AUGUST 2018 ECONOMIC COMMENTARY AND CAPITAL MARKET UPDATE

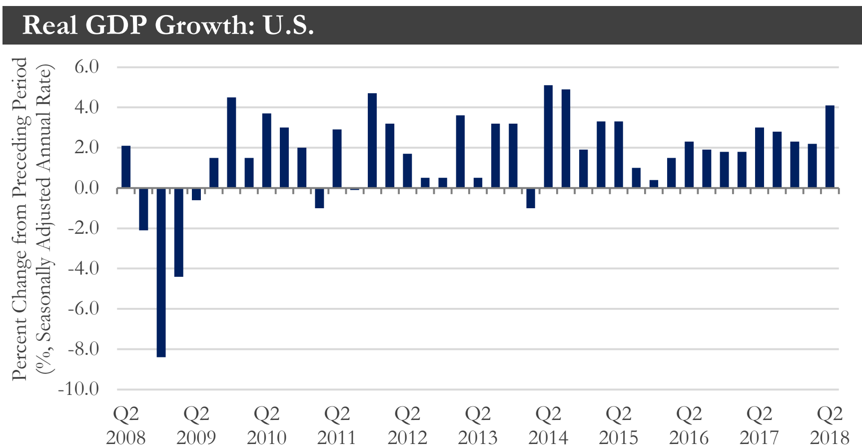
Recap: While the threat of further trade tariffs has continued to pose a substantial downside risk to U.S. and global growth, for the time being, the U.S. economy has been moving full steam ahead. The economy grew at its fastest pace in nearly four years this spring, reflecting broad-based momentum, and suggesting the second-longest expansion on record has not yet run out of fuel. Robust consumer spending, solid business investment, surging exports and increased government outlays were among the factors that boosted real GDP at an annual rate of 4.1% in the second quarter.

The critical question following the stronger second quarter figures has been how sustainable is this improvement? It is doubtful another 4% quarterly gain in real GDP growth will be seen anytime soon; the economy has no longer been shackled by a late-1980s' tax system and burdensome regulations. The net result has been an investment-led expansion. The strength in business fixed investment should provide the economy more resilience, by boosting productivity growth, reducing inflationary pressures and increasing the economy's long-run potential growth rate.

One of the factors pushing up second-quarter GDP was a jump in exports. That could reflect private-sector efforts to get ahead of impending tariff increases on goods. If that is the case, exports could slow in the months ahead as the Trump administration's trade dispute with its trading partners heats up. Another possible casualty of the trade dispute was business and consumer sentiment, which could affect investment and spending decisions.

Perhaps the biggest concern now is that the economy will overheat. With an unemployment rate below 4% and inflation at a six-year high, the Fed's goal should be to raise interest rates just enough to keep prices from rising faster, but not so much as to smother growth.

GDP: The U.S. economy grew at a 4.1% annualized pace in the second quarter, the strongest showing in nearly four years. An expansion in consumer spending, business investment and exports helped drive growth in the quarter. A low unemployment rate, steady job and wage growth and the late-2017 tax overhaul may have encouraged spending by consumers and businesses.

