UNION

MONTHLY UPDATE AND COMMENTARY
FEBRUARY 2018

Introduction: Eight years into what has been an unexpectedly slow expansion, the U.S. economy appears to have picked up steam. U.S. economic output remained on an above-trend path in the fourth quarter of 2017 as GDP rose at an initial estimate of 2.6% annual rate. Output grew 2.5% in 2017 as a whole, the most in three years. That put the economy in unusual territory: not quite booming, but still gaining momentum deep into an expansion.

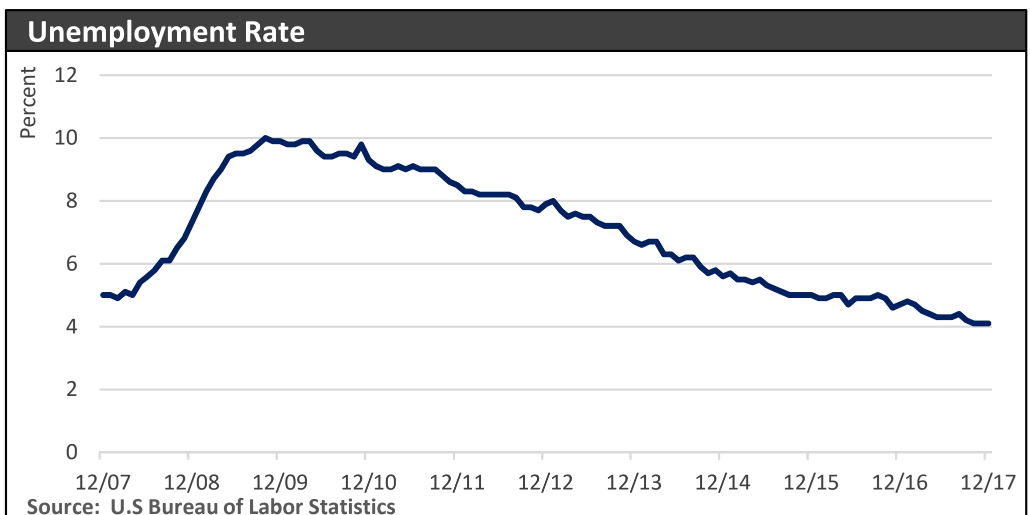
Several developments have helped the economy perk up. Among them were synchronized global economic growth and renewed investment spending by U.S. firms that have spent years hunkering down. Those factors have converged with low unemployment, tame inflation, low interest rates and a booming stock market to bolster business and household optimism and spending. Firms that earlier in the expansion focused on boosting payrolls while labor was cheap, now appear to have renewed investment in facilities and equipment.

A chunk of the fourth quarter's growth likely reflected a temporary boost in spending. Spending that had been halted by the hurricanes last summer, was simply pushed back into the year's final stretch. Likewise, the storms spurred a temporary boost in spending on repairs and replacement items.

Labor Market: The pace of hiring slowed a bit in the final month of 2017, but remained robust for the year as a whole, and the jobless rate held at a 17-year low, signs the broader labor market has maintained plenty of momentum going into the New Year.

Nonfarm payrolls rose by 2.1 million in 2017, the seventh straight year of increases exceeding two million. It has been only the second time on record—the other being in the 1990s—when the economy has produced jobs at that pace for that long. The unemployment rate has remained at 4.1%, matching the lowest level since December 2000 for the fourth straight month, with benefits hitting a widening swath of the population. Hiring has now risen for 88 straight months, the longest uninterrupted period of job expansion on record. The current labor-market expansion has been more notable for its length than its strength.

