Economic Summary

At the September meeting, the Federal Open Market Committee (FOMC) unanimously voted to raise the federal funds rate by 25 bps to a range of 2.00% to 2.25%. Gross Domestic Product (GDP) expanded at a rate of 4.2% in the second quarter and appears to be tracking in the 3% range for the third quarter. Inflation, measured by Core Personal Consumption Expenditures (PCE), which excludes food and energy, is around the Federal Reserve's (Fed) target of 2%. The Fed's median forecast for the federal funds rate was unchanged at 2.4% for year-end 2018 and 3.1% for year-end 2019. The Fed expects U.S. economic growth to rise by 0.3% to 3.1% for 2018, then slow down to 2.5% in 2019 and 2.0% in 2020. U.S. Federal Reserve Chairman Jerome Powell stated his outlook for the U.S. economy is "remarkably positive". The major change in the September FOMC statement was that the long-standing term "accommodative policy" was dropped. We expect the Fed to raise rates one more time in 2018 and at least one more time in 2019.

There is risk of an inverted yield curve if the Fed raises rates too high. Inverted yield curves occur when short-term rates are higher than long-term rates and they have historically preceded recessions. An inverted curve may not work as a lead indicator this time due to the distortion in interest rates caused by central banks. This distortion was created when central banks moved to zero interest rates and, in some cases, negative interest rates. There is potential risk that too much cheap debt has been accumulated in some areas of the world and that rising rates will cause something to break.

The economy continues to expand and create job opportunities. There are more job openings today than there are unemployed people. In July 2018, there were 6.9 million job openings, a series high. The ratio of unemployed persons per job opening was 0.9 in July 2018, a series low. The fact that there are more job openings than unemployed persons signals a strong labor market.

The U.S. has reached an agreement with Mexico and Canada. This was good news, though the biggest concern is the trade dispute with China. The size of the trade deficit with China is sizable, however, there are many other issues that make an agreement with China more difficult. Among the issues, the U.S. claims that China steals intellectual property and interferes in elections; China requires majority ownership in companies doing business in China and then obtains access to the companies' secrets; and China's stated goal is to become a global leader of technology. A trade agreement would fundamentally alter the way China plans to grow.

The U.S. economy has not had a recession since the Great Recession ended in 2009; many economists and market watchers feel that the economy is due for a recession in the next two years. We researched global economies and found that the developed Australian economy has not had two negative quarters of GDP growth for over twenty-five years. We don't believe that an economic expansion must come to an end simply because it is historically long. We believe that the U.S. economy can continue to expand if the appropriate policies are in place.

Bill Finley, CFA
Portfolio Manager

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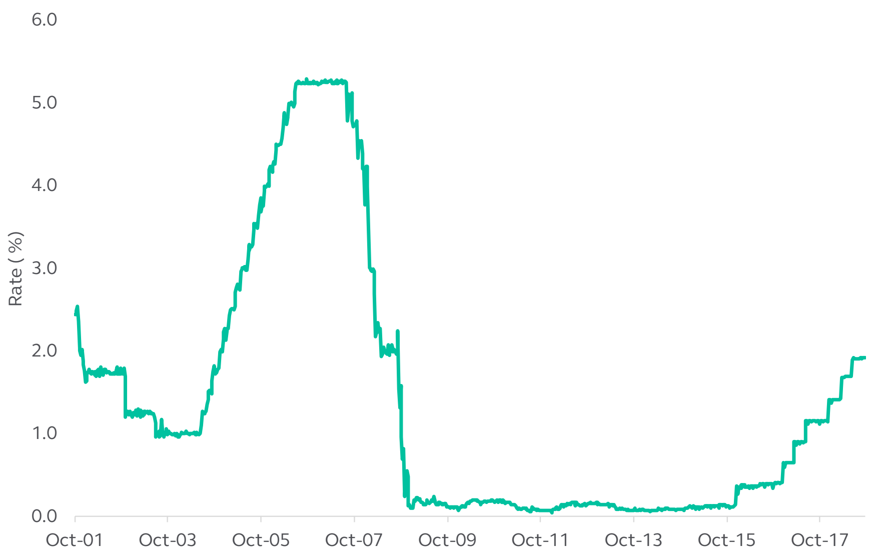
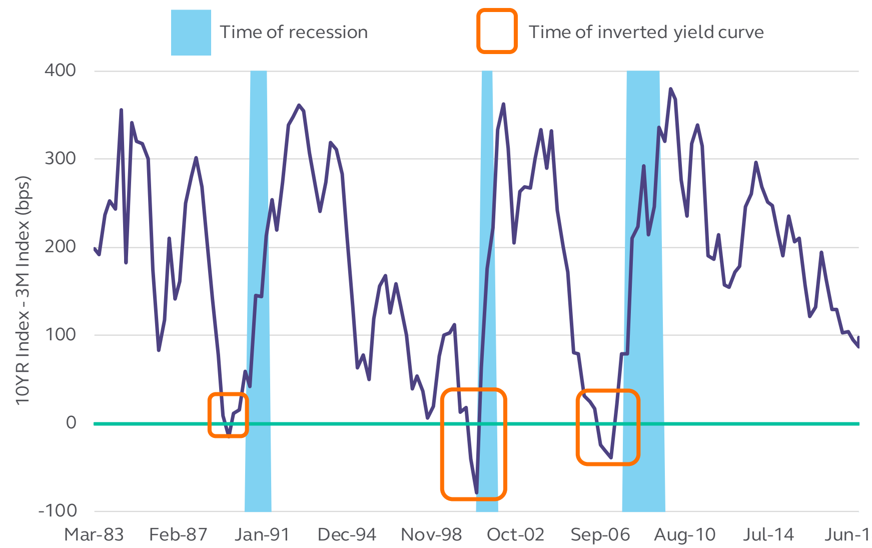
U.S. Federal Funds Rate