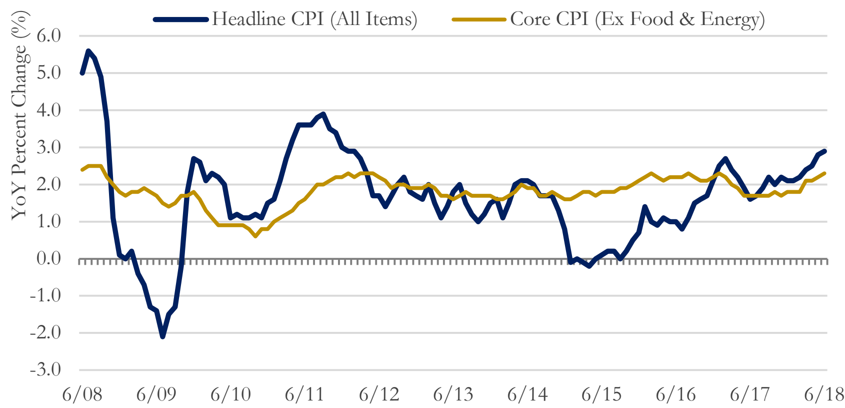


Source: U.S. Bureau of Economic Analysis

Housing: One sore spot in the second quarter was residential investment, which fell 1.1% – the second consecutive decline. Housing data out in recent weeks affirmed the downbeat narrative. Existing home sales fell 0.6% (m/m) in June, extending the losing streak to three months, despite a slight increase in inventories. The drop joined last month's tumble in housing starts, and a pullback in volatile new homes sales which rounded off the sour data for June. The housing market should continue to face headwinds on both the supply and demand side. A tightening labor market and rising incomes should continue to buoy buyer interest despite rising prices and higher interest rates. But, bigger challenges on the supply side, such as rising material costs due to recent tariffs and labor shortages are likely to continue to hold back supply and thus remain the determining factor over the evolution of the housing market in the coming months.

CPI Inflation: Amid tighter labor markets, backlogged supply chains and rising input costs, inflation continued its upward

climb. Modest wage gains by American workers were underscoring questions about how much they are benefiting from an economy that by many other measures has been booming. The monthly consumer-price index rose 0.1% in June, while core prices increased 0.2%. Prices rose 2.9% in June from a year earlier, the fastest pace since February 2012. Core inflation ticked up to 2.3% over the past 12 months, the highest rate since January 2017.



Source: U.S Bureau of Labor Statistics

Core CPI is expected to remain near its current rate through the second half of the year. Minimal slack in the economy points to price pressures intensifying. Broadening tariffs, including the possibility of consumer goods getting directly hit, also create some upside risk to the inflation forecast.

Small Business Optimism Index: The NFIB's small business optimism index fell by 0.6 points to 107.2 in June, still among the highest in the survey's 45-year history. The elevated level of confidence has continued to be marked by an increased appetite for workers. The lack of qualified labor, however, has remained a key impediment to expansion plans. There has been no quick respite on this front given a tightening labor market, unless the participation rate continues to rise.

U.S. Dollar: The dollar's surprisingly durable rally and expectations of strong U.S. growth have been upending investments across the globe, punishing commodities and emerging markets, while attracting more overseas money to the U.S. As growth abroad has slowed and the Federal Reserve has adopted a more aggressive stance on interest rates, the dollar's advance has gone on longer than anticipated.

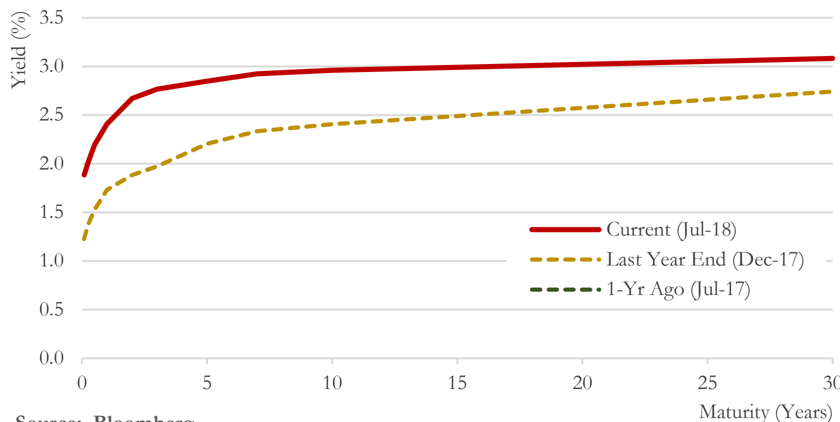
The rally has been poised to continue as factors boosting the dollar have remained in force. For one, the U.S. economic expansion has been gaining strength. Europe's growth, meanwhile, has moved in the opposite direction. Rising expectations for the Fed to accelerate the pace of rate increases will keep the dollar supported against currencies that are tied to more dovish central banks, such as the euro and Australian dollar.

