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

The second estimate of 1Q18 economic growth came in at 2.2% q/q, in line with consensus estimates but easing from last quarter's strength. Consumer spending continued to rise, though at a subdued pace, posting a 1.0% gain, mostly on strength in services. Business spending contributed too, with nonresidential gross private domestic investment rising 9.2%. Net exports were also a welcome positive. We expect economic growth to pick up throughout 2018, supported by fiscal stimulus, before a slowdown in the second half of 2019.

Jobs

The May employment report was strong with nonfarm payroll gains of 223,000, slightly stronger than consensus estimates. The unemployment rate fell to 3.8%, while the participation rate fell slightly to 62.7%. Wage growth increased 2.8% y/y for production and non-supervisory workers and 2.7% for total private workers in May. In addition, the spread between job openings and the number of unemployed persons widened in the latest JOLTS report. All of this confirms that the labor market continues to tighten and highlighted the growing difficulty in finding skilled workers, but should serve as a reminder that the economy is growing solidly rather than booming.

Profits

The bulk of the 1Q18 earnings season is now behind us. With 501 companies having reported (99.9% of market cap), our current estimate for 1Q18 earnings is $36.68 ($29.97 ex-financials). This represents a 27.3% y/y growth rate, with strength in energy, financials, industrials, technology and telecom. Earnings surprises, a measure of by how much companies beat earnings estimates, remain at all-time highs. This, combined with strong economic fundamentals and the impact of tax reform, should support double-digit earnings growth this year.

Inflation

Headline April inflation data were in line with expectations while core data missed, with headline CPI up to 2.5% y/y and core flat at 2.1% y/y. We continue to believe that inflation will rise gradually this year as the labor market continues to tighten. April PCE data also showed signs of stable prices, with the y/y headline and core measures up 2.0% and 1.8%, respectively. These results are in line with the Fed's outlook that inflation should gradually move upward toward its 2% target this year and should keep the Fed on track for 3-4 rate hikes in 2018.

Rates

As expected, the Federal Reserve left interest rates unchanged at a range of 1.50% to 1.75%. Economic projections were not updated for this non-press conference meeting, but Fed officials acknowledged that inflation is closer to target and did not indicate any change in their adherence to their gradual tightening of policy; the Fed still expects three rate hikes in 2018 and 2019. With interest rates set to continue rising on the back of firmer inflation and stronger growth, bonds will face continued headwinds, and investors will need to be more selective in fixed income investing.

Risks

- Danger of extensive fiscal stimulus in a full employment economy could lead to overheating.
- Elevated asset prices and valuations are pressured as 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 June 11, 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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