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MARKET INSIGHTS

Economic Update

May 22, 2017

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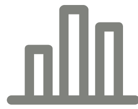
This weekly update provides a snapshot of changes in the economy and markets and their implications for investors.



Growth

The first estimate of 1Q GDP showed that the U.S. economy grew at a lower-than-expected pace of 0.7% in the first three months of the year. A pullback in the acceleration of consumption was a main cause of slower growth, with consumption contributing only 0.2% to growth, compared to 2.4% in the previous quarter. Strength in residential and nonresidential growth boosted GDP, and is an encouraging sign considering investment spending may indicate expectations for better growth in the future. We expect moderate GDP growth going forward in 2017.

Jobs

The April employment report showed that the U.S. economy added 211,000 jobs last month, surprising to the upside on the heels of a sub-trend reading in March. The unemployment rate fell to 4.4%, continuing a longer-term trend of tightening in the labor market. The lower rate seems to have been driven largely by a small drop in the participation rate, as demographic forces led the recent surge in participation to fade, but broadly speaking, April's report points to a labor market that has reached full employment.

Profits

1Q17 earnings season is coming to an end. With nearly 95% of market cap having reported, our model is currently tracking 20.8% y/y EPS growth, or 12.1% ex-energy. The energy, materials, technology and financial sectors are all exhibiting strong earnings growth. Currently, earnings surprises ex-financials are the highest we have seen since 1Q15, and revenue surprises ex-financials are the highest we have seen since 4Q14. We are currently seeing the highest percentage of revenue beats since 4Q13, showing that companies this quarter have been able to generate EPS growth from revenue growth and not by simply cutting costs.

Inflation

Inflationary pressures are subsiding in the U.S., and with headline CPI up slightly in April, the y/y number fell to 2.2%. Core CPI rose slower, down to 1.9% y/y. Energy prices rose 1.1% for the month, reversing last month's headwind. Additionally, the Federal Reserve's (Fed) preferred measure of inflation, the Personal Consumption Expenditure (PCE) deflator, decreased to 1.8% y/y in March, but is still running close to its 2% target.

Rates

In a widely anticipated move, the Federal Open Market Committee (FOMC) decided to maintain the target federal funds rate at the current range of 0.75% to 1.00% at its May meeting. While the Committee has noted continued strength in the labor market for some time now, it views the slowing growth in economic activity over the first quarter as a transitory event. Both the unemployment rate and inflation are near their long-term projections, and if economic activity can reclaim its path of moderate growth, we expect further interest rate increases at each press conference meeting in 2017.

Risks

- Reflationary policies steepen the path of Fed rate hikes.
- Volatility caused by unpredictability of U.S. president with no political track record.
- Low productivity growth in the U.S. suggests overstaffing by businesses.
- Concerns about a slowing Chinese economy resurface and impact emerging markets.

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.
- Despite disappointing returns due to a stronger dollar, international exposure is still warranted given growth prospects abroad.

■ Denotes updated information

Data are as of May 22, 2017

Past performance does not guarantee future results.

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

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index. Indexes are unmanaged.

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