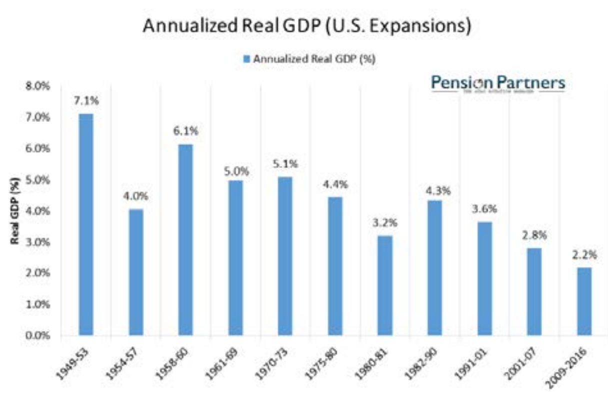
Q1 2017 Economic Commentary

"Everyone's got a plan until they get punched in the face."

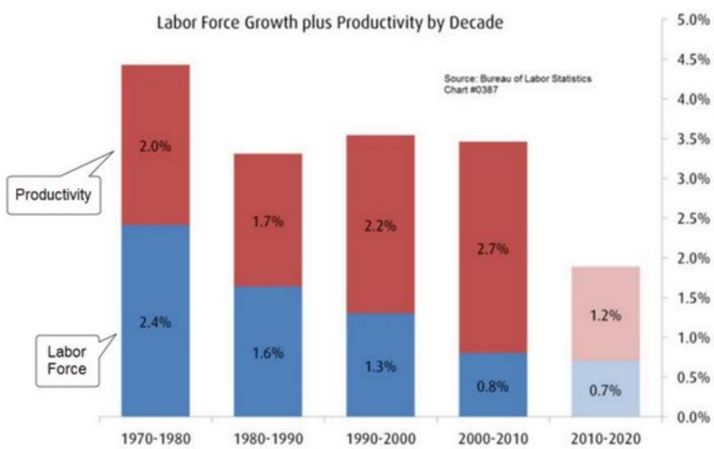
-Mike Tyson

Following years of fiscal policy hibernation, capital markets and most Wall Street strategists enthusiastically jumped on board the staunchly pro-business policies of the new administration of President Donald J. Trump. The consensus view has been that the U.S. economy would benefit strongly from implementation of an agenda focused on the main features of deregulation, corporate and individual tax reform and a long-term plan for infrastructure spending. With understandable trade-offs in spending and tax policies, faster economic growth would be the key to the successful implementation of the administration's agenda and much of Wall Street eagerly ratcheted up growth expectations. Consistent with this view has been the uniformed optimism from consumers, small business owners, homebuilders, and manufacturers as reflected in all economic sentiment surveys moving quickly to post-recession peaks. The question that must be asked is whether this is a realistic long term growth target or even one that may be achieved on a cyclical basis.

It is a basic rule of economics that a nation's underlying potential growth rate is a product of the number of people it employs (technically total aggregate hours worked) and how productively they work. The Federal Reserve, the Congressional Budget Office and most private economists view that the United States is mired in a slow growth environment due to the secular impact of an aging demography in the developed world along with stagnating productivity growth. From 1960-2008, gross domestic product in the U.S. grew at an average annual pace of 3.3%. It is estimated that about 50% of that was due to an expanding labor force as baby boomers and women entered the work force in droves. Those tailwinds have changed course and since 2008, GDP has grown at a pace of barely over 2.0% (see chart below on GDP growth by decade).

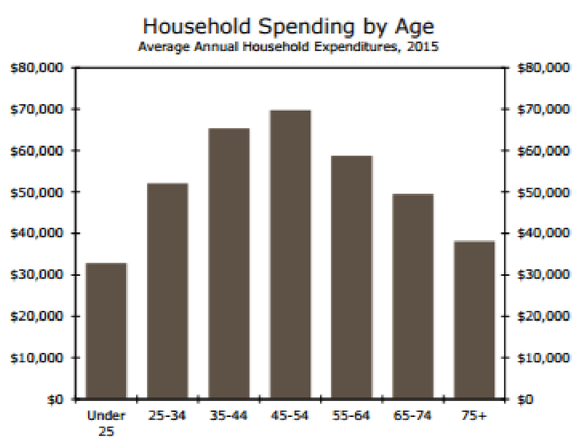


Growth in working age population is running at a 25-year low of less than 0.8% y/y (see chart below). This contrasts with the 40-year average of 1.3%. As baby boomers entered the work force commencing in the mid-60s, labor force growth averaged about 2% per year for over two decades from 1970-1990. Breaking this down further are the implications of this aging demography on the critical inputs of consumer spending and inflation.



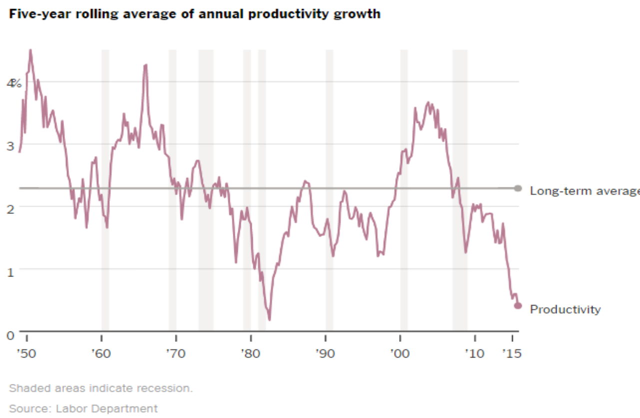
The median age of the population has increased over time; therefore, aggregate spending needs have slowed. Older people tend to be savers rather than borrowers. Younger people, by contrast, tend to be borrowers. Consumption follows a consistent pattern. As earnings rise and families grow, household spending increases through middle-age before declining as the kids move out and debts are paid off. Interestingly, this has been somewhat masked over the past few decades as the falling outlays among older households were offset by the rising earning and spending power of the baby boomers as they entered their prime working years. This is now changing and, again, has growth implications going forward.

The population of adults 65 and over is set to rise from 20% of the total adult population to 25% during the next decade. Currently over 75% of this cohort is over the age of 55 the point at which spending starts to decline (see chart below). Retirement age households in general spend as much as 25% less than younger households. The aging of the baby boomers will continue to weigh on consumption and the U.S. economy in the years ahead.



Productivity (defined as a measure of output such as revenue or inventory per unit of input of labor or capital) is one of the most important yet least understood areas of economics. Though volatile in the short term and subject to mismeasurement concerns, it is the only pathway toward higher levels of prosperity. It is the primary reason that despite slower economic growth an American worker makes much more today than a century ago and enjoys the benefits of a higher standard of living.

From 2011 through 2015, the government's official labor productivity measure shows only 0.4% annual growth in output per hour of work (see chart below). That is the lowest for a five-year span since the 1977-to-1982 period, and far below the 2.3 % average since the 1950s. The trend is heightened in the most recent period with productivity for 2016 ending up the year flat.



Lack of productivity growth in turn also has implications for the job market. The conundrum during the economic recovery as to why the labor market was so strong yet gross domestic product so weak lies in lack of productivity. From the 4Q of 2015 through the end of 2016, aggregate hours worked rose at a pace almost two-and-a-half times total business output. The need for additional labor is muted in such an environment and will start to slow absent greater gains in productivity.

There are differing economic views on the causes of this declining productivty. As a more service-based economy than decades past, there are limits to how much productivity can be enhanced via automation relative to manufacturing sectors (only on the Jetsons are haircuts more efficient via automation). However, capital investment by corporate America has been at the lowest levels over the last decade than it has in over 30 years and has clearly been a drag on this area.

