UNION

**MONTHLY UPDATE AND COMMENTARY**
**MAY 2017**

**Recap:** The U.S. economy is off to a slow start. Again.

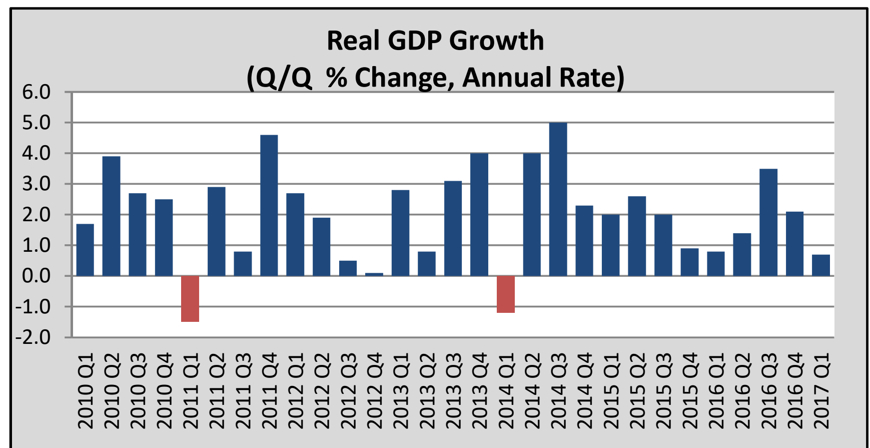
The economy stumbled during the first months of 2017, as consumers reined in spending despite a rise in household confidence and a surge in stock prices. Gross domestic product grew at a 0.7% annual rate in Q1 of 2017, the slowest pace of expansion in three years. Americans cut back sharply on spending for big-ticket items like cars, causing overall consumer purchases to grow at the slowest pace since late 2009.

Sluggish consumer spending drove the first-quarter slowdown, presenting the biggest puzzle of the economy this year. With confidence and stock prices high, gasoline prices modest, and jobs and wages increasing, spending should have picked up.

It is likely that some of the slowdown was transitory, as warm weather cut utilities use in January and February. Another possible factor was the later timing of tax returns this year, which may have pushed out some purchases to April. Still, those don't entirely explain why consumer spending on durable goods fell by the most in nearly six years.

A drawdown in inventories across the economy lowered the overall growth in GDP by nearly a full percentage point. Instead of placing new orders with manufacturers, many companies whittled down their existing stockpiles. Government spending also fell in the first quarter, though those declines should prove temporary. One possible factor: a three-month hiring freeze imposed by the Trump administration that was recently lifted. Declines in defense spending, which have varied greatly quarter to quarter, and state and local government spending, could reverse later this year.

Perhaps the most encouraging sign of the first quarter was the pickup in business investment. Throughout most of the recovery, many companies put off purchasing new equipment and building new more modern factories (the kinds of projects that make companies more efficient, boost worker productivity and, over the long haul, lift economic growth). Such spending grew at a 9.4% rate last quarter, the fastest since late 2013.



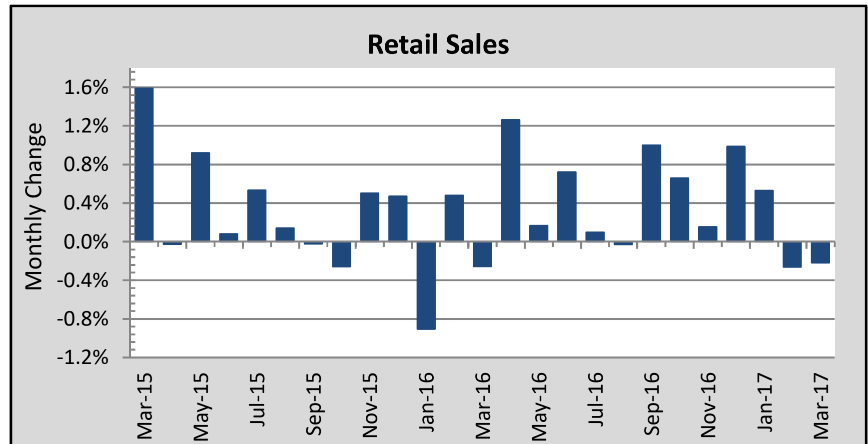

Economic fundamentals have supported a bounce back in consumer spending as the strong labor market supported income growth. Growth should rebound to a rate of between 2.5% and 3.0% in the second quarter and then settle back into its 2% trend in the months ahead.