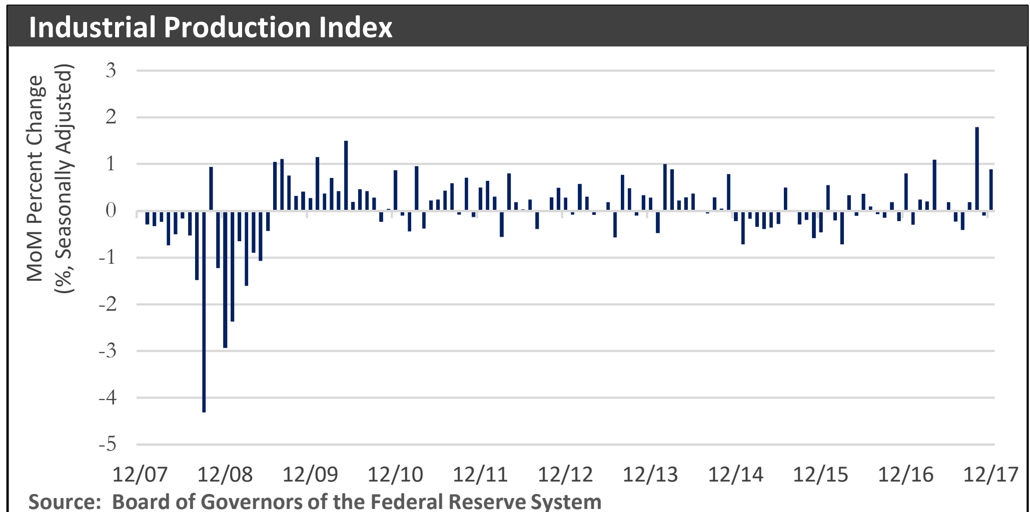
Still the economy could get an additional boost in 2018 as business and individual income tax cuts passed by Congress go into effect. The cuts could stimulate consumer spending and business investment. As the expansion rolls on, companies should report increasing trouble finding qualified workers. That could spur wage gains in the months ahead as employers bid to take on and retain employees.



The share of Americans participating in the labor force held steady at 62.7% in December. Participation has largely moved sideways the past two years, a sign that some Americans are being drawn off the sidelines of the labor market and countering the long-run trend of aging baby boomers retiring.

Manufacturing: The industrial side of the economy had put up an impressive performance in recent months, continued that run in December. Industrial production rose 0.9%. Growth in the manufacturing sector, which accounted for about three-quarters of industrial output, was more restrained. Production rose just 0.1% in December. That followed an upwardly revised gain in November and sharp upturn in October (following the unwinding of hurricane distortions), leaving

manufacturing output rising at a 7.8% annualized pace over the past three months.



Source: Board of Governors of the Federal Reserve System

Despite December's scant increase, manufacturing growth should remain strong in the near term. After a tough few years, the sector has now benefitted from much higher levels of business confidence, stronger global growth and a weaker dollar.

Non-manufacturing index: The U.S. service sector lost momentum during the last two months of 2017, but still expanded at a healthy pace. The ISM's nonmanufacturing index fell 1.5 percentage points to 55.9 in December 2017 after falling in November. But the two months of deceleration came after September and October posted intense growth that was likely related to post-hurricane bounce back in the services sector. Despite growth in the services sector decelerating at the end of 2017, the index still appeared to match the U.S.'s strong economic streak.

Inflation: A modest rise in consumer prices in December and solid growth in retail sales bolstered the view that inflation had firmed after a long run of softness. The consumer price index rose just 0.1% from November, but core prices jumped 0.3%, the most in 11 months. This offered the latest evidence to support the Fed's view that decelerating price pressures last spring would prove transitory. On a six-month annualized basis, core consumer prices rose 2.2% in December, up from a 0.9% gain in July. An upturn in inflation could overcome doubts about the need for a slightly more aggressive monetary policy path. That would clear the way for the Fed to raise rates at least three times this year, with the first increase coming in March. And raised rates would surprise investors who have been skeptical of inflation and higher rates.

Housing: Housing market data showed some softening in December with new and existing home sales pulling back for the month. New home sales fell 9.3% for the month, while existing home sales declined 3.6%. The sales declines came on the heels of strong November readings. For existing home sales, tight supply remained one of the biggest factors holding back the overall pace of growth.

Even with December's declines, new home sales were up 2.6% relative to December 2016 and existing home sales were up 1.1%. Residential investment should expand at least 5% this year after the modest 1.7% pace of 2017.

Several factors have been converging to buttress home buying. With so many Americans working, more can afford to go out and buy a home. Gauges of household confidence has remained elevated. Borrowing costs remained low by historical standards. Still, the limited inventory on the market has been driving up home prices at a rapid pace, potentially blocking some would-be buyers.

Changes in the tax law passed in December have limited deductibility of the most expensive mortgages and made it pricier to live in states with high property taxes. Some of the monthly sales pullback could be attributed to hesitancy on the part of potential home buyers in more expensive states.