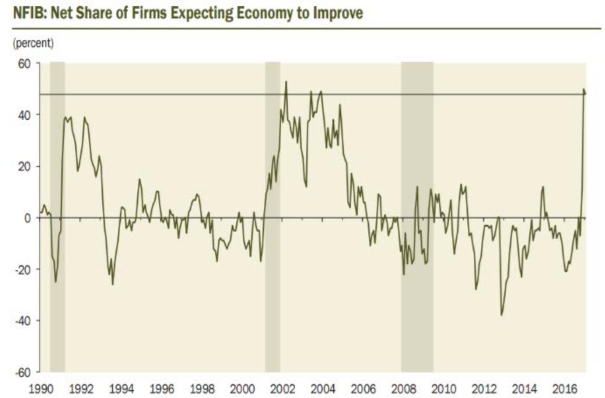
The achievement of the objectives of the new administration face headwinds of a diminished underlying potential growth rate. The economy may still get a cyclical boost, however, as reductions in unemployment are additive to growth and via additional increases in government spending and tax cuts. However, we are somewhat less sanguine on this in that we feel the economy to be very late in the cycle to engender the economic lift that would have occurred even six years prior when excess capacity was large. Additionally, the fiscal boost of tax cuts and increased spending may face the offset from the rising interest rate objectives of the Federal Reserve.

UNITED STATES:

"Soft" data comprises various poll-driven reports, like consumer confidence and business surveys. Among the most well-known of these are the Consumer Confidence index and the University of Michigan Consumer Sentiment index that seek to measure the views of consumers on the critical components of incomes and wealth, employment prospects, inflation, and spending intentions. For the business community, these surveys include the NAHB (National Association of Home Builders) Housing Market Index, NFIB (National Federation of Independent Businesses) Small Business Optimism Index and the ISM (Institute for Supply Management) Manufacturing and Services indices. In all the business surveys, the conditions of the respective industries are polled by those at the forefront of their sectors with an eye towards how these results will lead actual "hard" data in the periods ahead.

These surveys have been running strong for several months now. Consumer confidence as measured by the Conference Board's Consumer Confidence Index hit a decade high in March (chart on next page left).

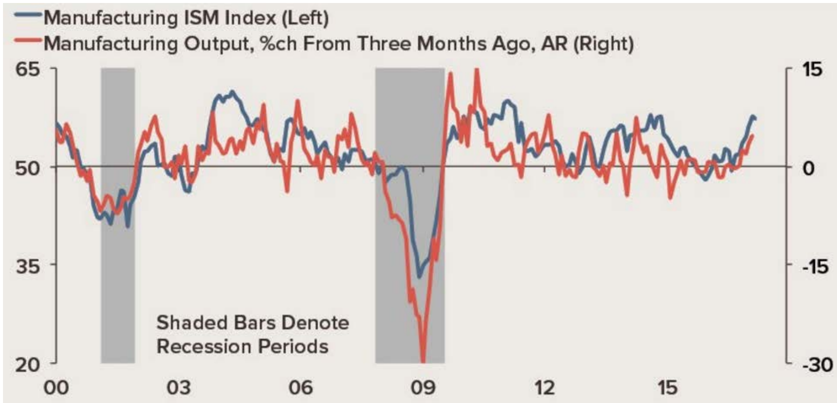
Business surveys, too, have been surging as they have reflected the optimism of the impact of a pro-growth administration to boost the economy (chart below right).



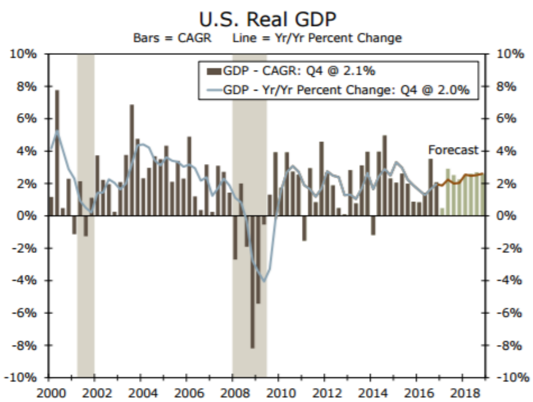
The problem is that so far, the hard data have not supported that optimism. The chart below shows the "soft data" of the Consumer Confidence Index versus the actual readings for real consumption spending that historically would be highly correlated. While the surveys do not reflect this, perhaps some of the spending weakness we have seen stems from rising inflation crimping consumer cash flows. Adjusting for inflation, average weekly earnings (the product of average hourly earnings and average weekly hours worked) has now declined for two months straight. Though a warm winter (less spending on utilities) and delayed tax refunds may have contributed to this slow start, the year-over-year pace of consumption is now down to 2.6% (from 3.2% in December) with the 3-month annualized rate now downshifting to +0.5%.

Some note that the efficacy of these surveys may now be in question. As the University of Michigan noted in their most recent release, it is very rare (and incongruous) that the data depict increasing optimism that usually promotes future spending alongside rising uncertainty most often associated with high degrees of caution on spending. According to Survey of Consumers chief economist, Richard Curtin, "All of these factors, however, have been influenced by partisanship. Democrats expect an imminent recession, higher unemployment, lower income gains, and more rapid inflation, while Republicans anticipate a new era of robust growth in incomes, job prospects, and lower inflation". How these discrepancies converge (and they will) remains key for domestic growth as consumer spending represents almost 70% of our economy.

One area where rising optimism does appear to be reflecting recent data is in manufacturing as convergence of the data points may be starting to take hold. Readings from the ISM manufacturing and regional Fed surveys of manufacturing activity have jumped much higher since the election. Factory data have firmed considerably from the weak patch that stretched from about mid-2014 to mid-2016 (see chart top of next page) as manufacturers struggled with soft global demand, the strong dollar and a downturn in the energy sector. Much of those headwinds are largely fading and incoming data have reflected that. Indeed, industrial production growth appears to be above 3% for 1Q, the strongest quarter since early 2014.



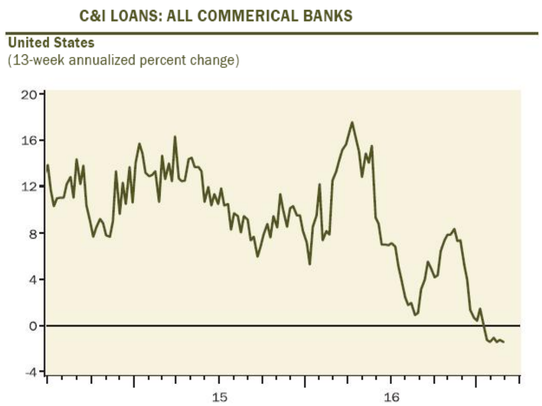
Final revisions for 2016 show GDP came in at a 2.1% annualized growth rate in 4Q and 1.6% for the full year. Real final sales to domestic purchasers (removing the impact of trade and inventory accumulation) continued to move ahead based on the strength of consumer spending and government. In Q4, consumer spending grew at a 3% annualized clip with better goods purchases but a bit of weakness in services. This represented the third straight quarter of consumer spending in excess of 3% but far below the 3.8% pace of 2014-2015. More importantly, much of the spending growth was in autos which have clearly decelerated in early 2017 and is also reflected in the softening data on spending. Continuing the pattern of the prior few years, the first quarter of the year is coming in weak and appears to be tracking at less than a 1.5% growth rate.

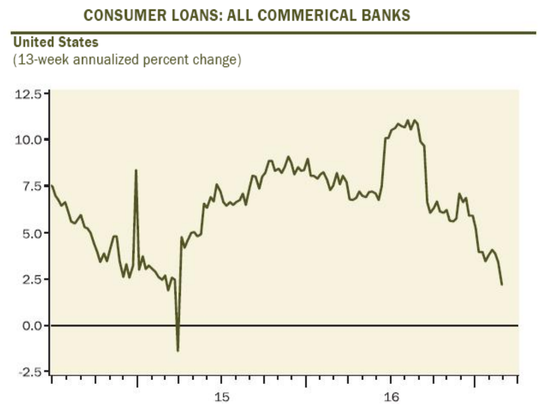


We have noted before the critical link between consumer credit, lending and consumption patterns. The recent slowdown in bank lending is turning into another debate over the growing gap between economic hope and reality. The pronounced deceleration in loans made to companies and consumers has surprised and confused many analysts who fear that the worst growth rate in about six years bodes ill for the U.S. recovery at a time when expectations remain high.

