UNION

MONTHLY UPDATE AND COMMENTARY
JULY 2017

Recap: The U.S. economic expansion remained on track as real GDP officially expanded at 1.4% in the first quarter. The unemployment rate fell to a 16-year low, although monthly job gains moderated. In what has become an annual occurrence, 2017 got off to a slow start due to temporary factors, which should reverse course and usher in a rebound in Q2 to around 2.5% (annualized). The pace of expansion has strengthened since last year, to a rate above the economy's estimated longer-term growth rate of around 2.0%. This would be about as strong as could be expected given the mature phase of the economic cycle, the absence of spare capacity and the presence of an aging population that has begun to weigh on job growth.

While the Trump administration has continued to emphasize tax reform, the prospects for a comprehensive plan passing Congress this year have faded. In addition, details have remained sparse on how to pay for the promised tax cuts, even though the administration's budget proposal stated that tax reform would be deficit-neutral. At the same time, the budget contained significant cuts to non-defense spending that, if enacted, would weigh on economic growth prospects. Not only would the pace of government spending growth be lower than projected under current law, but many cuts would hit lower income individuals who have a higher propensity to consume a greater amount of every dollar they earn.

Consumer Spending: April consumer spending data appeared to have bounced back from its winter weakness. However, it was not expected to grow at the same rate seen in the second half of 2016. At this point in the economic cycle, much of the pent-up consumer demand from the past, e.g., auto sales, has been satisfied. Housing and related expenditures however remained an exception and still have plenty of room to run. But achieving another cyclical spurt in consumer spending will likely be difficult within a mature economic cycle. Going forward, consumer spending growth should increasingly be driven by underlying wage gains and not pent up demand. Spending in real terms will likely grow in the 2%-2.5% range. This would certainly be healthy and run above overall GDP growth, but would mark moderation from the 3% pace over the 2014-16 period.

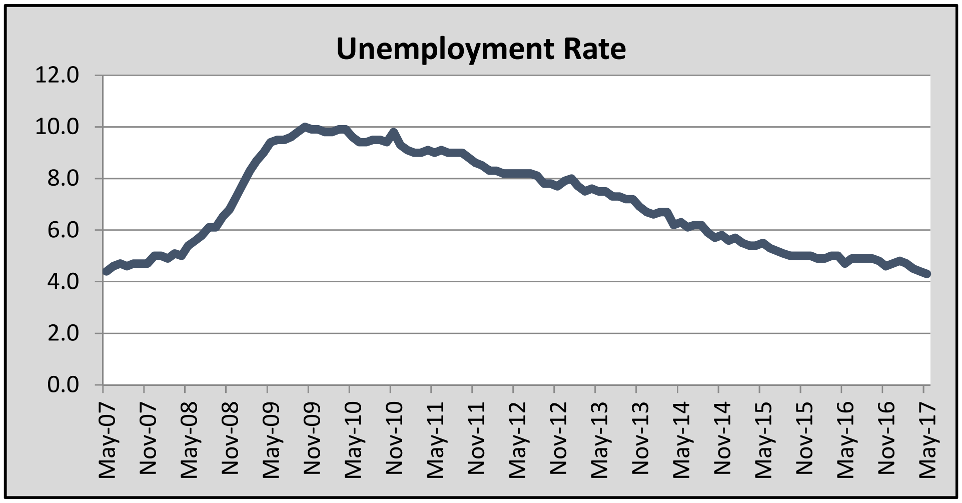
Business Investment: Business investment accelerated at an 11.4% annualized in Q1 due to a sizeable boost from activity in the oil and gas sector and spending on equipment and software. Business investment growth has been expected to moderate, but still sustain a healthy pace of about 4% in real terms. That would represent a marked improvement over recent years, and should help improve productivity growth.

