Economic Summary

Morley
Capital Management

During the June Meeting, the Federal Open Market Committee (FOMC) raised the federal funds rate by 25 bps to a range of 1.75% to 2.0%. Encouraged by falling unemployment rates and rising inflation, the FOMC added a potential fourth rate increase to the agenda. This leaves an expected two more 25 bp increases in 2018. The June Fed dot plot's median forecasts for the federal funds target rate were 2.375% for 2018 and 3.125% for year-end 2019: both increases of 25 bps over previous estimates. The post-meeting statement is more aggressive than previous statements, suggesting a slightly accelerated pace of rate increases. Countering the aggressive tone at the Fed, National Economic Council Director Larry Kudlow expressed concern and stated that the Fed should raise rates slowly, downplaying inflationary concerns.

For gross domestic product (GDP) growth expectations, the Fed raised its forecast by 0.1% to 2.8% for 2018. Extending into 2019, the Fed expects a decrease to 2.4% for the year. Similarly, Bloomberg's median growth estimates are 2.9% in 2018, and 2.4% in 2019. We believe the pro-business policies of the current administration will persist longer than the other estimates. We estimate a similar rate of 2.9% in 2018, but a higher rate of 2.7% in 2019.

Inflation and employment numbers both indicate a healthy economy. The economy added 213,000 jobs in June surpassing estimates of 195,000. The Fed's preferred measure of inflation, the core personal consumption expenditures (PCE), has reached the Fed's target of 2.0%. The core PCE was up 0.2% in May, and 2.0% YOY. Looking at strong growth numbers and these macroeconomic indicators, we are confident the Fed will follow through with its planned rate hikes this year, though potential trade wars on the horizon might curb the Fed's enthusiasm for multiple rate increases.

Economic confidence measures are trending higher as well. Consumer confidence remains strong: the Conference Board Index rose to 128.8 in May up from 125.6 in April. Supply side confidence is also robust with the National Federation of Independent Business Survey reaching the second highest level in its 45-year history. The Index rose to 107.8, a three-point gain, with small businesses reporting higher numbers in several key areas including compensation, profits, and sales trends.

Despite an overall healthy economy and strong indicators for the future, there are risks that warrant attention. Foremost in our minds is the threat of a trade war between the United States and China with rounds of retaliatory tariffs. Trade between the two countries is huge: estimated at $648.5B in 2016. Negotiations are ongoing and financial markets may experience volatility as a result. We remain optimistic that negotiations will be successful; both sides have done well under current arrangements, and have too much to lose from hasty actions. Another concern we have is central bank rate policy mistiming. Raising rates too quickly could force asset managers to unwind too quickly resulting in knock-on market volatility. In the other direction, if the Fed raises rates too slowly, the economy could overheat causing rapidly increasing inflation.

Bill Finley, CFA
Chief Investment Officer

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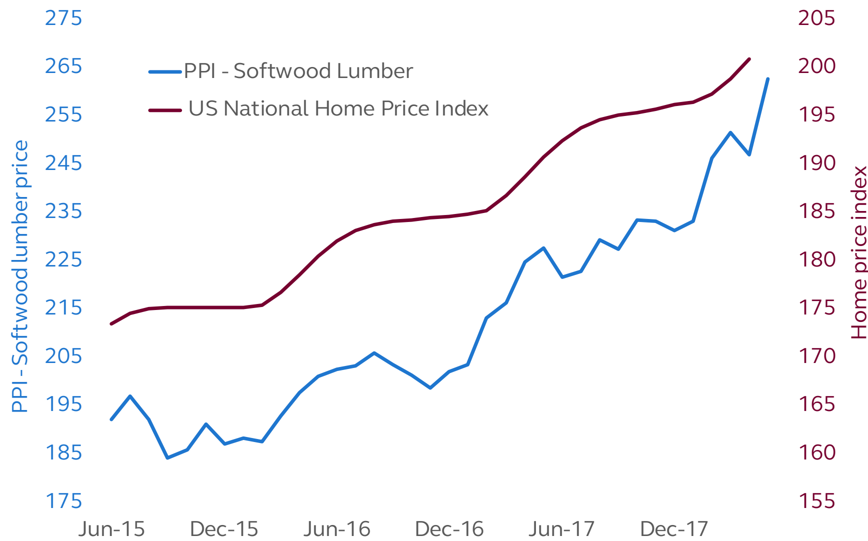
Lumber Tariffs



