Market & Economic Update

***Week of:* June 19, 2017**

CURRENT ECONOMIC EVENTS

Economic data for the past few weeks has been disappointing relative to consensus economist forecasts. However, the Federal Reserve (Fed) still believes the economy has sufficient momentum and decided to raise interest rates at last week's meeting. In our view, we believe economic growth remains on a path of modest expansion. Investor hopes of a quick implementation of pro-growth legislation have generally been dashed. Congress noted that tax reform legislation is now unlikely, perhaps until early 2018, for example.

- The U.S. economy is in the later stages of the recent expansion, especially when viewed through the lens of jobs market data. The unemployment rate is quite low, payroll growth is moderating and measures of "underemployment" have reached pre-financial crisis averages. Of recent concern is a slowdown in inflation, particularly with wage growth remaining modest. In our view, the recent slowdown in inflation is likely to be transitory, with the tight labor market ultimately leading to improving wage inflation this year.
- Loan growth is slowing, with Fed surveys indicating commercial real estate lending is particularly tight. This is one factor we are watching closely as a sign of a deceleration in growth. Recent sentiment surveys have also softened, but remain consistent with our slow growth story.

Central banks in Europe, Japan and the United Kingdom have maintained their accommodative monetary policy in contrast to the Fed. Economic data across Europe, Japan and the United Kingdom have been improving and we expect growth to remain a positive for these economies.

- Europe has been especially strong, with improving manufacturing data and solid sentiment trends. Of particular support to market sentiment, we would note the successful sale of the failed Banco Popular to Banco Santander, a test of new European Central Bank (ECB) policies to wrap up failing banks.
- Data in Japan has also been improving, with the Bank of Japan (BOJ) maintaining its accommodative stance. The United Kingdom has also been resilient, despite significant uncertainties around Brexit, especially since negotiations with the European Union (EU) are starting this week. We expect growth in Europe and Japan to remain positives for the global economic backdrop. U.K. growth is likely to stumble eventually, due to the uncertainties from Brexit. However, currency weakness will provide some offset by making exports more competitive.

Contributed by: Robert L. Haworth, CFA – Senior Investment Strategist

EQUITY MARKETS

A Goldilocks-like economic environment, still accommodative monetary policy, ongoing political uncertainty, improving corporate profits and disruptive technologies are all among items impacting equity prices. On balance, we continue to believe equities will grind higher into year-end 2017 as earnings trend upwards, absent a looming recession and widespread inflation. Near term, we expect equities to trend generally sideways into midyear and until the release of second quarter results, beginning in mid-July. Our published year-end 2017 price target for the S&P 500 is 2,475, based on a multiple of 19 times our 2017 earnings estimate of $130. Upside is contingent on better-than-expected earnings growth, potentially bolstered by improving global economic conditions and the magnitude and timing of legislative actions.

- Broad market equity performance continues to trend above expectations year to date, led by international companies, large companies and both growth/cyclical and defensive sectors. Information Technology, Healthcare, Utilities and Consumer Discretionary sectors are up over 10 percent, as of last Friday's close. Energy and Telecom Services are the two sectors in negative territory. Favorable broad-based returns are typically indicative of a market that is poised to trend higher.
- The global economy continues to improve at a measured pace, with little evidence of ramping inflation providing support to current valuation levels while earnings are increasing year over year. As of June 19, consensus is for 2017 earnings growth of roughly 10 percent over year-ago levels, according to FactSet. Stocks typically trend higher in an environment of synchronized global growth and rising earnings.
- Technically, a rotation appears to be occurring within but not out of equities. The S&P 500 remains near all-time highs, with the S&P 500 closing last Friday at 2,433.15, fractionally off of all-time highs of 2,440.35.
  - The growth-oriented technology stocks have been under pressure over the past couple of weeks over concerns that they represent a "crowded trade," thus subject to near-term profit taking as memories of the dot-com bust have been rekindled. We continue to believe price weakness surrounding information technology companies represents a "buy-the-dips" opportunity, based on favorable growth and valuation metrics.
  - Disruptive technologies continue to impact equity prices and investor sentiment, evidenced by Amazon's dominance in the e-commerce space. Amazon is innovative and disruptive. In fact, it is hard to find a retail segment that Amazon does not touch. Most recently, the grocery industry is being upended following the June 16 announcement of Amazon's intent to purchase Whole Foods (WFM). Amazon's ability to leverage its e-commerce platform with its online grocery business has investors worried about other grocers.

Contributed by: Terry D. Sandven – Chief Equity Strategist

FIXED INCOME MARKETS

Bond yields fell last week as inflation continues to disappoint to the downside. Consumer Price Index (CPI) data came in lower than expected, with year-over-year figures lower than previous month readings. This pushed bond yields lower in spite of the Fed's 0.25 percent increase to their target fed funds rate, which now stands at 1.00 percent to 1.25 percent. The two-year benchmark U.S. Treasury rate fell to 1.32 percent and the 10-year benchmark rate fell to 2.15 percent. Yields are slightly higher to start this week.

The Fed meeting last week resulted in three key items of note, none of which came as a material surprise to markets, but which combined to set a slightly hawkish tone. First, the Fed increased their benchmark rate by 0.25 percent as planned and left their longer-term expectations for their target rate little changed. Second, the Fed emphasized the importance of inflation, yet during the press conference, Chair Janet Yellen warned against putting too much weight on a small handful of data points. Markets interpreted this as a hawkish signal that low inflation data of late would need to persist for some time before impacting the Fed's plans. Third, the Fed made it clear that they plan to commence reducing the size of their balance sheet this year and provided additional details as to how they would go about doing so. A number of Fed speakers will be in the media this week, but the clear message from the Fed is that for the time being, they are undeterred by low inflation data that, until further notice, they will interpret as transitory.

The combination of lower rates, lower inflation and a tightening Fed are sources of concern for many investors fearing the Fed may make a policy error via over tightening. This concern is contributing to the persistence of low interest rates across the yield curve. Our base case is for inflation to trend higher, allowing the Fed to proceed largely as planned with their projected interest rate hikes and gradual balance sheet runoff. This outlook, combined with our anticipation for continued gradual economic expansion and currently unattractive risk/reward metrics in high quality bonds is the basis for our underweight to fixed income. However, the primary risk to this view is that inflation continues to remain dormant, which could serve to either limit the Fed's ability to normalize interest rates, or which could risk the Fed increasing rates too much despite low inflation, putting the economic expansion at risk. For the time being, we remain underweight fixed income, with a slight preference for incurring modest credit risk to supplement potential returns.

Contributed by: William J. Merz, CFA – Portfolio Strategist

COMMODITIES MARKETS

Commodities remained under pressure, with the U.S. dollar stronger in the wake of the Fed rate hike and among strong supply data. U.S. oil prices neared the lowest levels of the year, with total petroleum stocks, oil production and oil rig usage continuing to grow. Also dampening the market was news from OPEC that production grew, driven by a return of production from Nigeria and Libya. Oil prices and commodities, in general, are likely to remain under pressure in the near term, particularly with the return of a stronger U.S. dollar. Markets remain well supplied but lower prices should provide some pressure to production, which should limit the magnitude of losses over the next quarter. We remain cautious on commodity index investments reflecting headwinds from market structure, the U.S. dollar and modest global economic growth.

Contributed by: Robert L. Haworth, CFA – Senior Investment Strategist