Credit acts as the lubricant for economic expansion smoothing out the cyclical volatility. Solving the mystery of the downturn has gained fresh urgency as investors wait to find out if the enthusiasm tied to Trump's pro-growth agenda will translate into a tangible boost. Indeed, one of the main stories for optimism entering 2017 was that increased deregulation and confidence would engender a rebound in credit. So, far the opposite appears to have occurred (charts on top of next page).

Bank lending often lags business investment so it is possible that the recent slowdown is consistent with the weakness in corporate investment over the last few years. Will this firm as business investment strengthens? This will remain a key question as the year unfolds.





THE FEDERAL RESERVE:

The Federal Reserve continued its process of interest rate normalization at the March 15th meeting with the expected 0.25% increase in the interest on excess reserves (Fed Funds Rate). The recent strength in the employment and wage data continues to support the rate increases. However, the Federal Reserve may pause should growth remain below 2% and/or should the fiscal initiatives of the Trump administration (which the Fed claims to have ignored in their prognostications) become bogged down in Congress. We expect at most two more increases for 2017.

In addition to the tightening of monetary policy by the Federal Reserve (that has now increased from 0.25% to 1.0% in the last 15 months), one should look to LIBOR for greater color on changes to policy. Most individuals who borrow short term from banks or other lenders (including adjustable rate mortgages) reference the three-month LIBOR rate as the benchmark for changes in the costs of borrowing. Meanwhile, over the last three years, changes in the banking system and U.S. money market fund rules have combined to increase LIBOR from 0.25% to the current 1.15% over the same period. Said another way, regulatory changes alone amounted to almost the equivalent of an additional Fed tightening.

INFLATION:

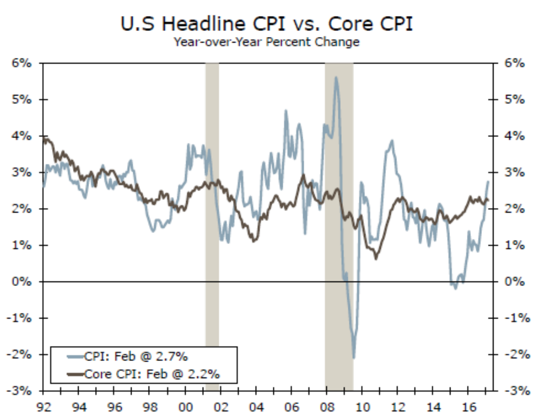
Previously noted in our annual commentary, perhaps the most important issue for the United States economy regarding the impact of fiscal policy on growth and inflation in 2017 and beyond is whether it's near its speed limit. Following nearly eight years of what might best be characterized as a glacial expansion, many believe the economy to be nearing full capacity, a level at which both employment gaps and manufacturing output gaps have nearly closed.

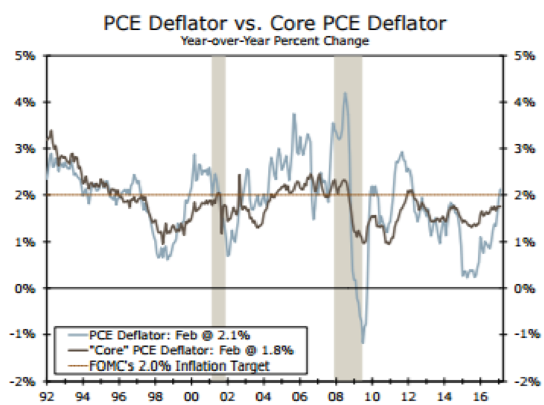
Output gaps in the job market manifest themselves in people who might otherwise return to the job market in a strong economy still not even looking for work while in the manufacturing sectors this would be in the form of empty warehouses and machines not running at full capacity. The Congressional Budget Office (CBO) estimates that growth in GDP in 2017 of 2.5% will be sufficient to reach their estimate of the nation's full economic potential.

Though we feel strongly that the economy remains very late cycle and output gaps have mostly closed, there remains some capacity and certain data points reflect some opposition to our position. If there is further room to expand above the CBO estimate then many of the proposed fiscal initiatives should be accretive to growth and the Fed should move slowly on raising interest rates so as not to choke off the expansion just as it gets going. Comments by Federal Reserve Chair Janet Yellen indicate that she, too, feels we are near full capacity and has noted little support for fiscal stimulus at this stage of the cycle. Her fear is that if slack is very small, such stimulus would likely risk increasing inflation not output and incomes.

The Federal Reserve watches the manufacturing sector by measuring what is called, "factory capacity utilization" which measures the extent to which the productive capacity of a business is being used. By this definition there remains idle capacity as American companies were operating factories at 75.9% of their potential as of the most recent data point in February (chart below) well below the 80% level that historically has been viewed as full capacity. Economic slack, however, is much more difficult to measure in the services area and as this now reflects over 85% of our economy, the efficacy of this measure is more in question.

Over much of the last year, we shared our view that inflation would converge towards 2% in 2016 and possibly reach 2.5% or greater in the first part of 2017 as the base effects of lower gas prices (that averaged only $33/barrel in 1Q 2016) are anniversaried. Inflation showed further signs of firming in February (see the CPI and PCE inflation charts below). Headline inflation is now above the Fed's 2.0% target for the first time since 2012. The PCE deflator ticked up just 0.1% on a drop back in energy prices over the month, but the year-over-year rate rose to 2.1% as energy prices have rebounded more than 40% over the past year.





Despite the current realization of higher inflation, we continue to maintain that the secular impacts of an aging population and excessive amounts of consumer and government debt will combine with the increasing spending challenges of the middle class (where the propensity to consume is highest) to act as a governor on longer term inflation and interest rates. We view the longer-term trend to be lower inflation and interest rates and anticipate that will begin to manifest later in 2017.

EMPLOYMENT & WAGES:

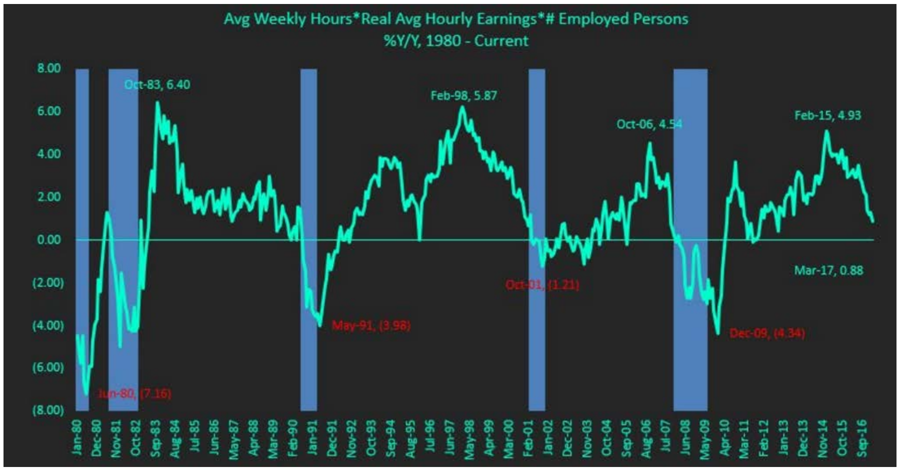
We have long noted the declining labor force participation rates in the United States to be mostly a function of the aging of our demography as the baby boom generation continues to retire in droves. However, there remain major concerns on the overall health of the job market outside of this secular evolution. Though the unemployment rate is now down to 4.5%, this may not reflect accurately those that currently reside outside the labor force with the potential to rejoin. For this we look to the labor statistics of the 25-54-year-old cohort to minimize the impact of an aging demography and here we find some very sobering data.

