Quarterly Economic Update

June 15, 2018

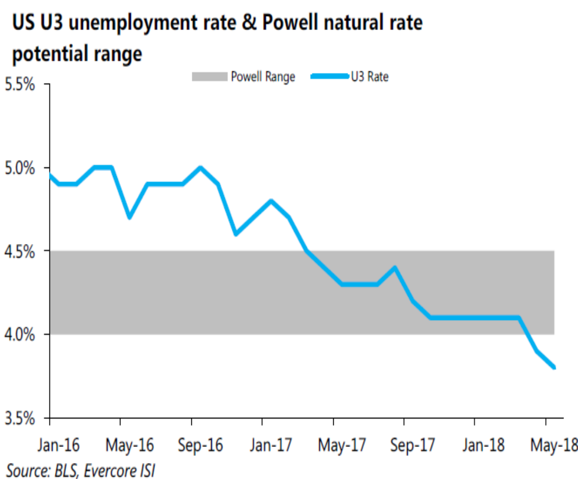
MACROECONOMIC COMMENTARY

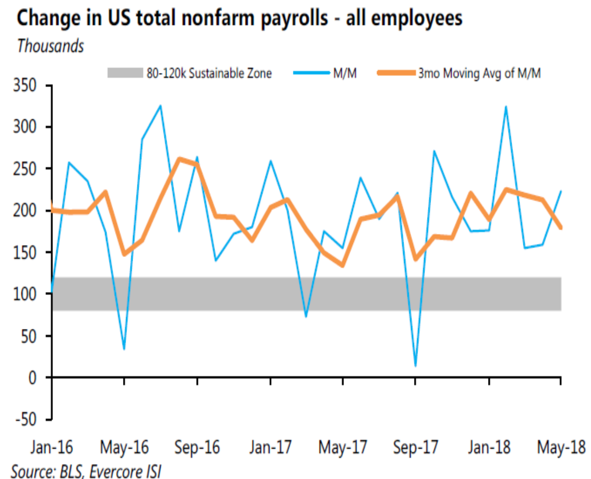
Monetary Policy

By Bobby Long

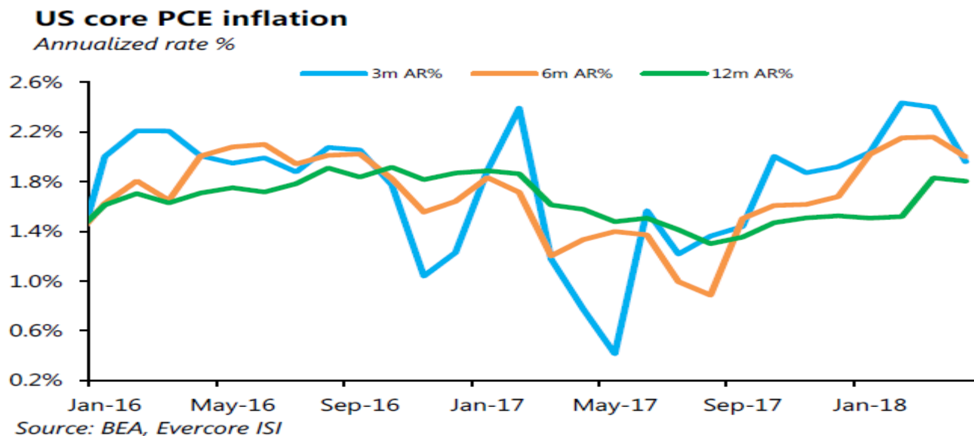
At their March meeting, the Federal Open Market Committee (FOMC) raised their target range for the federal funds rate to 1 ½ - 1 ¾ percent. After leaving the rate unchanged following their May meeting, they are now expected to increase the rate again at the June 13th meeting. Market expectations indicate a 100% implied probability of an increase at the upcoming meeting, with another quarter percent increase most likely. This would move the target range for the federal funds rate to 1 ¾ - 2 percent. Overall, economic activity and labor markets have continued to improve and inflation has been firming up closer to their 2% objective. These conditions have provided a clear path for the FOMC to move forward with increasing the federal funds rate further as they normalize monetary policy following a long period of accommodation.

At the May meeting, FOMC participants agreed that economic activity has continued to improve at a moderate rate and the minutes reflected their view that "a number of economic fundamentals were currently supporting continued above-trend economic growth." Labor market conditions have strengthened further, with the unemployment rate falling further and payrolls remaining strong. As the charts below exhibit, the unemployment rate has now fallen to 3.8%, which is below what is viewed as the longer term natural range for the rate. With economic growth running above-trend, it is expected that this rate will continue to run below the natural rate. If it continues to fall significantly further, it could warrant some FOMC participants to advocate for tighter policy. Nonfarm payrolls have paced above what is viewed as the longer-term sustainable range. By keeping policy accommodative to allow labor markets to run stronger than the longer-term sustainable trends, participants may be looking to support wages and labor participation rates, two components of labor conditions where improvements have been lagging.





Inflation has been providing cover for keeping policy accommodative and taking a gradual approach to normalizing policy. FOMC members have been concerned with inflation running persistently below their 2% objective despite accommodative policy and improving economic growth and labor conditions. Inflationary measures have shown improvement more recently and FOMC members seem to be more confident that it is moving towards their 2% objective on a sustained basis. The chart below shows how more recent readings have moved up and are now leading the measure on a 12-month annualized rate towards their objective.

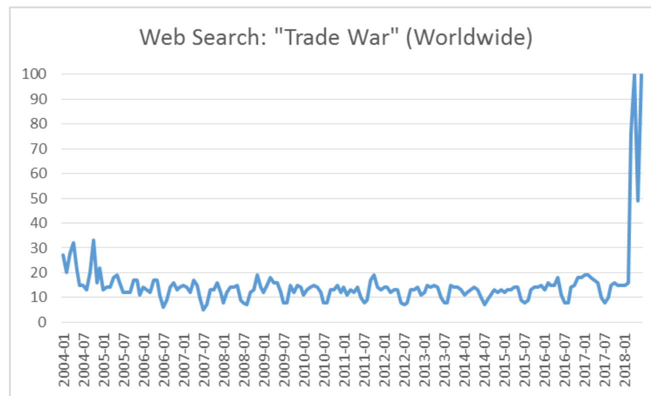


There has been a good amount of discussion that inflation may run slightly above their 2% objective for a while and that a symmetrical goal of 2% on a sustained basis may be appropriate given the extended period of lower inflation over the past several years. Inflation has remained stubbornly low despite the extraordinary amount of accommodation and there remain structural deflationary forces that are likely to persist. Allowing inflation to run slightly above their objective may ensure that the objective is met on a sustained basis and also help anchor longer-run inflation expectations that while stable, have drifted moderately lower.

Federal Reserve Chairman Jerome Powell and FOMC members continue to view risk to their economic outlook as roughly balanced and that a gradual approach to removing accommodation and raising the federal funds rate remains appropriate. FOMC participants' past projections have forecast the median longer-run neutral federal funds rate at 2.9 percent. There has been some discussion that this rate may be too high and that the current neutral rate may be lower than current estimates of its longer-run level. If this is the case, the federal funds rate may begin approaching the neutral rate sooner rather than later if they continue to raise the rate at the current pace. Market expectations have continued to fluctuate between whether the FOMC will hike rates three or four times during the calendar year, and Chairman Powell has sought to preserve the flexibility to implement policy as economic conditions dictate. Recent monetary policy actions have been implemented with the intent of removing accommodation to a neutral level as economic conditions have improved. If the FOMC more aggressively pushed rates higher above the neutral rate, it would represent a shift in policy to a tighter stance. For now, they continue the approach to cautiously normalize policy toward the neutral rate.

Fiscal Policy

By Michael McNair



The chart above tells us that worldwide internet searches for the term "trade war" is almost 500% higher than at any point since the data began in 2004.

It is widely assumed that President Trump is the cause of the spike in interest around trade wars. Yet this explanation is wholly incomplete and fails to understand the true cause for the rise of protectionism in the United States. This myopic view has caused the consensus to underestimate the sustainability of protectionism in this country. President Trump is not the cause of protectionism in the United States, he is the result.

In 2010 we wrote, "The Coming Trade Wars", a paper which laid out our firm belief that the current global trading system was unsustainable and that the beneficiaries of the system would resist adjustment, making trade wars the inevitable conclusion. Since that time we have resisted writing about the global trading system and the balance of payments, despite it being our central area of focus within economics, due to our concerns about being able to explain the subject within the confines of a publication like the *Fiscal Policy Report*. The reason for our hesitation is that the subject is complicated, details mind-numbing, and the prevailing understanding of the topic, both on Main Street and Wall Street, is highly distorted. In fact, there is no other subject within finance or economics that we believe is more widely misunderstood than global trade and capital flows (especially among Wall Street Economists).

Trade is now dominating financial news and we believe protectionism will be the defining fiscal policy issue of the next decade. Further, we believe the analysis of the issue is deeply flawed and confused. Therefore, despite our reservations, the *Fiscal Policy Report* has decided to examine the "Trade" topic. Over the next several quarters we discuss a number of topics on trade. This edition we will set the ground work for our future discussions by explaining the history of our current trading system and explain how its flawed structure has led to the current trade wars.

The Balance of Payments

Most analysts attempt to analyze trade issues looking only at the first order effects. However, the global trading and monetary system is complex and policies will almost always have second order impacts. Therefore, when analyzing trade it is essential to understand the balance of payments impacts - how trade policies impact capital flows and vice versa - so that we ensure our analysis is internally consistent.

The balance of payments is a bookkeeping system that divides a country's transactions into the current account and the capital account. To prevent confusion we will refer to the current account as the trade account from here on out; however, it should be noted that the current account differs slightly from trade account – a fact we can ignore. The trade account measures whether a country is running a trade surplus or deficit. The capital account measures transactions of financial instruments (stocks, bonds, etc…) and central bank reserves.

Capital account = trade account*

The above equation tells us that the capital and trade account must always balance. Further, if a country is running a trade deficit then it must run an exactly equivalent capital account SURPLUS and vice versa. In this case, a country running a trade deficit (net importing goods and services) must import capital (capital surplus) to pay for the net imports.

Bretton Woods

The current rise in protectionist policies is not a fad that will soon die down. This is the begging of the end of the current monetary and trading system. From the beginning, the current system was always unsustainable and anything that is unsustainable will end.

The history of our current trading regime begins in the economic chaos following the Great Depression and World War of the 1930s and 40s. One of the results of the Great Wars was the creation of considerable capital and trade imbalance (the destruction of manufacturing capacity and increased war investment caused large and persistent trade deficits among the European belligerents).

In 1944, the Allies met at Bretton Woods in New Hampshire in order to design a new global monetary and trade system to rectify these global imbalances. The American representative, Henry Dexter White (who was later revealed to be a Soviet operative), proposed a system that would replace the gold standard with a system that set countries exchange rates relative to the US dollar – with only the dollar pegged to gold. This agreement would see the US dollar replace gold as the world's new reserve currency.

John Maynard Keynes opposed this new system, instead proposing the Bancor, because he believed the system needed mechanisms to prevent countries from running persistent trade surpluses or deficits. Keynes understood that without

these mechanisms countries could game the system by implementing policies that benefited their domestic economy at the expense of the global system. Specifically, countries could reduce domestic unemployment by exporting capital, which would be matched by an equivalent increase in net exports (because the capital account = trade account) – in effect taking global demand from the rest of the world.

Unfortunately, Keynes' concerns were ignored and his proposal was rejected in favor of White's system, based on the US dollar as the global reserve currency.

Throughout the preceding decades, Keynes' concerns would prove prescient, as countries would game the system at the expense of their trading partners. The most infamous example began in late 1960's when countries, led by the French, took advantage of US dollar overvaluation in order to buy as much American gold as they could, at an undervalued price (the price agreed upon in the original Bretton Woods framework). These actions nearly caused the global trading and monetary system to collapse. Rather than scrapping the entire system, President Nixon saved it by reneging on the US' Bretton Woods commitment to convert dollars into gold. The US then implemented a series of ad hoc agreements in which Japan and Europe took steps to reduce their trade imbalance by increasing the value of their currencies relative to the dollar.

Nixon taking the US off of Gold in 1971 stopped one way in which countries could game the system but it did not prevent countries from doing so in more subtle, yet equally effective, ways.

The Ultimate Beggar they Neighbor Policy

Keynes foresaw how countries domestic imbalances could cause global imbalances. In order to explain how domestic policies are distorting the ability of the current global trade and monetary system to prevent trade imbalances, we will examine the case of China - who has run a persistent trade surplus for over 30 years - and the US - who has run persistent trade deficits for over 50 years.
First, we need two more accounting identifies to explain why a country runs a trade surplus or deficit.

trade account balance* = savings - investment

trade account balance = (production - consumption) - investment

The above equations tell us that if a country produces more than it consumes and invests it must run a trade surplus and export the excess production. The equation also tells us that a country will run a trade surplus only if savings exceed investment.

