Quarterly Economic Update 2Q 2017

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The Quarter in Brief. While the prospects for fiscal reform waned, a more synchronized global economic outlook and a strong earnings season helped propel markets higher in Q2.

Economic News. Much like the first quarter of previous years, U.S. economic growth was soft in Q1. GDP came in at a disappointing 1.4 percent according to the third estimate (released in June) reported by the Bureau of Economic Analysis. That was higher than the original estimate (+0.7 percent), but was less than the 2.1 percent reported in Q4 2016.

The labor market continued to be a bright spot for the economy. The 222,000 increase in non-farm payrolls in June put the monthly average increase at 193,667 for all of Q2. Headline unemployment hit a 15-year low in May (4.3 percent) and ended the quarter only marginally higher at 4.4 percent. Average hourly earnings growth remained stubbornly benign at 2.5 percent on an annual basis.

Overall business activity continued to expand in Q2. The Institute for Supply Management (ISM) Manufacturing index hit 57.8 percent in June while the ISM Non-Manufacturing index hit 57.4 percent, both two-year highs.

The Federal Reserve moved the overnight rate up .25 percent to a target range of 1.00 percent to 1.25 percent in June. The Fed also indicated that they expect to move rates higher in the coming quarters (another .25 percent by year-end) and signaled that they would begin to shrink the balance sheet (now exceeding $4.5 trillion in assets) in the near future. The Fed's own projection for the Fed Funds rate now stands at 1.4 percent by the end of 2017 and 2.1 percent by year-end 2018.

Growth in other major economies appeared to be accelerating as Q1 GDP for the Eurozone (1.9 percent year-over-year) was the highest level in two years and the Japanese economy expanded for the fifth consecutive quarter. China's growth (aided by fiscal stimulus) also surprised on the upside.

The ongoing dysfunction in Washington and the Republicans' inability to get any legislation started, let alone passed, has brought a little reality to consumer and business confidence. The Conference Board's Consumer Confidence Index fell from its 16-year high of 124.9 in March down to 118.9 in June. The Duke CFO Survey saw a decreased level (20 percent less) of optimism, citing less confidence in the ability of the current administration to implement its pro-growth agenda.

While the U.S. political scene heightened investor uncertainty in Q2, political developments across the pond had the opposite effect. Elections in France (Emmanuel Macron was elected) helped calm investors as the centrist leader pledged to keep France in the EU. Theresa May was re-elected in a snap-election in the United Kingdom (though she lost her majority in parliament), leading many to believe that "Brexit" negotiations will go more smoothly.

The Markets. The S&P 500 Index rose 3.09 percent in Q2, marking the seventh straight quarter of positive returns for the index. Gains were fueled by a solid U.S. economy, growing economic momentum overseas, fading political risks in the Eurozone, and a second consecutive quarter of stellar earnings reports in the U.S. First quarter S&P 500 Index earnings per share grew 20.0 percent (following a 21 percent increase in Q4 2016), and companies beat expectations at a rate not seen in over five years. At the same time, market volatility was almost non-existent as the CBOE Volatility Index (known as the "VIX") remained near record lows for much of the quarter. In fact, there were only four trading days in the first six months where the S&P 500 Index moved (plus or minus) by more than 1.0 percent. That is the fewest days ever recorded in the history of the index.

Index Performance	Q2 2017	Q1 2017	YTD
Domestic Equity			
S&P 500	3.09%	6.07%	9.34%
Russell Mid Cap	2.70%	5.15%	7.99%
Russell 2000	2.46%	2.47%	4.99%
International Equity			
MSCI EAFE	6.12%	7.24%	13.81%
MSCI Emerging Markets	6.38%	11.49%	18.60%
Fixed Income			
Barclays Aggregate	1.45%	0.82%	2.27%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

Large-cap shares did slightly better than their smaller peers. The S&P 500 Index returned 3.09 percent versus 2.70 percent for the S&P 400 Mid Cap Index and 2.46 percent for the small-cap Russell 2000 Index. The S&P 500 Index is now up 9.34 percent year-to-date, with leadership within the index meaningfully tilted toward growth stocks.