Source: Bloomberg

Yield Curve Inversion



Source: Bloomberg

Highlights

After the financial crisis the Fed moved the federal funds rate to near zero. The idea was to encourage people to move into more risky assets and revive the economy. Almost a decade later, the economy has finally picked up with 4.2% GDP growth in the 2nd quarter.

The FOMC raised rates to a range of 2.00% to 2.25% at the September meeting. The Fed repeated that it expected "further gradual increases" in rates. The statement released dropped the long-standing phrase "policy remains accommodative."

Outlook

The Fed is moving to what it considers a neutral rate, though it appears the Fed is struggling with how to define that neutral rate. The median projection calls for one more rate increase in 2018 and three in 2019. We expect the Fed to raise rates one more time in 2018 and at least one time in 2019.

Highlights

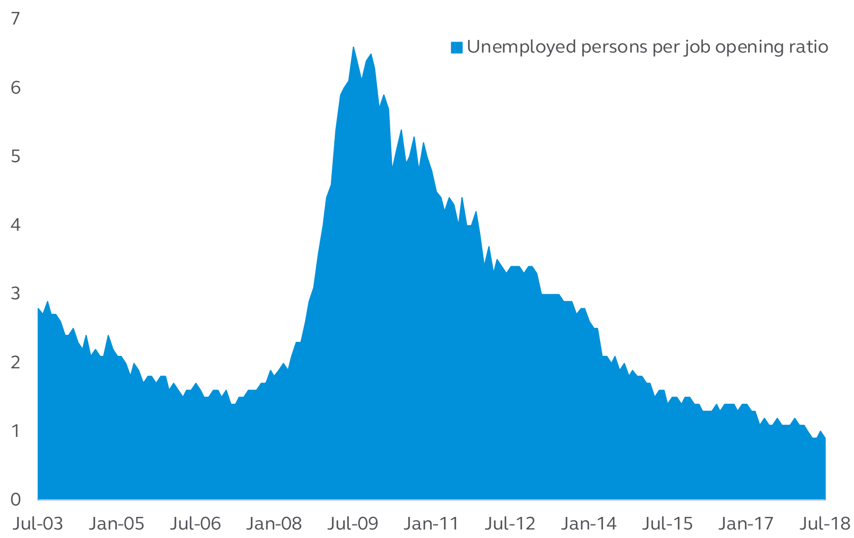
A normal yield curve is one where short-term rates are less than long-term rates. Usually investors are rewarded for taking on the risk of investing their money for longer time periods. An inverted yield curve is one where short-term rates are higher than long-term rates and is typically spurred by the Fed raising the federal funds rate. The current yield curve is fairly flat and, if the Fed continues its projected pace of tightening (raising rates), it could become inverted.

The yield curve has historically been a predictor of upcoming recessions. James Bullard, President of the St. Louis Federal Reserve Bank, discussed this at a recent conference in Chicago. He stated that the current yield curve suggests the Fed is already in a neutral to restrictive mode.

Outlook

The Fed may not want to push the curve into an inverted position, unless inflation starts to consistently exceed its target of 2%. The yield curve may not have the same historical predictive power, due to the unprecedented central bank policies where many developed countries drove interest rates to zero and even negative in some countries. It was previously common economic thought that no one would pay a bank to hold their cash. Clearly, we are in unprecedented times as central banks normalize rates.