In our 2015 report, "The Chinese Economy and the Path to Rebalancing", we explained that China's investment growth model is a set of policies that implicitly tax domestic consumption and subsidize production. As a result of these taxes and subsidies, the Chinese economy creates far more production than it consumes. The size of China's trade surplus became historically unprecedented. Before the start of the financial crisis, China had the highest trade surplus, as a percent of global GDP, ever recorded. This has important implications for the rest of the world because China's excess production must be exported to foreigners for consumption. Further, as China grew over the last several decades, the larger gap between their production and their consumption became and the more the rest of the world had to consume.

Globally, consumption accounts for 65% of GDP. In the US consumption accounts for 72% of GDP, most European countries are in the 60 - 65% range, while consumption accounts for 65 – 70% for most developing countries outside of Asia. At the start of the economic reforms in the 1980s, consumption in China was already very low at 52% of GDP. However, as China began implementing the reforms that suppressed household income and subsidized investment, the consumption share of China's economy dipped to an alarming 46% of GDP by the late 90s, eventually reaching a staggering 34% in 2011. This is the lowest level ever recorded in any economy, let alone in an economy as large as China's.

If China runs a trade surplus, by definition, an equal trade deficit must be run outside of China. A trade surplus adds to a country's GDP, while a trade deficit subtracts from a countries GDP. When China runs a trade surplus they are capturing more than their share of global GDP, which comes at the expense of lower GDP for the rest of the world. In order for the rest of the world to absorb China's excess production (i.e. their net exports) either production outside of China has to drop, which means slower GDP growth, or consumption has to boom through an increase in debt. For most of the last decade, the US responded to China's, and other Emerging Markets', growing trade surplus - and the resulting loss of production - by easing credit standards and setting off a consumption and housing bubble. This surge in consumption kept the US economy growing despite the increasing amount of demand being lost through the trade account (i.e. US consumption of foreign goods). However, this consumer debt binge could not continue for long and it inevitably led to a financial crisis in 2008.

The balance of payments math tells us that if China runs a trade surplus they must also be a net exporter of an equivalent amount of capital (which entails accumulating foreign financial assets). The United States has been forced to bear the brunt of China's, and other countries', trade imbalance because they are the only country with deep enough financial markets to absorb the large amounts of capital and an open financial account that does not prevent countries from accumulating US assets.

Under the gold standard, a US trade deficit would have been met with a corresponding outflow of gold from the US to China. A loss of gold would be deflationary for the US while increased gold in China would be inflationary. As a

result, Chinese prices would become expensive relative to the US and cause a reversal in the trade imbalance.

The finite amount of gold a country held represented the limit on the trade imbalance. Once a country lost all its gold they were forced to run a current account surplus and accumulate gold.

In November 2010, Ben Bernanke gave one of his most important speeches, "Rebalancing the Global Recovery", in which explained how the current trading system was flawed and the persistent trade imbalances put the global economy at risk. Bernanke concluded by saying:

"As currently constituted, the international monetary system has a structural flaw: it lacks a mechanism, market based or otherwise to induce needed adjustments by surplus countries, which can result in persistent imbalances."

Under the gold standard global imbalances could not persist because the system contained a natural feedback loop to reverse the imbalances. In today's trading regime countries can resist the appreciation of their real exchange values and prevent the reversal of their trade surplus. Rather than trading gold, countries trade financial assets (mostly debt). Therefore, a trade imbalance can continue for as long as one side is willing to continue trading financial assets for goods and services.

We are not making an argument in favor of going back to the gold standard. The gold standard was a brutal system with its own set of flaws. We are only stating that the strength of the gold standard was its ability to reverse global trade imbalances in a self-organizing manner, while today's system lacks such a mechanism.

Trade Surpluses are not a Result of Domestic Virtue

President Trump's administration is making the argument that the world must reverse the persistent trade deficits that the US has been forced to run for over 50 years. It should be noted that this is not a partisan issue, as President Obama also said it was one of his top economic priorities. The reason that both President's agree on this issue is that the analysis is clear cut: persistent trade imbalances are neither healthy nor natural and only occur because of policy distortions that prevent the proper reversal of the imbalance.

The US is having problems stating their case because people mistakenly believe that trade surpluses are the result of moral superiority. Michael Pettis explains:
Countries that run large and persistent trade surpluses never seem to understand that their surpluses are mainly <u>the consequences of domestic policies that generate additional domestic growth by absorbing foreign demand</u>.

They usually insist that the surpluses are the consequences of domestic virtue, and they see no reason to give up being virtuous. Surpluses, they seem to believe, are the way God rewards them for their enviable behavior, and as their surpluses

decline – an inevitable consequence of the malaise affecting their trading counterparts – they actually try to limit the decline and prevent it from becoming a trade deficit.

But this violates simple arithmetic. Trade deficits nations have received capital inflows for many years from surplus nations as the automatic counterpart to their deficits. If the surplus nations ever hope to get repaid – i.e. reverse the capital flows – then it must be obvious that the trade imbalance must also reverse.

The Capital Account Drives the Trade Account

President Trump's administration believes that the persistent trade deficits are bad for the US economy; yet, it is obvious from their actions that they do not fully understand the problem.

From President Trump's perspective, the trade deficit is a result of bad trade deals. Thus, his attempts to rectify the situation have focused on renegotiating existing trade deals: China and the WTO, NAFTA and GATT.

What the President has failed to do is understand that the trade deficit is a structural result of the global monetary and trading system.

The trade account is not the only way an imbalance can occur. Whatever imbalance occurs in the trade account must be mirrored by the capital account. In the 1800 and early 1900s, trade finance accounted for 90% of all international transactions. As a result, the trade imbalances were usually the result of policies that distorted relative production costs between countries. Thus, policy tools aimed at reversing an imbalance were focused on the trade account and adjusting relative prices -tariffs on imported goods for example.

However, today capital flows dwarf trade flows. The daily exchange volume of foreign exchange volume is now 100x larger than the daily volume in international merchandise trade. Therefore, capital flows now dominate and it's the trade account that is forced to balance. For this reason, global imbalances are far more likely to be the result of capital flow distortions than distortions in relative production costs and trade.

President Trump's administration is viewing trade the way it was a hundred years ago. Restructuring trade deals and placing tariffs on our trading partner's exports will not reduce the US' trade deficit. Only policy prescriptions that focus on the capital account will ensure a reduction in the US trade deficit.

Fortunately, capital account policies are easier to implement than tariffs. All the US has to do is restrict foreign countries from purchasing more US financial assets than goods and services. By definition, this will reduce the US trade deficit. Further, this is a policy that most other countries in the world follow - either implicitly or explicitly.

Capital Account Distortions and Countries Gaming a Flawed Trading Regime

There are two main causes for the distortion in global capital flows that have led to persistent global imbalances. The first is a result of a deliberate strategy by certain countries to game the flawed system and the second is endemic to the system itself.

Accumulate Excess Foreign Currency Reserves

The first source of global capital flows distortions is a result of countries gaming the flawed Bretton Woods system, precisely in the way John Maynard Keynes predicted.

Foreign Currency reserves are the foreign financial assets held by central governments. In our balance of payments equation, we can break the capital account into private capital flows and government capital flows. When government capital flows out of the country they are accumulating foreign currency reserves (usually dollars – i.e. US Treasuries).

As an example, let's assume China runs a $100 billion trade surplus and a $40 billion private capital **deficit** (the private sector is investing $40 billion more outside of China than inside). In this case, government capital deficit must equal $60 billion ($100b = $40b + $60). The increase in China's foreign currency reserves is equal to the $60 billion government capital deficit.

The current global monetary and trading system requires non-reserve countries to hold some level of foreign currency reserves to settle global trade and protect their currencies from devaluation in the case of a crisis. However, the unprecedented accumulation of foreign currency reserves (mostly US dollars) over that past 20 years is orders of magnitude greater than what can be justified by for settling trade or macro-prudential reasons.

Under the current Bretton Woods system, countries can increase demand for their goods and services by exporting capital (running a capital account deficit), which results in an increase in net exports. Since a foreign currency reserve represents the government exporting capital, foreign currency reserves serve to increase net exports.

The exponential growth in countries holding foreign currency reserves is the result of a deliberate strategy by central governments to game the system and support their domestic economy at the expense of the reserve-issuing countries.

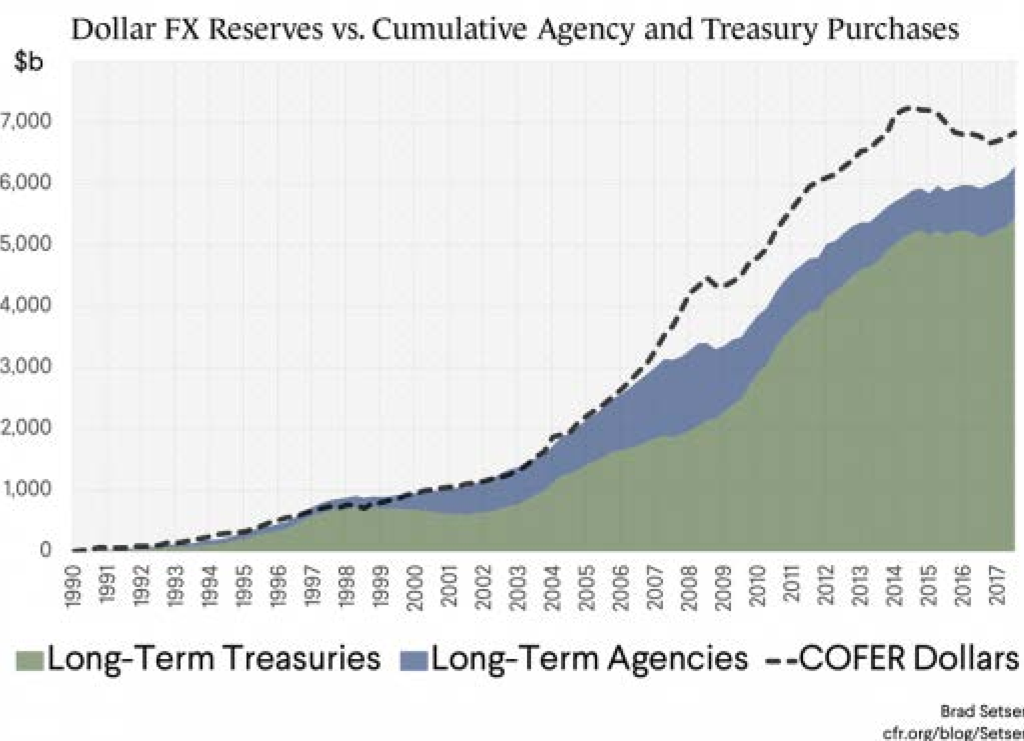
The Chinese policies to force a capital account deficit (and subsequent trade account surplus) perfectly complemented their domestic policies - policies that taxed consumption and subsidize production in order to increase the competitiveness of Chinese industry. Yet, this strategy was only possible due to the flaws in the current monetary and trade system because China was able to resist the feedback loop prevents persistent trade imbalances.

Under the gold standard, a country that runs a trade surplus would accumulate gold and rise relative prices levels which would raise the real exchange value of their currency relative to the countries running deficits and losing gold.

However, under the current system, the trade surplus countries can resist a real appreciation of their exchange rate by matching the trade surplus with an equivalent purchase of debt from the trade deficit nation. It is again to a country running a deficit and losing gold and then immediately having the trade surplus country lend them back the gold they lost.

An optimist might believe that the private investors in charge of directing capital flows, like the Retirement Systems of Alabama, will easily overcome government distortions and capital will be efficiently directed into areas with the highest expected return and capital will not be misallocated. Unfortunately, that view would be incorrect. For most of the past decade, China has actually been a net importer of capital from the private sector (i.e. private capital account surplus). Yet, China has also run enormous trade surpluses during this time. This is only possible because the public sector capital outflows have not only matched the private sector inflows but greatly surpassed them.

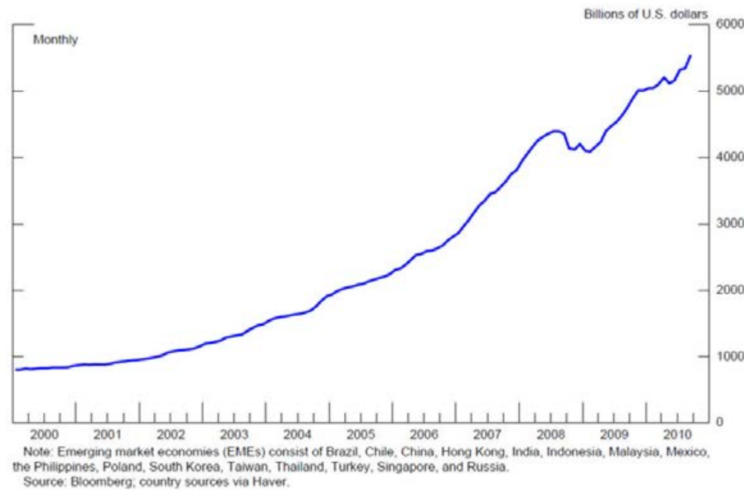
According to former US treasury department official and balance of payments expert, Brad Setser, all net demand for US government securities from 1990 to 2014 came from the world's central banks (i.e. government capital flows). Which means that foreign government's purchases of US reserves were the overwhelming cause of the US trade deficits over this period.