For every unemployed American male between 25-54 years of age, there are estimated to be another three that are neither working nor even looking for work. A recent study by Alan Krueger, former chairman of the President's Council of Economic Advisors, noted that nearly half of all prime working age male labor force dropouts currently take pain medication on a daily basis. Another 21% of this group were Medicaid beneficiaries and nearly 57% were collecting disability benefits. While these social programs obviously do not support a lavish lifestyle, they do offer an alternative to re-entering the work force. Additionally, America's population of non-institutionalized adults who have a felony conviction somewhere in their past has now exceeded 20MM as of the end of 2016 limiting their ability to obtain employment.

The chart below indicates that as many as 2MM workers would be currently employed if the labor force participation were the same as prior to the recession. The concern with this data point along with the argument for remaining excess capacity is whether this group weighed down by increasing levels of disability, drug use, incarceration, and inadequate skill sets will be able to re-enter the labor force.

The anticipated deceleration in job growth has continued into the early stages of 2017 with nonfarm payroll growth averaging 178K new jobs through data from March. This compares with an average of 187K in 2016 and is down from the prior two year levels of 226K and 250K, respectively. This late cycle slowdown in job growth remains more than sufficient to continue to bring down the unemployment rate. As such we have continued to expect increasing wage growth to benefit the consumer and the economy. In this area, we continue to see only modest progress and rising inflation levels are pressuring this metric.

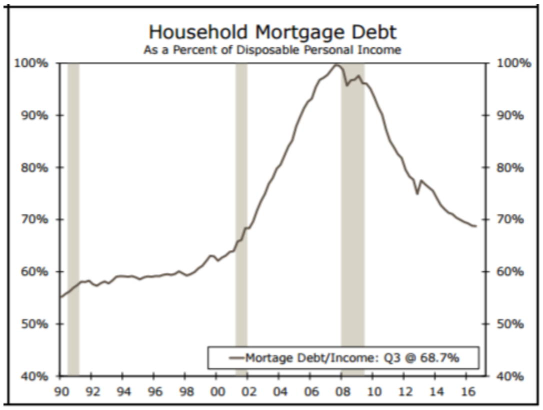
Though average hourly earnings have glacially improved to a 2.7% y/y increase, the average workweek has been slowly edging lower every month since December suggesting firms may feel less staffing pressure for their needs. Though we often reference the metric of hourly wage growth, it is more accurate to review the total weekly earnings (that include the average number of hours worked) and then adjust for inflation. Here we can see that a contracting number of hours worked along with modestly rising inflation have combined to dramatically slow real take home pay. The chart on the following page depicts a slowdown from levels near a 4% annual rate in the middle of 2016 to virtually 0% real growth following the most recent report from March. The incomes of the median household remain under pressure.

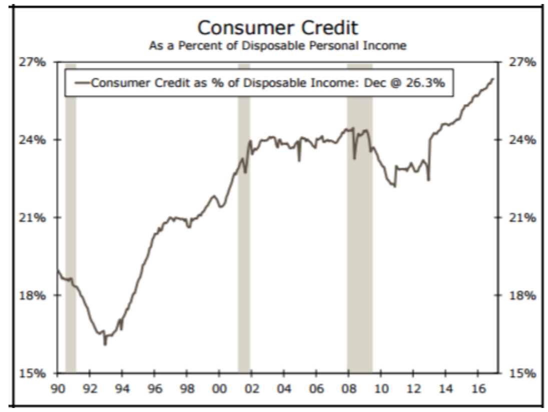


CONSUMER:

We have noted previously that increases in total household net worth have surpassed the pre-recession peak in both nominal and inflation-adjusted terms as both housing and financial markets have surpassed prior peak levels. Data from the most recent Flow of Funds report show that U.S. household net worth climbed to $92.8 trillion in the fourth quarter of 2016 as the end-of-year surge in stocks and a continued climb in home prices added more than $2 trillion of wealth to household balance sheets. Additionally, the same release notes that the financial obligations ratio (the ratio of total household debt payments-including rent and auto leases- to disposable income) is just over 15%, one of the lowest readings in the over 37-year history of the series (chart below). By many metrics, the U.S. consumer on an aggregate level may be considered in strong shape. However, both data points (and many other metrics) have been distorted during the recovery period by near zero interest rates that both elevate asset prices and reduce the interest cost of servicing debt. We are continuing to see some signs of consumer stress that might be exacerbated by rising interest rates and a stock market correction.

Total consumer credit (excludes mortgage debt) has risen considerably since 2013 and is currently at an all-time high of over 26% of disposable personal income (chart on next page). Mortgage debt to personal income has declined dramatically since the housing crisis (chart on next page) reflecting a decline in homeownership from over 69% as recently as 2006 to 63.7% as of the latest reading. Still, the consumer has levered up in other areas, most problematic of which are student and auto loans.

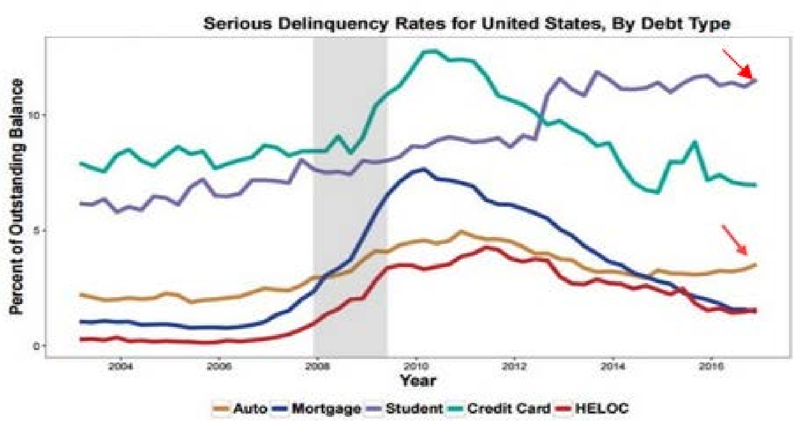




As college attendance increases, the cost of not going to college in terms of opportunity is escalating. This creates an inelastic demand for higher education and has given colleges much room to raise prices just as state funding has declined. The subsidization of tuition via the Federal Student Loan Program has abetted a rise in education costs far greater than inflation forcing students to take out ever higher amounts of debt. From 2006 to today, total student loan debt soared more than 170% from $517 billion to over $1.4 trillion, to cover surging tuition costs. Over that same period, real starting wages for college grads were essentially flat.

High levels of student debt reverberate throughout our society and graduates are postponing the traditional norms of marriage, childbearing and housing purchases. It is estimated that 35% of males 18-34 are currently living at home with parents creating a large bottleneck in the housing cycle via the first-time home buyer. A mere 20% of 25-35-year-olds changed addresses in the past year the lowest mobility over the prior five generations for that cohort. This also has impact on entrepreneurship among young people as the debt crowds out the ability to start a new business. These are large obstacles to economic growth.

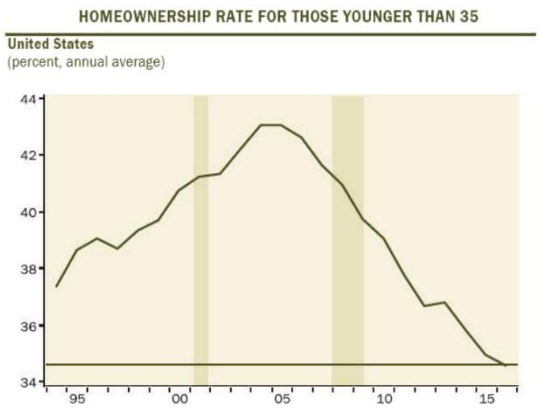
Serious delinquency rates for student loans are now approaching 11% (chart below top red arrow). Additionally, we now have over $1.1 trillion in auto debt (almost $300 billion of which is subprime) that appears to have replaced subprime mortgages in where low cost debt has found a home. Not surprisingly, serious auto debt delinquencies have also started to rise (chart below bottom red arrow). When many continue to wonder why improving job and wage growth along with rising asset values have not translated into greater consumer spending, this is an area to which we return.