Inflation: The slowdown in the current inflation rate has been due to several factors including a deceleration of energy prices and a large one-time drop in the price of cell phone plans. A tight labor market has been putting upward pressure on wages. What is more, the disinflationary impulse from the rising U.S. dollar has also turned the other way. This can already be seen in prices further up the supply chain. The dollar's peak looked to have been in the fourth quarter of last year, and should continue to edge lower over the next 18 months as other central banks move closer to the exit door on monetary stimulus. As long as inflation heads higher the Fed rate would likely hike again toward the end of this year.

Labor Market: The unemployment rate fell to 4.3% in May, its lowest level in 16 years, a fresh sign the slow and long-running U.S. economic expansion has entered a new stage leaving businesses struggling to find qualified workers. Job creation, however, has cooled. Employers added only a seasonally adjusted 138,000 jobs last month. After a robust start to the year, the economy has added an average 121,000 jobs each month over the past three months, which was about two-thirds of the growth rate recorded last year.

The current unemployment rate would suggest the labor market is at or near full employment. Pressures have been building on employers to cope with the problem of finding qualified workers, which possibly explains the slowdown in hiring. Some businesses have been adding workers more slowly and accepting less growth than they might otherwise achieve, while others are adjusting pay scales, boosting overtime shifts or accepting higher turnover. Workers have been voluntarily quitting jobs this year near the highest rate since the recession ended. An elevated pace of voluntary departures would indicate workers have confidence in the job market.

Problems like this pose a conundrum. A high-pressure job market ought to push wages up more, as employers compete for labor. Despite some pickup from low levels early in the expansion, however, wage growth has remained relatively lackluster. There are a number of factors at work here.



Firstly, a global labor market could hold U.S. wages in check. Factory workers in the U.S. compete for jobs not only with each other, but also with workers in China and Mexico, where wage rates have been much lower.

Secondly, companies have been reluctant to raise pay, in part to protect their profit margins, which would hold back hiring.

Thirdly, a shift in immigration policies under the current administration could be contributing to worker shortages in some low-wage fields. So far in this expansion, job growth has tilted toward lower-wage fields including work at restaurants and retail stores. Minimum-wage increases in many states have boosted pay in those sectors. But employment growth in those fields have been dragging on overall wage gains, potentially skewing national wage data down. However, the national tilt toward low-wage job growth has now shown signs of shifting. Better-paying work in fields including construction and health care have continued apace, which could support firmer wage growth later year.

Lastly, the ranks of Americans who are unemployed or out of the workforce may simply not have the skill set employers are demanding. The skills mismatch between what workers have and what employers are demanding could be weighing on the labor market as well.

Housing: Rebounding home prices and increasing mortgage rates have led to an erosion of affordability, raising questions as to the sustainability of the American housing recovery. While deteriorating affordability may weigh on activity somewhat, the metric has been poised to remain favorable across many housing markets and should support housing demand over the coming years.

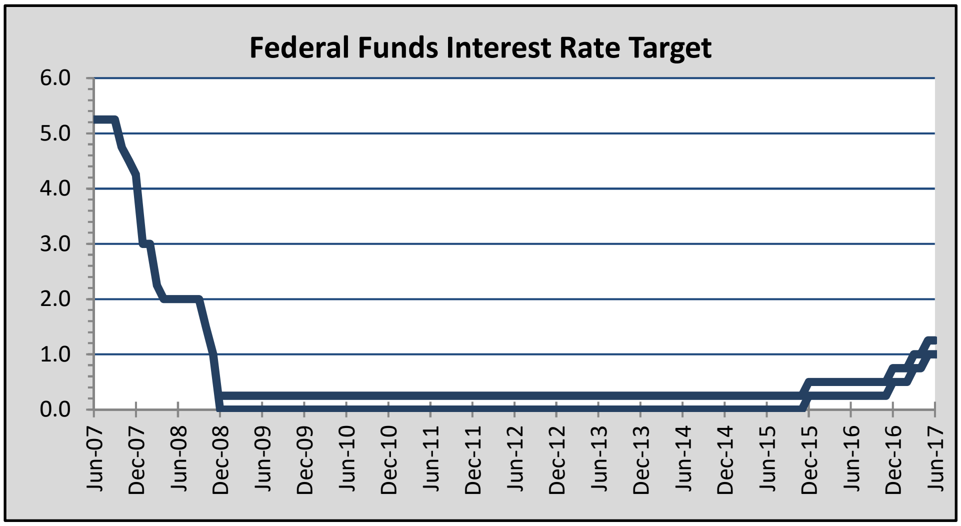
U.S. new-home construction declined for the third straight month in May, signaling a softening in home building at a time of tight supply. Housing starts dropped 5.5% in May from the prior month to a seasonally adjusted annual rate of 1.092 million. The plunge in starts was led by continued weakness in multifamily construction, but single-family starts were lower as well. A shortage of construction workers may have weighed on building industries, and in some parts of the country, short supply of land to build on was also a factor.