US Dollar: The Trump administration has signaled that it preferred a weaker U.S. dollar. Coupled with new tariffs and harsher administration talk about trade pacts, this appeared to crystallize the market's reckoning with the Trump administration's policy. A weaker dollar would make U.S. goods cheaper to foreign markets and could especially be seen, as a boost for multinationals who derive a large portion of their income from outside the country. The risk of a weaker dollar could undermine confidence in a wide swath of U.S. assets, including the U.S. Treasury market.

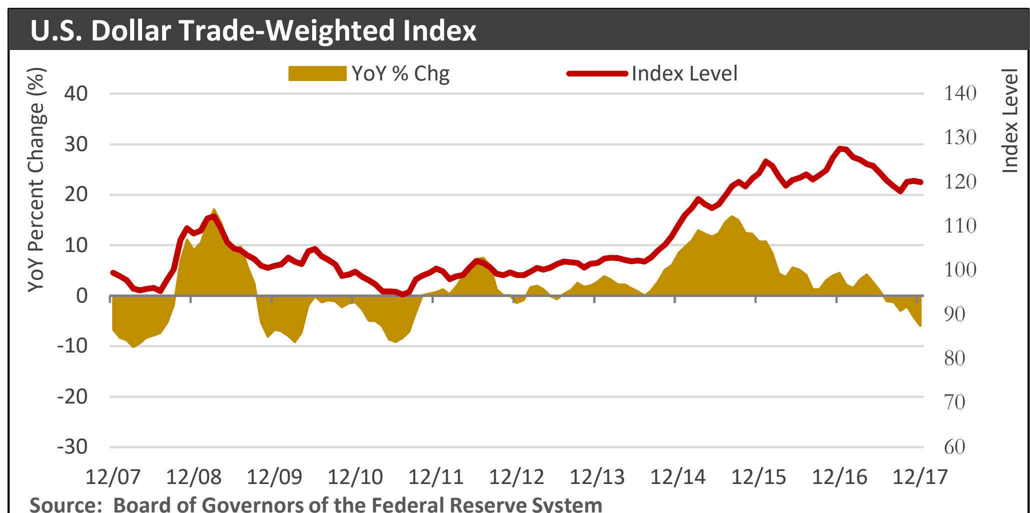
The new tax law will expand the federal budget deficit to as much as $1 trillion by fiscal year 2019, which will need to be financed with debt sold to many foreign investors. If those investors demand higher rates to compensate for the risks of a weaker currency, that could in turn push higher costs to U.S. taxpayers.

While the U.S. Federal Reserve is expected to raise interest rates this year, the change in outlook for its global peers has become a more powerful force in currency markets. Some central banks, like the Bank of Canada and Bank of England, have started raising rates. That's giving investors more options as they seek higher returns on their investments.

Even more curious is that the dollar's decline has occurred despite a surge in U.S. Treasury yields. That is an unusual trend. Higher U.S. government bond yields typically make the dollar more appealing to investors, especially as global interest rates have remained low. And yet, the dollar index has been on track for its worst performance since last July.

This may be attributed to the widening budget deficit—and the potential that it could widen even further because of recent tax cuts—and worrying about the rising cost of funding such a disparity would have as interest rates move higher. Any undermining of confidence in the ability of the U.S. to pay its debts could add to the pressure.

Meanwhile, a much weaker dollar could spur further risk-taking in markets where worries about valuations are already rife. That might bring more debate about the risk of financial-market instability: after many years in which ultraloose monetary policy appeared not to bring dividends, it has suddenly had a turbocharged effect. Despite the acceleration in global growth and buoyant markets, even U.S. policy rates have been negative in real terms.



Source: Board of Governors of the Federal Reserve System

The dollar's decline thus bears watching. If the pace of the decline were to moderate, and be matched by strong global growth, then it would be more benign. Otherwise, the dollar could test markets in unexpected ways.

Divergence in currency values: Japan and the eurozone have shared negative interest rates and stronger economic growth, but their currencies have been heading in different directions. That's because interest rates could rise more quickly in the Eurozone than Japan, a factor that is likely to continue pushing their currencies apart.

In the past year, the euro has rallied by 14% against the dollar, while the yen is up by less than 2%. A stronger currency would feed through to broader markets and the economy, often crimping exports, dragging on equity markets and reducing inflationary pressure. European shares, for instance, have underperformed those in Japan and the U.S., in part due to concern of the effect of a stronger euro on local exporters.