Jobs



Source: Bureau of Labor Statistics

Highlights

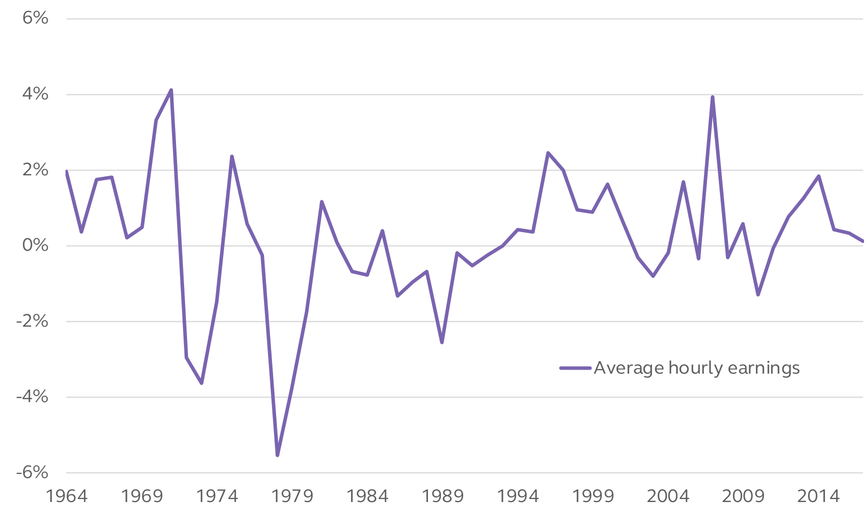
The Bureau of Labor Statistics publishes the Job Openings and Labor Turnover Survey (JOLTS), which defines job openings as all positions that are open (not filled) on the last business day of the month. This data serves as demand-side indicators of labor shortages at the national level.

The National Federation of Independent Business (NFIB) reports that 61% of employers reported hiring or attempting to hire and 87% of those reported few or no qualified workers.

Outlook

We expect employment opportunities to continue to increase, but at a slower pace due to the lack of qualified workers and an unemployment rate that is already considered low at 3.7%.

Wage Growth



Source: Federal Reserve Bank of St. Louis

Highlights

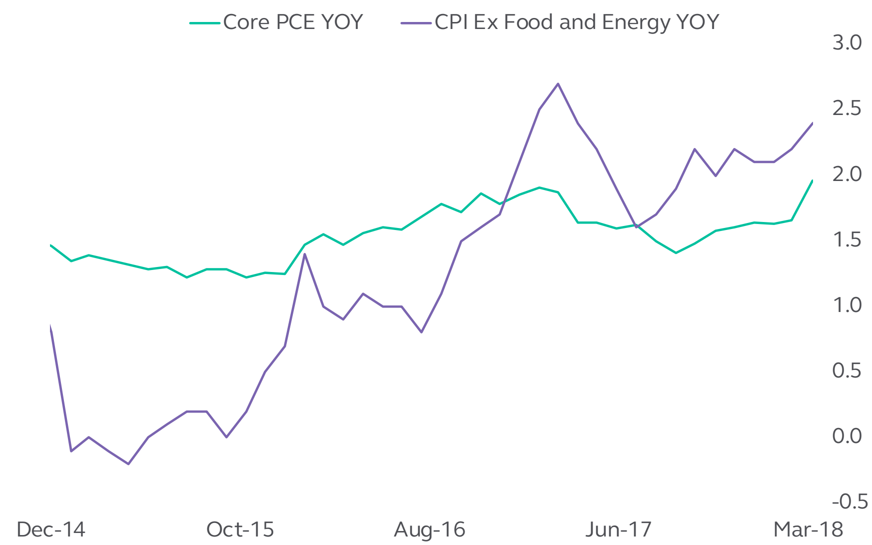
Average hourly earnings (AHE) are thought to increase earnings, giving consumers more spending power to grow the economy. Further, companies that cannot offset increased AHE by productivity gains either need to raise prices or lower their margins by absorbing the expenses. AHE have been running in the 2% range since the Great Recession, though have been slowly picking up over the last two years, with the latest release in February at 2.7%.

The Bureau of Labor Statistics calculates unit labor costs (ULC) as the ratio of hourly compensation to labor productivity. Increases in hourly compensation tend to increase ULC and increases in output per hour tend to reduce them. ULC have been fairly contained, though, similar to AHE, have also started to increase.