The disturbing problem is that when the PBOC is investing this capital into other countries they are not doing so because they believe the returns are higher, which is supposed to be the sole economic reason for determining where capital flows. Instead, their decision to increase their foreign currency reserves (i.e. buy US treasuries) is entirely driven by their desire to maintain their trade surplus.

The indiscriminate flow of capital by central governments represents one of most widespread misallocations of capital in history. It is no coincidence that the period of foreign currency reserve growth has coincided with a host of the most infamous financial bubbles in history (Japanese stock and property bubble, Tech Bubble, Global Property Bubbles). We will go into much greater detail on this subject in a future report but we must note the sheer scale of these government-driven capital flows.

China is not alone in using this strategy of using central government directed capital flows to ensure trade surpluses. In the decade ending in 2010, Emerging Market countries increased their foreign currency reserves by over 600% to over $5.5 trillion. China only comprises half of those reserves.



The Exorbitant Burden

The second major source of the capital flow distortion is a direct result of the system itself.

When the Allied Powers at Bretton Woods agreed to implement a system with the US dollar as the world's reserve currency it ensured that existence of persistent global imbalances.

The US dollar as the world's reserve currency has been called the "exorbitant privilege". The privilege is supposed to be that the US is able to borrow at interest rates below that of the rest of the world. However, this is certainly not the case today as even Greece has interest rates below the United States. Since the world moved to a fiat currency system - with domestically denominated debt and free-floating currencies – the US no longer enjoys an interest rate discount due to the Dollar being the world's reserve currency.

The US also derived some geopolitical benefit from being the world's reserve currency but this benefit has declined with the end of the Cold War.

The benefits of having the world's reserve currency are drastically overstated; while the costs are even more drastically understated.

The cost of having the dollar as the global reserve currency is that the US must run a trade deficit.

In the 1960s, economist Robert Triffin, explained that as long as the US dollar was the global reserve currency that other nations needed to hold, the US would need to run persistent trade deficits with the rest of the world in order to supply the world with dollars (trade surplus causes the US to exchanges dollars for net imports of goods and services).

The cost of the resulting US trade deficits is lost demand and growth relative to the rest of the world. Further, if a country imports goods (i.e. runs a trade deficit) it must also export an equivalent amount of financial assets. Thus, the persistent current account surpluses force the US to continually sell US assets or increase their debt obligations, to the rest of the world, which will eventually put the US economy at risk.

The costs associated with reserve currency status, famously known as the Triffin Dilemma, are a persistent trade deficit that reduces US GDP and continually increasing indebtedness to the rest of the World. This "exorbitant burden" is why the Bretton Woods monetary and trade system was always unsustainable – as Keynes tried in vain to explain. However, the system could last as long as the United States believed the benefits outweighed the costs.

If the US has been willing to accept the costs of reserve currency status for nearly 75 years then why would they know decided that the costs are too high? The first reason is that the longer the system operates the more the accumulated imbalances put the US economy at risk. The second is that the benefits US receives proportional, and costs inversely proportional, to the size of the US economy relative to the global economy. As the US economy as a percent of the global economy has been cut in half the benefits have fallen while the costs have risen. And finally, countries actively "gaming the system" over the last 20 years, by exponentially increasing their holdings of foreign currency reserves, has resulted in an exponential increase in the cost for the United States. We are now well past the point at which the costs outweigh the benefits.

Economic Outlook

By Hunter Bronson

Growth

According to the BEA's second estimate for the first quarter, the US economy grew 2.2% quarter-over-quarter, down from 2.9% growth in the fourth quarter of last year. Continuing a trend set over the last several years, consumer spending was relatively weak in the first quarter, only posting 1% growth. Housing was a modest negative at -2%, while net exports and government spending continue to add slightly to growth. Non-residential fixed investment or business capital expenditures was the lone bright spot of the quarter – advancing 9.2%. Inflation remains relatively restrained with April's headline CPI reading at 2.5%. We continue to believe that the U.S. economy is still somewhere near the middle innings of an expansionary cycle. As we have written for several years, a strong CAPEX investment phase is critical to kick-starting productivity growth and sustaining ongoing GDP growth. We are hesitant to get ahead of ourselves, but the most recent CAPEX follow-through makes us optimistic over the near term.

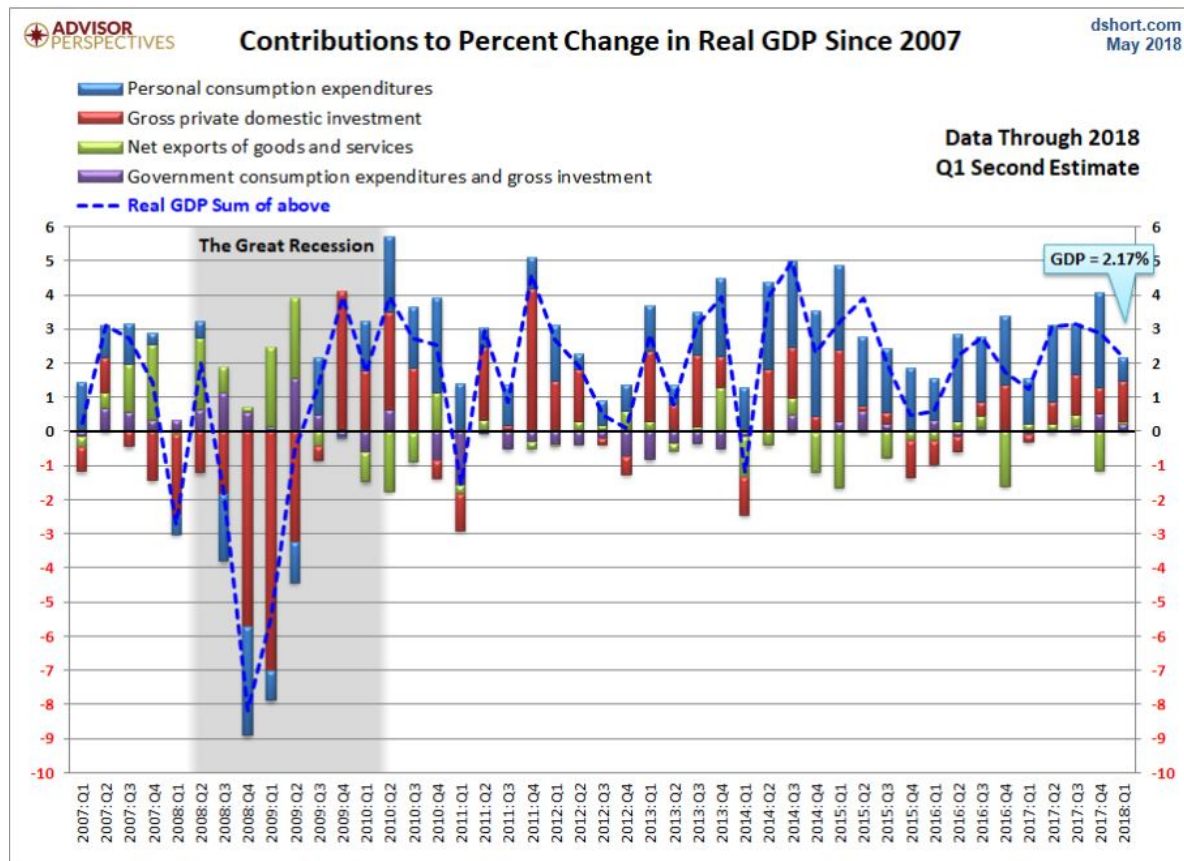


Figure 1: Q1 GDP Contributions

Consumer, Wages, and Employment

We continue to see signs that the labor market is tightening with all manner of headlines like the Wall Street Journal's "American Job Openings Now Outnumber

the Jobless" splashed across front pages nationwide. The most recent unemployment rate dipped to 3.75%, the lowest in over 15 years. It appears that we are pushing the structural limits of employment. This will continue to matter, as unemployment can't be pushed down indefinitely without seeing wage inflation, and we are at the point where history tells us it is a near certainty.

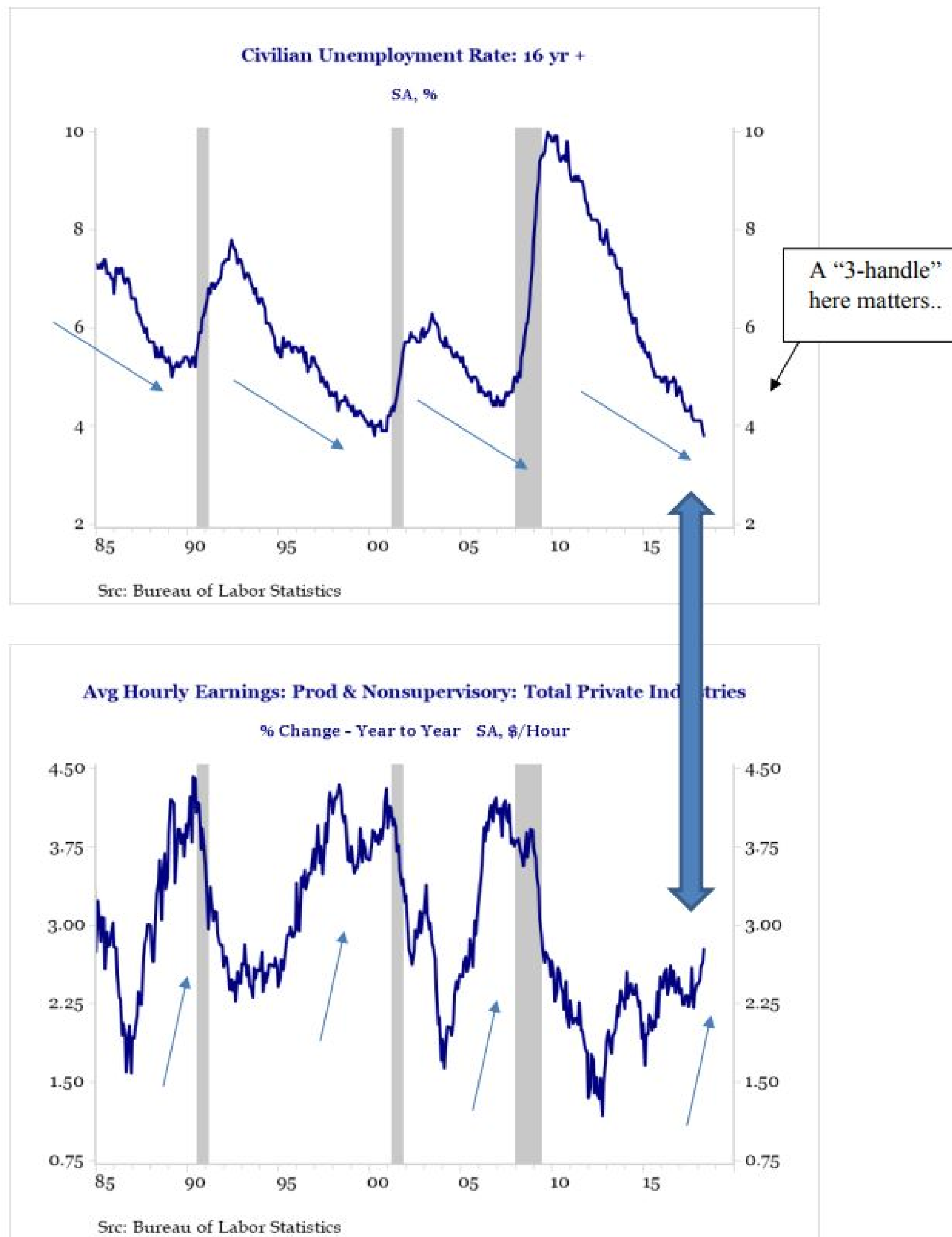


Figure 2: Unemployment vs. Wage Growth; Source: Strategas

The bottom half of Figure 2, above, will be an important leading indicator of recession risk going forward. As labor takes more share of economic profits, corporate profits necessarily fall - typically bringing down CAPEX, productivity, and eventually job growth with it. This is a natural function of the ebb and flow of the economic cycle, and the anticipatory nature of the series has been quite consistent

since the 1980s. As you can see in Figure 3 below, when Average Hourly Earnings growth crosses 4%, a recession (shaded area) is typically 2 years away. It would appear that we are a little over halfway through the wage recovery cycle, although they tend to accelerate more rapidly as the labor market tightens.