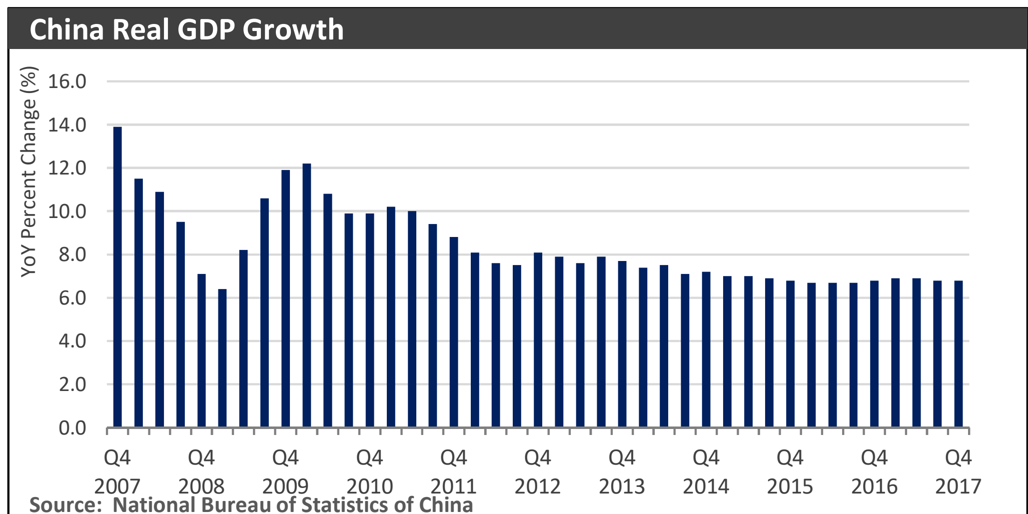
Both the European Central Bank (ECB) and the Bank of Japan (BOJ) have already reduced the size of their monthly bond purchases, but neither has yet raised their interest rates from negative territory.

Japanese inflation has been rising gradually but domestic economic conditions are not strong enough to accelerate this inflation. To help boost inflation, the Bank of Japan aims to continue with its accommodative monetary policy, in order to increase inflation by driving down the yields of government bonds, pushing investors into assets like stocks and corporate bonds, and encouraging business activity and, eventually, price escalations.

The eurozone has also repeatedly missed its close-to-2% inflation target. Core inflation is currently at 1.1%. But the current strength of the euro could cause the price of imports denominated in other currencies to decline, squeezing inflation. Exports from the eurozone have yet to suffer much from the stronger euro, rising by more than 5% in 2017. But Japan's export growth has been considerably stronger, a surge of around 11%.

The net long position in euro foreign-exchange futures—a measure of bullish bets on the currency's value—has been near record levels. In contrast, speculators are heavily positioned for a fall in the yen, with significantly more short than long contracts on the Japanese currency. The euro and yen are expected to drift even further apart.

China: Chinese real gross domestic product (GDP) rose by 6.8% (year-on-year) in the fourth quarter of 2017. The Chinese economy recorded a healthy advance in 2017 despite a slowdown in credit-fueled construction.



Efforts by Chinese authorities to slow credit growth, in order to manage financial stability risks, seem to have borne some fruit. Credit growth slowed in 2017, helping China's debt-to-GDP ratio level off. Moreover, firming growth in the services sector has been an encouraging sign that the process of rotation away from a dependency on debt-financed investment could be well underway. But, there's much work still to be done including restructuring industries saddled with overcapacity and resolving bad debts. As such, policymakers will continue to maintain a tightening bias in domestic credit conditions this year.

The Chinese economy is likely to grow at a 6.5% pace this year. Although strong global demand should help support Chinese exports, policies aimed at improving air quality and environmental conditions, together with tighter credit conditions and the closure of inefficient firms, are likely to exert some drag on the output of primary and secondary industries (e.g. mining, manufacturing, and construction). Nevertheless, growth of 6.5% would still be above the trend-pace of growth in China, estimated to be between 5.75% and 6.25%

United Kingdom: The U.K. economy in 2017 grew at the slowest pace in five years, highlighting that Britain wasn't reaping the full benefits of the recent upsurge in global growth as it prepared to leave the European Union. The UK economy expanded 0.5% in the fourth quarter of 2017, an annualized rate of 2.0%. The economy grew at an annual rate of 1.8% in 2017, 0.1 percentage point slower than the previous year and the slowest rate of expansion since 2012. The slowdown in the British economy has come as the world's major economies have been in a rare spell of synchronized expansion. Both the U.S. and Eurozone economies have been experiencing accelerated growth.