**Small Business Optimism Index:** The NFIB's small business optimism index fell 0.6 points to 104.7 in March. Despite this being the second consecutive monthly pullback, optimism remained strong as expectations regarding an improvement in the economy and the belief that now was a good time to expand remained largely unchanged.

More importantly, the rise in optimism has had some staying power, which has slowly translated into some improvement in investment and employment plans – a welcome development. In the coming months, the outlook for small businesses will depend on how fast and how much the new administration can deliver on its promises. While businesses have hope, they remain highly uncertain about the future.

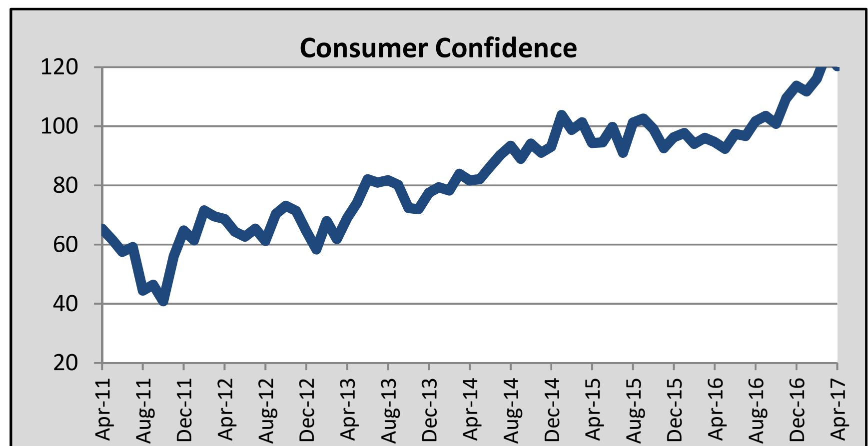
**Inflation:** Inflation unexpectedly weakened in March as the consumer-price index (CPI) declined a seasonally adjusted 0.3% from February, and core CPI fell 0.1%. It was the first decline for the core prices since January 2010 and the steepest drop for overall prices since January 2015. Slowing inflation pressures could be a sign that it is difficult for firms to pass along further price increases to consumers.

**Retail Sales:** Retail sales fell 0.2% in March while February's 0.1% gain was revised downward to -0.3%. These softer numbers reflected the softening in auto sales, which may be turning over after peaking in 2016. Retail sales were flat in both February and March, excluding autos.

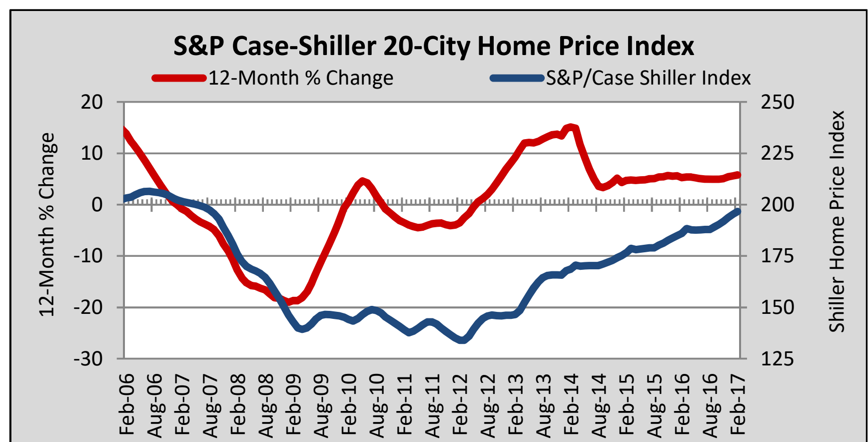



Uneven retail spending stood in sharp contrast to soaring measures of consumer confidence and sentiment. Consumers were saying one thing in response to a survey, but doing something different with their pocketbook. The underlying fundamentals to spending, chiefly job and wage growth, should support better spending later in the year.

