Q2 2017 Economic Commentary

*"I have no idea what the Fed will do next, but I'm sure whatever they do it will be the wrong thing."*

**--Credit Strategist Michael Lewitt**

Efforts by the Federal Reserve to normalize monetary policy appear to be firmly underway. With four increases in the Federal Funds rate over the last 18 months and at least one more expected in the balance of 2017, focus has now turned to plans to reduce the Fed's balance sheet. Asset holdings by the Fed sat around \$870B before the financial crisis and have ballooned to almost \$4.5T today via purchases of assets (Treasury bonds and mortgage-backed securities) designed to lower long term interest rates and stimulate economic growth. This is accomplished by reducing the supply of investment grade paper and agency issues in the mortgage market thus creating overwhelming demand that increases prices of bonds thereby lowering rates.

The decision by the Fed in the 4th quarter of 2014 to end the bond-buying program (QE), has the effect of tightening monetary policy by allowing the maturity of the bond portfolio to shorten due to the passage of time. Deutsche Bank has recently estimated that the average duration of the Fed's portfolio has declined from 7.5 years to less than six years during this period. This is a process that Fed Chair Janet Yellen has said has the same impact on bond yields as two short-term increases in the Fed Funds rate.

Recent comments by Federal Reserve Governors including Bill Dudley of the Federal Reserve Bank of New York and his counterpart from Philadelphia, Patrick Harker, underscore the thought process of the Federal Open Market Committee (FOMC). In an interview with the Financial Times, Harker "stressed that his business contacts were being 'really pressured' by demands for wage rises given the strong jobs market and that he expected inflation should eventually assert itself." Later in the interview, he went on to say, "You look at this labor market and you do have to question when we are going to start to see some increases in inflation. We know from history that when that happens it happens very quickly."

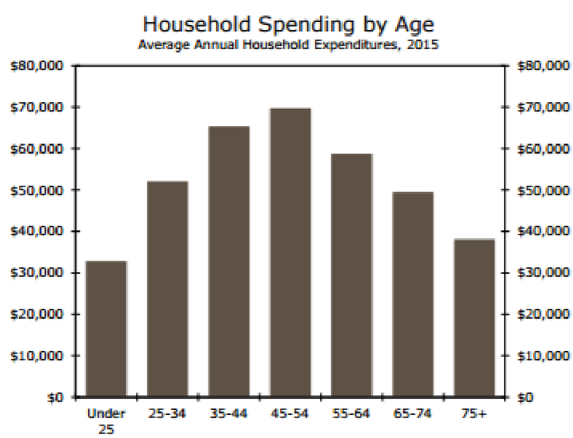
With an economy still mired in a 2% growth range and an inflation rate that has consistently fallen short of the Fed's 2% target for almost the entire eight-year expansion, we feel the Federal Reserve has missed the prime opportunity to normalize interest rates. Janet Yellen herself has acknowledged it would be easier for the Fed to deal with an inflation spike rather than another decline. The FOMC would have only limited room to reduce the target range for the federal funds rate while the Committee could readily increase the rate should inflation overheat and move persistently above the target level.

Rather than what appears to be a strict adherence to econometric models such as the Philips Curve (an economic concept that depicts an inverse relationship between the level of unemployment and the rate of inflation), there is a strong case to be made that the central bank should continue to allow the unemployment rate to decline and reassess how low it can go without becoming inflationary. A jobless rate now down to 4.4% has coincided with wage growth that at best may be described as tepid and inflation moving further below the 2% targeted level. Low inflation should give the Fed the luxury of time to keep monetary policy on hold now until there are signs of inflation picking up rather than stifling the job market as it begins to show signs of life.

The prior comments from Harker seem to be oblivious to what may be taking place around us amidst the impact of technological innovation and an aging demography. As the prospective acquisition of Whole Foods by Amazon is underscoring, companies like Amazon, Facebook, Tesla and many others continue to disrupt the old order by putting downward pressure on prices and making it much more difficult for central banks to achieve the inflation targets outlined. The macro implications of this dynamic are profound and impact many industries in our country.

For example, food costs away from home represent about 6% of the CPI calculation and have been rising over 0.7% per year (much of this due to minimum wage increases) above the aggregate CPI level. While millions of Americans will benefit from speed of delivery and reduced pricing, there will be deflationary pressure from increased automation and from the internet on all things consumed. Additionally, restaurants and bars have been responsible for over 2.4 million new jobs since the employment market bottomed in 2010. This area now represents more than 8% of total employment in the U.S. but is now undergoing continued threats to job security via this technological revolution.

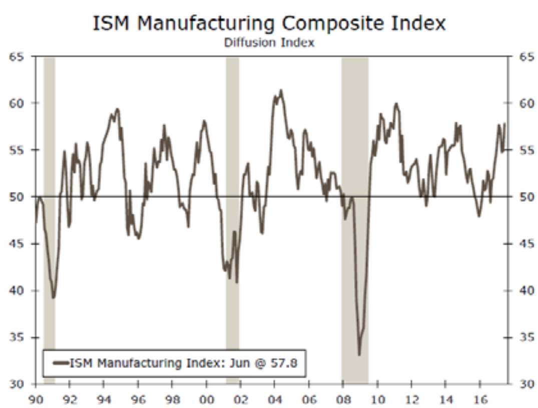
Current demographics are also hugely deflationary as it is estimated that more than 1.5M baby boomers are turning 70 each year until 2032. The population of adults 65 and over is set to rise from 20% of the total adult population to 25% during the next decade. Currently over 75% of this cohort is over 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.