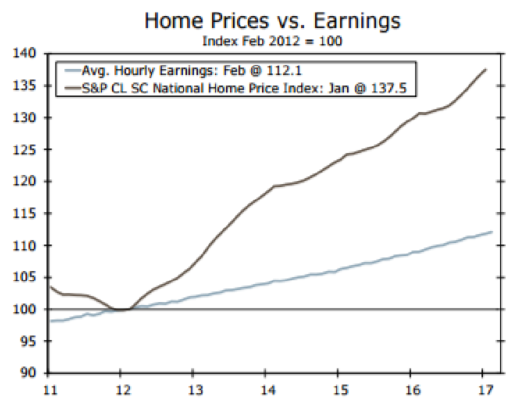


HOUSING & AUTOS:

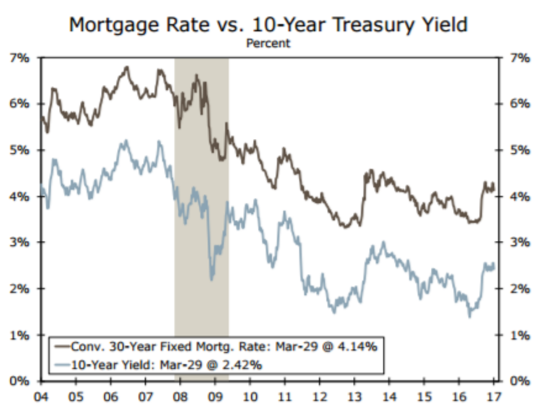
The housing market is still one area of the U.S. economy where significant upside remains based on demographics and demand. The traditional drivers of housing demand of job growth, wage gains and consumer confidence have collectively soared to their strongest levels in years and combined with the maturing of the millennial cohort should equate to a positive housing outlook. However, without builders adding materially to the low levels of existing inventory, the supply side of this equation continues to cause demand to remain largely untapped especially in the first-time homebuyer demographic (chart below left).

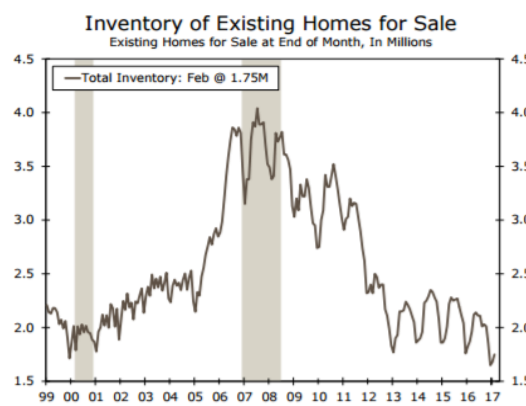
After sitting out the early stages of the recovery in the existing home category, first-time homebuyers have been modestly recovering and driving the incremental gains in activity as repeat buyers continue to trend sideways. Two of the key factors restraining this cohort from returning to the historic levels of housing activity (closer to 40% than the recent levels just over 32%) continue to be affordability (chart below right showing income versus house price gains) and access to credit.





The inventory of homes for sale in February were 6.4% below a year earlier and about 30% below the long-term average after ending 2016 at the lowest level since the National Association of Realtors began tracking such data in 1999 (chart below right). This lack of inventory is pushing up national home prices. According to the S&P CoreLogic Case-Shiller indices home prices climbed 5.9% in January, the fastest rate of year-over-year growth since mid-2014. Adding to the affordability challenges for buyers, mortgage rates have risen recently to about 4.14% from roughly 3.50% in November (chart below left). Though still historically low, this increase in mortgage rates serves to increase the monthly principal and interest payment for a homebuyer by over 8%. This would represent over a 14% increase when combined with the nearly 6% gain in home prices.



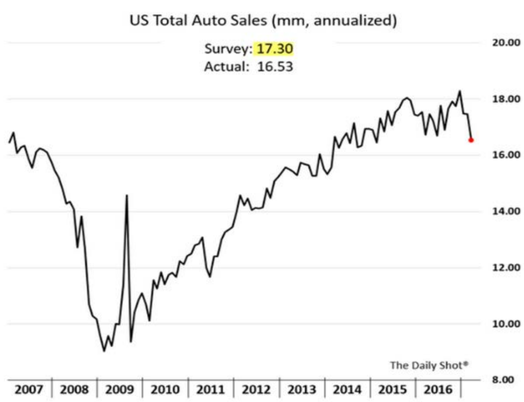


Though lack of supply remains the greatest impediment to the housing market, there remain some concerns on the demand side. Prospective buyers are also facing challenges with access to mortgage credit. Bank lending standards continue to remain quite stringent with the current average FICO credit score for a qualified applicant standing at 763 compared to 721 prior to the last recession. With approximately 17% of the population registering a FICO score between these two figures according to data analyzed by Goldman Sachs, a sizable portion of the potential market is being left out.

The need for affordable new construction is high but builders are facing their own concerns. Builders face many cost constraints that were mostly absent during prior periods. Labor shortages are pronounced with builders reporting a serious dearth of qualified construction workers following the aftermath of the housing crisis and exacerbated by tightened immigration laws and the aging of many skilled workers. This is increasing the cost of hiring and retaining workers at a time when the lack of buildable land adds to these cost accelerations. Additionally, the costs of government-mandated "impact fees" that fund the local infrastructure needed to support a growing population (schools, transportation, environmental mitigation, and utilities) crimp new home construction. These fees are levied on new construction and average over $21,000 per unit making it challenging for builders to make affordable entry-level homes at a profit.

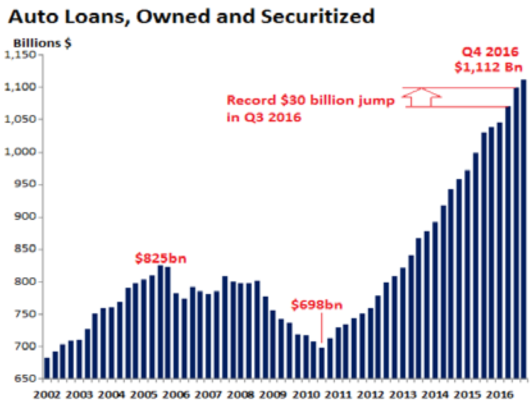
So, despite a backdrop that should remain constructive for housing demand, the headwinds noted above will not clear easily or quickly. We envision home prices continuing to rise faster than incomes placing further pressure on affordability and keeping us cautious on our outlook for housing.

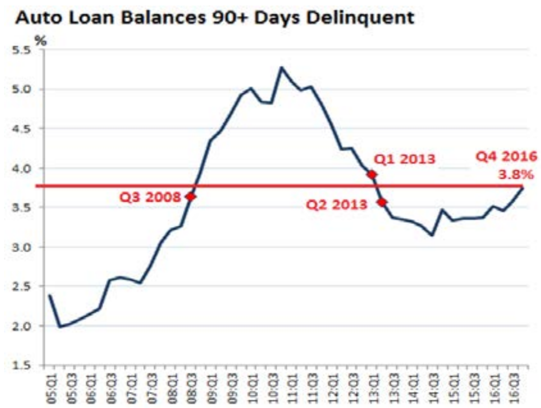
According to data provided by auto analysts at Wards, auto sales appear to have hit the peak levels that we have been anticipating for over a year. Final sales totals for March of an annualized pace of 16.53MM vehicles sold (chart below) were the lowest in over two years (and now down year-over-year in 9 of the last 13 months). This total is more than 4% below expectations and continues a decline from the 17.4MM record pace set in 2015 and 2016. Moving cars off the lots is getting far less profitable for auto makers as the average incentive hit a record of $3,830 per vehicle sold, according to J.D. Power, representing a 10% increase vs. the prior year, the latest in a string of incentive-spending increases. Additionally, inventories are expanding even as auto sales remain high, with vehicles taking an average of 74 days to turn (65 is considered equilibrium), a level not seen since 2009 according to J.D. Power (chart below right).



