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 final estimate of 1Q18 economic growth came in at 2.0% q/q annualized, slightly below consensus. Monthly data on retail sales, homebuilding, durable goods, international trade and inventories point to a rebound to north of 4% growth annualized in 2Q, boosting year-over-year real GDP growth to 3.0%+. We expect growth to maintain this solid pace over the next few quarters before slowing in the second half of 2019, reflecting fading fiscal stimulus and higher interest rates.

Jobs

In June, the unemployment rate rose to 4.0% due to a 601,000 increase in the civilian labor force rather than job losses. In addition, 213,000 new payroll jobs were added and the prior two months were revised upward by 37,000 jobs. Average hourly earnings for production and non-supervisory workers rose 2.7% year-over-year , slightly down from the initially reported 2.8% for May. On balance, the employment report showed continued labor market strength . As strong consumer demand clashes with weak labor demographics, this should lead to wage growth acceleration, rising labor force participation and productivity growth and , eventually, slowing economic growth.

Profits

The 1Q18 earnings season is now behind us with S&P500 operating earnings per share coming in at $36.43, up 26.4% y/y, with strength in energy, financials, industrials, technology and telecom. Earnings surprises were very strong and analysts now expect earnings growth of 26.5% for 2018 as a whole and 10.9% for 2019. The former forecast looks realistic given the very beneficial impacts of tax reform. However, moderating economic growth, combined with higher wages and interest rates, makes the 2019 forecast look very optimistic.

Inflation

Both headline and core May inflation data were in line with expectations, with headline CPI up 2.8% y/y and core up 2.2% y/y. Both figures were higher than April's numbers, continuing a gradual trend of rising inflation. In addition, the Fed's preferred inflation measure, PCE, rose 2.3% y/y with core PCE rising 2.0% y/y. The Fed acknowledged rising prices by increasing its inflation outlook for 2018 and 2019, which further supports the backdrop for two additional hikes this year and three next year.

Rates

As expected, the Federal Reserve raised its target for the federal funds rate to a range of 1.75%-2.00% at its June meeting. Both the language in its statement and economic projections were slightly more hawkish than in previous meetings. The committee raised both economic growth and inflation forecasts and cut the unemployment rate forecast for this year and next. In addition, the slightly more hawkish view was enough to increase the median forecast to four rate hikes in 2018 and maintain its March forecast of three in 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

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