Still, looking past month-to-month fluctuations, starts in the first five months of the year were up 3.2%. Residential building permits, an indication of how much construction is in the pipeline, increased 5.5% but fell for the month 4.9% to an annual pace of 1.168 million.

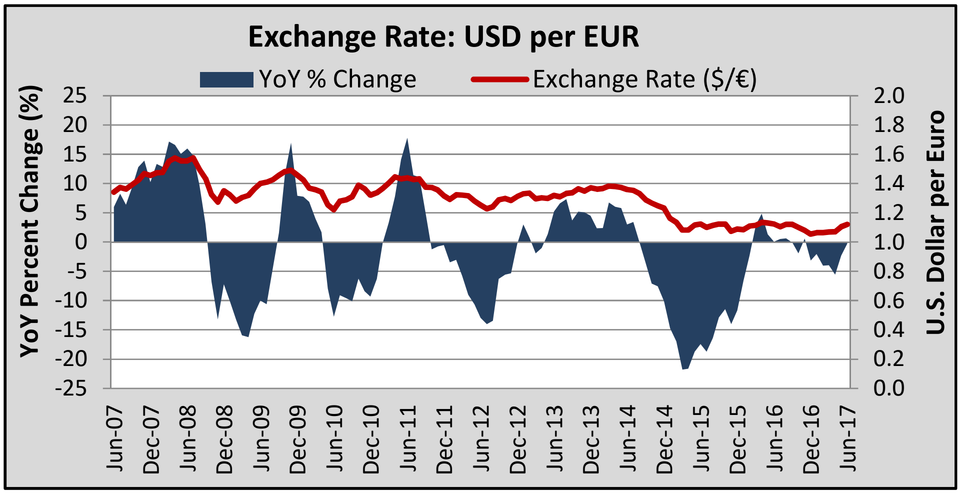
FED: On June 14th, the Federal Reserve raised its policy rate for the third consecutive quarter. Another rate hike should be possible later in the year, after balance sheet normalization has begun. Through the combination of effective forward guidance and rate hikes, the Fed has done all it can to reinforce its policy bias to the markets. Additionally, the Fed has provided more information on how it plans to unwind its balance sheet, confirming that normalization will start this year, and will follow a step-wise process of increasing run-off every quarter.

Even with this transparency, market pricing does not reflect the Fed's guidance, suggesting a fair bit of skepticism. The reasons why markets doubt the Fed are twofold. The first would be that there is uncertainty around the balancing act the Fed will strike between normalizing the balance sheet and raising the policy rate. This goes back to the debate about whether these two actions have been complements or substitutes (cancelling each other out). With the run-off starting at $10B per month and growing to $50B per month, this pace should not cause market disruption and result in a substitution effect.

The second reason why markets doubt the Fed's normalization path seems to be because low inflation has continued. With an ultra-low unemployment rate, dwindling spare capacity and low productivity, higher labor cost should squeeze profit margins, eventually pushing corporations to pass on these costs via higher prices. That said, inflation has remained benign.