The Federal Reserve is raising rates and removing accommodation from the economy to fight inflation that does not exist and to provide the Fed with more ammunition (in the form of potential rate cuts) to fight the next recession. However, by raising rates with inflation and economic growth quite tepid, the Federal Reserve is more likely increasing the risk of tipping the U.S. into a recession. As is evident in the chart on the top of the following page, every recession in the last 60 years was preceded by a period of interest rate increases by the Federal Reserve and 10 of the last 13 periods of such rate increases have been followed by recession.


**UNITED STATES:**

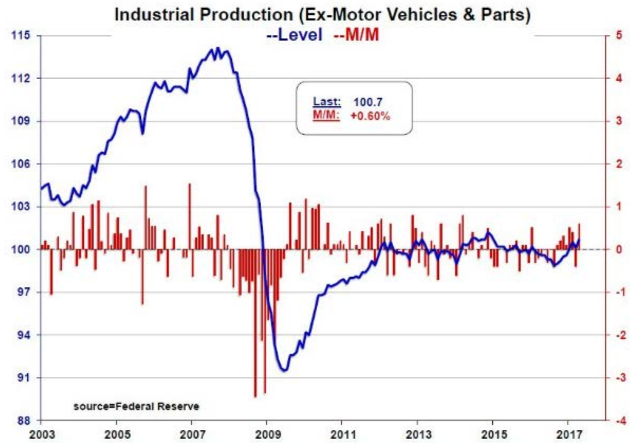
We have noted since the start of 2017 the continuing gap between hard and soft economic data and maintained healthy skepticism that the euphoria reflected in the survey reports since the presidential election would translate into actual economic gains. One of the most highly followed soft surveys for the business community is the Institute for Supply Management (ISM) Manufacturing index. These are surveys of purchasing managers at the forefront of their respective company supply chains. As manufacturers need to respond quickly to the changing demand in their respective industries, this is historically considered a strong barometer for prospective economic conditions. Indeed, one can see in the chart below the correlation between the ISM Index and prior recessions indicated by the grey vertical bars. The most recent reading for the ISM Manufacturing Index (chart below) continues strong with a reading of 57.8 for June which is near a six year high.



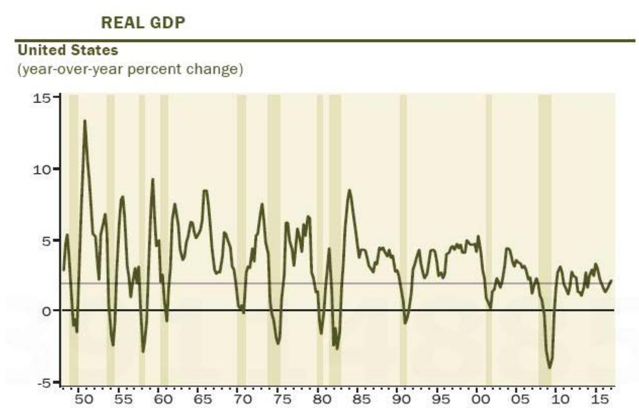

In contrast to consumer confidence surveys that continue to diverge from actual consumer spending, there were signs in the first quarter that the stronger incoming factory data were aligning with leading indicators for manufacturing. The period from mid-2014 to mid-2016 for this critical sector was characterized by soft global demand, the strong dollar and a downturn in the energy sector. With much of those headwinds fading, optimism was increasing. Indeed, industrial production (the measure of the volume of goods produced in manufacturing, mining and utilites) for the three months through April appeared to reflect that growing at the fastest rate since 1Q 2014.

However, our expectation since the end of 2015 has been for the contributions of the auto sector to slow and form a peak for the economic cycle. As auto production is up 15% from the pre-recession peak and over 130% from the 2010 trough, the contributions from this sector cannot be ignored as it is rolling over. Alongside slowing auto sales has been a weakening pace of auto inventory accumulation. As weaker auto sales reduce the need for upcoming production, we are expecting a sharp drop in motor vehicles and parts production impacting both 2Q and 3Q growth. With this sector accounting for about 1.5% of GDP, we can anticpate this decline to further shave about 0.1%-0.2% from expected growth over the next few quarters.