The economy's prospects for 2018 look mixed. U.K. consumers, a key engine of growth for the largely domestic-driven economy, have seen their spending power eroded as inflation, spurred by the pound's steep depreciation in the wake of the 2016 Brexit referendum, has outpaced growth in wages. The British economy should return to growth rates closer to 2% by the end of 2019, assuming Brexit negotiations do not reverse the gradual improvement in consumer and investment spending in the meantime. The Bank of England will also likely maintain a cautious approach to tightening policy as Brexit negotiations continue, inflation slows and growth gradually picks up. The British pound should gradually appreciate against the dollar in the coming quarters.

Outlook: The United States appears to have completed 2017 on a solid note. This year should see even stronger growth, with real GDP rising close to 3.0%. Recently enacted tax reform creates some potential upside risks for the economy in the near term. Lower tax rates will provide a much-needed boost to take-home pay, which lagged behind consumer spending in recent months. Business fixed investment may also be a touch stronger.

With tax cuts providing more ammunition for pay upgrades, there is some evidence that inflation is about to break out to the upside. Overheating may yet be an issue but most likely not in 2018. And, additionally, the recent increase in commodity prices may squeeze profit margins further, translating into consumer price increases as the year progresses.
The new tax law is taking effect at a time when the economy, by most traditional measures, is at full employment. Hence the Federal Reserve may need to hike interest rates a bit more aggressively than they otherwise would. As the labor market approaches full employment, the pace of hiring will subside as the unemployment rate stabilizes in the medium term. Employers will have to dole out larger pay increases, in order to attract and retain workers.

The global upswing is a two-edged sword for the United States. Exports have risen, but so have imports. While consumer spending has been on an upswing, many of the goods Americans bought are being produced abroad. A widening trade deficit subtracted more than a percentage point from growth in the fourth quarter. That came even though the dollar had weakened, a development that should be improving the U.S. trade position by making imports more expensive and exports cheaper.