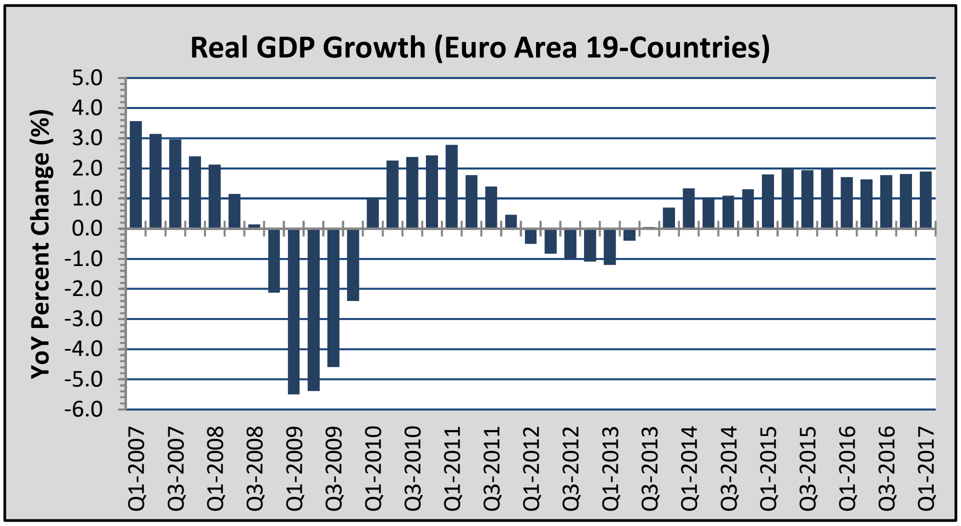
Dollar: Despite clear preferences from the U.S. administration for a lower value of dollar, political factors alone cannot take credit for the recent decline. First, the market is undertaking a rebalancing of foreign exchange portfolio positions from overbought levels on the U.S. dollar to a more neutral stance. This is in part occurring because growth convergence between major international economies and the U.S. has boosted confidence in these regions and their respective currencies. Further, calming political winds in the UK and Europe has caused a positive sentiment boost to the euro and pound. The broad and major currency trade-weighted U.S. dollar indices have also been declining since last December, despite elevated levels of interest rate differentials. However, no further drops to the value of the dollar seem likely, except at the margins. It should receive support from a Federal Reserve whose eyes will be firmly placed on economic fundamentals that would continue to warrant further rate hikes.



ECB: GDP growth in the 19-nation Euro zone bloc outpaced that in the U.S. in the first quarter of 2017, unemployment fell to an eight-year low of 9.3%, and inflation rose from less than zero to 1.4% over the past 12 months. The pickup has been aided by another strong rise in investment spending, although that slowed from the previous quarter. Crucially, trade was not a drag on growth, as it was in the previous quarter, as exports matched the increase in imports. In addition to becoming stronger, growth has also become more widespread across the eurozone's members. The Greek economy grew after a fourth-quarter contraction, while previously weaker economies such as Finland, Portugal and Italy experienced a pickup in growth.

As the euro zone economy gathered pace, the European Central Bank indicated it will first phase out a €60 billion-a-month bond-purchase program known as quantitative easing, and then increase short-term interest rates, which have been negative since 2014. The path the central bank chooses could have big consequences for bank stocks and lending, market volatility and the outlook for the euro. The two policies are different in part because they have affected different kinds of interest rates. The negative rate policies have impacted short-term rates, while bond purchases have hit long-term rates. The timing of this change in policy has remained uncertain.

Overall, policy makers have remained cautious about removing the stimulus they have provided over recent years, awaiting clear evidence that the recovery is stoking underlying inflationary pressures. Moreover, the large number of unemployed and underemployed workers in the eurozone would indicate that slack in the region's economy has remained substantial.