In anticipation of this decline, it is instructive to look at total industrial production without the contributions from the auto sector. The chart below shows industrial production over the last 14 years ex-motor vehicles & parts. Since 2012, this metric has flatlined and is still -12% below the prior peak in 2007. Additionally, as motor vehicles and parts and related industries comprise as much as 3% of total employment, we expect labor data related to the industry to also come under modest pressure



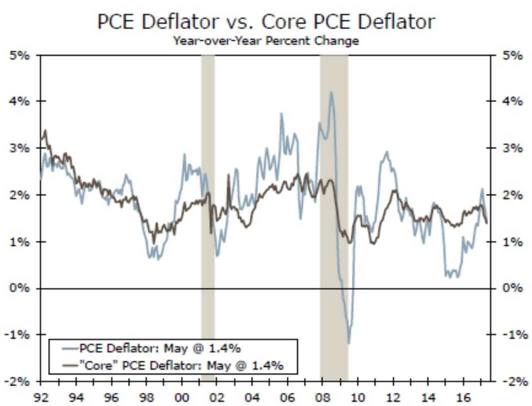

Final revisions for 1Q 2017 show GDP continued the pattern of the last few years with a soft opening quarter growing at a 1.4% annualized rate and 2.1% over the last four quarters (see chart below) in line with our prior estimate. Following a 3.5% pace of consumer spending from the middle of 2014 through the end of 2015, last year witnessed a slowing to a 2.75% level that has slowed further through the opening five months of the year. With spending on autos having been a critical component of spending growth and wage gains remaining subdued despite strong levels of job growth, we remain more cautious on the impact of the consumer on GDP growth. While 2Q should rebound towards 2.5%, we expect the second half of the year to be consistent with recent levels of growth around 2% as contributions from the auto and housing sectors moderate.

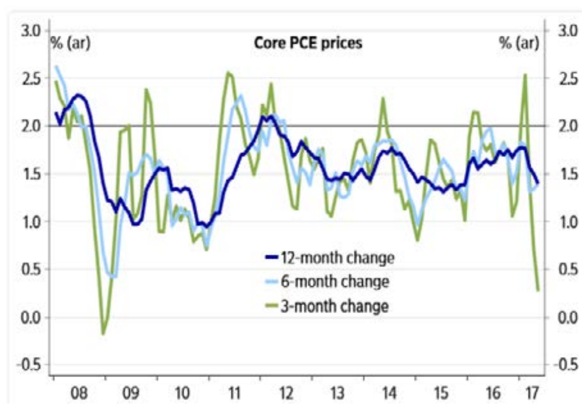



## INFLATION:

The reflationary impact of rising oil prices has reversed course. As of late June, prices had dropped approximately 14% on a year-over-year basis (see chart on top of next page) before rebounding as the quarter ended. While this still should generally be positive for the consumer, lower oil prices have thwarted attempts by global Central Banks to move deflationary concerns far into the rear-view mirror.

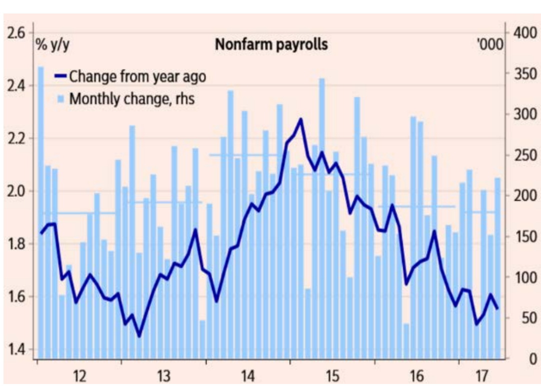

Personal Consumption Expenditures (PCE) is the preferred inflation gauge of the Federal Reserve and these declining energy prices have continued to frustrate their objectives of achieving a sustainable 2% target. The May PCE reading added to this frustration with an annual increase of only 1.4% down from 2.1% as recently as February. Falling goods prices (-2.5% y/y) continue to be the primary driver of these lower trends but services have also seen decelerating price increases and are now up only 2.2% y/y. Annualizing inflation readings over the last three months places both headline and core CPI at basically flat.

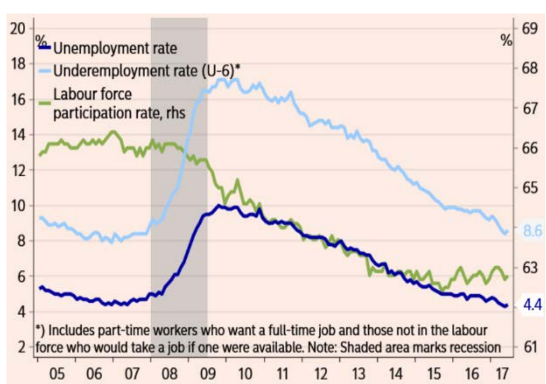


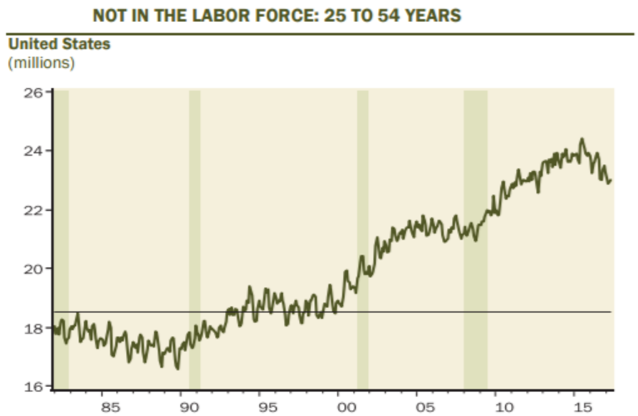

## EMPLOYMENT & WAGES:

Though having clearly slowed from the near 240K per month pace of 2014-2015, nonfarm payrolls still averaged 180K new jobs per month through the first half of the year, a pace that continues to lower the unemployment rate as it exceeds growth of the labor force.