Figure 3: Average Hourly Earnings and Recession; Source: Strategas

Finally, we believe that tax cuts have a chance to marginally boost consumer spending in the near term, although we think that rising fuel costs will largely offset any gains. We think a fair early estimate for increased gasoline and heating oil costs to consumers in 2018 is around 20%. This translates to a $61B "tax hike on consumers or 0.4% of disposable personal income. Personal tax cuts will boost DPI by 0.5%, so the overall net effect is a wash. However, not all households will be affected the same way. The tax cuts are skewed toward benefitting middle and high income households, while rising gasoline prices hurt lower income households more. Since lower income households have a higher propensity to spend, the second-order effects are likely a slight negative for consumer spending. Given these considerations, we would not expect consumer spending to be the major driver of GDP over the rest of the year.

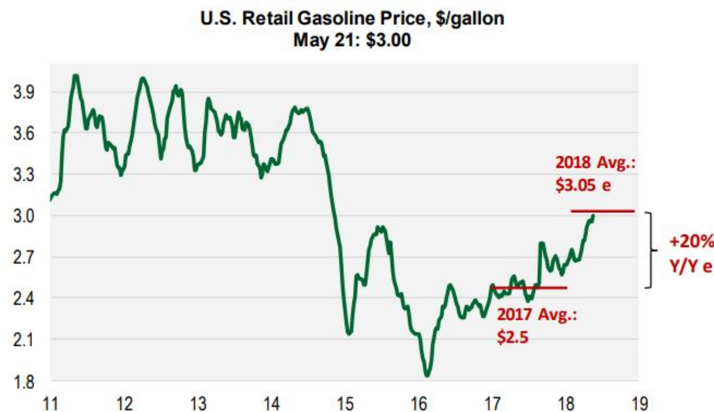


Figure 4: Retail Gasoline Prices; Source: Cornerstone Macro

Productivity, Investment, and Inflation

One year ago, we wrote about the importance of capital investment in sustaining the momentum of this mid-late cycle economic expansion. At the time, we were skeptical about the corporate sector's appetite for or even need for additional CAPEX. We offered that perhaps U.S. business had become less capital intensive for various reasons over the years. However, it appears that we may have been overly pessimistic. As after-tax corporate profits have continued to accelerate through 2018, real CAPEX has ramped commensurately.

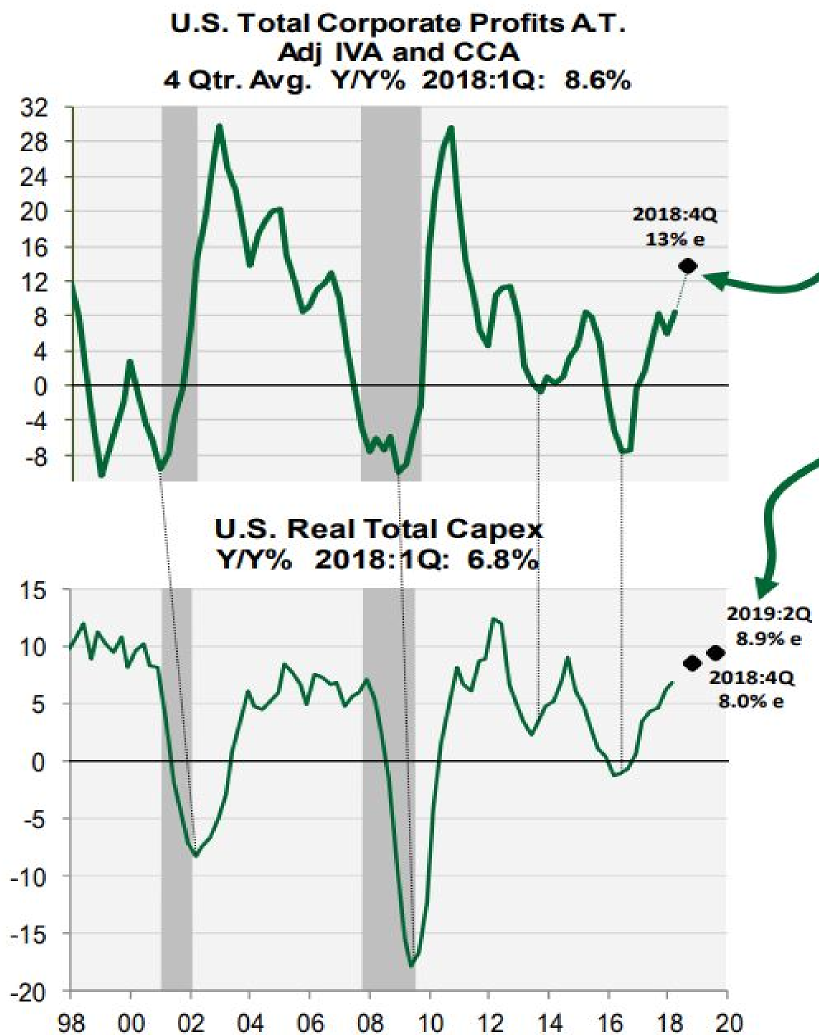


Figure 5: When U.S. corporate profits accelerate, so does U.S. CAPEX; Source: Cornerstone Macro

Looking beyond the tailwinds from profit growth, we believe there could be longer-term secular factors that might boost CAPEX spending going forward. First, as China transforms itself into a more consumer-based economy, it is no longer a competitive place for global businesses to invest. Second, corporate tax reform (lower overall rate and full CAPEX expensing) has reversed the United States' historically uncompetitive corporate investment environment.

These dual forces could prove to be vital to extending the length of this already long economic cycle for several reasons:

- As we have stressed, productivity lies at the intersection between capital investment and labor growth. As we see both rising in the U.S., we finally have an environment in which productivity can sustainably improve – a first in a decade.
- As productivity improves, unit labor costs are held down, acting as a dampener on inflation and keeping corporate profits higher for longer.
- Lower core inflation mean interest rates are lower for longer, and longer-term potential GDP growth is bolstered by accelerating productivity and labor force growth.

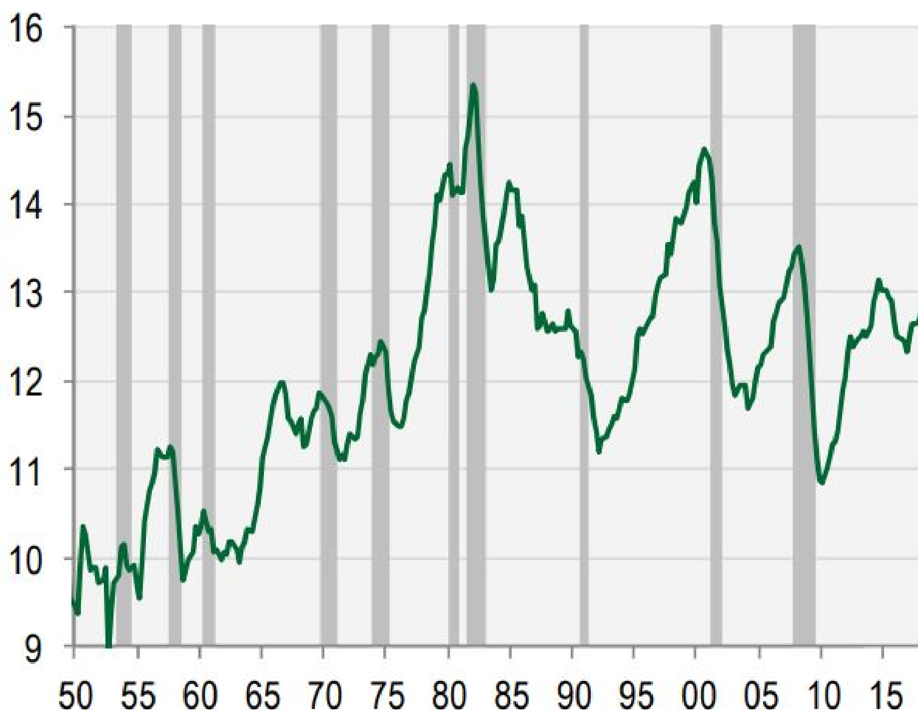


Figure 6: We would prefer to see CAPEX sustainably above 13% of GDP;

Source: Cornerstone Macro

This rising CAPEX scenario is the most bullish picture we can paint for the extension of the cycle. Productivity growth tends to lag capital investment by several years, so spending today has long-lasting expansionary effects on the economy. There is, of course, no guarantee – wage or input cost inflation could spike and lead to more general inflation or CAPEX could fail to follow through. However, we are more optimistic now than at this time last year that the lengthening capital investment cycle means that the current economic expansion has more room to run.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Julie Barranco

At the time of our last meeting the March quarter was coming to an end. The Fed had met and increased the federal funds rate by another .25% to 1.50 – 1.75%. The increase was widely expected and accepted by the markets. The Committee also reiterated its projection for at least two more rate increases by the end of the year, which was also widely expected, as they acknowledged an upgraded outlook for the economy.

As we moved into April, equity market volatility was still somewhat elevated concerning trade tensions with China. The yield curve continued the flattening trend seen in March as investors seemed to be more skeptical about economic growth projections for the year, which in turn dampened inflation fears. The front end of the curve moved higher in response to the rate hike as well as from a large amount of Treasury issuance on the short end of the curve. By mid-month, a more optimistic tone was present in the market which allowed risk assets to outperform once again. The Fed's March minutes were released and indicated their continued belief that inflation would hit their 2% target. Yields rose and the curve steepened by several basis points from the low point seen mid- month. This did not last long however, as the flattening trend resumed late in the month as the short end sold off on inflation concerns as well as from continued heavy Treasury bill issuance.

For the month, Treasury returns were negative as the shorter end saw yields rise roughly 25 basis points while longer end yields rose 15-20 basis points, resulting in a (.82)% return. Government agency and mortgaged backed sectors fared slightly better as spreads stayed fairly stable and the shorter duration of these two sectors versus Treasuries provided some cushion. Agency debt returned (.60) % for the month while mortgage debt returned (.48) %. High grade credit was actually the worst performing sector April, returning (.85) % for the month. While early in the month the sector saw spreads narrowing on limited supply and positive political news, the tone changed later in the month as heavy new issue supply was met with somewhat soft demand. Spreads widened back out a bit but still managed to produce a positive excess return for the month. However overall higher yields and the longer duration of this sector led to a negative total return. The high yield sector did manage to eek out a small positive return as spreads tightened much more than the high grade sector, mainly within the energy sector.

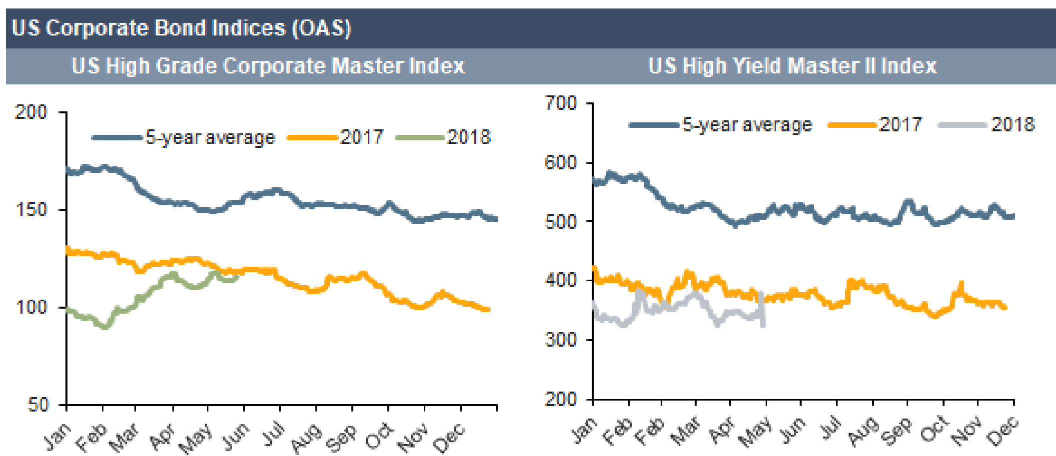
May started out on a relatively quiet note as economic data early in the month was mixed. Construction spending, the ISM manufacturing report and monthly auto sales all came in slower; additionally, April non-farm payrolls came in lower than consensus, however upward revisions to prior months and the unemployment rate moving below 4% helped to still make it a solid report. Treasuries showed little movement in response to these reports. Yields did rise briefly in response to higher oil prices after the U.S announced its withdrawal from the Iran-nuclear accord put investors on inflation watch again, however this was short-lived as CPI

data came in lower than expected and left investors feeling a little more confident that the Fed might only raise rates two more times this year.