Outlook: Following a slowdown in the first quarter, economic growth appears to have rebounded, resulting in what should be another year of moderate growth. While the U.S. economy's expansion enters its ninth year, it has been disproportionately weak, with GDP growth averaging just above 2.0% a year.

Several labor market indicators suggest that some degree of slack remains in the employment market. Hopes for a big Q2 rebound in real GDP growth when statistics are announced have been scaled back following May's disappointing nonfarm employment numbers. Job growth is expected to moderate this year and the unemployment rate to drop somewhat further.

Some form of tax reform is still in the cards for 2017 at least nominally reducing individual marginal and corporate tax rates. The size and timing looks to be smaller and later than earlier hoped. Infrastructure spending will also likely be increased but should provide little to no boost to growth this year and next.

Given the lower likelihood of meaningful fiscal stimulus it is somewhat surprising to see `consumer confidence hold onto most of its post-election gains. While the initial improvement was triggered by the election, confidence is now being sustained by the improved job market. Consumer spending should rebound to 2.0%-2.5% pace in Q2 when numbers are reported, as temporary constraints such as unseasonably mild winter weather and delayed tax refunds move into the rearview mirror.

As for the future of the housing market, interest rates are expected to rise gradually, with households able to withstand the incremental increases in borrowing costs for now, as a strong labor market delivers continued job and income gains. Some improvement in the homeownership rate is also expected to provide a gentle tailwind to housing demand, while a rebound of for-sale inventory should keep price growth in check. All in all, housing activity should maintain a modest upward trajectory, with sales tilted toward the bigger single-family segment. As is the nature of the housing market, performance will vary by region.

Business fixed investment looks to be advancing at a solid pace, thanks in large part to the stronger global economy and a recovering energy sector. Investment in plants and equipment is expected to climb at a 4.0% pace in the coming quarters. Policies in Washington provide a two-sided risk to this forecast however. While proposed tax reform could provide a catalyst for stronger investment, the longer it takes Congress to work out a tax reform package, the greater the risk that businesses delay investment decisions until they have more clarity on its potential impact.

A distracted Congress or an inability to push forward reforms that typically require leadership from the President could very well put the financial markets into reverse quickly. This is the main risk that could cause the Fed's interest rate hike cycle to pause, because all other signals remain in place for an economy to push through the political noise.

Capital Markets in Review

Recap: The S&P 500 Index witnessed another bountiful return for the second quarter, rising 3.09% to bring the year-to-date total return to 9.34%. Similarly, the Dow Jones was up 9.35% through the second quarter, while the Technology heavy NASDAQ 100 Index saw a total return of 16.8%. Meanwhile, the Barclays U.S. Aggregate Bond Index climbed 1.45% in the second quarter as interest rates continued their downward trend despite the Federal Reserve raising interest rates in March and once again during the quarter at its June meeting.

Global stock markets have continued to see strong investor interest this year as reflected in sizable flows into stocks, largely through passive investment vehicles like index funds and ETFs. Optimism around improvements to economic growth and corporate earnings through new policies and real changes in Washington has waned somewhat as little progress has been made on the legislative front. Primary concerns for the markets include above average equity valuations, the impacts of rising interest rates off of historically low levels, periodic conflicting signals from officials at the Federal Reserve regarding the timing and number of rate hikes in 2017, and the potential for political surprises overseas that could influence market clarity. So far 2017 has been generous to investors with better returns from global markets helping to push the U.S. stock market indexes to new record levels despite a growing list of skeptics within the strategist ranks.

Domestic Stocks: Domestic stock market indexes repeatedly set new record highs during the quarter supported by a domestic economy that continued to show signs of gradual improvement, or at least few signs of broad slippage. Performance results for the S&P 500 Index have already exceeded the average strategist estimate for an approximate 6% return for all of 2017. Foreign markets also performed well as many of these economies also appeared to be gaining traction and gradual improvements in corporate earnings appear to be on the horizon.