Though the prime age (25-54-year-old cohort) worker who is in the labor force but still unemployed is less than 4MM people, there remains approximately 23MM Americans in their prime working years that are not even considered part of the labor force (see chart below). This is at a time when job openings as reported by the Jobs Opening and Labor Turnover Survey (JOLT) for April printed a record number of unfilled positions of just over 6.04MM.

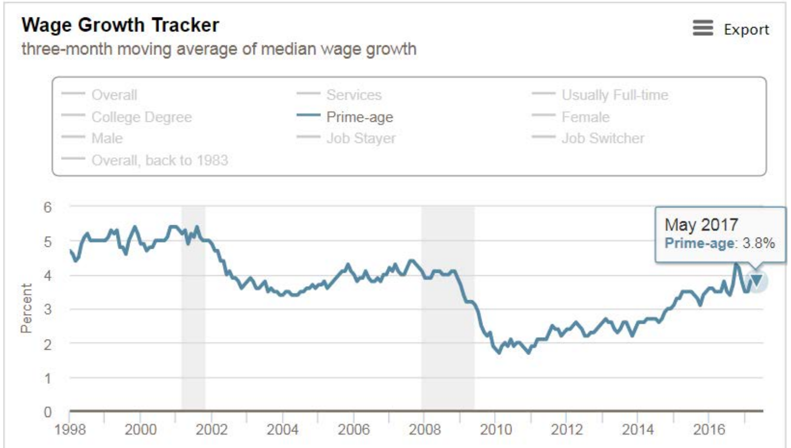



The total pool of available labor is well estimated by the U-6 figure released by the Bureau of Labor & Statistics (BLS). The U-6 rate adds to the official unemployment rate (U-3) those persons considered marginally attached to the labor force (would take a job if offered but are not actively looking) along with those working part-time purely for economic reasons. Based on this metric, the current labor supply (chart below left) as a percentage of total employment is now down to levels very consistent with the late stages of prior expansions indicating a very tight labor pool. More indicative may be the chart below on the right showing the share of long term unemployed (27 weeks or longer) as a share of the total which is still at recessionary levels. Simply put, it remains likely that the skills of the pool of available labor are not a match with that desired by employers.



We have been disappointed in the level of wage growth this cycle which appears to be decelerating over the most recent 3-month and 6-month periods versus year ago levels. The reason for these slow wage gains may again be demographics. Older workers tend to earn more than younger workers, due to skills, experience, and tenure. Data available from Ned Davis Research show that since 2000, their median weekly earnings have been nearly double those of the 16-24 age group, about 20% higher than those of the 25-34 age group, and about 5% higher than those of the entire 25-54 age group. Therefore, as older workers leave the labor force and are replaced by younger workers, the downward pressure on average wages from this demographic shift intensifies. This impact will be felt for another decade until the baby boomer cohort retires and it is a logical explanation for the elusiveness of aggregate wage growth in this cycle.

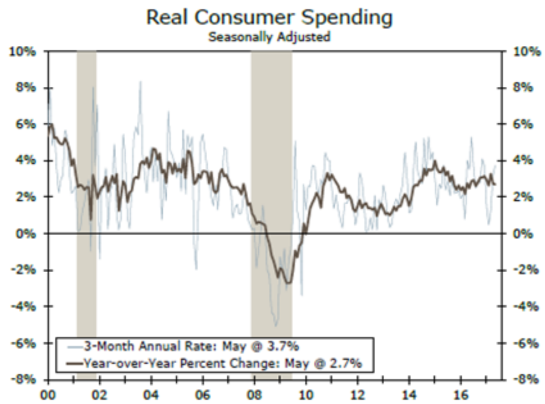
Due to this shifting demographic, it may be instructive to use prime age (25-54-year-old cohort) median wage growth to better gauge actual changes in wages. Though still slower than reductions in unemployment would otherwise lead us to expect, there are still clear signs of modest wage gains. The Atlanta Fed Wage Growth Tracker below depicts this demographic which has risen 3.8% y/y through May.




## CONSUMER:

Debt and demographics are two themes to which we seem to often return when analyzing critical factors facing the U.S. economy. The actions of the U.S. consumer are certainly central among them.

With financial markets hitting record highs following an 8-year bull market, employment in the U.S. now approaching 16-year lows and wages modestly moving higher, the consumer should be in good shape. Indeed, aggregate household net worth is 37% higher than it was during the peak of the housing market. Given this backdrop, personal spending growth should be close to 4% by historical comparisons yet is growing only 2.7% year-over-year and barely more than 2% on an annualized basis in 2017.




The consumption boom of the past few decades was fueled by a massive credit expansion as total household debt in the latest quarter reached a record $12.73T, eclipsing the $12.68T that Americans owed at the height of the housing bubble. With interest rates historically low, keeping up with household debt payments is still broadly manageable for consumers as shown by the household debt service ratio as a percent of disposable personal income plumbing all-time lows below 10%. This contrasts with a historical average of 11.33% and 13.2% prior to the last recession.