Auto loan balances in 2016 surged at the fastest pace in the 18-year history of the data series and have ballooned since the Great Recession per data from the Federal Reserve Board of Governors (see chart on left on next page). Following the housing crisis of 2008, lenders found that borrowers in financial difficulty were surprisingly more likely to default on their mortgages than auto loans thus prompting lenders to lower credit standards. A house could be replaced by a rental but a distressed consumer still needs their car to get to work. At $1.1 trillion, total car loans are now 35% higher than they were during the crazy peak of the prior bubble. Note that during the $93 billion increase in auto loan balances in 2016, new vehicle sales were essentially flat indicating larger and larger loans per vehicle.

Unsurprisingly, what the auto industry has been dreading is now happening: delinquencies have begun to surge. "Seriously delinquent" auto loan balances, composed of all loans that are 90+ days past due, rose in Q4 to 3.8% of total auto loan balances (see chart on right on next page). That puts them right between 1Q and 2Q of 2013, a period in which auto credit was recovering from the Financial Crisis. The last time auto loan delinquencies had surged to that level was after 3Q 2008, as the Financial Crisis was tearing into the economy.





We have noted increasing concerns about auto lending for over a year as balances and terms continued to increase to record levels. A direct manifestation of this is found in recent data from Edmunds showing that so far in 2017, over 34% of all “trade ins” toward the purchase of a new care were underwater (i.e. the outstanding loan balance exceeds the value of the car). This is up from 19.2% as recently as 2010. Such transactions add to the loan balance on the new car and further the increases in consumer indebtedness.

However, we are not concerned about systemic risk to the financial system from such loans as this fallout would not likely be centered in traditional banks but on auto financing specialists and financing arms of the automakers. Still, this is another indication of a financially stressed consumer and suggests that much of the strong car sales data of recent years is a case of demand being pulled from future sales. As autos have contributed strongly to overall economic growth and employment during the recovery, we anticipate a drag on these areas over the next year.

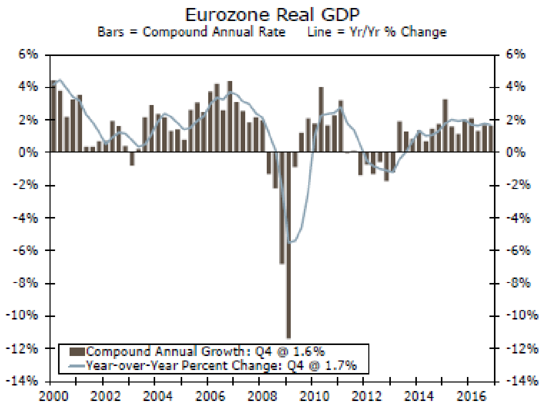
INTERNATIONAL:

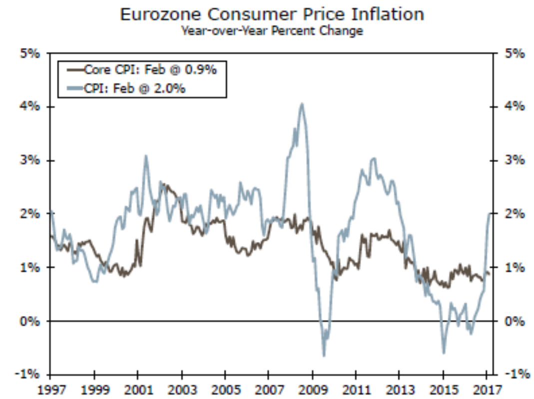
While polls favor establishment candidates in the French elections (a first round on April 23rd and likely run-off between the two leading candidates on May 7th) and German elections in the fall, polls proved quite unreliable in 2016. The distinctions between Marine Le Pen and Emmanuel Macron in the election in France are stark in the ideological divide between Le Pen’s nationalism and the more global view of Macron. A win by Le Pen representing the National Front party in the Presidential election could lead to a crisis as she seeks to take France out of the European Union and redenominate the country’s debt in francs, resulting in devaluation, default, and, potentially, a huge shock to the financial system. In contrast, Macron, the En Marche party candidate, seeks further eurozone (EZ) integration while pressing Germany to adopt trade policies to reduce their surplus to benefit the rest of the EZ. This may be the single most impactful election in the history of the Eurozone.

EUROZONE:

In the face of ongoing uncertainty regarding these upcoming elections, the negotiations with the UK on Brexit and continuing concerns in the banking sector, the real economy in Europe has been remarkably stable. Real GDP in the Eurozone rose 0.5% (a 2.0% a/r) on a quarter over quarter basis in 4Q2016. Growth has been positive on a sequential basis since 2Q 2013, 15 consecutive quarters. For the full year, growth in the Eurozone registered a 1.7% increase slightly down from the 2.0% pace registered in 2015. For the entirety of this recovery, growth has not been strong enough to lift inflation to any significant extent. We are hopeful (though not confident) that this may have turned the corner early this year.

Consumer prices were 2.0% higher in February (the most recent final data) than the same month a year earlier, a pickup from 1.8% in January 2017 and 1.5% at the end of 2016. As is the case with much of the reflationary data across the globe, this acceleration was mostly due to a 9.2% rise in energy prices. The core rate of inflation, which excludes food and energy prices and which is more reflective of underlying inflationary momentum in the economy, has been trendless since 2014 and is currently at 0.9% slightly above the 0.7% registered at the end of 2016.

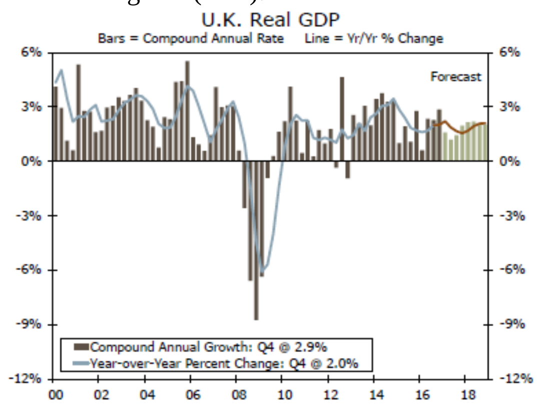


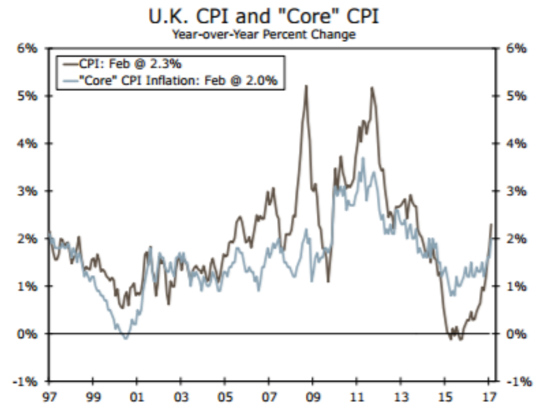


The February Economic Confidence index for Europe moved to the highest level in six years but is still below where it stood in 2007. According to the European Central Bank (ECB), loan growth to households and companies is growing over 2.3% y/y with the money supply expanding by almost 5%. This reflationary data is welcome but is 2% loan growth all that the extraordinary monetary policy of the ECB can engender? Europe is clearly on the rebound but the continued accommodation of Quantitative Easing and low to negative interest rates appears in little danger of being removed. As ECB President Mario Draghi noted in an early April conference, “We are not yet at a stage when inflation dynamics can be self-sustaining without monetary policy support. The recovery of inflation still depends on the very favourable financing conditions that firms and households enjoy, which in turn depends on the substantial degree of monetary policy accommodation we have in place today.”

UNITED KINGDOM:

Economic growth in the United Kingdom has seemingly held up well since the Brexit referendum last June. The two-year process of withdrawing from the EU was triggered by Prime Minister Theresa May on March 29th by invoking Article 50. Real GDP in the United Kingdom grew 2.9% a/r in Q4 2016 with broad-based sector strength supporting overall growth (see chart below left). Expected economic weaknesses stemming from the Brexit vote continue to remain subdued no doubt aided by the monetary accommodation from the Bank of England (BoE).