Trade tensions between the U.S. and China have also given the dollar a boost as the U.S. would be hurt less than China or Europe should a full-blown trade war break out. The dollar has also been supported by companies bringing home overseas funds to take advantage of a one-time cut written into the GOP tax overhaul signed into law late last year.

Federal Reserve: The current condition of the labor market has given comfort to Federal Reserve officials who have played down concerns about the economy overheating and left them on track to continue gradually raising interest rates. The Fed appeared to hold rates steady at their July-August meeting and should raise rates in September and, again, in December. The question for the Fed has been whether and how quickly tighter labor markets will lead to sustained wage gains that might push inflation too high.

Flattening Yield Curve: The gap between yields on short- and longer-term Treasuries has narrowed to less than 0.3% nearly 11-year lows, a sign that investors have remained cautious about the outlook for economic growth even as they expect the Federal Reserve to continue raising interest rates in the face of economic growth. Two-year yields have typically climbed along with investor expectations for tighter Fed interest-rate policy, while longer-term yields have been more responsive to sentiment about the outlook for growth and inflation.

The dispersion between shorter-term and longer-term rates, known as the yield curve, has been a crucial indicator of sentiment about the prospects for economic growth. Investors have monitored the curve closely because short-term rates have exceeded longer-term ones before each recession since at least 1975—a phenomenon known as an inverted yield curve. Following five of the past six periods in which the yield curve inverted, the economy tipped into recession within a year.



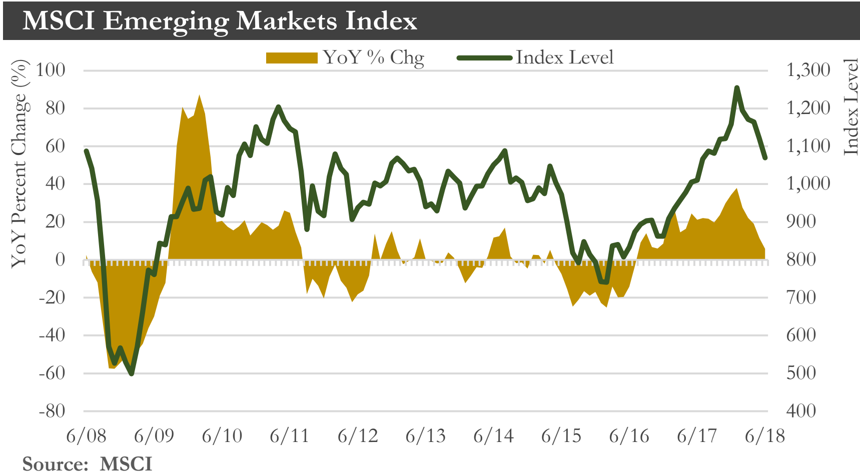
The flattening has occurred as U.S. economic growth remains steady. Two-year yields have climbed as policy makers have raised rates to normalize monetary policy following extraordinary stimulus undertaken in the wake of the financial crisis. They have signaled the possibility of two more rate increases this year. That has kept upward pressure on short-term rates as the Treasury also is selling more short-term debt to fund tax cuts and government spending.

At the same time, the 10-year yield has retreated from a nearly seven-year high reached in May, weighed down by trade-war fears. The concern has been that trade tensions will disrupt global growth, tempering expectations for an economic surge spurred by recent tax cuts. Investors also have bought Treasuries, a safe-haven asset as tariff fears have rattled markets around the world. Low wage growth has dragged longer-term yields down, flattening the curve further. It would seem possible that those circumstances have negated the traditional signal sent by a flattening yield curve.

Recent escalations in trade tensions have spurred increased volatility in financial markets, making risky assets including stocks and emerging-market bonds less attractive, and leading many investors to reallocate more funds to the safer assets such as Treasuries. Rather than serving as a gauge of future economic performance, the yield curve has probably been the most important tool in explaining the backdrop for risk-taking in financial markets.

