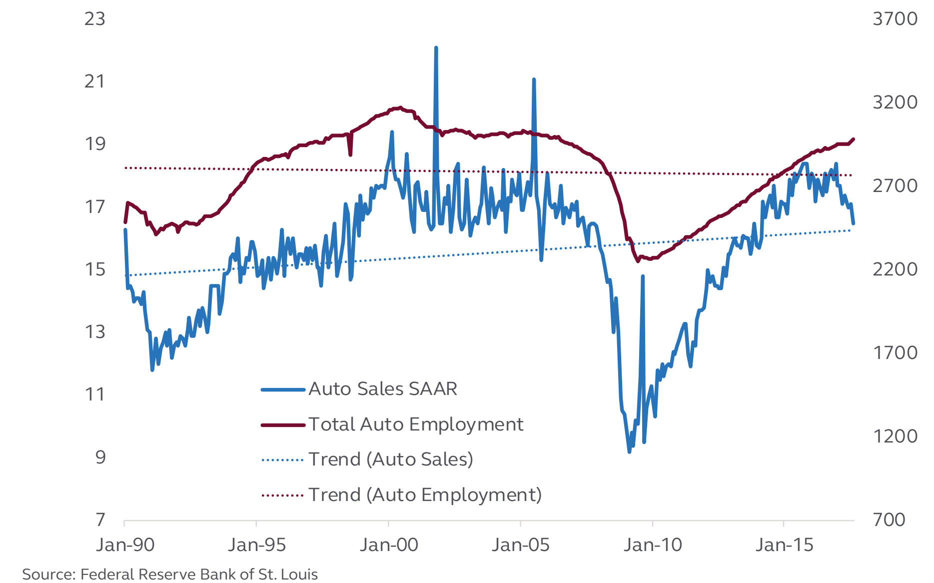
Increasing world growth and moderate inflation expectations have prompted the US central bank to begin gradually removing accommodative monetary policy. Economic performance in Europe and Japan has reduced deflation risks which will encourage the respective central banks to consider tapering their quantitative easing programs at some point in the future.

Crude Oil



Source: Bloomberg

Auto Employment



Source: Federal Reserve Bank of St. Louis

Highlights

The US Gulf Coast, included in the Petroleum Administration for Defense Districts (PADD III), is the epicenter for petrochemical refining, handling of imported crude, and exporting of both crude and refined products. PADD III contains 52% of US refining capacity, 58% of crude oil production and handles 55% of crude oil imports.

Hurricane Harvey landed between Corpus Christi and Houston, TX, on August 25, 2017. Refineries and other crude oil infrastructure were quickly overwhelmed in places by over 40 feet of water and subsequent flooding. At the peak, 40% of PADD III refining capacity was shuttered.

Limited refining capacity pushed prices lower for a few days as regional crude production overwhelmed available capacity. Pricing quickly responded as refining capacity returned.

Outlook

Remarkably, within six weeks, the PADD III-located refining industry recovered. The resilience and flexibility of the energy markets should add stability to both production and pricing.

Highlights

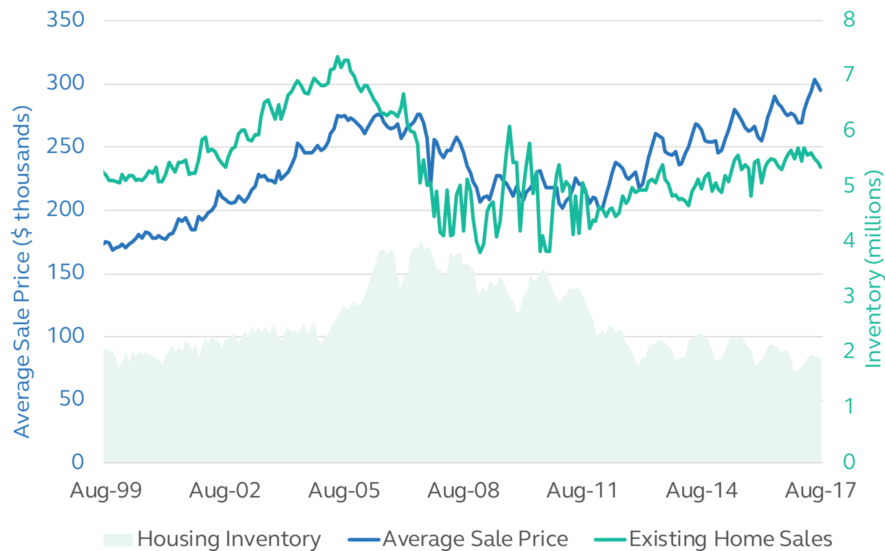
Auto-related employment tracked by the St. Louis Fed, including auto manufacturing and auto/parts dealerships, has historically risen and fallen with the auto cycle. In 2009, the United Auto Workers union made concessions allowing auto manufacturers greater flexibility to reduce employment to manage costs in a down cycle.