Late in month, mixed economic data led to some concern for investors, however the greater concern was due to re-emerging European sovereign risk related to Italy and uncertainties around them forming a new government. At the same time, President Trump called off his meeting with Kim Jong Un and indicated he might place tariffs on all imported autos and auto parts. A flight to quality ensued, with the intermediate and longer part of the curve seeing yields decline 10-13 basis points while the shorter end declined a bit less. Credit spreads leaked wider around these events and posted a negative excess return for the month, however overall total return was still positive due to the rally within the Treasury sector. For the month, Treasuries performed the best, returning .91%. Mortgages and agency debt returns were slightly lower at .73% and .63%, respectively. High grade credit returned .45%, while high yield returned (.02) % for the month with energy, telecom and retail names still underperforming here.

Through the first week of June Treasury yields have moved a little higher, with a fairly even increase across the curve. Trade concerns, inflation and the Fed are still on investors' minds and there will be news around all of these topics in the coming week. High grade credit spreads have not seen much movement as the primary market saw decent issuance in recent days, while high yield credit spreads tightened in several basis points during the week.

The chart below shows credit spread movement year-to-date versus last year and the 5-year average for both the high-grade and high-yield indices:



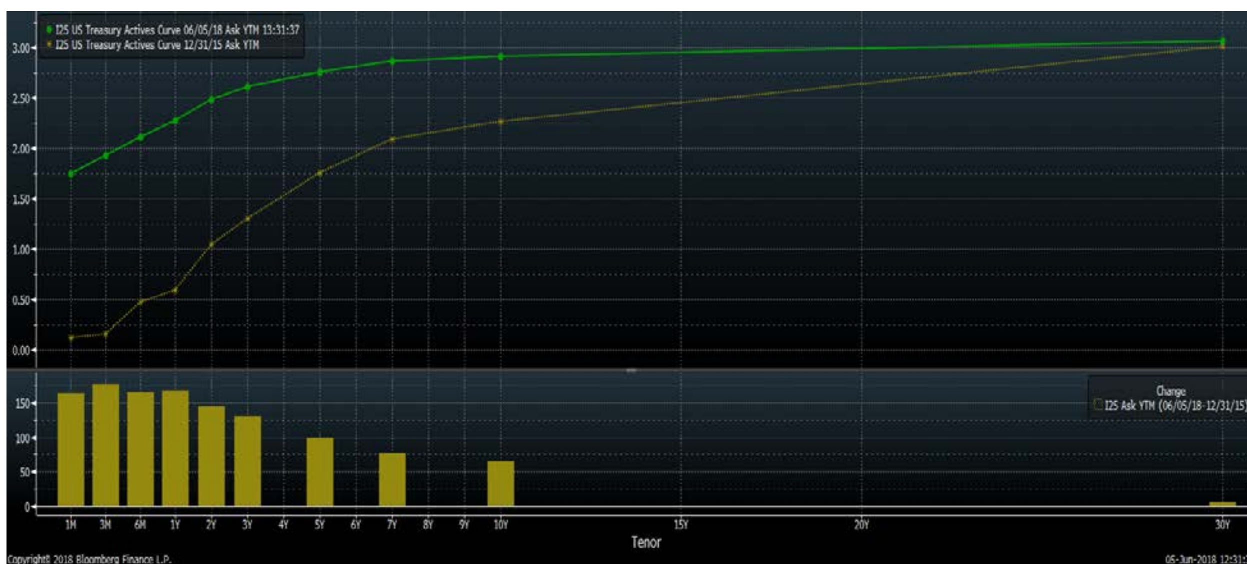
	May 25 2018	Change (bp) Week	MTD	YTD		May 25 2018	Change (bp) Week	MTD	YTD
High Grade	116	2	2	17	**High Yield**	353	12	7	-10
Financials	108	3	2	21					
Industrials	119	1	1	15					
Utilities	119	1	4	14					

Source: CreditSights

High-grade spreads have been creeping higher the past few months, however they are still well below the 5-year average. At the end of May spreads were wider by roughly 17 basis points. High-yields spreads have been choppy, but overall are still well below their 5-year average and 10 basis points tighter year to date.

There has been much discussion and concern the past few months about the flattening yield curve and the potential for the curve to invert. The curve has been flattening since the Fed started tightening in late 2015, which is a normal consequence. The flattening has picked up steam over the past couple of months, which has led to some investors thinking that the curve will invert, and recession will soon follow. For reference, the 2-year/10-year curve was at 125 basis points in December 2015, whereas now the level sits at roughly 45 basis points. While all recessions since the early 1970's have been preceded by an inverted yield curve, that doesn't guarantee that it will invert with this current flattening. Several FOMC members have been very vocal about not wanting to see the yield curve invert, and to date economic growth expectations have not indicated that there is cause for concern; they have been stable and even rising a bit for some time.

Current market expectations show the Fed continuing to tighten gradually until about the 3-3.25% level. This would imply yields moving a little higher from current levels, with the short rates rising more than longer rates. Eventually the curve could be completely flat, as the 30-year Treasury rate is already in this range. Time will tell if this rate level is too high and if rates need to adjust down to a lower neutral level. But for the near term it does not seem that a recession is imminent. The graph below depicts the yield curve change since December 2015; one can clearly see that the majority of the flattening has come on the short end of the curve as the Fed has hiked rates, while the longer end of the curve has moved much less as inflation expectations have remained low.



Source: Bloomberg

Despite a small bit of volatility in yields over th past couple of months, we have been somewhat active within the fixed income portfolio. Activity in the corporate sector has been in the secondary market as well as the new issue market. At different points over the past couple of months we added some short and intermdiate maturity issues, including Goldman Sachs, Bank of Nova Scotia, General Mills, Campbell Soup and Celgene. In these cases we were able to lock in very attractive spreads over comparable Treasuries yet not take on much interest rate risk in the process. Depsite the spread widening within the credit sector the past few months, levels are still fairly tight on a historical basis. We felt this was a prudent way to invest at attractive yields but not really raise the risk profile of the portfolio. We will continue to look for attractive names/maturities to selectively add to the credit sector, particularly if we get any further weakness in spreads that provides an attractive opportunity.

In the agency debt sector we have seen spreads remain stable and fairly tight. Over the past couple of months we have replaced a maturity, purchasing a 1.5 - year agency bullet issue and a 4-year callable agency issue. With yields on the short end of the curve near decade highs, the shorter maturity allowed us to add yield with minimal interest rate risk; the 4-year callable offered a higher yield than a 5-year bullet, and should perform well in a flat to rising yield environment. These purchases also allowed us to shorten duration a bit as we feel it prudent to stay neutral at this point in time. We would expect any upcoming trades to be maintenance type trades to replace a call or maturity, or perhaps a swap to adjust interest rate risk. We do not anticipate adding any significant new money to this sector given the tightness of spreads versus Treasuries.

Spreads have remained fairly stable within the mortgage sector as well. The overall upward trend in rates the past few months has slowed prepayments somewhat and our activity within this sector has mainly involved swapping longer duration pools for shorter duration pools. Recently we have swapped several 15 and 30-year lower coupon pools into 15 and 30-year pools with higher coupons. Since rates have been moving higher, risk of prepayments on these higher coupon pools has declined. Additionally, the higher coupon pools have lower duration and help reduce the sensitivity of the portfolio. The duration of the mortgage index has been fluctuating the past few months, therefore these swaps have helped to adjust our duration accordingly. We are still underweight versus the index, with our weighting staying essentially the same the past few months. With the mortgage sector outperforming even high grade credit in recent months, we may look to add some new money here as we think this trend could continue in the near term with credit spreads still at fairly tight levels. We will also continue to monitor interest rate movements and adjust duration as needed.

Lastly, we executed one swap within our Treasury portfolio, selling a November 2018 issue and then purchasing a February 2020 issue. This swap looked attractive to us as we were able to pick up more than 50 basis points of yield with minimal interest rate risk. We are still underweight the sector as a whole and our duration is currently a little short versus the Index. We continue to watch yield levels closely and will adjust our Treasury positions and duration as needed.

Domestic Equity Strategy

By Allan Carr

The first half of 2018 has been quite a rollercoaster. It started off with a bang up 7.5% in the first four weeks, only to have a 12% drawdown the following two weeks. The see-saw continued as the market clawed back over 8% the next month before experiencing yet another 9% decline the following two weeks. There had not been a 10% correction in the prior two years and we more or less had two transpire in the first quarter. The second drawdown ended the day after our last economic update and since then the market is up just over 7%. We now sit roughly 3% below the January all-time closing high and are up 5% for the calendar year and nearly 12% for the fiscal year.

One may not know it from watching the news but the United States of America is doing very well. Refer to the economic update in this piece for more specific details, but the economy is jamming. Consumer Confidence has not been this high, nor the unemployment rate so low, since the year 2000. Female unemployment is as low as it's been since the early 1950's and African American unemployment is at an all-time low. U.S. Consumer Net Worth just eclipsed $100 TRILLION for the time ever and has nearly doubled during the current expansion. (Exhibit 1, Evercore ISI)

EXHIBIT 1

Corporate profits have been even more impressive than the economy. First quarter earnings were a blowout with over 80% of S&P 500 companies beating estimates. Not only did they beat on the bottom line, they delivered on the topline as well with roughly 75% of companies beating revenue estimates. Barring an unforeseen setback, 2018 EPS should be up north of 20%. We could go on and

on with stats about earnings; but simply put they have been spectacular and estimates continue to be ratcheted upwards. (Exhibit 2, Morgan Stanley)

EXHIBIT 2

We are now over nine years into this current bull market with the S&P 500 up nearly 400% inclusive of dividends. Yet the individual investor has remained on the sidelines as evidenced by domestic fund flows being negative through this cycle (Exhibit 3, Strategas).

EXHIBIT 3

Net Flows into Mutual Funds + ETFs ($BN)

	Domestic Equity		International Equity		Bond	Money Mkt
Year	MF	ETF	MF	ETF		
2009	(27.6)	30.9	29.6	39.6	417.2	(539.1)
2010	(81.1)	46.7	56.7	41.5	262.0	(525.1)
2011	(133.3)	47.3	4.1	24.3	163.7	(124.1)
2012	(159.1)	80.9	6.4	51.9	358.5	(0.2)
2013	18.1	104.1	141.4	62.8	(59.0)	15.0
2014	(60.2)	141.5	85.4	46.6	94.5	6.2
2015	(170.8)	65.4	93.9	109.7	29.4	21.5
2016	(235.4)	167.6	(24.5)	20.1	190.1	(30.3)
2017	(236.0)	186.0	76.7	159.8	381.1	106.9
2018 YTD	(56.2)	3.3	40.8	39.9	74.5	(61.2)
TOTAL	(1141.4)	873.6	510.5	596.1	1912.0	(1130.4)

A recent Gallup poll showed that only 38% of adults younger than 35 had investments in public companies. A decade ago it was 52%. There is not a single answer as to why the individual investor, and young investors in particular, have chosen to sit this one out. Having the tech bubble and financial crisis occur in such a short timeframe certainly has a portion of the investor base skittish, especially those closer to retirement. Young people seem more interested in cryptocurrencies given all the media attention to “college kid turned millionaire via Bitcoin.”

The average stock price in the S&P 500 is now $111. For institutional investors such as us, the absolute price does not matter. But to a majority of retail investors, buying a share of Google at $1121 or Amazon at $1687 is simply not appealing. Whatever the reasons are, the fact that we are still in net redemption territory is one of the more remarkable aspects of this run versus prior bull markets. We are yet to see money piling into equities which historically has been a warning sign that the cycle is peaking.

Even with the economy and earnings doing well, there are definitely more people in the camp that the cycle is set to be derailed at any moment. We often refer to climbing the "wall of worry" with markets, and that wall has gotten higher recently. After having stability in the Eurozone for the better part of five years, Italy recently spooked global markets with fears of them leaving the Euro. Over the last year we talked about the "synchronized global expansion", but we are now seeing some dispersion with some foreign countries slow down. There is always the fear of the unknown and geopolitical risks. Below, we will discuss a few hot topics currently weighing on investors.

In the nation's capital, we have midterm elections coming up and what appears to be a President that is not going to change his stripes. Nearly a year and a half into his term, there are mostly empty seats in the room of people that hoped he would soften his tone and become less spontaneous and unpredictable once in office.