However, there are signs of both rising inflation and a downshift in the pace of consumer spending over the last few months placing the BoE in a quandary. Do they ease policy further to shore up spending, raise rates to combat inflation concerns or wait to react to further developments?

Though still positive, the pace of consumer spending appears to have contracted by around 1% in 1Q 2017 from the rate in 2016. This slowdown may be due to the rise in inflation in recent months which reflects both the rise in energy prices and the lagged effect of a plummeting pound raising import prices.

About a year ago, the overall rate of CPI inflation was essentially zero (chart above right). By February, it had risen to 2.3%, the highest overall rate of CPI inflation in almost three years. Yes, much of the rise in the overall rate of inflation reflects energy prices, which have stabilized after collapsing from mid-2014 to early 2016. Consequently, the overall rate of inflation is reverting to the core rate of inflation, which is more reflective of the economy's underlying inflation momentum. In that regard, the core rate of inflation has edged higher for three consecutive months, reaching a three-year high of 2.0% in the most recent report.

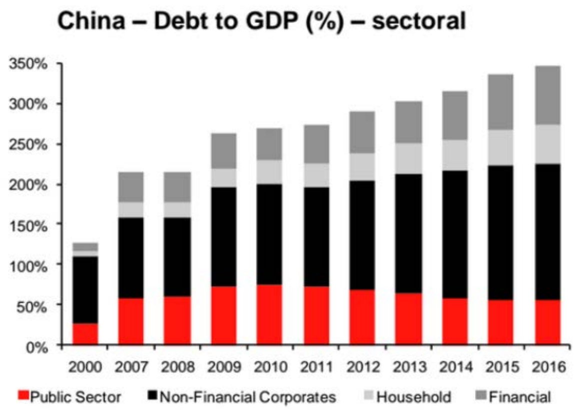
Despite positive economic performance since the Brexit referendum, we still maintain that the greatest risks will not appear until the actual negotiations commence. We do not anticipate that the European Union will be so generous in trade terms due to the fear it might encourage other nations to follow suit. This will put further pressure on the pound and increase inflationary concerns.

CHINA:

In 2016, exports from China fell -7.7%, a major concern for the stability of the economy and a continuing cause of the major debt buildup to help support growth. In fact, the era of China's growth by exporting has long been threatened as the large majority of manufacturing jobs that could be moved from the West to China and other developing countries have already moved. The decline of manufacturing in the U.S. (from 17% of GDP in the late 90s to less than 12% currently) facilitated export growth from China of between 20% and 30% per year. Now these exports are contracting (chart below in year-over-year growth).

The demise of the TPP (Trans-Pacific Partnership) represents a major blow to many emerging Asian countries as it was a multinational trade agreement among a dozen members that represented 40% of global GDP but one that did not include China. As such, Beijing now stands to benefit by the rival Regional Comprehensive Economic Partnership (RCEP) that will include 16 mostly Asian countries (about 30% of global GDP) but not the U.S. With the U.S. by far the largest export market for China (as much as the next three countries combined), an unhappy United States will demand new trade agreements be worked out. With China currently holding a $347 billion trade surplus with the U.S., these trade talks will be critical for global trade and growth especially for China.

To offset declining exports, China has been on a long infrastructure spending spree that has spawned major excess capacity and non-financial debt that has soared from 164% of GDP in 2008 to the most recent reading of 247% during 2016. The long-desired shift towards consumer spending and services remains a work in progress. Increases in minimum wages are designed to help promote household spending as much low-end manufacturing has in turn already been offshored to cheaper locales such as Vietnam.



Real GDP continues to soften (per official government data) though it still expanded at a 6.8% rate in 2016. Growth in the construction and industrial sectors appears to have held steady at around 6%, while growth in the service sector, appears to have strengthened somewhat. In this area, we note that nominal retail spending has picked up recently but is still below levels necessary for the transition from infrastructure to consumption that is the primary cause for the deceleration in the Chinese economy. The housing market has also slowed from the turbocharged gains that were registered earlier in the decade. China will continue to try to engineer this soft landing and still maintains ample excess reserves to cushion this transition. However, these reserves have been contracting from in excess of $4 trillion in 2014 to below $3 trillion recently. With debt levels rising rapidly and the pace of capital outflows accelerating odds of a hard landing are increasing.

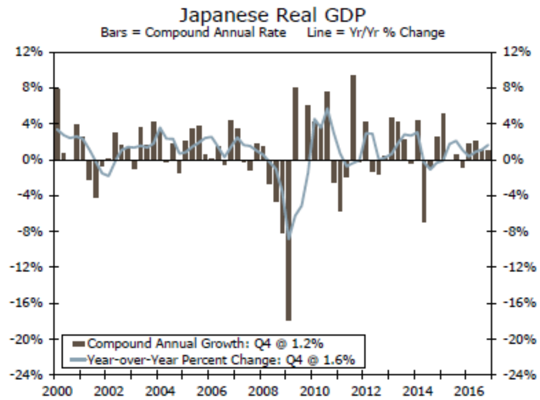
JAPAN:

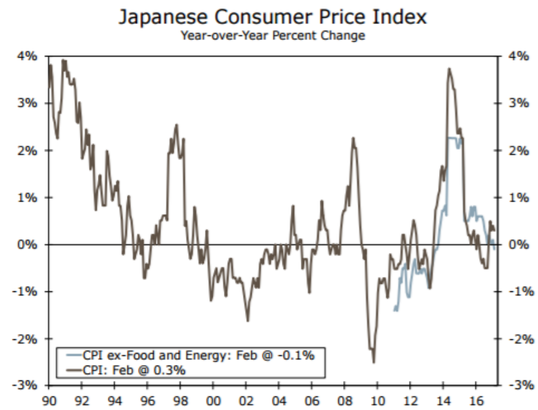
Almost four years into the experiment by the Bank of Japan (BOJ) of a "shock-and-awe" stimulus plan involving printing trillions of yen and even negative interest rates, Japan fell back into deflation in 2016 following a brief spurt of economic growth and rising prices. Twenty-five years following the burst of one of the largest real estate bubbles ever, a younger, frugal generation has emerged that knows only economic malaise and not growth, stagnant wages and deflation not prosperity and optimism.

Deflation is bad for an economy because it undermines economic growth. Businesses earn less, so they invest less, cut wages and stop hiring. The monetary logic behind ultralow and even negative rates is that they jolt consumers and businesses into spending by stoking inflation. However, when deflation becomes so rooted in this expectation, consumers and businesses eschew this desired outcome and, perversely, increase savings to hunker down for more perilous times exacerbating the downward spiral. This is today's Japan.

Contrasting this sober assessment has been data for the most recent quarter in Japan that has engendered some optimism as the Japanese economy expanded at a 1.2% annualized pace in 4Q (chart below left), marking four sequential quarters of growth—a feat not seen in three years. Growth was led by an increase in net exports made more attractive by a weaker yen. Trade needs to be a primary driver for Japanese growth. Unfortunately, the termination of the Trans-Pacific Partnership (TPP) by the new U.S. administration is not a short-term positive for this objective.

Though the inflation rate has turned positive in recent months, this again is more a function of rising energy prices and a weaker currency rather than economic fundamentals. Inflation as measured by the CPI rose 0.3%y/y in February (chart on right on next page) but core inflation (excluding both food & energy) still fell -0.1%y/y.





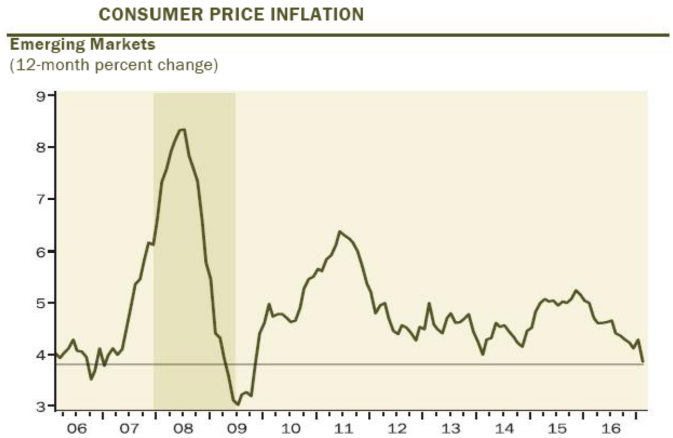
The missing component in a Japanese recovery remains consumer spending. Real average household spending dipped to -3.8% y/y in February accelerating from the -1.2% decline seen in January. This marks the 12th consecutive monthly y/y decline. Despite a job market continuing to show healthy signs (a 2.8% unemployment rate and an annual gain of over 500K net new jobs), it appears deflation is still front and center in the fears of the Japanese consumer.