Source: Bureau of Labor Statistics/St. Louis Federal Reserve Bank

Highlights

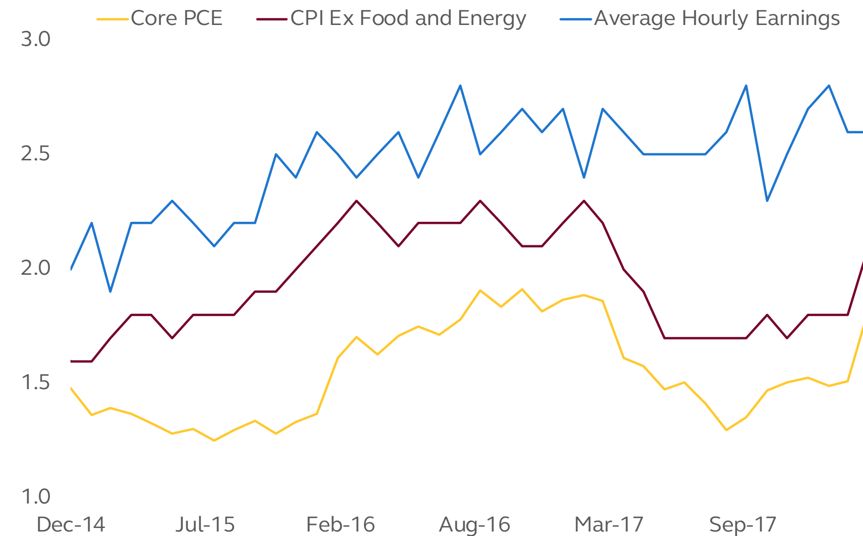
Softwood lumber (cedar, spruce, Douglas fir, pine) is used extensively in the housing market for building construction, interior/exterior woodwork and furniture. Domestic producers can only supply two thirds of U.S. demand, with imports accounting for the remainder and 95% of those coming from Canada.

After trade negotiations between the U.S. and Canada failed to reach a resolution last year, the U.S. Commerce Department imposed average import duties of 21% on Canadian lumber. As a result, softwood prices have risen dramatically and show no signs of abating as home builders struggle to meet strong demand for new construction in the U.S. market. According to the National Association of Home Builders, the lumber tariffs have increased homebuilding costs by approximately $9000/unit.

Outlook

With record low inventories of homes for sale, higher mortgage rates and hurricane/wildfire-related rebuilding efforts underway, Canadian lumber tariffs are coming at a particularly inopportune time. We expect U.S. housing affordability to deteriorate further as higher building costs get passed through to homebuyers, with entry level/first time buyers being hardest hit.

Inflation



Source: Bureau of Economic Analysis, Bureau of Labor Statistics

Highlights

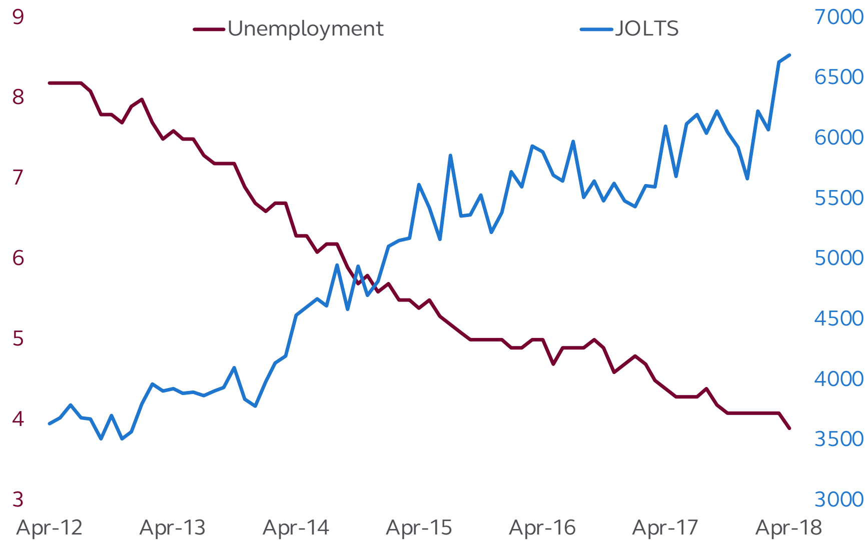
The FOMC expects its preferred measure of inflation, the core PCE, to continue to increase at or around 2% YOY. The price indicator moved up to that level in May of 2018 for the first time since early 2012.

The Consumer Price Index (CPI), which represents core price increases to the consumer excluding food and energy, has also moved up but at a slightly higher rate than the core PCE.