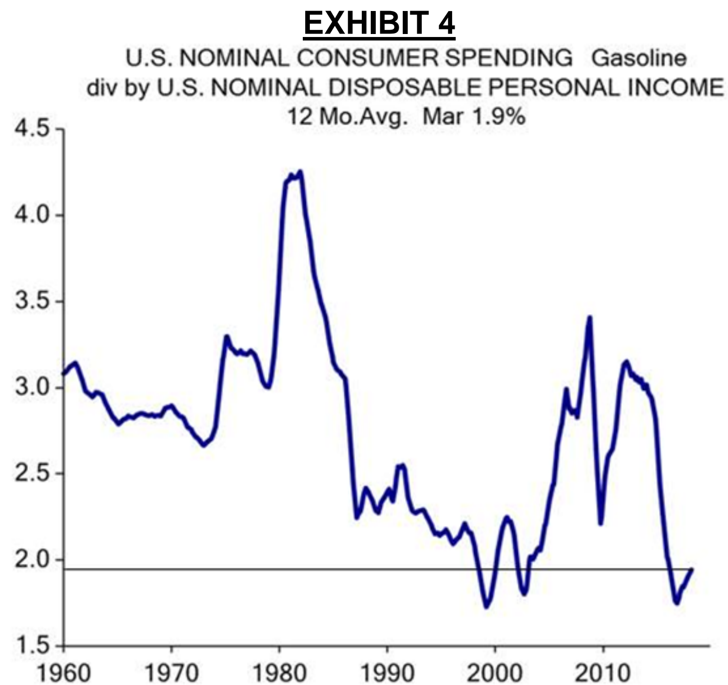
Trying to predict Trump's next move is a futile exercise. One minute he's instilling confidence by agreeing to sit down with North Korea's Kim Jung Un; the next minute he's cancelling the meeting over Twitter without informing allies. On May 20th, Treasury Secretary Steven Mnuchin calmed the markets by saying "we are putting the trade war on hold" with China. Just over a week later the President "trumped" Mnuchin and said the U.S. would go forward with tariffs on Chinese imports.

Needless to say the President's unpredictability can be unsettling to markets. As of right now the meeting with North Korea's Kim is back on for June 12 and in recent days China has upped the ante on possible concessions. Some D.C. analysts we speak to are of the belief he is using the U.S. strength as leverage to get more out of deals and will not take things to draconian levels. We hope that is the case given all the positive things taking place in the economy, but we don't expect headline risk to go away anytime soon.

Oil prices have been a hot topic as well. Crude peaked at just over $72 in late May, which was up 50% from a year ago and 20% since the beginning of 2018. In the last two weeks prices have dropped roughly 9% which has calmed worries a bit. Given the ramp in domestic production over the last decade, the overall impact of an oil shock to the U.S. economy as a whole is not as punitive as it was in the past. It's still a negative to energy users, but instead of foreign producers reaping the benefits, much of it it now goes to domestic companies which can then redeploy into the economy through capex, hiring, pay raises, etc.

Additionally, consumer spending on gasoline as a percentage of disposable income is near record lows. (Exhibit 4, Evercore ISI)

EXHIBIT 4



While the overall effect of an energy spike on the U.S. economy is not as severe as it was a decade ago, the group most effected is the one that can least afford it; the low income consumer. We have yet to see any meaningful data that is alarming, but subprime is an area we will have a close eye on as energy prices and rates have moved up.

One of the most talked about worries in the market is the flattening of the yield curve. Recently the 2's/10's spread broke below 50 bps which has only exacerbated fears. We certainly understand the attention paid to the yield curve as every recession has been preceded by an inversion of the yield curve. However, there are some misconceptions when it comes to the subject.

The yield curve has indeed flattened since the Fed started tightening in December 2015, but that is normal and to be expected. A flattish curve does not necessarily mean the end is near or inversion is imminent. From November of 1994 until June of 1998 the 2's/10's spread was inside 75 bps virtually the entire time and it was inside 50 bps for about 65% of that time. The market did more than ok during that span returning over 160%. We are not calling for those kinds of returns but rather pointing out that a flattish curve in isolation is not a reason to sell equities.

Another misconception is that the yield curve inverts in conjunction with a recession starting. To the contrary, there is historically a lag on average of 17 months between the curve inverting and the economy entering recession. (Exhibit 5, Cornerstone Macro)

EXHIBIT 5

Is The Yield Curve A Good Predictor Of Recessions?

Recession	Curve Inverted	Recession Started	Lead Time
1980	August 1978	January 1980	1 Years, 5 months
1981-1982	September 1980	July 1981	10 months
1990-1991	January 1989	July 1990	1 year, 6 months
2001	June 1998	March 2001	2 years, 9 months
2007-2009	December 2005	December 2007	2 years

Naturally the next question after telling someone that is: ok fine, so it takes time to officially enter recession, but the market is a discounting mechanism so it will react ahead of it. Again, the answer is not what many expect. In the last five recessions, the market has had positive returns between the time the curve inverted and recession ensued. (Exhibit 6, Cornerstone Macro)

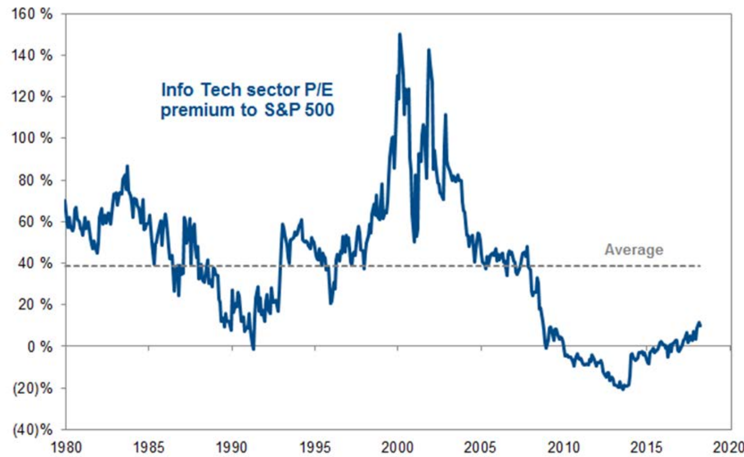
EXHIBIT 6

Stock Market Performance After An Inversion Of The Curve

Some naysayers talk about the technology sector's outperformance and that it could be another bubble. To be clear: tech has been a massive outperformer. In the last year the sector is up 33% versus the market up 16.5%, over the last three years 83% versus 40%, and the last five years 170% versus 90%. That is certainly impressive but that only tells the "P" side of the story in the P/E equation. Earnings have just as impressive. Looking back to the year 2000, tech was 33% of the S&P 500 market cap but only 16% of earnings. Today both the market cap and earnings

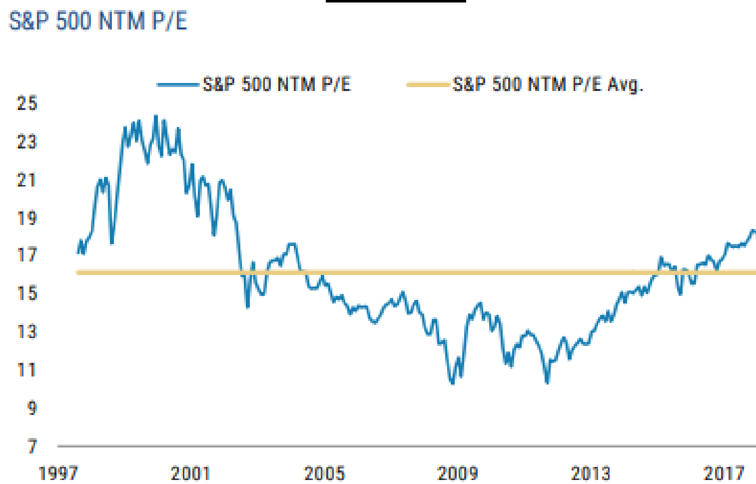
are roughly 25%. There are definitely some names and areas that look expensive, but the sector as a whole is not expensive relative to the market or history. (Exhibit 7, Strategas)

EXHIBIT 7



The first half of this year was an earnings blow out without a large move in the market. This digestion phase resulted in multiple contraction to the point that stocks currently do not look expensive versus the last 20 years. (Exhibit 8, Morgan Stanley)

EXHIBIT 8



In summary, there are areas to keep an eye on as we get later in the cycle, but we still do not see the typical red flags that it's time to throw in the towel. The outlook is promising as the economy should continue to benefit from tax cuts, repatriation, infrastructure spending, capex being fully deductible for five years, easing regulatory environment, etc.

Respected businessmen such as Jamie Dimon of JP Morgan and Ed Hyman of ISI have recently suggested we're likely in the "sixth inning" of the business cycle. Economist Nancy Lazar of Cornerstone has a "Recession Risk Index" which now places the highest odds of recession starting in the second half of 2021. As it has seemingly been this entire cycle, the far less popular view is that the expansion continues and equities move higher. We have tactically sold some S&P exposure to raise cash and will continue to look at hedging opportunities to provide us some downside protection that allow for additional upside.

International Equity Strategy

By Steve Lambdin

The global equity markets experienced quite a ride during the first quarter of 2018. Early January continued on the strength from the fourth quarter as global equities pushed to new all-time highs, only to give way to a sharp dip in February. Investors feared the U.S. Federal Reserve would embark on a faster than anticipated tightening cycle and increase the risk of a policy error which could potentially derail the global recovery. Further concerns were stoked in the quarter as a potential trade war with China loomed as the U.S. announced import tariffs on steel and aluminum in an effort to reduce the U.S's trade deficit with China. China responded with tariff announcements on a variety of imported goods from the U.S. Finally, political uncertainty in Europe was alive and well again as many looked upon the political issues in Italy as another source of risk for the markets. This was enough to push the MSCI EAFE Index into slight negative territory during the period. However, on the economic front, things seemed decent to us, even though several economic data points have begun to basically "rollover" a bit. Corporate earnings remained robust and should be so for most of 2018 at this point. Central banks outside of the U.S. still remain accommodative with few surprises. The U.S. dollar continued to follow its recent falling trend and helped cushion the blow from weaker local markets in the quarter. European economic activity may have peaked out in the period, but still continues to grow and give confidence to the region. On the Brexit front, news was relatively quiet, but an agreement on the transition period to end in late 2020 should bring a bit of comfort to both sides. The Japanese equity market managed a slight gain in the period as Kuroda was reappointed Governor of the Bank of Japan (BOJ) for another five years. China's economic climate remained resilient even in the face of a potential trade war with the U.S. This helped push emerging market equities slighter higher in the quarter.

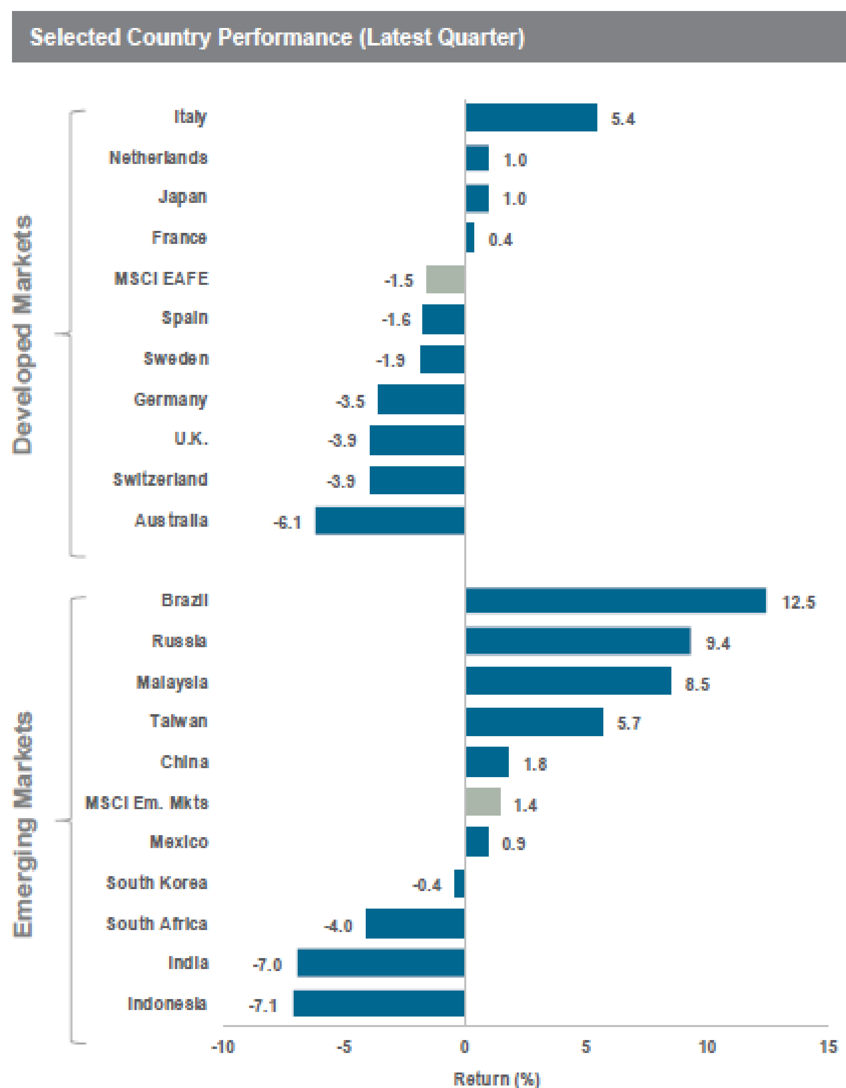
International Market Benchmarks

Equities	Representative	Q1 Return	1-Year Return
Developed	MSCI EAFE	-1.5%	14.8%
Europe	MSCI Europe	-1.9%	15.1%
Japan	MSCI Japan	1.0%	20.0%
Asia	MSCI Pacific ex-Japan	-3.7%	8.6%
Emerging	MSCI Emerging Mkts	1.4%	24.9%