Outlook

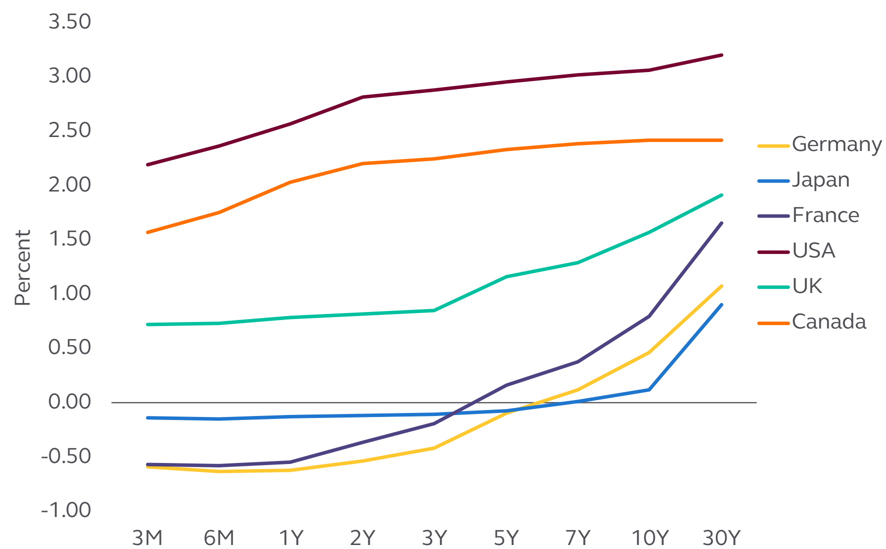
As the unemployment rate drops, pressure increases to raise wages to attract and keep workers. This has been slow to develop in the U.S. because we are part of a global economy. China and India have both brought large work forces into the global economy; 10 million people in India enter the workforce each year. We believe that wage growth will be contained at around 3%. Clear evidence that higher wages cause inflation does not exist, however, there is evidence they are correlated with inflation.

Inflation



Source: Bureau of Economic Analysis

Global Rates



Source: Bloomberg

Highlights

The FOMC expects their preferred measure of inflation, the Core PCE Deflator, to continue to increase at or around 2% on a year-over-year basis.

Core price increases to the consumer as measured by the Consumer Price Index (CPI), excluding food and energy, have also moved up but at a consistently higher rate than the Core PCE.

Outlook

We anticipate that there will be some modest upward pressure on these price measures given our expectation for economic growth.

Highlights

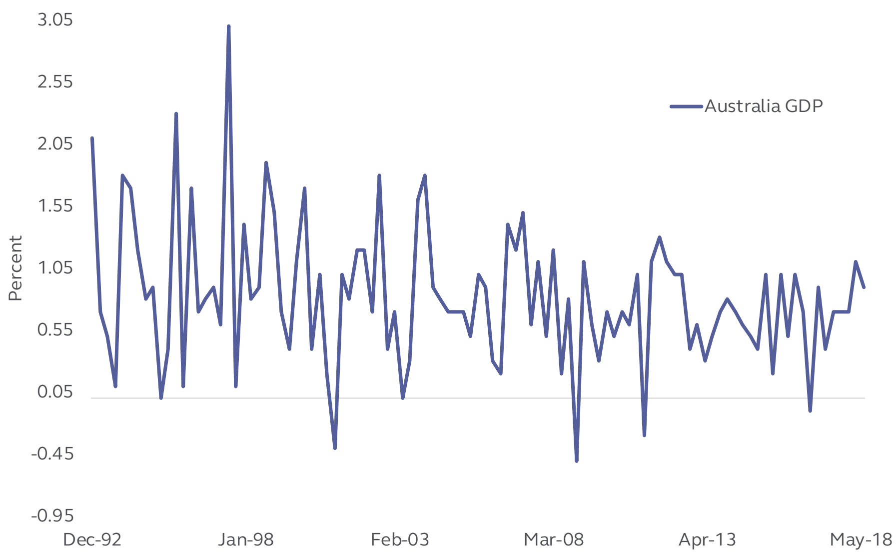
Rates throughout the developed economies have all risen over the last three months.

Global monetary policy remains divergent among the major central banks. The U.S. Federal Reserve'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. The European Central Bank has taken the first hawkish step, ending asset purchases by the end of the year, though, it is not expecting to raise policy rates until 2019. Japan has also taken a first small step toward normalization, but it is clear in its guidance that it intends to keep rates extremely low for an extended period of time.