It must be noted again that these are aggregate ratios skewed by income inequality and it is too soon to say whether recently growing signs of stress among borrowers are just a return to more normal levels of delinquencies or evidence of a more serious credit downturn. Loan delinquencies are creeping higher after plunging from 2010 to the middle of 2016, but they are still below historical averages.

The percentage of debt that is at least 90 days delinquent rose to 3.37% in 1Q, the second consecutive quarterly increase, according to data from the New York Fed. It's the first time those delinquency figures have risen twice in a row since the end of 2009 and beginning of 2010. About 46% of Americans surveyed by the Federal Reserve could not pay a hypothetical $400 emergency expense, or would have to borrow to do so, according to a 2016 report. With the Federal Reserve raising interest rates and loan growth slowing, we are watching closely for growing signs of increased distress among consumers especially with expenses concentrated and growing in three primary areas-health care, housing and education.

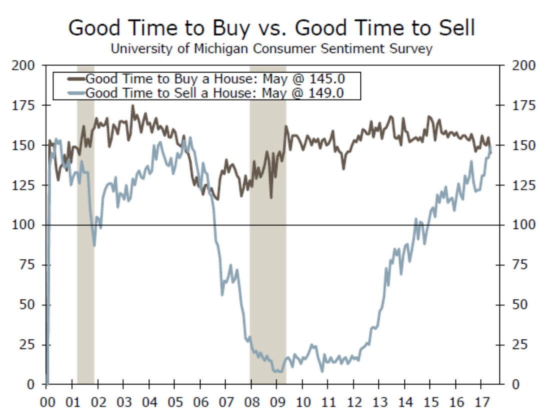
In a study done by Gallup in 2016, it was noted that the share of national spending eaten up by these three categories has ballooned from 25% in 1980 to more than 36% by 2015. Student debt is a particularly large albatross having risen to 11% of total household debt, versus 5% in 2008, and the burden increasingly is borne by millions of parents who have borrowed to help pay for their children's education. Gallup estimates that a third of new student loans are considered subprime, and 11% of student loans have gone 90 days or more without payment. Spending in these areas is crowding out more traditional retail expenditures on discretionary items.

As noted in the opening paragraphs, demographics will continue to play an overriding role in analyzing consumption as over 1.5MM U.S. baby boomers are estimated to turn 70 years of age annually over the next 15 years. This shifting demographic profile has profound implications for consumption growth and will for years to come as the average annual expenditure for the 65-74-year-old cohort is over 25% less than the 45-54-year-old group.

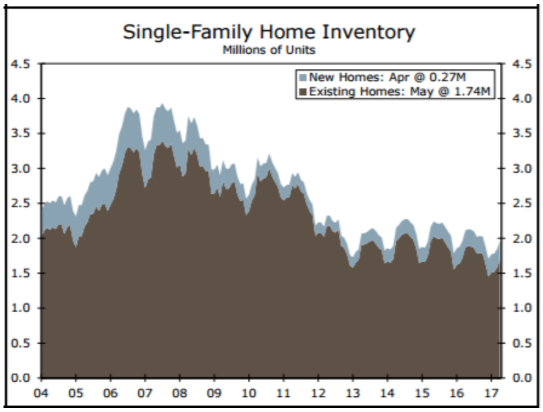
## HOUSING & AUTOS:

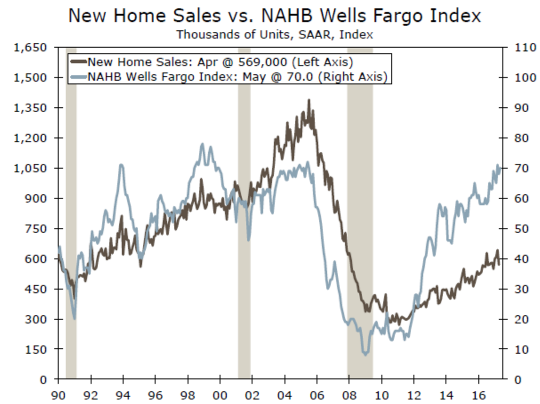
Though slowing in the monthly rate of growth, the S&P CoreLogic Case-Shiller U.S. National Home Price Index for the most recent period still increased 5.5% from levels of a year ago and nearly double the rate of income growth. Since the trough of the housing crash in February of 2012, national housing prices are 40% higher while income growth according to the Department of Labor has risen only 12%.

This lack of affordability has become increasingly apparent in many recent surveys including the University of Michigan Sentiment showing the proportion of consumers that feel now is a good time to buy slipped below the level of those feeling it to be a good time to sell for the first time since 2006 (chart below left). Affordability is a critical issue but it is still the lack of supply holding back the potential of the housing market and elevating prices.