Performance returns as of 3/31/2018

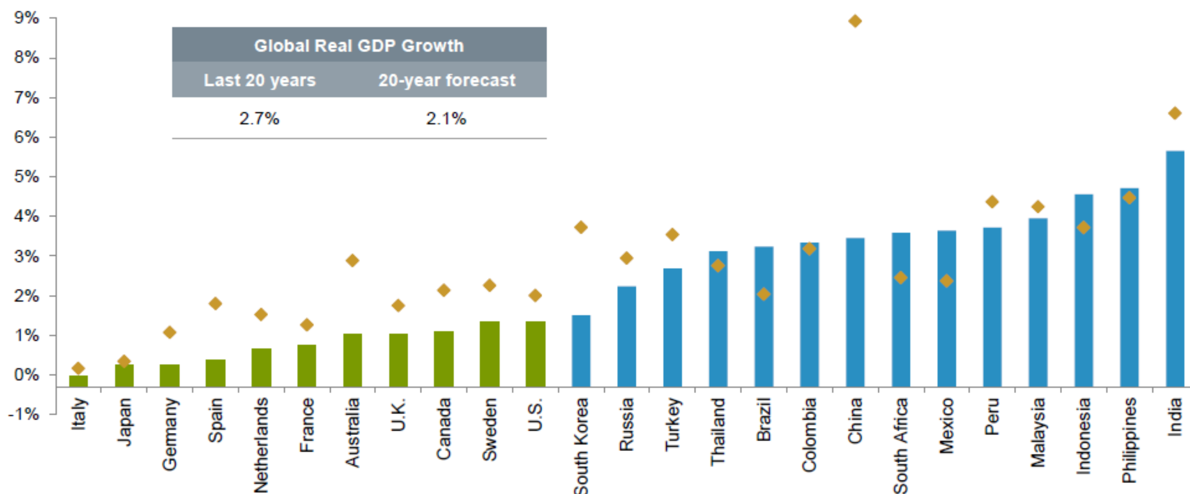
Source: Baird Market Update Q1 2018 Review and Outlook

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -1.5% and +1.4% respectively during the first quarter of 2018 vs. -.80% for the S&P 500 Index. Even though emerging market equities led the way, there was not much difference in returns across these asset classes. The U.S. dollar continued to fall in the first quarter and provided another nice benefit for unhedged U.S. investors as mentioned earlier. The Pacific region was a bit stronger than the European region again this quarter, as the Japanese equity market managed to finish in positive territory in the period. From an economic sector standpoint, Technology and Utilities finished positive, while Telecom, Materials, and Staples were fairly weak in the period. Most commodities were lower in the period with the exception of crude oil, which rose +7.5%, as tension with Iran could have come into play here.



Source: Baird Market Chartbook; Morningstar Direct; MSCI

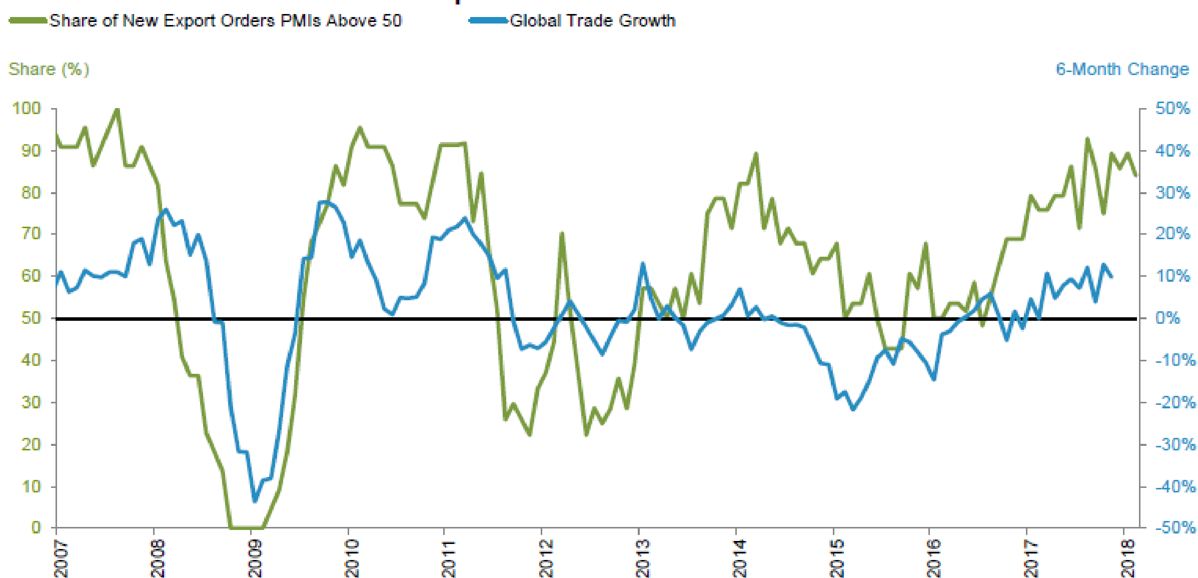
So far into the second quarter of 2018, global equities continue to be quite volatile as a few issues seem to be dominating the headlines. Rhetoric on the potential of a trade war with China seems to be heating up. Both sides seem to be trading jabs with each other as each side has announced new tariffs over the last several weeks. The real risk is an economic slowdown because of these actions as companies attempt to push through price hikes. China could also respond in non-trade ways such as selling U.S. treasuries and/or devaluing its currency. In the end, no one really wins a trade war and we hope that a negotiated solution between all sides can be worked out in order to keep the global economic momentum going in the right direction. In addition, the recent Italian elections do point to a lot of contention building in this country's political views. This pushed interest rates up quickly in Italy and serves notice that the current economic recovery is at risk. Also, the upcoming summit between Trump and Kim Jong-Un could bring a lot of volatility to the markets, depending on what happens. No one knows at this point as all eyes will be on this. Even with these issues on the forefront at this time, the overall global economic picture remains bright at the moment, even as some measures may have peaked out already. The MSCI EAFE Index is up approximately +1.7% and the MSCI Emerging Markets Index is down approximately -1.3% through early June, vs. +5.3% for the S&P 500 Index. Investors seem more comfortable with U.S. equities in the current climate.



Source: Fidelity Q1 2018 Market Update; OECD

Asia Update

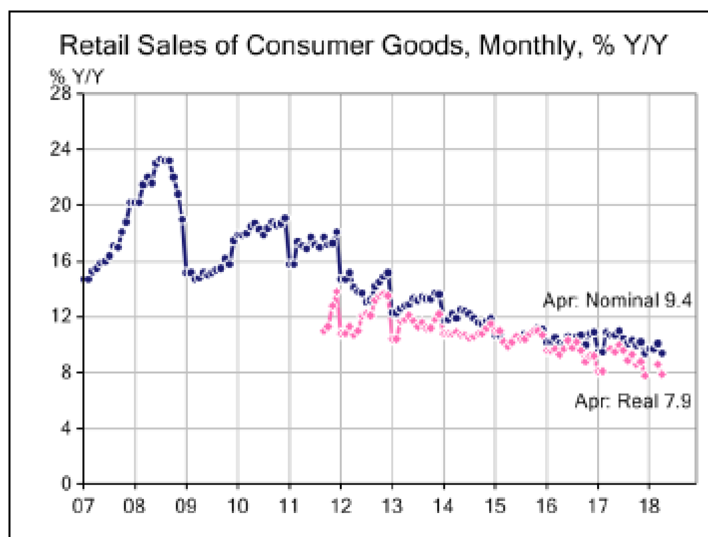
The recent run of good fortunes came to an end in the first quarter of 2018 as the MSCI Pacific region fell -2.8% as investors sold selective Australian and Honk Kong banking shares aggressively in the quarter. We believe this was much more company specific rather some type of new systemic problem. Generally, most economic data points were in-line with expectations, but did weaken slightly on the margin. Unhedged U.S. investors did get a slight benefit from currency movements in the quarter as this did help lessen the blow from weaker local currency returns. The Japanese equity market was one of the better performers in the quarter as this market rose another 1%, as currency movements wound up benefitting us by +5.6% and masked weak local market returns. Surprisingly, Chinese equities were a bit stronger than anyone was looking for, rising another +1.8% in the quarter, as investors seemed to shrug off trade war news with the U.S. better than we would have expected. Beyond the obvious risk of a trade war with China, the Asian basin seems decent from an economic standpoint.



Source: Markit, ISM, Haver Analytics, Fidelity Investments (AART)

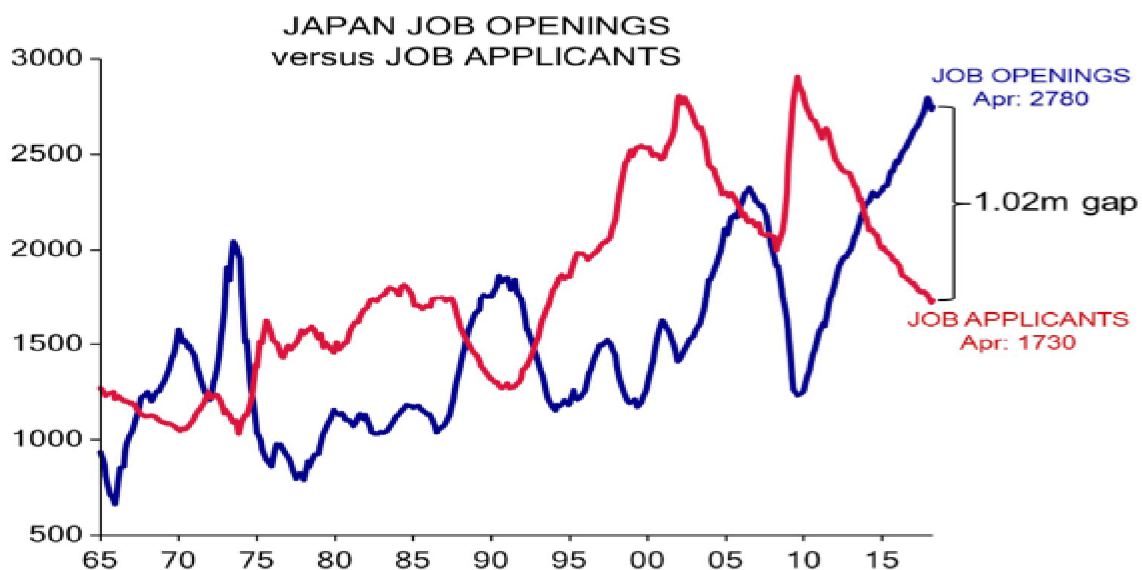
Steady as she goes has been the best way to describe the Chinese economy lately as first quarter GDP rose +6.8% from a year earlier, which is the third straight quarter of this growth rate. This was right in line with most analysts' expectations even as China spars with the U.S. over the future of

trade between the two largest economies in the world. The "old economy" continues to slow here while the "new industries" of e-commerce, technology, and health care are showing good growth. Xi Jinping's "Made in China 2025 Initiative" seems to be beginning to make some headway here as cutting edge technologies such as artificial intelligence are paving the way to new paths of growth. This can certainly be transformative over the next several years. Digging a bit deeper into some economic data points, industrial production still remained very steady in the first quarter and rose +6.8%, which was actually a slight acceleration from late 2017. This was a bit of a positive surprise, as most were expecting something less. Fixed asset growth continued to trickle down as the growth rate fell to +7% in the first four months of 2018. The growth rate of infrastructure spending continues to fall as the economy tries to rebalance to other areas of growth. Exports and imports both grew double digit in the first quarter even in the face of negative trade rhetoric with the U.S. as the global economy still remains solid in most parts of the world. Retail sales growth continued to slip recently as April sales were up only +9.4% year over year, as rising incomes have been a little less than stellar lately. Inflation remained well in check with little net movement over the last six months as April's consumer prices rose +1.8% from the year earlier period. This should mean that monetary policy should remain very steady going forward here. Obviously, all eyes will be on trade issues between China and the U.S. over the next few months. We have no way to know what the ultimate outcome will be other than no one wins in the end. Developments on these issues will no doubt set the path on the economic outlook here as well as the direction of the equity markets.