Outlook

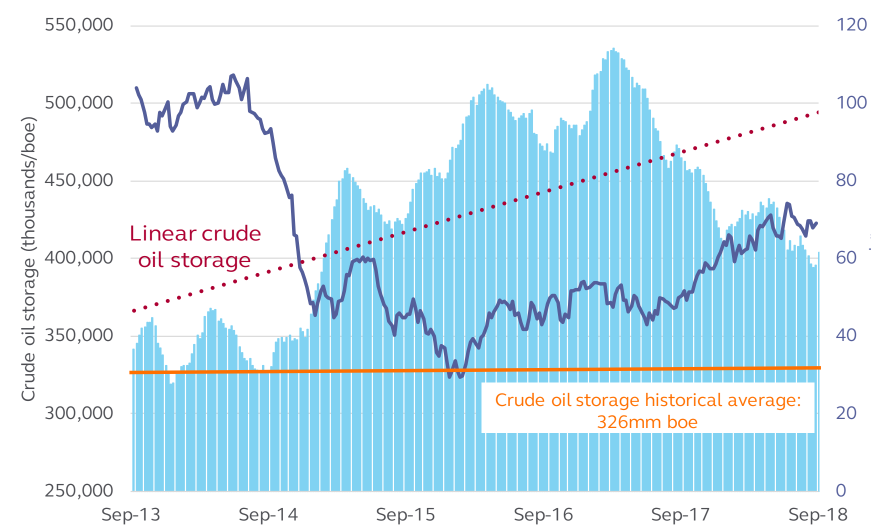
Continuing economic strength in the U.S. and relatively hawkish monetary policy should maintain the relative attractiveness of U.S. debt and currency relative to that of the other major economies.

Economic Expansion Sustainability



Source: Bloomberg

Crude Oil Price vs. Storage



Source: U.S. Energy Information Administration

Highlights

The U.S. economy has not had a recession since it came out of the financial crisis starting in 2009. Given the length of the economic expansion, market participants are speculating that the U.S. is due for a recession in the next two years.

Our research found that developed economies can continue growing past 10 years. Looking back to 1992, the Australian economy has not had two consecutive negative quarters of GDP growth, and has experienced over twenty-five years of sustained growth.

Outlook

We remain skeptical that the U.S. economy must experience a recession simply because it is closing in on its longest growth run. Provided appropriate policies are in place, we believe this economy can continue to grow beyond the next two years.

Highlights

Changes in crude oil inventory are negatively correlated with West Texas Intermediate (WTI) crude oil prices per barrel.

Strong U.S. oil production, at approximately 11M barrels of equivalent (boe) per day at the quarter's end, has resulted in above average storage levels.

Outlook

We expect crude oil prices in the near term to be supported in the current range of $65-$75/boe.

Morley
CAPITAL MANAGEMENT

Macroeconomic outlook offering a base case and two tail scenarios.

	Base Case (80%)	Tail 1 (10%)	Tail 2 (10%)
	Modest growth	**Prolonged weakness**	**Inflation / Stronger than expected growth**
	GDP growth forecast for 2018 is 3.00%. The Trump Administration fosters a pro-business climate. Reduced regulation and tax cuts are positive drivers for the economy. The $1.3 trillion spending bill provides stimulus, but increases the deficit. Our growth estimate of 2.70% exceeds the Bloomberg consensus estimate of 2.50%. 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. The Fed remains data dependent and is willing to moderate increases in the fed funds rate if necessary. The trade war with China is prolonged, but does not derail the U.S. economy. Low global rates make U.S. term rates attractive and mute their rise. Solid growth and inflation lead to modestly higher interest rates.	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 Trump Administration's concern with China extends beyond trade. A major concern is the transfer of technology. China continues to expand its presence in the South China Sea. Its Belt and Road initiative leads to unsustainable debt in those emerging countries that have accepted aid. These concerns make the goals broader than just reducing the trade deficit number. This leads to a major trade war, which pushes up prices and significantly slows the U.S. economy. The Fed raises rates too quickly and slows the economy. The Democrats take the House and Senate and stop the Trump Administration from continuing its business-friendly policies.	The strong GDP growth of the second quarter continues. Consumer confidence and business confidence moves to record levels. The successful renegotiation of a new trade deal with Canada and Mexico reduces trade frictions in North America. The trade war with China ends resulting in better access for American companies and farmers. Chinese growth rebounds as tariffs are removed. The U.K. and the EU come to amicable terms on the U.K. 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 1.00%	Greater than 3.75%
Change in Rates	2Yr 3.20%, 10Yr 3.40%	Sharply lower / -125 bps (10Yr UST)	Sharply higher / +100 bps (10Yr UST)
Change in Curve	Curve remains flat 2-10s	Bull flattener	Bear steepener
Volatility	Moderate	Higher	Higher