First quarter earnings came in quite strong and have been supportive of above average valuation levels. Earnings for S&P 500 companies saw growth of over 20% from the same quarter one year ago, following up on a similarly strong fourth quarter of 2016. Interestingly, analysts are predicting another quarter of 20% growth for the second quarter of 2017 versus the same period a year ago, 7% earnings growth versus the previous quarter, and we have also seen the smallest number of estimate cuts to the upcoming quarter in several years. Research analysts began the year expecting overall 2017 S&P 500 operating earnings to come in near $131, a 20% increase over the 2016 tally. Through the end of June that had slipped a bit and now stands near $128.50 (which is normal as the year progresses) – a drop of about 2%. All of this is good news for domestic stock investors.

Mid and small-cap stocks lagged behind large-cap stocks in the quarter but still posted nice positive total returns. The Russell Mid-Cap Index still rose a solid 2.7% in the quarter and the Russell 2000 Index representing small stocks rose 2.5%. This brings their year-to-date total returns to 8.0% and 5.0%, respectively. These areas have not appeared to benefit as much from the passive investment push see in the large-cap stock benchmarks. However, returns at these levels for just six months' time are respectable nonetheless.

Growth stocks maintained their momentum over Value stocks so far in 2017. The Russell 1000 Growth Index climbed over 4.7% based on total return, while the Russell 100 Value Index came in at 1.3% for the quarter. Similar margins were seen within the Russell Mid Cap and Russell 2000 Growth and Value universes. Sector performance was a primary driver of this divergence as The Health Care sector performance drove Growth stocks in the quarter along with strong results in Technology and Consumer Discretionary (to a lesser extent). Financials performed better this quarter and make up a larger share of the Value universes, but weakness in other Value sectors weighed on comparative results.

Sector performance for the S&P 500 Index was predominantly positive for the quarter with 9 of 11 sectors in positive territory. Health Care was the top performing sector climbing 7.1%, followed by Industrials (+4.7%) and Financials (+4.3%). Energy and Telecom were the two sectors seeing negative returns for the second consecutive quarter. Energy shares declined 6.4% during the quarter as oil price uncertainty remained. The Telecom sector slipped another 7.1%.

Foreign Stocks: Developed equity and Emerging Markets outside the U.S. remained in the sweet spot during the second quarter. The MSCI EAFE rose 6.1% for the quarter and the MSCI ACWI ex USA Index (that has greater emerging markets exposure) was up 5.8%. Tacking these results onto the first quarter brings year-to date results for these foreign benchmarks to 13.8% and 14.1%, respectively. The MSCI EM Index rose 6.3% for the quarter, bringing its year-to-date total return to 18.4%. Foreign stock markets started 2017 with some uncertainty due to a number of elections, particularly in Europe, with concerns centered on whether any additional populist victories could ultimately lead to the demise of the European Union. So far these elections have not trended this direction and markets have responded in a positive fashion. Central banks remain biased towards stimulative policies, and recent economic traction should bode well for earnings improvements overseas. Currency trends have also been positive for international investments.

Bonds: The US 10-Year Treasury closed the quarter with a 2.31% yield (down slightly from 2.40% at March 31, and 2.45% at year-end 2016). Similar 10-Year notes for Germany and Japan posted yields near 0.47% and 0.08%, respectively. The Barclays U.S. Aggregate Index rose 1.45%, despite the Federal Reserve raising interest rates by another 25 basis points in June. The Barclays Global Aggregate ex U.S. rose 2.6% - with Emerging Market debt also performing well.

The high yield bond market remained a fixation for investors seeking higher levels of income. For the quarter the Barclays High Yield Corporate Index was up 2.2%. Despite some upheaval in energy markets due to volatile oil prices there has not been a detrimental shift in default rates in the sector. The High Yield asset class has benefited from improving stability in borrower earnings along with improved balance sheets. Continued gradual economic improvements have been supportive of this debt segment.