Source: Evercore ISI

The longest consecutive period of growth in the Japanese economy in the last 16 years came to an end in the first quarter of 2018 as GDP fell -.2% from the previous quarter, or -.6% from the year earlier period. We don't consider this to be much of an issue as growth should pick back up from this temporary blip this quarter. Capital investment surprised to the downside and private consumption wound up about flat in the quarter. However, even as the consumer remains challenged, business confidence remains high as the export markets remain good in the face of a growing global economy. Many will be watching developments on the trade front with regard to U.S. tariffs for any effects on this economy. The Bank of Japan (BOJ) kept its short term rate at -.10% and is still targeting a 10-year government bond target yield at 0% at its recent meetings. We don't expect anything new on this front over the near term, especially as core prices remain well under the BOJ's targeted level. Industrial production fell in the first quarter from the previous quarter, but still managed to be up +2.2% in the period. In conjunction with a slowing economy in the quarter, consumer confidence moved lower as May's reading of 43.8 was a bit lower than had expected. This remains a continuing problem for government officials and has to improve if we are to see faster growth over the long term here. The labor market still remains very tight as the jobless rate rose just slightly in April to 2.5%, while the jobs-to-applicant ratio remained at 1.59. Wage growth was actually better recently, perhaps a signal that upward pressure on wages has finally arrived. Overall, we believe growth should increase over the next couple of quarters, but we all must be cognizant of with regard to the current state of trade issues with the U.S. Things could change in a hurry.



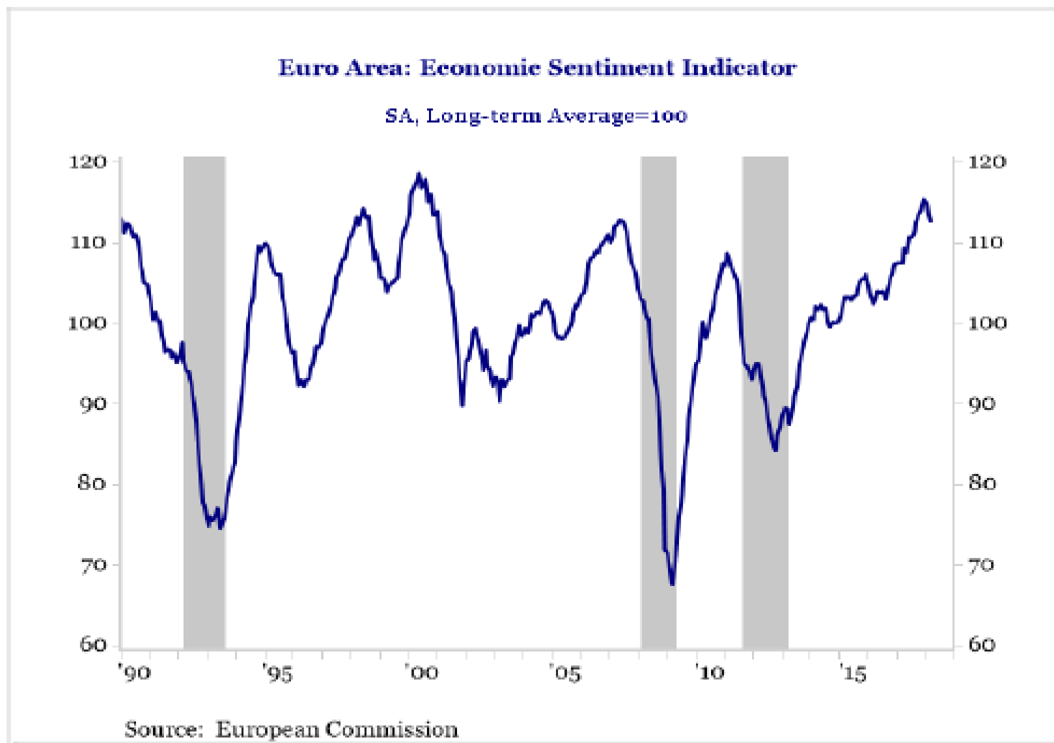
Source: Evercore ISI

Europe Update

European equities took a pause in the first quarter as the European Central Bank (ECB) begins to wind down its bond purchasing program at a time when key economic data points may have begun to roll over just a bit. In addition, uncertainty around recent elections in Italy as well as with Italian banks has put pressure on interest rates here and planted a seed of worry in investors' minds. This pushed the MSCI European Index (ex. U.K.) down -1.2% in the quarter. Results would have been worse had it not been for a currency benefit of +2.0% in the period, as the U.S. Dollar fell against the Euro. Despite a new coalition between the Social Democrats and the Christian Democrats in Germany, the market here still fell -3.5% in the period. This is probably more of a reflection that we have reached a peak in economic fundamentals than anything else. At its recent meeting, the ECB continued to maintain its key interest rate levels and still expects to curtail its asset purchase targets going forward, which came as little to no surprise.

The European economy continued to grow in the first quarter of 2018 as GDP rose .4% from the previous quarter, or +2.5% from the year earlier period. This is the weakest growth in six quarters, but only a slight deceleration from the pace of late 2017. The, German, French, and Italian economies were the main culprits from a country standpoint, as manufacturing was somewhat weaker than expected in these regions. From a broader perspective, industrial production growth did slip somewhat from late 2017 levels, rising approximately +3.0% in the first quarter from the year earlier period. All in all, we do not believe this is too bad as most expected this to cool just a bit. Representative of a slightly cooling economy, the index of executive and consumer sentiment fell to 112.5 in May, from nearly 116 in December, as momentum has now turned in the wrong direction. Investors need to see this reverse in order to become more positive on the region. Retail sales have held in better than we would have expected as first quarter sales were reported to be up +1.6% from the previous year, just a slight fall from late 2017 levels. We believe this will reverse somewhat in the second quarter as winter weather has passed and consumers are still in good shape to purchase. Core CPI still continues to bounce around very low levels, rising only +1.0% in the first quarter from a year earlier, very near the slowest pace of the last year. Inflation still remains well below ECB targeted levels as many segments of the economy still have little pricing power. As we have previously stated, we would expect this to rise a bit going forward as the economy regains some level of momentum. The unemployment rate continued to move in the right direction as April unemployment fell to 8.5%, a fresh new low since the great recession. This is certainly very encouraging and still remains a key for an improving outlook in the Eurozone economy. Looking forward, no doubt that we have come off of a peak in many of the fundamentals in this economy, but others are still getting better on the margin. Things seem stable at the moment pending

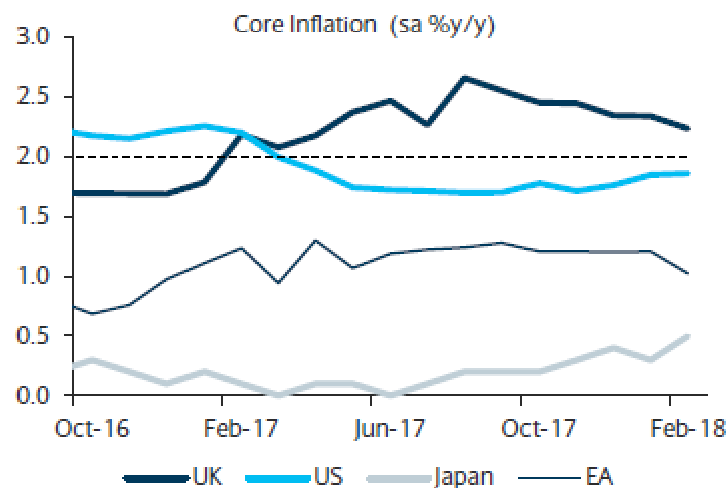
developments on the trade front with the U.S. Investors and business leaders alike will be watching news flow on this with a heightened level of scrutiny over the next couple of months. This will probably set the tone for the equity markets in the region.



Source: Strategas

U.K. equities struggled in the first quarter as investors saw little in the way of good news to get excited about. Brexit negotiations between the U.K. and the European Union (EU) have made little headway in the first quarter as the U.K. Prime Minister has found little political support and very few other officials are providing any level of direction for these discussions. So as a result, investors sold equities off in the period as the MSCI U.K. Index returned -3.9%. The economy here continues to slow down, as GDP grew only by +.4% in the first quarter from the previous quarter, or +1.2% from the year earlier period. This is the slowest pace in year over year growth in the past couple of years and leaves little doubt that a soft patch has developed in this region. The services side of the economy slipped just slightly, while construction saw a sharper fall. Industrial production continued to post weak results and grew only +.4% from the previous quarter. The manufacturing, mining, and oil&gas sectors have all struggled lately to produce any measure of sustained growth. Retail sales continued to come in below

expectations and only rose +1.5% in the first quarter from a year earlier. Clothing and footwear continue to trend downward here as consumers seem to only be interested in bargain based pricing. Core CPI continued to fall as April's reading of +2.1% from a year earlier, is right near the Bank of England's (BOE) targeted rate of +2.0%. Travels costs, food prices, and clothing have all fallen lately putting downward pressure on the CPI. The BOE still expects Core CPI to trend downward as we move through 2018. At its recent May meeting, the Monetary Policy Committee (MPC) held its benchmark interest rate steady at .50%, while maintaining its bond purchase target of 435 billion pounds, including 10 billion in corporate bonds. With the recent string of weak economic data points, this puts a projected August rate hike more in a 50/50 type of scenario. Economic releases over the next couple of months will probably the determining factor if we see a hike or not. On a positive note, the employment situation has improved on the margin as the first quarter unemployment rate was reported at 4.2%, which is still near multi-decade lows. Employment increased by 197,000 workers with ending employment at a new record of 32.34 million workers. Wage growth continued to get better as well, as wages grew by +2.9% in the first quarter, the best since the summer of 2015.

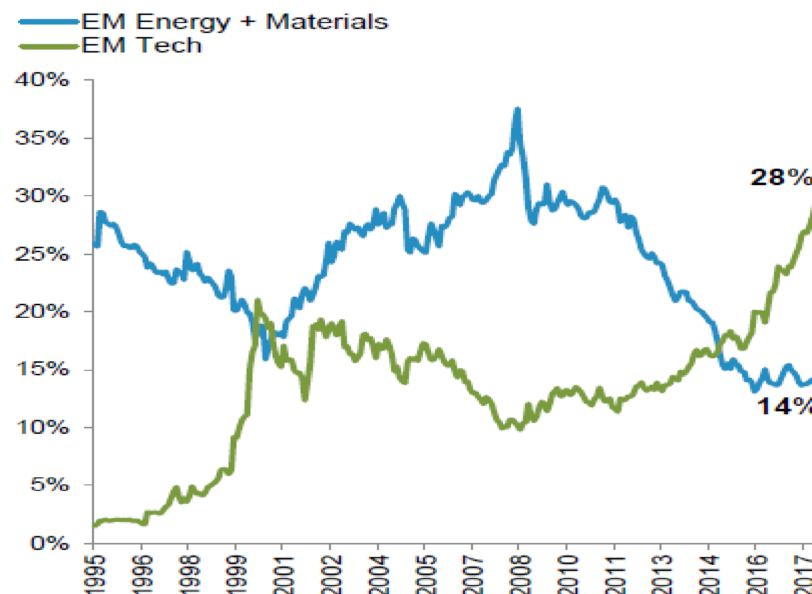


Source: Haver Analytics, Barclay Research

Emerging Markets

Even though the rally in emerging market equities has cooled off over the last few months as heightened global volatility has hit this asset class much harder than others, we still believe the future looks promising here as the global growth environment continues. The MSCI Emerging Markets Index is up approximately +7.4% in our current fiscal year vs. +11.5% for U.S. equities, as investors tend to feel more comfortable with U.S. equities in this

climate. Still, these are good results. The global economy is still expanding, valuations are appealing, and reforms continue in many of these countries, which could come together to push these markets higher. Corporate earnings should be very good this year and could even eclipse earnings growth in the U.S. China's growth has helped decently relative to expectations, Brazil is cutting interest rates and pushing reforms, and other Asian countries are robust at the moment. With all of these issues in mind, we continue to have a positive near and long term view toward emerging market equities as do most investors at this time.



Source: Fidelity Quarterly Update Q2 2018

International Equity Activity/Strategy

Even as trade negotiations heat up with China and many other partners around the globe and global manufacturing PMI's falling from very high levels, we still believe the economic expansion can muster along in 2018, barring some unforeseen turn that surprises us. Central banks still seem to be proceeding with caution as they move towards lifting accommodations in an effort not to spook the markets. Global employment remains healthy and inflation still remains well in check. This is an environment where corporate earnings should flourish as the business climate is about as good as it can get. From a valuation standpoint, global equity valuations have come down just a bit over the last few months, as earnings expectations have increased and markets have been somewhat flat lately. Of course there are risks, such as further escalations in trade tensions, the U.S./North Korean summit,

Iran, and the Italian political landscape. Barring a detrimental outcome on one of these issues, we could see the markets move higher as investors become more comfortable with the economic and geo-political scene.

We continue to remain active with our put writing on EEM over the last few months and expect to continue to be going forward in an effort to add further to this asset class after an extended period of under-performance lasting several years. Premiums for doing this strategy still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 3.0% of total assets and approximately 11.2% for MSCI EAFE equities. *(Credit is given to the following entities for charts provided: Haver Analytics, Barclay Research, Strategas, Markit, Fidelity Investments (AART), ISM, Baird Market Update, Haver Analytics, MSCI, Factset, Evercore ISI, and Morningstar Direct)*