Outlook

Wage gains are running at a relatively flat rate and do not appear to be putting labor cost pressure on prices. We anticipate that there will be some modest upward pressure on price measures given our expectation for economic growth.

Unemployment



Source: Bureau of Labor Statistics

Highlights

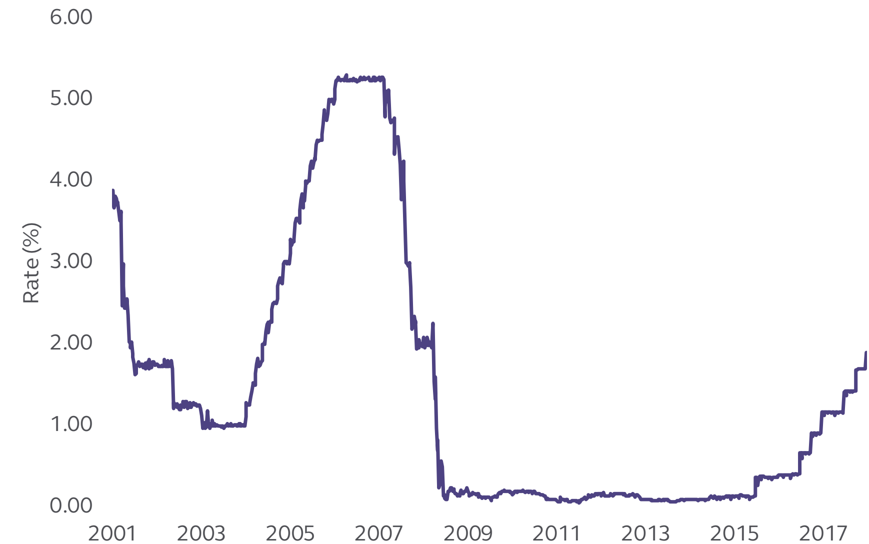
The Job Openings and Labor Turnover Survey (JOLTS) increased to 6.7M in March while unemployment rates continue to decline to below 4%, a 17-year low.

The U.S. labor market participation rate has declined from 67.3% to 62.7% since 2000.

Outlook

The employment picture points towards a labor shortage which could lead to wage growth, and support additional counter inflationary pressures by the Fed.

Federal Funds Rate



Source: Bloomberg

Highlights

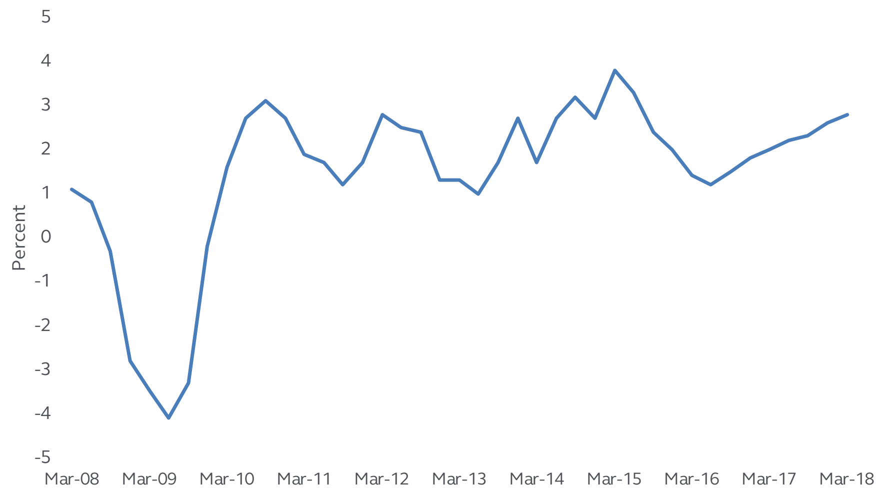
The federal funds rate, a key economic indicator and the main tool used by the Fed for managing inflation and the pace of U.S. economic growth, was last raised during the 2004-2006 period in an effort to contain the overheating economy during the real estate bubble. After the market crashed in 2008, the Fed drastically reduced the rate to a range of 0 – 25 bps, and held it artificially low for the better part of a decade; providing stimulus to the economy during the extended recovery period.

The federal funds rate has been slowly ratcheted upwards through 2016 and 2017; however, with the increasing pace of economic growth, new Federal Reserve Chair, Jerome Powell, has been much more hawkish in his rhetoric concerning inflation and the pace of increases in the federal funds rate.

Outlook

Based on the minutes from the past two FOMC meetings, it appears likely that the Fed will increase the federal funds rate two more times before the end of 2018. Although confidence is on the rise, we expect a gradual pace of raising rates to continue to ensure the recent economic strength and rise in inflation is sustainable.