Non-Traditional Investments: Commodity-related investments were generally lower during the quarter. MLP investors saw results slide 6.4% on the back of weakness in the Energy sector and lower oil prices. West Texas Intermediate crude oil slipped from near $51 in March to approximately $46 at the end of the quarter.

Real estate investments fared a bit better again this quarter as fears of sharply higher interest rate levels seemed to dissipate from investor concerns. The FTSE NAREIT Equity REIT Index rose 1.5% in the quarter. Rising interest rate environments can stoke investor concerns of negative impacts to property values. However, often times these fears prove short-lived, particularly in markets with positive fundamentals and rental rates adjusting higher.

Outlook: We remain constructive on the primary asset classes that comprise our investment portfolios. Domestic stock valuations linger at above average levels, although constructive improvement in corporate earnings growth and economic conditions may take some of the edge off. International stocks are now contributing meaningfully to portfolio performance following several years of disappointing results. Even bonds are adding incremental value, albeit small, as interest rates have been stubborn to move higher. Investors should be pleased with the investment outcomes they have been achieving of late.

It is appropriate to reiterate that strategic investors should keep their focus on maintaining a disciplined long-term positive perspective on capital markets. Attempts to make substantial portfolio adjustments as markets ebb and flow for all kinds of reasons are not likely to prove fruitful. Preference should be placed on meaningful and purposeful strategic allocations to client portfolios and adjusting them modestly from time to time as needs arise or conditions change. With relatively reasonable market expectations, diversified portfolios should continue to provide investors an appropriate balance of risk and return.

Index Performance as of 6/30/17

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Russell								
3000 Value	0.41	1.78	1.29	1.29	4.32	16.22	7.32	13.89
3000	-0.50	0.90	3.02	3.02	8.93	18.52	9.10	14.59
3000 Growth	-1.42	0.00	4.65	4.65	13.69	20.73	10.83	15.20
1000 Value	0.37	1.63	1.34	1.34	4.66	15.54	7.36	13.94
1000	-0.55	0.70	3.06	3.06	9.27	18.04	9.26	14.67
1000 Growth	-1.48	-0.26	4.67	4.67	13.99	20.44	11.10	15.30
Mid Cap Value	0.50	1.49	1.37	1.37	5.18	15.94	7.46	15.14
Mid Cap	-0.16	0.99	2.70	2.70	7.99	16.50	7.69	14.72
Mid Cap Growth	-1.05	0.30	4.21	4.21	11.40	17.06	7.83	14.19
2000 Value	0.98	3.50	0.67	0.67	0.54	24.88	7.02	13.39
2000	0.10	3.46	2.46	2.46	4.99	24.62	7.36	13.70
2000 Growth	-0.74	3.44	4.39	4.39	9.97	24.42	7.64	13.98
Standard & Poors								
S&P 500	-0.58	0.62	3.09	3.09	9.34	17.91	9.61	14.63
Consumer Disc	0.14	-1.20	2.35	2.35	11.00	16.91	12.21	17.41
Consumer Staples	-1.05	-2.25	1.57	1.57	8.03	3.06	10.19	12.61
Energy	0.65	-0.18	-6.36	-6.36	-12.61	-4.14	-10.51	1.64
Financials	3.29	6.43	4.25	4.25	6.88	35.40	12.35	18.00
Health Care	-1.53	4.62	7.10	7.10	16.07	12.48	11.02	17.86
Industrials	0.02	1.39	4.73	4.73	9.51	22.28	10.24	16.07
Information Technology	-2.88	-2.70	4.14	4.14	17.23	33.91	15.94	17.18
Materials	-0.06	1.85	3.17	3.17	9.21	18.61	4.74	11.09
Real Estate	-0.88	1.92	2.76	2.76	6.40	-0.42	9.00	9.79
Telecom Services	-1.08	-2.92	-7.05	-7.05	-10.74	-11.72	4.03	5.85
Utilities	-2.29	-2.70	2.21	2.21	8.75	2.47	9.36	11.17
Other U.S. Equity								
Dow Jones Industrial Avg.	-0.21	1.74	3.95	3.95	9.35	22.14	11.01	13.45
Wilshire 5000 (Full Cap)	-0.44	0.89	2.96	2.96	8.85	18.67	8.78	14.42
International Equity - Broad Market								
MSCI EAFE	-0.26	-0.18	6.12	6.12	13.81	20.28	1.15	8.69
MSCI EM	0.10	1.01	6.27	6.27	18.43	23.76	1.07	3.96
MSCI Frontier Markets	0.63	0.61	6.13	6.13	15.57	19.23	-3.38	8.60
MSCI ACWI	-0.35	0.45	4.27	4.27	11.48	18.80	4.82	10.54
MSCI ACWI Ex USA	-0.07	0.31	5.78	5.78	14.10	20.47	0.80	7.22
MSCI AC Asia Ex Japan	-0.12	1.59	8.31	8.31	22.81	26.75	5.01	7.97
International Equity - Country Region								
MSCI Brazil	3.49	-1.70	-6.67	-6.67	3.00	17.01	-7.91	-4.72
MSCI BRIC	0.14	0.70	4.70	4.70	16.82	25.39	1.70	3.92
MSCI China	-0.59	2.30	10.57	10.57	24.86	32.21	8.07	8.95
MSCI Europe	-0.29	-1.09	7.37	7.37	15.36	21.12	-0.24	8.82
MSCI India	-0.43	-0.78	2.91	2.91	20.53	17.48	4.27	9.03
MSCI Japan	-0.85	1.06	5.19	5.19	9.92	19.19	5.53	9.56
MSCI EM Latin America	2.20	0.66	-1.74	-1.74	10.12	15.02	-6.62	-3.76
MSCI Russia	1.45	-3.79	-10.03	-10.03	-14.18	10.34	-7.72	-3.43