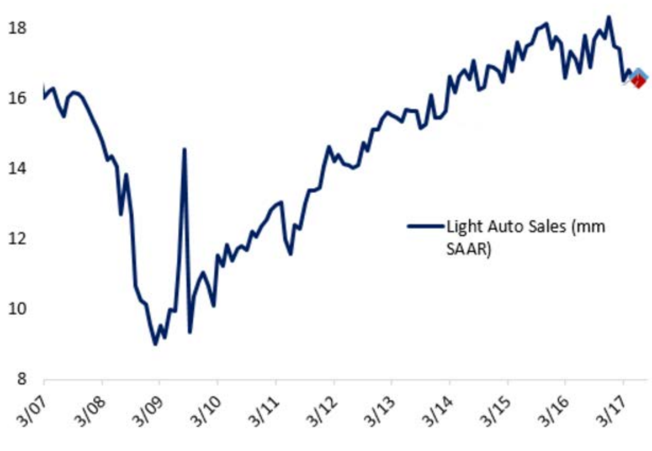
Single family inventory of both new and existing homes (chart on following page) is plumbing levels not seen in decades. Indeed, according to an analysis by the Federal Reserve Bank of Kansas City the level of home construction relative to the number of U.S. households is at its lowest level since the U.S. Census Bureau began tracking such data in 1957. It is just this dearth of supply that may explain elevated levels of the National Association of Home Builders Index (NAHB) despite levels of actual new home sales being more than 50% lower than the last time this sentiment indicator was at these levels. Simply put, builders can virtually sell homes quicker than they are built.




Underlying traditional drivers of housing demand (job and wage growth) are improving for the critical first-time buyer (25-34-year-old cohort) at rates higher than the aggregate. 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.

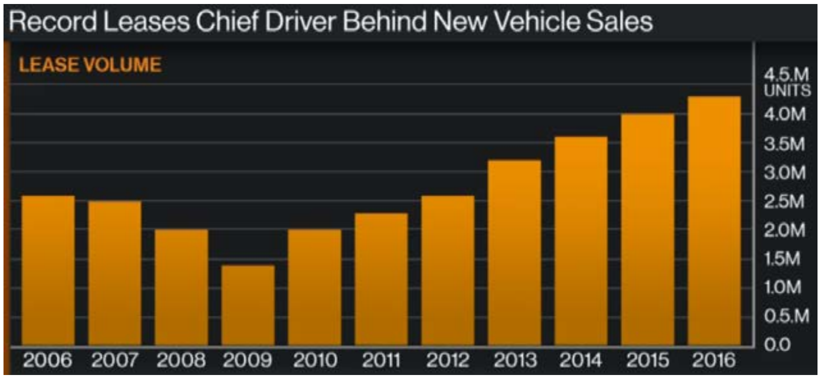
Auto sales for June continued the soft patch experienced throughout the year rising at a seasonally adjusted pace of 16.4MM a/r (lowest since February of 2015) and declining over 2% for the first half of the year versus the comparable period last year. Following a record 17.55MM new vehicles sold in 2016, the U.S. auto industry may be less than prepared for a downturn amidst a widening supply and demand concern.




According to Edmunds.com, the average monthly payment on a car or truck has risen to a record $517, forcing buyers to stretch loan terms longer than ever to obtain a new car despite record manufacturer incentives of almost $4,000 per vehicle. The firm estimates the average auto-loan length reached a record 69.3 months in June, with the average amount of financing reaching $30,945, up $631 from May.

As dealers have extended loan terms to accommodate more attractive monthly payments, the auto industry is experiencing another phenomenon that will curtail future sales. Over 32% of all trade-ins toward the purchase of a new car in 2016 were underwater (consumers owe more on the loan than the value of the car), the highest rate on record. The average negative equity for these car owners is $4,832 (see chart below) according to Edmunds.com and is rolled over into the amount financed on the new car loan. For car owners who enjoy a new car every few years, this is a nightmare that dealers have addressed via the growth in leases as a method of financing. Leasing now makes up 33% of new car transactions but adds another layer of concerns for future sales.


By the end of 2019, an estimated 12 million low-mileage vehicles are coming off leases inked during a 2014-2016 spurt in new auto sales, according to estimates by Atlanta-based auto auction firm Manheim and Reuters. As a percentage of new retail vehicle sales, leasing has grown from between 15%-20% of total sales before the financial crisis to in excess of 30% today (see chart below). In inventory terms, this means that some 3.6 million leased vehicles are due to be turned in this year with another 4.1 million due back in the market next year. Most of those will end up on dealer lots, where they make enticing and less expensive alternatives to new cars.



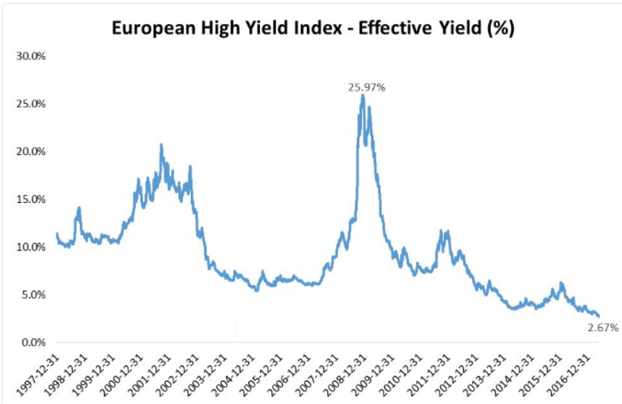

## INTERNATIONAL:

Despite a weak rate of growth in the U.S. in 1Q, the pace of global economic activity is picking up after several years of disappointing economic returns. Early readings in 2Q confirm the continuation of a solid expansion in both manufacturing and services. A broad-based rebound in the 19 country Eurozone GDP at an annual pace of 2.3% along with moderating but still strong readings in China, India and Japan offset some slowing in the UK (declining from a 3% annualized growth rate in 4Q to 1.2% in 1Q 2017). Additionally, global trade and industrial production are improving.