Index Performance as of 1/31/18

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Russell								
3000 Value	-1.12	3.67	3.67	8.20	3.67	16.65	11.54	13.35
3000	-0.63	5.27	5.27	9.55	5.27	25.16	14.11	15.53
3000 Growth	-0.16	6.84	6.84	10.87	6.84	34.11	16.66	17.69
1000 Value	-1.04	3.87	3.87	8.61	3.87	17.22	11.54	13.47
1000	-0.56	5.49	5.49	9.92	5.49	25.84	14.28	15.73
1000 Growth	-0.10	7.08	7.08	11.19	7.08	34.89	17.01	17.95
Mid Cap Value	-1.37	2.30	2.30	7.06	2.30	14.03	10.36	13.56
Mid Cap	-1.19	3.76	3.76	8.25	3.76	20.08	11.52	14.29
Mid Cap Growth	-0.97	5.66	5.66	9.78	5.66	28.09	12.97	15.20
2000 Value	-2.20	1.23	1.23	3.17	1.23	9.95	11.56	11.98
2000	-1.53	2.61	2.61	5.14	2.61	17.18	12.12	13.33
2000 Growth	-0.91	3.90	3.90	7.00	3.90	24.90	12.55	14.62
Standard & Poors								
S&P 500	-0.47	5.73	5.73	10.18	5.73	26.41	14.65	15.91
Consumer Disc	-0.30	9.34	9.34	17.64	9.34	29.00	17.43	18.44
Consumer Staples	-0.97	1.59	1.59	9.72	1.59	13.42	9.40	12.35
Energy	-3.58	3.81	3.81	10.80	3.81	6.60	2.74	2.04
Financials	-0.92	6.48	6.48	12.36	6.48	29.79	19.10	18.33
Health Care	-0.84	6.65	6.65	9.05	6.65	27.33	10.18	17.44
Industrials	0.19	5.31	5.31	11.45	5.31	25.68	15.28	16.65
Information Technology	0.23	7.63	7.63	8.87	7.63	43.11	23.28	22.36
Materials	-0.67	4.14	4.14	7.21	4.14	23.26	12.01	12.26
Real Estate	0.58	-1.89	-1.89	0.52	-1.89	8.82	3.61	8.64
Telecom Services	0.52	0.55	0.55	12.77	0.55	1.81	8.63	7.11
Utilities	1.61	-3.07	-3.07	-6.52	-3.07	7.32	5.51	10.86
Other U.S. Equity								
Dow Jones Industrial Avg.	-0.39	5.88	5.88	12.49	5.88	34.80	17.98	16.36
Wilshire 5000 (Full Cap)	-0.65	5.36	5.36	9.76	5.36	25.02	13.90	15.37
International Equity - Broad Market								
MSCI EAFE	-1.38	5.02	5.02	7.82	5.02	27.60	9.39	7.85
MSCI EM	-0.32	8.33	8.33	12.45	8.33	41.01	11.83	5.74
MSCI Frontier Markets	-0.90	5.73	5.73	10.31	5.73	30.71	8.47	8.91
MSCI ACWI	-0.78	5.64	5.64	9.42	5.64	27.48	11.90	11.02
MSCI ACWI Ex USA	-1.11	5.57	5.57	8.81	5.57	29.68	9.85	7.11
MSCI AC Asia Ex Japan	-0.19	7.56	7.56	11.17	7.56	43.54	12.51	9.18
International Equity - Country Region								
MSCI Brazil	1.94	16.84	16.84	18.40	16.84	30.95	14.74	-0.18
MSCI BRIC	-0.14	11.47	11.47	15.36	11.47	48.61	14.87	6.64
MSCI China	-0.27	12.49	12.49	16.43	12.49	62.29	16.37	11.61
MSCI Europe	-0.74	5.40	5.40	7.23	5.40	29.60	8.58	7.28
MSCI India	-1.40	3.44	3.44	7.73	3.44	37.55	7.15	8.54
MSCI Japan	-3.57	4.58	4.58	8.46	4.58	25.02	12.43	11.36
MSCI EM Latin America	0.88	13.15	13.15	14.63	13.15	30.12	10.49	-1.51
MSCI Russia	-0.24	12.57	12.57	19.70	12.57	18.75	24.41	-0.54

Index Performance as of 1/31/18

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Fixed Income								
Barclays U.S. Aggregate	-0.16	-1.15	-1.15	-0.83	-1.15	2.15	1.14	2.01
ICE BofAML US 3M Trsy Bill	0.03	0.12	0.12	0.31	0.12	0.93	0.45	0.29
Barclays U.S. Gov't	-0.22	-1.33	-1.33	-1.17	-1.33	0.70	0.12	1.16
Barclays U.S. Credit	0.03	-0.93	-0.93	-0.23	-0.93	4.84	2.35	3.22
Barclays High Yield Corp.	-0.24	0.60	0.60	0.65	0.60	6.60	6.33	5.62
Barclays Municipal	-0.63	-1.18	-1.18	-0.68	-1.18	3.52	1.97	2.69
Barclays TIPS	-0.08	-0.86	-0.86	0.18	-0.86	1.27	0.71	0.10
Barclays Gbl Agg Ex USD	0.13	3.03	3.03	5.50	3.03	11.77	3.43	0.62
Barclays Global Aggregate	0.00	1.19	1.19	2.67	1.19	7.46	2.48	1.22
JPM EMBI Global Div	-0.01	-0.04	-0.04	0.74	-0.04	8.64	6.76	4.85
Alternative Investments								
Alerian MLP	-3.59	5.76	5.76	9.28	5.76	-5.75	-6.66	-1.31
Bloomberg Commodity	-0.71	1.99	1.99	4.55	1.99	3.58	-3.32	-8.53
FTSE NAREIT Equity REIT	-0.77	-4.18	-4.18	-1.79	-4.18	0.71	1.90	7.74
S&P Global Natural Res.	-1.53	5.24	5.24	11.84	5.24	23.56	10.05	2.80
S&P N. Amer Natural Res.	-3.97	2.35	2.35	9.88	2.35	4.32	2.16	0.36

Sources: *Department of Commerce, Department of Labor, Institute for Supply Management, UK Office for National Statistics, China National Bureau of Statistics, National Association of Realtors.*

Securities are not insured by FDIC or any other government agency, are not bank guaranteed, are not deposits or a condition to any banking service or activity, are subject to risk and may lose value, including the possible loss of principal.