**Consumer Confidence:** Consumer confidence fell 4.6 points in April to 120.3. The pullback followed a downward revision to the March reading. Nevertheless, the index still stood at its second highest reading of the expansion and above the highs of the past expansion. Although there has been a disconnect between readings of consumer confidence and household spending in recent months, the index has remained at a level supportive of a pickup in spending in the second quarter.




**Housing:** New home sales rose 5.8% in March to a 621,000-unit pace. It was the second strongest pace of the current cycle. Existing home sales also increased by 4.4% m/m in March, marking a strong rebound from February. The supply of new homes for sale fell to 5.2 months, while the median sales price of a new home rose 7.5%, reflecting strength at the high end of the market. Existing home sales activity had been quite volatile since December. The uneven performance could be partly explained by the rapid rise in interest rates immediately following the election, which likely brought forward some contract signing, while unseasonal weather may have also contributed to volatility in recent months.




Going forward, sales activity will likely remain constrained in the near-term by low inventory levels and fast-rising prices continuing to outstrip income growth. However, the medium-term outlook will remain upbeat, as rising employment, wages, and incomes provide considerable impetus to the housing market and remain an important contributor to economic growth.

**Fed's Balance Sheet:** If the economy performs in line with the Federal Reserve's forecasts, the bank could begin allowing its holdings of Treasury securities and mortgage bonds to mature without reinvesting all of the proceeds into new securities later this year or early in 2018.

Among the issues the Fed is working to resolve is how large should the balance sheet be when the Fed ends the process. The

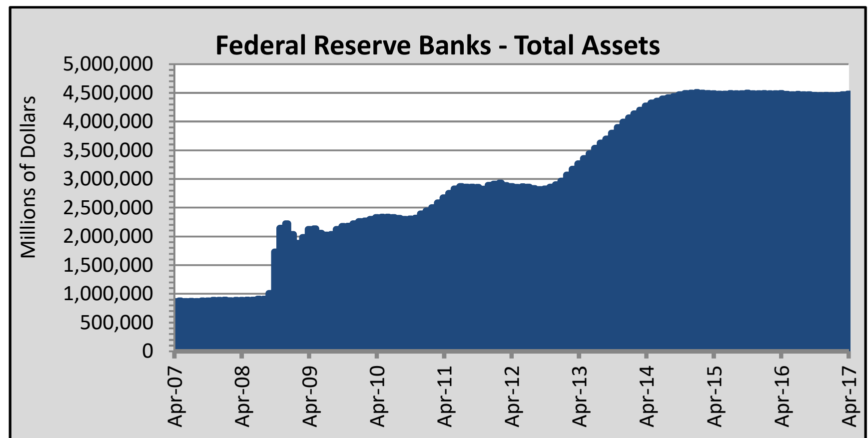
Fed's holdings swelled to $4.5 trillion from less than $900 billion before the financial crisis in 2008, through asset-purchase programs aimed at lowering long-term interest rates and boosting economic growth.

Already, the Fed's portfolio has been providing less support to the economy than before because it has been holding fewer bonds with long maturities. Holding long-maturity bonds is stimulative because these are especially risky assets. Constraining the supply of these risky assets would send investors in search of other risky assets, pushing up the values of stocks, corporate bonds and other private holdings. At the end of 2013, the Fed owned nearly $750 billion in U.S. Treasuries with maturities between seven and ten years. That total should be on track to decline to $100 billion by the end of this year.