Many view the European Union to be at a similar point in the economic cycle that the U.S. was five years ago and this is consistent with remarks by European Central Bank (ECB) President, Mario Draghi, in late June that were viewed by the markets as very optimistic on European growth. These reflationary comments combined with the bank rescue plan from Italy and the pro-growth labor reform changes from new French

President Emmanuel Macron may lead the markets to reprice the current suppressed level of global interest rates.

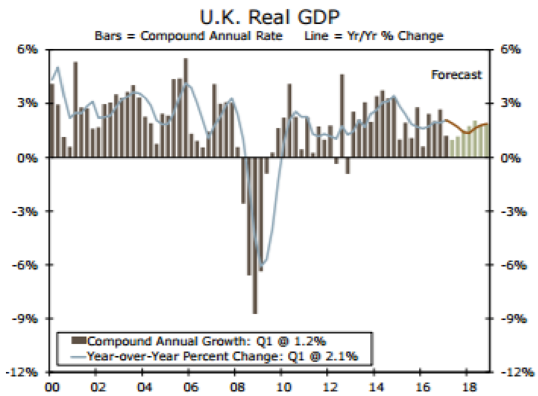
In addition to the U.S. and the ECB, the Bank of England and Bank of Canada have also indicated prospective rate increases. Expectations of a taper of central bank accommodation should place upward pressure on local rates and may impact interest rates around the globe. This is not inconsistent with our secular view of low inflation and interest rates but rather reflects potential for a cyclical move up from artificially low levels and the interconnectivity of global yields. Indeed, even the lower quality bonds in the European High Yield Index (chart below) were recently yielding only 2.7% or about half of the yield on comparable fixed income in the United States. This has continued to keep a lid on local rates that may lift over the short term but it is still economic growth and inflation fundamentals that inevitably impact long term interest rates.

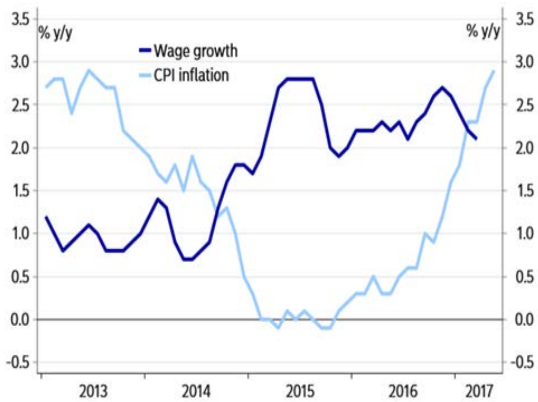



**UK:**

The rate of growth for the UK in 1Q 2017 was revised down to an annualized rate of 1.2%, a precipitous drop from the near 3% pace that ended 2016 and has compounded fears that the delayed impact of last June's Brexit vote is at hand. Despite the downshift, real GDP is still up 2.1% over the last full year (chart below left).

The sharp depreciation of the British pound along with improving economic activity in many trading partners buoyed U.K. export growth until a slowdown in 1Q. Further softness in the pound followed the general election on June 8 as Prime Minister Theresa May's Conservative Party did not win enough seats to form an absolute majority, thus weakening the country's position at the Brexit negotiating table. This strength in exports in the second half of 2016 may have blurred the view of many as to the economic impact of Brexit as the weakness in the currency has profound inflation implications.



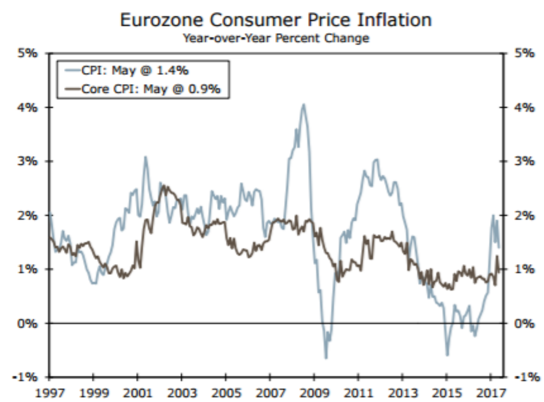



Though slowing recently, the prior rise in energy prices exacerbated currency-related price pressures increasing CPI inflation to 2.9% in the most recent reading, a level that has trended upwards since mid-2016. The jump in prices has eroded growth in real income (chart above right), which has weighed on consumer spending as real wage growth has recently turned negative. Household consumption that buoyed the economy last year has slowed from a 3% rate in the last half of 2016 to about 1% in the first quarter. Though we do not foresee a recession, growth should slow towards 1.5% or less for the full year.

## EUROZONE:

Economic growth in the Eurozone (EZ) was more than 50% greater in 1Q of 2017 (up 2.3% on an annualized rate) than in the United States. Is this just a pleasant uptick or, perhaps, the self-sustaining recovery that Mario Draghi and the European Central Bank (ECB) have been seeking? What is unnoticed in this comparison is that the Eurozone economy's outperformance of the U.S. goes back to the last quarter of 2014 despite the 2015 Greek crisis. During this period, GDP for the EZ has expanded over 5.1% while the U.S. has lagged with 4.7% total growth. Interestingly, this recent reading marks the ninth consecutive quarter in which the year-over-year growth rate has fallen in the range of 1.5% to 2.0%. Feeding off this momentum, early indicators in 2Q depict an economy growing close to 2.5%. which is our full year target.