We've seen five major auto sale declines of 20% from peak to trough in the US since 1950. During the Great Recession ending in 2009, sales declined 40%; a more typical downturn, like the recession ending in 1975, saw only a 23% decline in sales. Absent a recession, any dip in auto sales is likely to be much more benign.

Outlook

If auto sales continue to decline, we should start to see a decrease in auto-related employment, dampening US economic growth. However, a weak auto market alone cannot cause a recession as auto manufacturing and retailing account for only 2.1% of US GDP.

Housing



Source: National Association of Realtors

China

Source: National Bureau of Statistics of China

Highlights

In the years leading up to the housing market peak in 2005, home sales, housing inventory and real estate prices all rose steadily and in unison. During the subsequent housing bust from 2006-2009, home sales and prices declined sharply while inventory remained elevated due to tight credit conditions and rising foreclosures. As a result of the Fed's QE programs, mortgage rates declined from near 6.5% in 2008 to 3.5% by 2012, driving a partial recovery in the level of home sales. Much of the affordable/distressed inventory, however, was purchased by investors/institutional buyers while first-time buyers were shut out of the market and forced to rent.

The inventory of homes for sale has continued to decline steadily, prompting a corresponding rise in home prices that has outpaced income growth, eroding affordability.

Outlook

We believe the new Treasury department proposals to ease regulatory burdens on mortgage origination, servicing and securitization are a step in the right direction and should ease credit conditions for entry level buyers, whose participation is essential for a properly functioning housing market.

Highlights

China's housing market rebounded strongly from the softness experienced in 2014 and 2015 due to significant monetary and fiscal stimulus. A combination of six rate cuts, reduction in down payments and lower sales taxes boosted prices in major tier 1 cities 30-40% since December 2015.

Starting in the 4th quarter of 2016, numerous cities implemented restrictive policies to cool runaway home prices. Cities imposed higher down payments and restricted the maximum number of homes one can own. For example, down payments for second home purchases were raised to as high as 70% in Shenzhen and Guangzhou. Further, mortgage rates have increased for first-home purchases.

Outlook

With the rebound in economic growth, driven primarily through real estate investments, China has somewhat receded as the primary macro risk. Although risk does abound in trying to implement a soft landing in a heated housing market. Regulatory actions over the last year have reduced speculative activity while maintaining economic growth.

Macroeconomic Outlook

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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 2017 is 2.25%. 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 failure of health care repeal increased the markets 'skepticism. Tax cuts may happen. Increased growth will lead to modestly 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 looks likely to raise rates in December. The hurricanes hurt GDP growth, but recovery puts the economy back on track. 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.	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 move any of his major initiatives through Congress. He is seen as a weakened president and confidence falls. A trade war develops with China over their failure to control North Korea. 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, 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. 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	2.25% in 2017: 2.50% in 2018	Below 0.50%	Greater than 3.50%
Change in Rates	2Yr 1.65%, 10Yr 2.60%	Sharply lower / 120 bps (10Yr UST)	Sharply higher / +100 bps (10Yr UST)
Change in Curve	Little change 2-10s	Bull flattener	Bear steepener
Volatility	Moderate	Higher	Higher

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