U.S. GDP



Source: Bloomberg

Highlights

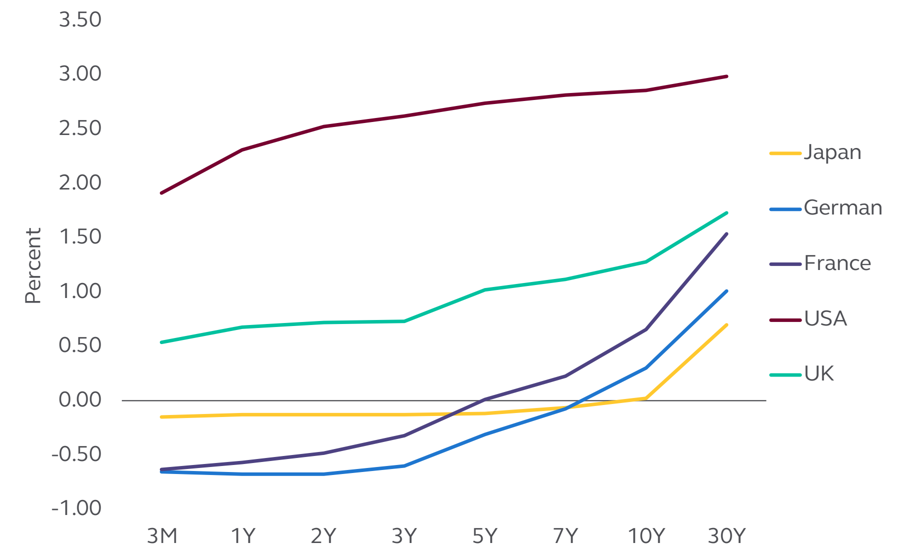
GDP growth slowed in the 1st quarter to a rate of 2.0% from 2.9% in the 4th quarter of 2017. GPDNow, a GDP forecast published weekly by the Federal Reserve of Atlanta forecasts for 3.9% growth in the 2nd quarter.

Economic releases during the quarter were positive. Job creation was strong while consumer and small business confidence remained high.

Outlook

A growth pattern emerged over the last few years where growth slows in the 1st quarter and picks up in the 2nd quarter. We believe this pattern will be seen in 2018 and expect second quarter growth to approach 4%. Our forecast is for GDP to expand at a 2.9% rate for 2018.

Global Rates



Source: Bloomberg

Highlights

U.S. Treasury rates rose over the last three months. Rates decreased across the major Euro-based economies and the UK.

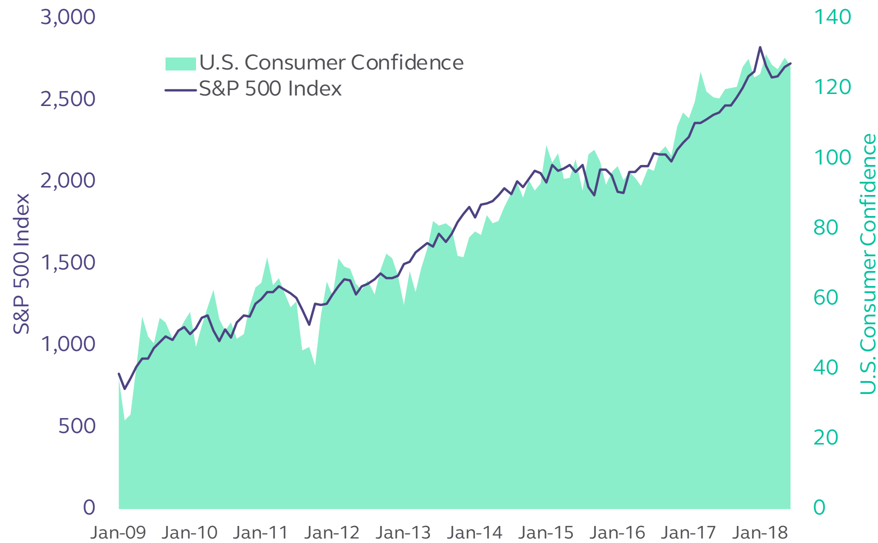
Yield curves of U.S. and Euro government issues have flattened further over this period. Curves in Japan and the UK are relatively unchanged for the same period.

Outlook

The Fed's monetary policy remains on a path of gradual rate hikes and tapering of open market asset purchases, keeping them ahead of other central banks in the removal of monetary stimulus. The European Central Bank has signaled that an end to asset buying is near but has seemed to push any changes to policy rates well into the future. Japan's monetary policy is expected to remain unchanged.

