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Economic Update

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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 was adjusted one-tenth of a percentage lower to 2.5% q/q in the fourth quarter according to the second estimate. Consumer spending was unchanged at a healthy 3.8%. Residential investment was adjusted higher to 13.1% from 11.6%, while slowing inventory build and nonresidential investment dragged on growth. We expect economic growth to pick up in the first half of 2018, supported by fiscal stimulus, before a second-half slowdown.

Jobs

The February employment report was extremely strong, with payroll gains of 313,000 almost 100,000 higher than the consensus estimate. In addition, the prior two months were revised upward by 54,000. The unemployment rate stayed flat at 4.1% despite strong payroll gains thanks to a surge in the participation rate, up to 63.0%. Wage growth increased 2.5% y/y for production and non-supervisory workers, faster than last month, and total private wage growth figures were revised down for January and healthy at 2.6% y/y for February. Last month's report confirms that the labor market continues to tighten, a reality that will likely limit U.S. economic growth past 2019.

Profits

With 485 companies having reported (98.8% of market cap), our current estimate for 4Q17 is $33.86 ($28.15 ex-financials). This represents a 21.4% y/y growth rate, with strength in energy, materials, technology and industrials, while telecom and real estate have struggled. So far 75% of companies have beat on earnings and 67% have beat on revenue. 2018 earnings estimates have risen from $149.70 to $158.00 since the beginning of the quarter. Although analyst estimates have historically been optimistic, strong economic fundamentals and the impact of tax reform should support double-digit earnings growth this year.

Inflation

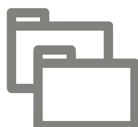
February inflation data were unexciting, with headline CPI up slightly to 2.2% y/y and the core measure (less food and energy) flat at 1.8% y/y. By contrast, PCE data showed signs of gradual firming inflation, with the month-over-month headline and core measures up 0.4% and 0.3%, respectively, in January. However, this still wasn't enough to move the year-over-year readings, which stayed steady at 1.7% and 1.5%, respectively. These results are in line with the Fed's outlook that inflation should gradually move upward toward its 2% target this year. We believe this will keep the Fed on track for 3-4 rate hikes in 2018.

Rates

As largely expected, the Fed left rates unchanged at its meeting in January, the last with Chair Yellen at the helm. Economic projections were not updated at this meeting and still show real GDP at 2.5% and unemployment at 3.9% for 2018. Fed funds rate projections indicate three rate hikes this year, in line with expectations, as well as the continuation of the gradual reduction of the balance sheet. As outlined at the September conference, the cap increased to $20 billion from $10 billion this quarter. Investors should note that there will be a changing of the guard this 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 are pressured if rates move materially higher.
- 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 March 19, 2018

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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