Even though the Fed will shrink its holdings from current levels, it will end up with more assets than before the crisis because its liabilities have grown—there's more currency in circulation and the U.S. Treasury has increased its cash balance. Changes in how it sets interest rates will also make the portfolio larger than before. Prior to 2008, banks held relatively low levels of deposits at the Fed. The central bank has managed the federal funds rate by making small adjustments in the amount of these reserves through routine purchases and sales of Treasury securities. Now, with a large portfolio of securities, the Fed has left the banking system flush with trillions of dollars in reserves. It will manage rates now by paying interest on these reserves.

The balance sheet could shrink to $2 trillion if the Fed chose to minimize reserves, and hover near $3 trillion if the central bank pursued a higher level of reserves.

But how fast should the Fed get there? They could reduce these holdings gradually by tapering the reinvestments of principal payments, or they could stop the reinvestments which would be easier to communicate to markets but could also create more market volatility. Significant shares of the Fed's Treasury holdings are scheduled to mature in 2018 and 2019.




The Fed is likely to phase out their holdings gradually which would help to avoid a re-run of the 2013 "taper tantrum" on Wall Street, when the Fed signaled an end to its asset purchases and roiled emerging stock and bond markets, and sent interest rates up.

Finally, the Fed would need to manage the composition of its holdings. The Fed would want almost all central bank holdings in treasuries, not mortgages. But because their mortgage bonds have longer durations than treasuries, the Fed could hold a much larger share of mortgage bonds once their balance sheet stabilize. This could prompt the Fed to remix its portfolio down the road, perhaps by reinvesting principal from maturing mortgages into treasuries.

**China:** China posted a GDP growth rate of 6.9% in the first quarter of 2017, its strongest quarterly growth in a year and a half. The growth was the result of better-than-expected investment, industrial production and building starts for March—all evidence that last year's easy-money policies and infrastructure spending have developed a momentum of their own.
Much of the firepower has come from state-owned companies and government infrastructure coffers. Government spending ramped up in March and despite Beijing's efforts to crack down on companies' debt levels, there was a rush for loans, much of it going to a property market that had gained new life from the state stimulus.

This lift to growth came as China tried to shift from debt-fueled state investment and low-end manufacturing to private consumption. Total debt grew to an estimated 277% of the economy, up from 125% at the end of 2008. Credit continued to expand significantly faster than economic growth despite Beijing's bid to address growing economic risk.

Beijing faces a tug of war between supporting short-term growth and guarding against financial risks from too much debt and property bubbles. How it will calibrate this is likely to determine both its success at transitioning to healthier more balanced growth as well as how soon its stimulus will run out of steam.

**Euro Zone:** European Central Bank (ECB) policy makers have been wary of signaling an end to their monetary stimulus amid the risk posed by the rise of euro skepticism. That is despite evidence of a strong economic rebound in the 19-nation eurozone. A rise of Emmanuel Macron to France's presidency could trigger a scaling back of the ECB's vast stimulus program. Any such move by the ECB would have a big effect on markets, driving money out of bonds and, if investors stay confident about the local economy, moving more cash into riskier assets. Away from the political sphere, the outlook for the eurozone has been brightening for months. Economic activity has been at its strongest level in six years. The region's unemployment rate, at 9.5%, has been the lowest since May 2009 and consumer prices rose 1.5% in March from a year earlier, a rate not far away from the central bank's target of close to, but below, 2%.

ECB interest rate setters will meet in early June. While no significant policy moves are expected to happen then, officials should start preparing markets for tighter money in the future. They could drop a pledge to increase the bank's stimulus efforts again if the outlook darkens. The political risks that have sandbagged European markets over the past year should be starting to dissipate. A Macron's victory in France will increase the possibility of tapering.

