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Economic Update

December 25, 2017

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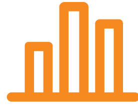
This weekly update provides a snapshot of changes in the economy and markets and their implications for investors.



Growth

Economic growth in 3Q17 was revised slightly lower in the final estimate, hitting an annualized rate of 3.2% and registering the fastest growth rate since 2014. Consumer spending was revised down slightly to 2.2% from 2.3% in the quarter, a solid pace despite likely being suppressed by the recent hurricanes. Equipment spending was the bright spot in the revision, improving to 10.8% from 10.4%, indicating that businesses continue to increase capex spending. Inventories were revised slightly lower, though export growth contributed positively to growth. We expect economic growth to remain robust in the last quarter of the year, supported by hurricane rebuilding, and some fiscal stimulus could sustain strong growth for the first half of 2018 before a second-half slowdown.

Jobs

The November employment report showed that the U.S. economy added 228,000 jobs last month, and was accompanied by a downward revision to last month's number. The unemployment rate and participation rate remained at 4.1% and 62.7%, respectively. Wage growth picked up slightly last month as production and nonsupervisory wage growth accelerated to 2.3% y/y. The November payroll gains show that the labor market continues to remain tight.

Profits

With 473 companies having reported (97.0% of market cap), our current estimate for 3Q17 is $31.40 ($26.13 ex-financials). 74% of companies that have reported beat earnings expectations, and we saw particular strength in revenue growth this quarter, with revenue surprises ex-financials jumping to 1.3%, far above what we've seen in previous quarters of just about 0.5%. While 9.4% growth was slower than the 20% and 19% we saw in the first and second quarter, this slower pace is mostly due to stronger comparisons as the year has progressed rather than any weakness.

Inflation

November inflation data was a bit mixed. Headline CPI rose to 2.2% y/y on the back of higher gasoline prices, yet the core measure (less food and energy) cooled to 1.7% y/y, which can be attributed to a sharp decline in apparel and a small decline in housing. However, some signs of future inflation appear positive through producer prices, which rose 3.1% y/y. Importantly, the Fed expects inflation to stabilize at its 2% target over the medium term, indicating current low readings should not take its rate hiking schedule off course.

Rates

The Federal Reserve announced last week that it was raising the federal funds rate by 25 bps to a range of 1.25% - 1.50%. Economic projections for 2018 showed real GDP was revised up to 2.5% and unemployment down to 3.9%. Fed funds rate projections indicate three rate hikes next year, in line with expectations. It also announced the continuation of the gradual reduction of the balance sheet. As outlined at the previous conference, the cap will increase to $20 billion from $10 billion, effective in January. Investors should note, there will be a changing of the guard next year with several voting members rotating out and a new chair. We believe the composition of this new committee may be slightly more hawkish than the current Board.

Risks

- Danger of extensive fiscal stimulus in a full employment economy could lead to overheating.
- Elevated asset prices, and valuations continue to rise in a low-rate environment.
- Weak demographics could negatively impact labor force growth in the future.

Investment Themes

- Increasing earnings growth, coupled with slowly rising interest rates, still make stocks look attractive in relative terms.
- High yield bonds look more attractive than Treasuries, but a diversified approach to fixed income investing seems appropriate given Fed tightening.
- International exposure is warranted given growth prospects abroad, and a weaker dollar can enhance foreign returns.

■ Denotes updated information

Data are as of December 25, 2017

Past performance does not guarantee future results.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

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