China: Chinese real gross domestic product (GDP) rose by 6.7% (year-on-year) in the second quarter of 2018. Chinese authorities have already reacted to mitigate the negative impact of $265 billion in U.S. tariffs by easing monetary policy and allowing the renminbi to depreciate more than 6% against the U.S. dollar. Given China's limited capacity to retaliate in kind to the proposed tariffs, Chinese authorities are likely to undertake non-tariff actions to impede U.S. business interests in the region, such as imposing more stringent customs controls targeting U.S. goods, and seeking out allies to help generate a global response to U.S. protectionism. Overall, that protectionist action by the U.S. administration could put about 0.5 ppts of Chinese growth at risk over the next six quarters and may even place downward pressure on the economic growth of its supply chain partners.

Emerging Markets: Emerging markets could become collateral damage in an escalating trade conflict where the U.S. is squaring off against China and Europe. Export-dependent Asian economies may be especially vulnerable, and major stock markets in the region have tumbled in recent months. A significant portion of U.S.-bound exports from countries like Malaysia, South Korea and Thailand pass through China, given its central role in the global supply chain. The trade conflict has also slowed a revival in global growth, stoking worries over demand for raw materials and hurting the economies of commodity exporters.



Outlook: The U.S. economy continues to be red-hot, but this pace of expansion will be hard to sustain going forward as it starts to bump against capacity constraints, particularly on the labor front. Higher material prices, wages and shortages of labor in some sectors will affect future growth. U.S. economic growth is expected to remain near a 3.0% annualized pace in the second half of the year, but an escalation in trade tensions could push that estimate down. To prevent the economy from overheating, the Federal Reserve is likely to raise rates twice more this year, bringing the upper end of the target range to 2.5% in December.

The tariffs and counter-tariffs imposed by the U.S. and their trading partners, respectively, remain a downside risk to the U.S. economic growth outlook. Although the direct threat to the U.S. economy from the tariffs enacted so far is relatively low, trade data are already showing signs that tariffs are affecting activity. In addition, the second-order effects, such as a potential decline in the stock market and corresponding fall in household net worth/consumer confidence, are another threat that could compound any direct effect on growth from a full-blown trade war.

Hopefully such a scenario never materializes, and ongoing discussions between the U.S. and its major trading partners prove fruitful.

Index Performance as of: 7/31/2018

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
3000 Value	1.16	3.79	3.79	5.11	2.59	9.91	9.76	10.05
3000	-0.20	3.32	3.32	6.93	6.64	16.39	12.18	12.83
3000 Growth	-1.55	2.84	2.84	8.52	10.49	22.86	14.51	15.56
1000 Value	1.26	3.96	3.96	4.83	2.20	9.54	9.51	10.04
1000	-0.17	3.45	3.45	6.78	6.40	16.19	12.19	12.96
1000 Growth	-1.59	2.94	2.94	8.48	10.40	22.84	14.80	15.83
Mid Cap Value	1.20	2.72	2.72	4.67	2.56	9.07	9.82	10.71
Mid Cap	0.33	2.49	2.49	5.54	4.90	13.45	10.21	11.51
Mid Cap Growth	-0.97	2.15	2.15	6.38	7.66	19.08	10.92	12.49
2000 Value	-0.05	1.77	1.77	8.34	7.31	14.37	12.91	10.19
2000	-0.54	1.74	1.74	8.69	9.54	18.73	12.04	11.33
2000 Growth	-1.03	1.72	1.72	8.97	11.58	22.91	11.08	12.39
S&P 500	-0.13	3.72	3.72	6.87	6.47	16.24	12.52	13.13
Consumer Disc	-0.43	1.83	1.83	7.61	13.56	23.50	13.35	15.21
Consumer Staples	1.75	4.07	4.07	7.10	-4.83	-0.58	5.04	8.17
Energy	1.94	1.42	1.42	5.25	8.32	19.72	6.96	1.50
Financials	-0.26	5.27	5.27	2.32	0.97	13.47	13.24	13.10
Health Care	1.34	6.61	6.61	8.59	8.57	13.31	6.97	13.63
Industrials	3.39	7.32	7.32	6.90	2.29	12.99	13.87	13.01
Information Technology	-3.60	2.09	2.09	9.23	13.19	28.48	22.22	21.42
Materials	1.70	2.96	2.96	5.46	-0.21	11.44	11.44	10.29
Real Estate	2.25	1.08	1.08	7.95	1.90	4.90	7.17	9.22
Telecom Services	0.59	2.33	2.33	2.37	-6.22	-2.46	4.66	4.15
Utilities	1.49	1.86	1.86	3.50	2.19	2.83	10.19	10.06
Dow Jones Industrial Avg.	0.69	4.83	4.83	5.80	4.07	18.75	15.67	13.11
Wilshire 5000 (Full Cap)	-0.30	3.28	3.28	6.96	6.77	16.46	12.08	12.65
MSCI EAFE	0.48	2.46	2.46	-1.07	-0.36	6.40	5.03	5.86
MSCI EM	0.71	2.20	2.20	-5.52	-4.61	4.36	8.94	5.25
MSCI Frontier Markets	0.30	3.67	3.67	-9.22	-7.60	3.25	4.41	4.25
MSCI ACWI	0.18	3.02	3.02	2.59	2.57	10.97	8.95	9.04
MSCI ACWI Ex USA	0.60	2.39	2.39	-1.85	-1.46	5.94	5.99	5.59
MSCI AC Asia Ex Japan	0.46	0.84	0.84	-5.27	-3.96	5.20	9.69	7.97