**Global:** The global economic outlook has continued to improve as recent economic weakness has given way to more certainty regarding economic prospects. However, some uncertainties have remained in place, especially those related to global trade, which was one of the most important drivers of economic growth during the first decade and a half of this century. One of these uncertainties had to do with the new U.S. administration's talk against international trade. However, the Trump administration's position regarding trade seemed to have changed or morphed into a more benign view about the changes needed for trade to benefit the U.S. economy. That is, it would seem that changes being sought on the North American Free Trade Agreement (NAFTA) are more cosmetic right now and the changes would not seem to represent a threat for the trade agreement's survival. This is a breath of fresh air in the discussion regarding international trade, which had been one of the political issues that generated great uncertainty for the global economy during the last year or so.

A second uncertainty had been the United Kingdom's decision to exit the European Union (EU). In March, the United Kingdom finally triggered the clause to leave the EU, a process that will likely take two years. Furthermore, the United Kingdom had been looking into the possibility of negotiating a free trade agreement with the United States and will probably need to do the same with many other countries as it reorients its external trade policy as an "independent" country.

**Outlook:** Once again, 2017, as in prior years, has begun with a slow start. It is possible the first-quarter slowdown would quickly reverse itself. In several years of this expansion the economy started out on a slow footing only to pick up as the year progressed. The rest of 2017 should come in at a 2.5% average growth rate. Real final sales would be supported by steady growth in consumer spending and an improvement in business equipment spending and structures over the 2016 pace. Government spending could add modestly to overall economic growth while trade would remain a drag. Inflation, as measured by the PCE deflator, would continue to persist near or above the FOMC's 2% target, and the FOMC could increase the funds rate in June and again in the second half of this year.

Benchmark two- and ten-year U.S. Treasury rates are expected to rise modestly with the spread narrowing as the year progresses. A pick up in the employment cost index, along with continued modest top-line nominal GDP growth, would indicate a modest improvement in economic profits in 2017. The trade-weighted dollar should continue to appreciate in 2017 as U.S. short-term rates rise. This would represent a continued challenge to any attempts to reduce the U.S. trade balance.

The prospect of single-party control of Congress and the White House, coupled with campaign promises to overhaul the health-care system, simplify the corporate tax code and launch a major infrastructure package has sent optimism about the U.S. economy soaring in recent months. But the collapse of the initiative to "repeal and replace" President Obama's health-care law has underscored deep divisions in the Republican Party. They could make it difficult to reach consensus on initiatives that would provide economic stimulus, such as lower corporate taxes or federal funding for infrastructure. Less scope for fiscal stimulus would imply a more gradual process of monetary policy normalization than previously anticipated. Add into the mix elevated geopolitical uncertainty, and it would look more and more like the reflation trade's days are numbered as a slower and perhaps more modest pace of change begins to emerge.

