Market Insights

Economy | Capital Markets

Q2 2018

Economy

The global economy and financial markets could be entering a new era of change, which could make the next decade look very different from the last. The post-crisis global environment has been characterized by financial repression, as a result of regulation and dominant central bank policies, weak growth in productivity and real wages, subdued inflation, largely uninhibited trade policies, and low market volatility. At the same time, global debt levels have risen to all-time highs. Over the horizon, we see a potential "shift" in this economic landscape, which could bring significant changes, for better or worse.

First, the monetary and fiscal policy mix is changing as central banks retreat and fiscal policy becomes more expansionary. Already, the Federal Reserve (Fed) has lifted short-term interest rates seven times since December 2015, including four times in the last twelve months. This is an effort to "normalize" short-term interest rates after lowering them close to zero from 2009 to 2015, amidst the aftermath of the Great Recession. Further, the Fed announced plans to shrink its balance sheet by $10 billion a month, starting last October. By the fourth quarter of this year, it will increase that amount to $50 billion per month and continue until the balance sheet returns to a more normal level, whatever that turns out to be. These actions taken by the Fed have resulted in a quick and pronounced increase in U.S. Treasury yields over the past year. Since last September, the yield has risen about 1.0 percent, which translated into a significant decline in price.

On the fiscal side, the U.S. federal budget deficit and long-term debt and liabilities has been a growing issue for decades. In May, the U.S. posted a $146.8 billion budget deficit, the largest month since 2009, as revenues declined. The budget gap rose 66 percent from a year earlier as spending rose almost 11 percent and revenue fell about 10 percent. In addition, the government is facing increasing borrowing needs in the coming years, partly due to tax cuts enacted this year along with the strain on social and health spending from an aging population. For the full year, the budget deficit is expected to hit $800 billion, then surpass $1 trillion by 2020. In moderation, a deficit can help stimulate economic growth and increase wealth for individuals and corporations. Concerns arise when the debt-to-GDP ratio exceeds 100 percent, a level we have currently reached. The act of reducing deficits necessitates painful spending cuts or tax hikes, not to mention the political will. For the foreseeable future, it appears that deficit spending is here to stay, which could further push interest rates higher if investors demand more compensation amidst growing debt worries.

Next, trade policies are starting to change quite dramatically under the new administration. Over the past 25 years, U.S. production and export of goods and services have flourished, while technological innovation and competition from imports have reduced employment in domestic manufacturing industries. In response to some of these issues, the Trump administration withdrew from the Trans-Pacific Partnership (TPP); repeatedly threatened to withdraw from the North American Free Trade Area (NAFTA); stated its strong preference for bilateral trade agreements; and announced tariff increases to protect U.S. producers of steel, aluminum and several other products. Taken together, those actions threaten a reversal of the trade policies that the United States has pursued for over 80 years. For many years, Congress, federal and state governments, and corporations have failed to provide adequate support and retraining to the workers and communities adversely affected by the impact of technology and trade. Perhaps, we should not be surprised by the growing hostility toward the current international trading system.

Amidst these potential "pressure points", the domestic economy continues to show strength and sustainability of growth, highlighted by a robust jobs market, solid consumer spending and a rebound in business activity. The latest employment numbers show the lowest initial and continuing jobless claims since 1969, the highest jobs openings rate ever, and the lowest unemployment rate in nearly 20 years. Not too surprising, the latest read on retail sales showed a significant upside surprise. Retail sales are now running at a 5.9 percent year-over-year pace, close to the fastest pace since 2012, with broad distribution across sectors. Further, growth accelerated in the manufacturing sector during May, with order backlogs rising the most in 14 years.

Looking ahead to the second half of the year, we expect stable, above-trend growth, balanced inflation risks and gradual removal of central bank accommodations. At the same time, concerns about trade and geopolitics are likely to remain. Still, the latest estimates on second quarter GDP growth shows a very healthy 3-3.5 percent or better pace. Corporate earnings are growing at a rate not seen in many years, and the estimates look bright for the next year or two. In short, a very solid economy should help underpin returns in the equity markets, while higher interest rates and higher trending economic growth may continue to pressure interest rates to the detriment of core bond returns. The wild card is growing tensions from geopolitical spats and trade wars. Any significant escalation could severely impact global financial markets until there is a resolution.

As always, investing in the capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive risk-adjusted portfolio returns to our clients. Should you have any questions, please do not hesitate to reach out to your financial adviser.

Capital Markets

The yield on the 10-year U.S. Treasury bond drifted modestly higher during the quarter which negatively impacted returns across most sectors of the bond market. Domestic equities bounced back from a volatile first quarter to produce positive results. Mid- and small-cap stocks hit new highs while larger stocks lagged a bit. In foreign markets, the rising dollar along with higher interest rates hurt returns in emerging markets and some international equity markets.

Disclosure: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.

Market Index Performance(%)
As of June 30, 2018

	2nd QTR	YTD	1 Year	Annualized 3 Year
S&P500	3.43	2.65	14.36	11.92
Dow Jones Industrial	1.26	-0.73	16.31	14.07
Nasdaq Composite	6.61	9.38	23.64	16.04
Barclays Aggregate Bond	-0.16	-1.62	-0.40	1.72
Citigroup BIG Corporate	-0.98	-3.24	-0.80	3.00
MSCI World	1.89	0.74	11.71	9.12

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	3.80%	6.10%	**Represents the number of unemployed persons as a percent of the labor force**	Near historic lows
Consumer Price Index	2.80%	4.10%	**Represents changes in prices of all goods and services purchased for consumption**	Trending modestly higher
U.S. Capacity Utilization	77.85%	80.28%	**The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime**	Trending higher
Gross Domestic Product+	2.80%	2.80%	**Total value of all goods and services produced indicates strength or weakness of the economy**	Trending higher
10 Year Treasury Yield	2.84%	6.38%	**Yield on the current 10 year treasury bond**	Has increased over the past year
Annual Housing Starts	1,350,000	1,433,000	**New privately owned housing unit starts annualized rate**	Steadily rising

*Average from 1966 to Present + Annualized *Source: Bloomberg*

Disclosures: Investments are not insured, and may lose money. Client should be prepared to bear the risks associated with investing.

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