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	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
MSCI Brazil	-0.38	11.82	11.82	-14.27	-7.51	0.45	11.76	-0.01
MSCI BRIC	-0.42	1.14	1.14	-5.19	-3.55	7.73	10.16	7.01
MSCI China	-1.58	-2.49	-2.49	-5.89	-4.20	8.56	10.29	10.65
MSCI Europe	0.83	3.33	3.33	-0.73	-0.01	5.63	4.29	5.40
MSCI India	2.41	6.51	6.51	1.69	-1.49	5.30	6.95	11.00
MSCI Japan	-0.54	0.40	0.40	-3.09	-1.63	8.75	6.22	7.33
MSCI EM Latin America	0.28	9.22	9.22	-9.01	-2.96	0.71	8.15	-0.45
MSCI Russia	2.97	3.95	3.95	5.51	6.82	25.80	14.60	1.43
Barclays U.S. Aggregate	0.07	0.02	0.02	0.61	-1.59	-0.80	1.49	2.25
ICE BofAML US 3M Trsy Bill	0.04	0.16	0.16	0.48	0.97	1.43	0.73	0.45
Barclays U.S. Gov't	-0.02	-0.41	-0.41	0.49	-1.46	-1.20	0.61	1.41
Barclays U.S. Credit	0.27	0.72	0.72	0.75	-2.29	-0.66	2.89	3.37
Barclays High Yield Corp.	0.36	1.09	1.09	1.47	1.25	2.60	6.12	5.35
Barclays Municipal	-0.04	0.24	0.24	1.48	-0.01	0.99	2.69	3.76
Barclays TIPS	0.15	-0.48	-0.48	0.34	-0.51	1.17	1.69	1.43
Barclays Gbl Agg Ex USD	-0.24	-0.36	-0.36	-2.91	-1.67	-0.27	3.15	0.40
Barclays Global Aggregate	-0.10	-0.17	-0.17	-1.36	-1.62	-0.48	2.45	1.21
JPM EMBI Global Div	0.63	2.55	2.55	0.38	-2.81	0.07	5.34	5.43
Alerian MLP	2.43	6.58	6.58	10.23	5.91	0.40	-2.85	-2.77
Bloomberg Commodity	1.61	-2.13	-2.13	-4.22	-2.14	2.73	-1.61	-7.06
FTSE NAREIT Equity REIT	1.80	0.80	0.80	9.35	1.83	3.07	6.39	8.28
S&P Global Natural Res.	1.89	1.05	1.05	1.48	4.79	19.03	12.55	5.18
S&P N. Amer Natural Res.	1.84	1.08	1.08	5.04	6.43	16.98	6.97	0.81

Sources: Department of Labor, Department of Commerce, National Federation of Independent Business, National Bureau of Statistics in China

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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