## Index Performance as of 4/30/17

| | 1 Week | 1 Month | QTD | 3 Month | YTD | 1 Year | 3 Year | 5 Year |
|---|---|---|---|---|---|---|---|---|
| **Russell** | | | | | | | | |
| 3000 Value | 0.94 | -0.14 | -0.14 | 2.24 | 2.84 | 17.35 | 8.28 | 13.29 |
| 3000 | 1.49 | 1.06 | 1.06 | 4.89 | 6.86 | 18.60 | 10.09 | 13.57 |
| 3000 Growth | 2.03 | 2.25 | 2.25 | 7.60 | 11.08 | 19.84 | 11.88 | 13.79 |
| 1000 Value | 0.94 | -0.19 | -0.19 | 2.35 | 3.07 | 16.56 | 8.26 | 13.32 |
| 1000 | 1.49 | 1.06 | 1.06 | 5.04 | 7.15 | 18.04 | 10.20 | 13.63 |
| 1000 Growth | 2.02 | 2.29 | 2.29 | 7.77 | 11.40 | 19.51 | 12.11 | 13.87 |
| Mid Cap Value | 0.44 | 0.19 | 0.19 | 2.24 | 3.96 | 17.53 | 8.86 | 14.27 |
| Mid Cap | 0.90 | 0.77 | 0.77 | 3.46 | 5.96 | 16.71 | 8.97 | 13.34 |
| Mid Cap Growth | 1.47 | 1.48 | 1.48 | 4.98 | 8.48 | 15.84 | 8.95 | 12.29 |
| 2000 Value | 0.96 | 0.39 | 0.39 | 0.98 | 0.26 | 27.20 | 8.70 | 12.96 |
| 2000 | 1.50 | 1.10 | 1.10 | 3.18 | 3.59 | 25.65 | 9.03 | 12.95 |
| 2000 Growth | 2.07 | 1.84 | 1.84 | 5.57 | 7.29 | 24.08 | 9.27 | 12.89 |
| **Standard & Poors** | | | | | | | | |
| S&P 500 | 1.53 | 1.03 | 1.03 | 5.16 | 7.16 | 17.93 | 10.47 | 13.68 |
| Consumer Disc | 2.07 | 2.44 | 2.44 | 6.58 | 11.09 | 15.79 | 14.05 | 16.51 |
| Consumer Staples | 0.33 | 1.03 | 1.03 | 5.71 | 7.45 | 8.65 | 10.61 | 13.06 |
| Energy | 0.11 | -2.89 | -2.89 | -6.00 | -9.38 | 2.08 | -7.47 | 1.32 |
| Financials | 1.62 | -0.84 | -0.84 | 1.43 | 1.66 | 27.18 | 11.91 | 15.74 |
| Health Care | 2.43 | 1.54 | 1.54 | 7.63 | 10.04 | 10.10 | 10.86 | 17.07 |
| Industrials | 1.27 | 1.76 | 1.76 | 4.92 | 6.40 | 19.41 | 10.00 | 14.82 |
| Information Technology | 2.63 | 2.52 | 2.52 | 10.54 | 15.41 | 35.39 | 17.68 | 15.65 |
| Materials | 1.77 | 1.39 | 1.39 | 2.58 | 7.33 | 15.19 | 5.75 | 9.96 |
| Real Estate | -2.03 | 0.10 | 0.10 | 3.71 | 3.65 | 4.90 | 9.37 | 9.54 |
| Telecom Services | -1.47 | -3.31 | -3.31 | -4.79 | -7.15 | 0.45 | 6.17 | 8.40 |
| Utilities | -0.09 | 0.78 | 0.78 | 5.90 | 7.23 | 10.57 | 10.06 | 11.87 |
| **Other U.S. Equity** | | | | | | | | |
| Dow Jones Industrial Avg. | 1.91 | 1.45 | 1.45 | 6.06 | 6.71 | 20.91 | 10.82 | 12.44 |
| MSCI USA | 1.56 | 1.08 | 1.08 | 5.20 | 7.38 | 18.14 | 10.34 | 13.58 |
| Wilshire 5000 (Full Cap) | 1.51 | 1.09 | 1.09 | 4.82 | 6.88 | 18.84 | 9.86 | 13.41 |
| **International Equity - Broad Market** | | | | | | | | |
| MSCI EAFE | 3.09 | 2.54 | 2.54 | 6.87 | 9.97 | 11.30 | 0.86 | 6.78 |
| MSCI EM | 1.73 | 2.19 | 2.19 | 7.98 | 13.88 | 19.15 | 1.79 | 1.49 |
| MSCI Frontier Markets | 0.61 | 1.16 | 1.16 | 3.28 | 10.16 | 10.79 | -3.08 | 6.27 |
| MSCI ACWI | 1.98 | 1.56 | 1.56 | 5.68 | 8.57 | 15.15 | 5.29 | 8.96 |
| MSCI ACWI Ex USA | 2.47 | 2.14 | 2.14 | 6.40 | 10.17 | 12.60 | 0.83 | 5.14 |
| MSCI AC Asia Ex Japan | 1.98 | 2.18 | 2.18 | 9.09 | 15.85 | 21.12 | 5.17 | 5.21 |
| **International Equity - Country Region** | | | | | | | | |
| MSCI Brazil | 0.96 | -0.05 | -0.05 | -0.38 | 10.31 | 29.31 | -4.66 | -6.16 |
| MSCI BRIC | 1.66 | 1.86 | 1.86 | 6.89 | 13.65 | 22.94 | 3.69 | 1.16 |
| MSCI China | 1.45 | 2.67 | 2.67 | 8.57 | 15.94 | 23.14 | 8.16 | 5.41 |
| MSCI Europe | 4.39 | 3.53 | 3.53 | 8.97 | 11.24 | 10.94 | -1.18 | 6.86 |
| MSCI India | 2.25 | 1.93 | 1.93 | 14.40 | 19.38 | 20.13 | 8.55 | 7.71 |
| MSCI Japan | 0.57 | 1.05 | 1.05 | 1.80 | 5.59 | 10.51 | 7.32 | 7.74 |
| MSCI EM Latin America | 0.14 | 0.00 | 0.00 | 4.14 | 12.06 | 16.32 | -4.82 | -5.39 |
| MSCI Russia | 3.26 | -0.21 | -0.21 | -4.56 | -4.81 | 18.16 | 1.01 | -3.89 |