Stronger economic growth, a resilient manufacturing sector, fewer political uncertainties, and a weaker U.S. dollar all helped international lead domestic equities for the second straight quarter. The MSCI EAFE Index (Developed Markets) climbed 6.12 percent, and is now up 13.81 percent in 2017. The MSCI Emerging Markets Index rallied 6.38 percent in Q1 and is up 18.60 percent so far this year.

The yield curve flattened again in Q2 as the two-year Treasury rose from 1.26 percent to 1.38 percent and the 30-year went from 3.01 percent down to 2.84 percent. Most fixed-income categories posted positive returns during the second quarter. Longer-term bonds performed best while a narrowing of credit spreads allowed most credit-sensitive categories to outperform. The Barclays Aggregate Bond Index, which measures the performance of the U.S. investment-grade taxable bonds, finished the quarter up 1.45 percent.

S&P 500 Sector Performance	Q2 2017	Q1 2017	YTD
Consumer Discretionary	2.35%	8.45%	11.00%
Consumer Staples	1.57%	6.36%	8.03%
Energy	-6.36%	-6.68%	-12.61%
Financials	4.25%	2.53%	6.88%
Healthcare	7.10%	8.37%	16.07%
Industrials	4.73%	4.56%	9.51%
Information Technology	4.14%	12.57%	17.23%
Materials	3.17%	5.86%	9.21%
Real Estate	2.76%	3.54%	6.40%
Telecommunications	-7.05%	-3.97%	-10.74%
Utilities	2.21%	6.40%	8.75%

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Nine of the eleven Sectors in the S&P 500 were positive in Q2. Economically sensitive groups like Industrials (4.73 percent) and Materials (3.17 percent) did well. Consumer related groups posted positive returns (Consumer Discretionary +2.35 percent and Consumer Staples +1.57 percent), despite the fact that the retailing industry continued to get clobbered. Healthcare stocks (+7.10 percent) finished in the top spot as regulatory concerns faded throughout the quarter. Financials rebounded late in Q2 (ending the quarter +4.25 percent), when the Fed announced that all of the major banks passed their long-awaited stress tests, opening the door for banks to begin returning capital (through share buy-backs or increased dividends) to shareholders. A slight drop in bond yields helped push interest rate-sensitive groups like Real Estate and Utilities to positive returns. Energy stocks continued their poor performance amid falling crude oil prices (dropping from $50.6 per barrel to $46 per barrel in Q2). The Telecommunications sector continued to struggle, dropping 7.05 percent in the quarter and 10.74 percent year-to-date.

Outlook. While the U.S. economic expansion is already one of the longest in history, there are few signs that would indicate the end is near. A more global expansion should provide a steady backdrop for risky assets, at the same time, a lack of inflationary pressures should keep the economy from overheating. In other words, we expect more of the same, just with a more global footprint.

With the outlook for better growth overseas, foreign central banks are likely to become a bit less accommodative with their own monetary policy. This would be a reversal from previous periods where monetary policies were diverging, and should give the Fed ample cover to normalize ours.

At quarter-end, the S&P 500 Index traded at 18.5 times 2017 earnings estimates, compared to a 10-year average of 15.5 times. High valuations and low volatility have many believing the market is complacent. Both are a product of aggressive monetary policy and lower interest rates. As the Fed normalizes monetary policy (and interest rates presumably move higher), earnings need to continue to advance to justify premium valuations.

A broadening of economic growth outside the U.S. should bode well for international equities. Even after two straight quarters of outperformance, international equity valuations are still below those of the U.S. and growth rates are trending higher. U.S. dollar strength could also be less of a headwind (with an improving international outlook) for U.S. investors owning foreign assets.

While the actual Q1 economic data didn't necessarily support the "soft" data (confidence surveys), a significant rebound in corporate earnings was enough to push the market forward. Most of the policy-related trades (tax reform, Obamacare, infrastructure) have been "unwound" which probably puts even more emphasis on earnings in the coming quarters. However, the reduced expectation for fiscal stimulus probably means that if any legislation ever does get passed, the market has more room to be surprised on the upside.