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	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Fixed Income								
Barclays U.S. Aggregate	-0.57	-0.10	1.45	1.45	2.27	-0.31	2.48	2.21
BofAML 3-Month T-Bill	0.01	0.08	0.20	0.20	0.31	0.49	0.23	0.17
Barclays U.S. Gov't	-0.66	-0.16	1.17	1.17	1.86	-2.18	1.99	1.30
Barclays U.S. Credit	-0.59	0.26	2.35	2.35	3.68	1.84	3.40	3.68
Barclays High Yield Corp.	0.28	0.14	2.17	2.17	4.93	12.71	4.48	6.89
Barclays Municipal	-0.53	-0.36	1.96	1.96	3.57	-0.49	3.33	3.26
Barclays TIPS	-0.73	-0.95	-0.40	-0.40	0.85	-0.63	0.63	0.27
Barclays Gbl Agg Ex USD	-0.06	-0.09	3.55	3.55	6.12	-3.80	-2.42	-0.36
Barclays Global Aggregate	-0.28	-0.09	2.60	2.60	4.41	-2.18	-0.35	0.78
BofAML Emerg. Mkt. Cred	0.21	-0.43	1.66	1.66	5.96	12.57	6.05	9.47
Alternative Investments								
Alerian MLP	4.22	-0.65	-6.35	-6.35	-2.66	0.40	-11.23	1.77
Bloomberg Commodity	3.74	-0.19	-3.00	-3.00	-5.26	-6.50	-14.80	-9.25
FTSE NAREIT Equity REIT	-1.15	2.19	1.52	1.52	2.70	-1.70	8.35	9.52
S&P Global Natural Res.	1.10	0.03	-0.93	-0.93	1.96	15.36	-4.67	0.55
S&P N. Amer Natural Res.	0.91	-0.57	-7.09	-7.09	-11.04	-2.62	-11.92	0.13

Sources: Department of Commerce, Department of Labor, the Conference Board, Organization for Economic Co-operation and Development, National Association of Realtors.

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