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# Economic Update

June 19, 2017

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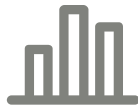
This weekly update provides a snapshot of changes in the economy and markets and their implications for investors.



## Growth

The second estimate of 1Q GDP showed that the U.S. economy grew at a faster-than-expected pace of 1.2% in the first three months of the year. An unexpected gain in consumption growth, which doubled, was a main driver of the upward revision, contributing 0.6% to growth (though this still compares unfavorably 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 May employment report showed that the U.S. economy added 138,000 jobs last month, surprising to the downside. The three-month average job gains is the slowest pace in nearly 5 years. On the bright side, the unemployment rate fell to 4.3%, continuing a longer-term trend of tightening in the labor market. The lower rate seems to have been driven by a small drop in the participation rate, as demographic forces led the recent surge in participation to fade, but broadly speaking, May’s report points to a labor market that has reached full employment.

## Profits

1Q17 earnings season is coming to an end. With over 99% of market cap having reported, our model is currently tracking 20.5% y/y EPS growth, or 11.8% 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 down slightly in May, the y/y number fell to 1.9%. Core CPI rose slower, down to 1.7% y/y. Energy prices fell substantially, down -2.7% for the month, reversing last month's gain, while food prices rose slightly, +0.2% m/m. Additionally, the Federal Reserve's (Fed) preferred measure of inflation, the Personal Consumption Expenditure (PCE) deflator, decreased to 1.7% y/y in April. Core PCE also decreased to 1.5% y/y, which is the lowest rate since December 2015.

## Rates

In a widely anticipated move, the Federal Open Market Committee (FOMC) decided to raise the target federal funds rate 25 basis points to 1.00%-1.25% at its June meeting. The Committee views the recent slowing growth in economic activity as a transitory event, and left most long-run targets unchanged. The FOMC also detailed a plan for balance sheet reduction, which should begin before the end of the year. We expect one additional interest rate increase 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 June 19, 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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