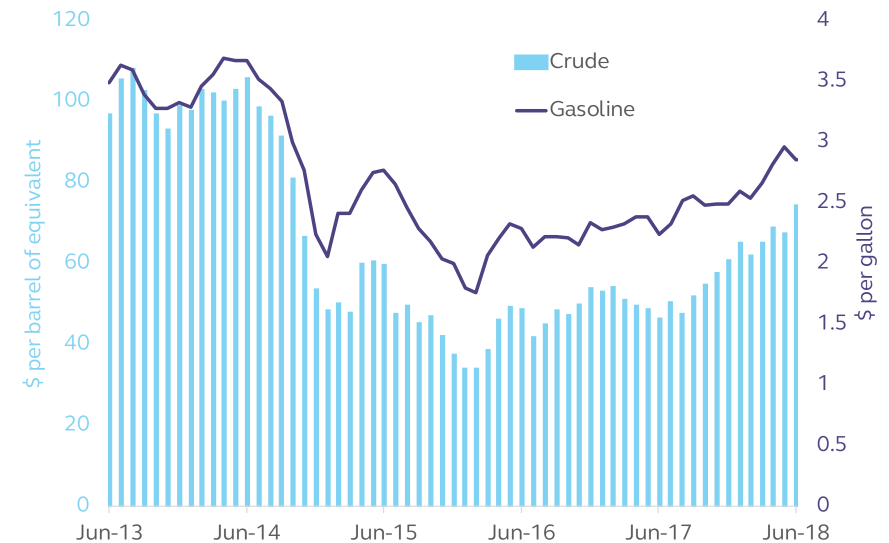
Continuing economic strength in the U.S. and relatively hawkish monetary policy should maintain the relative attractiveness of U.S. debt relative to that of other major economies.

US Consumer Confidence



Source: Bloomberg

Oil and Gas Prices



Source: U.S. Energy Information Administration

Highlights

Consumer confidence in the U.S. remains near 17-year highs, despite a recent dip due to less optimism on future economic and income growth. On the whole, Americans maintain a favorable view on the overall economy, driven by low unemployment rates and tax cuts. These favorable attributes have largely offset the adverse impact of increasing fuel prices, global trade war concerns, and U.S. stock market volatility.

The gap between consumers' optimism regarding current conditions versus future more muted expectations, is at the highest level since early 2011, indicating a belief that recent strength is likely to abate.

Outlook

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

Highlights

Gasoline, along with other energy components, is the largest seasonally adjusted factor in the CPI year-to-date at +4.9%.

Oil prices are recovering from cyclical lows of $34/barrel or $0.81/gallon.

Outlook

While gasoline prices are expected to remain above $2.50/gallon, strong employment and tepid growth in other components (vehicles, apparel, food) suggests demand will be fairly inelastic to this pricing.

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

	Base Case (70%)	Tail 1 (20%)	Tail 2 (10%)
	Modest growth	**Prolonged weakness (w/high chance of recession)**	**Inflation / Stronger than expected growth**
	GDP growth forecast for 2018 is 2.90%. The Trump administration fosters a pro-business climate. Reduced regulation and tax cuts are positive drivers for the economy. The $1.3T spending bill provides stimulus, but increase the deficit. Trade skirmishes remain contained, though increased risk that someone makes a miscalculation. Political turmoil around Russian remains, but does not directly touch the President. Core PCE stays near 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. Increased growth leads to modestly higher interest rates.	The major risk comes from China, the world's second largest economy. A slowdown due to the significant debt builds up in China reverberating throughout the world. Announcement of tariffs is prelude to a trade war with China. Other trade wars develop in North America and the EU leading to a significant global slowdown. The slowdown spills into the U.S. economy. The current recovery grows old and rising inflation and interest rates lead to a recession. Global conflicts and terrorism disrupts growth. The equity markets decline, reducing household wealth. The Fed raises rates too soon and must reverse course.	President Trump's policies stimulate the economy. Trade worries dissipate as negotiations result in increased and fairer trade. Growth surprises most economists and GDP growth exceeds 3.50%. China is able to maintain strong growth in the 6.5% to 7% range. 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	2.90% in 2018	Below 0.50%	Greater than 3.50%
Change in Rates	2Yr 2.85%, 10Yr 3.15%	Sharply lower / 150 bps (10Yr UST)	Sharply higher / +100 bps (10Yr UST)
Change in Curve	Curve removes flat 2-10s	Bull flattener	Bear steepener
Volatility	Moderate	Higher	Higher

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