EMERGING MARKETS:

According to data from the Bank for International Settlements (BIS), U.S. dollar-denominated debt to emerging markets (EM) soared to $3.3 trillion towards the end of 2015 almost double the level from 2009. An increase in the U.S. currency places increased stress on the ability of local economies to service that debt as it becomes more expensive to repay from depreciated local currencies. Indeed, the near 25% appreciation of the U.S. dollar from mid-2014 to early 2016 created a massive headwind for these countries. The stabilization of the dollar over the last year (chart below) has mitigated this concern.

Consistent with the more stable global economic backdrop, emerging markets have enjoyed a solid economic resurgence despite the modest rate increases long feared from the Federal Reserve and the developing anti-trade rhetoric emanating from the United States. Indeed, trade volumes in emerging market countries are exceeding 4% spurring estimates for 1Q growth in these regions to collectively approach 4.5% on an annualized basis, more than double the pace of developed economies.

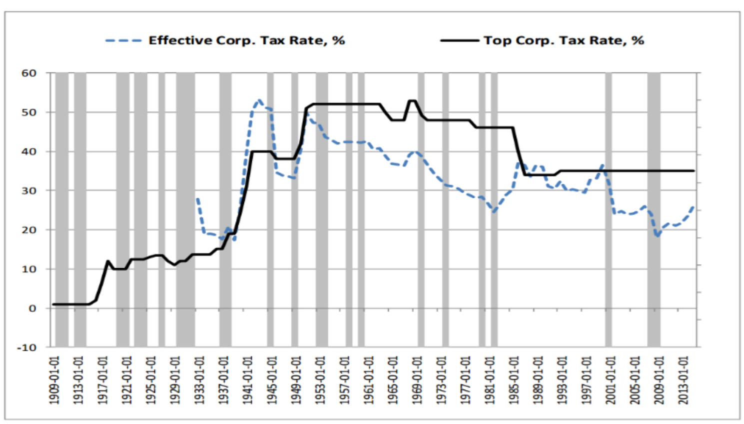
Additionally, more stable currencies have engendered a slowing in the rate of inflation (chart on next page) that has declined from a recent peak of 5.2% in late 2015 to 3.8% y/y in February (and 3.2% when excluding Venezuela and Argentina). This lower inflation lends support to growth by pushing borrowing costs lower. We are more positive on a continuation of improving growth in these countries and relatively attractive equity markets. The risks of policy tightening from China (and the commensurate commodity impact) along with greater protectionist policies from the United States are the most pronounced concerns.



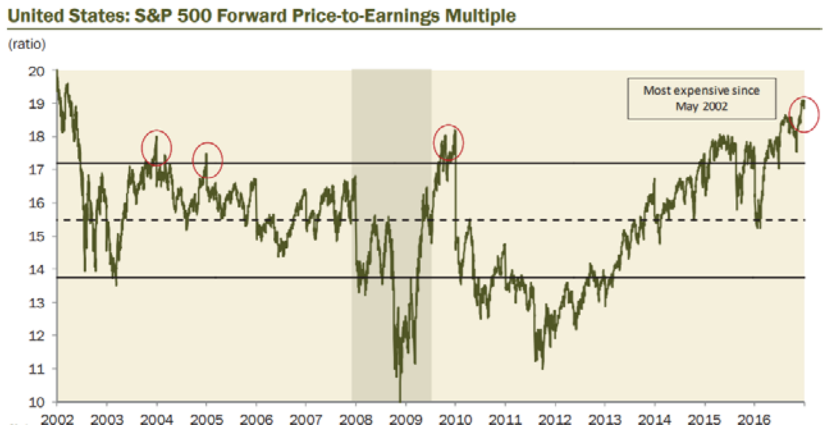
MARKETS:

As we entered 2017, we noted in our commentary the enthusiasm of analysts to extrapolate the pro-growth agenda of the Trump administration immediately into very strong earnings gains for the S&P 500. Following three years of virtually flat earnings around $118, consensus estimates are for index earnings to increase to around $131, a gain of 12%. Our call for an increase in S&P earnings of about 6% to $125 is based on a still slow growth economy being offset by the benefit of moving beyond the major drag on earnings caused by the collapse of the energy sector. Though optimistic on the longer-term benefits of deregulation, infrastructure spending and the growing confidence that a pro-business agenda will have on corporate America, we have remained more circumspect regarding the impact of fiscal initiatives for 2017 and the ability of a very divided Congress to move forward quickly. In the first 100 days of the new administration, we are seeing this play out.

The goal of major corporate tax reform has become more problematic following the inability of the administration to pass the American Health Care Act (AHCA) in March. The estimate of a $1T savings over 10 years from the AHCA was critical to fund the reduced revenue expected from reducing corporate tax rates towards 20%. With the Border Adjustment Tax (BAT) struggling for support, any reduction in the corporate tax rate will likely have a much more muted impact on corporate earnings than the market has been anticipating. It is now more likely that a target near 28% may be necessary to achieve the objective of revenue-neutral reform. With a current "effective" tax rate (what firms actually pay after deductions) of around 26% for S&P 500 companies (chart below), the impact on earnings may be much less than hoped for pressuring current valuations.



Following the depths of the recession, corporate profits, as defined by S&P 500 operating earnings, rose at an annual rate of over 24% from 2009-2011. Since the beginning of 2012, earnings have grown just over 3% per year. The over 80% increase in the S&P 500 since the end of 2011, has been driven in large part by the expansion in the P/E multiple from 11x to almost 18.5x forward expected earnings (chart below). This metric compares to a 10-year average of 15x and now sits at the highest level in the last 15 years.



The post-election rally continued through the first two months of the year before pausing in March. For the quarter, the S&P 500 returned 6.07% with the Dow Jones Industrial Average +5.19%. Following a powerful early start to 2017 that saw the Russell 2000 gain over 4% through February, the index of small cap stocks drifted lower but still finished the quarter with a gain of almost 2.5%. The strongest domestic gains were found in the technology-laden Nasdaq index that moved ahead 9.8%.

The largest equity gains were found overseas. Emerging markets were the beneficiary of a weak dollar and rising commodity prices and the MSCI Emerging Market index gained over 11.4%. The MSCI EAFE index of developed countries enjoyed a gain of 7.25%

Despite the annual calls for rising rates and the end of the bond bull market, modest appreciation was still to be enjoyed in fixed income with the Barclays Aggregate Bond index moving ahead by 0.82% and the long-term Treasury index gaining 1.4%. Lower rated corporate bonds continued to participate in the rally with a solid return of 2.7% for the quarter.

We noted above our continued concerns about current valuations in the markets stemming from a pronounced increase in the present value of these assets without a commensurate increase in expected future cash flows. While there is currently some optimism for strong earnings growth during 2017 much of this is predicated upon the successful implementation of policies that may be at risk. We have brought forward expected future returns to the present virtually assuring that future returns will be lower than they otherwise would be.

Elevated market valuations alongside a slow growth economy and a Federal Reserve intent on normalizing interest rates present greater challenges for investors. At Coho Partners our focus continues to be on downside protection. We seek to provide this from the construction of a differentiated portfolio populated with high quality companies with resilient earnings streams, growing dividends, strong balance sheets and reasonable levels of expectations and valuations.

Sincerely,

Rick S. Wayne, CFA

Eric M. Hildenbrand, CFA