## Index Performance as of 4/30/17

| | 1 Week | 1 Month | QTD | 3 Month | YTD | 1 Year | 3 Year | 5 Year |
|---|---|---|---|---|---|---|---|---|
| **Fixed Income** | | | | | | | | |
| **Barclays U.S. Aggregate** | -0.16 | 0.77 | 0.77 | 1.40 | 1.59 | 0.83 | 2.66 | 2.27 |
| **BofAML 3-Month T-Bill** | 0.02 | 0.07 | 0.07 | 0.13 | 0.17 | 0.40 | 0.19 | 0.15 |
| **Barclays U.S. Gov't** | -0.26 | 0.68 | 0.68 | 1.13 | 1.37 | -0.57 | 2.09 | 1.45 |
| **Barclays U.S. Credit** | -0.10 | 1.00 | 1.00 | 1.97 | 2.31 | 2.74 | 3.45 | 3.63 |
| **Barclays High Yield Corp.** | 0.66 | 1.15 | 1.15 | 2.40 | 3.89 | 13.31 | 4.74 | 6.84 |
| **Barclays Municipal** | -0.37 | 0.73 | 0.73 | 1.65 | 2.32 | 0.14 | 3.39 | 3.16 |
| **Barclays TIPS** | 0.27 | 0.59 | 0.59 | 1.01 | 1.86 | 1.73 | 1.77 | 0.69 |
| **Barclays Gbl Agg Ex USD** | 0.15 | 1.42 | 1.42 | 2.02 | 3.94 | -4.51 | -2.66 | -1.10 |
| **Barclays Global Aggregate** | 0.02 | 1.13 | 1.13 | 1.76 | 2.91 | -2.10 | -0.40 | 0.37 |
| **BofAML Emerg. Mkt. Cred** | 0.55 | 1.86 | 1.86 | 3.49 | 6.16 | 16.80 | 8.07 | 8.65 |
| **Alternative Investments** | | | | | | | | |
| **Alerian MLP** | 0.31 | -1.28 | -1.28 | -2.17 | 2.62 | 14.09 | -6.88 | 1.92 |
| **Bloomberg Commodity** | 0.15 | -1.51 | -1.51 | -3.93 | -3.80 | -1.32 | -15.03 | -9.74 |
| **FTSE NAREIT Equity REIT** | -2.69 | 0.12 | 0.12 | 1.17 | 1.29 | 6.23 | 9.11 | 9.40 |
| **S&P Global Natural Res.** | 1.10 | -0.53 | -0.53 | -2.01 | 2.38 | 11.48 | -3.26 | -0.82 |
| **S&P N. Amer Natural Res.** | -0.46 | -3.04 | -3.04 | -6.52 | -7.17 | 2.59 | -8.24 | -0.75 |

*Sources:Department of Commerce, Department of Labor, National Federation Independent Business, The Conference Board, Eurostat, Federal Reserve Bank, Standard & Poors, National Association of Realtors*

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