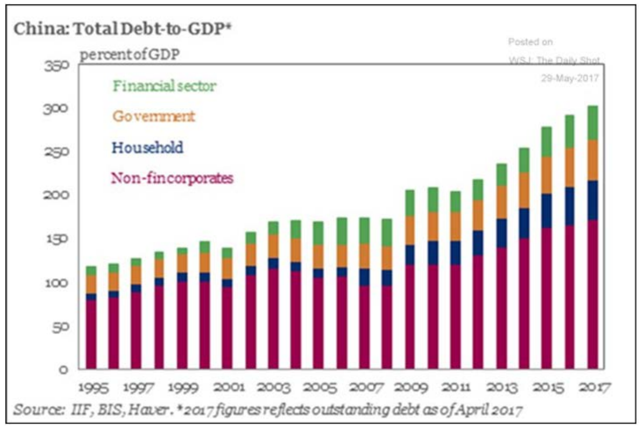
Consistent with global inflation concerns, the targeted rise towards 2% inflation by the ECB has been thwarted by the decline in energy prices and weak wage growth which have driven inflation readings back to 1.9% in 1Q and just 1.3% for the June print. The core rate, however, has managed to move to 1.1%, the highest level since mid-2013.


Some of the uncertainty in Europe created by the failed attempt of Prime Minister Theresa May of the UK to consolidate power has somewhat disappeared with the victory of Emmanuel Macron in France. Macron's surprising ascent has dispelled for now much of the concern regarding an extreme right and anti-Eurozone party from taking hold of the second largest economy in the EZ. There remain plenty of risks in the Eurozone and the next couple of quarters may add to this with potential elections in Italy and also in Germany where Angela Merkel has recently appeared to solidify her standing.

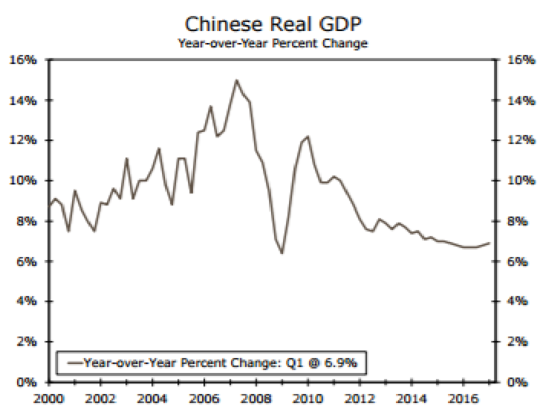
## CHINA:

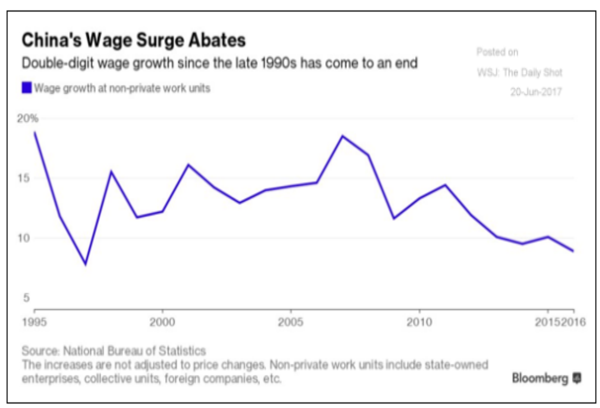
In late May, Moody's Investor Services surprised many with a downgrade of China's sovereign debt rating pointing to the continued increase in debt that has been a focus of many of these commentaries. Credit growth has now outpaced economic growth by a ratio of more than two-to-one in recent quarters with total debt to GDP now sitting at a level of 280% (see chart below). A primary concern of Moody's stems from the fixation of the Chinese leadership to ensure the economy continues to hit its 6.5% growth target with only rhetoric given to the concerns of reining in credit. Under this scenario, excess leverage should continue to build leading to a concern that the financial strength of China will erode over time as debt rises and potential growth slows. If China does address this concern, there may be global ramifications as it may act as a source of global disinflation and as a drag on the commodity sectors.




Over the short term, however, the Chinese economy and foreign exchange rate have been fairly stable this year. According to official figures, Chinese GDP grew 6.9% in 1Q 2017, and over the last three quarters, has grown 6.7%, 6.8% and 6.9% (see chart below). This represents an upward trend that has reversed the previous gradual slide in GDP growth rates. We continue to note that official figures are unreliable and merely an indicator of the direction of the economy but increased activity was noted in each of the retail, service and manufacturing sectors.

With a major focus of the Chinese regime on keeping workers happy, the official unemployment rate (amazingly stable at between 4%-4.3% over the last decade) and strong hiring have been important. We note that China's wage growth has slipped to single digits and is now the lowest since the 1990s (chart below right), but with CPI inflation of only 1.5%, real wages are still strong.

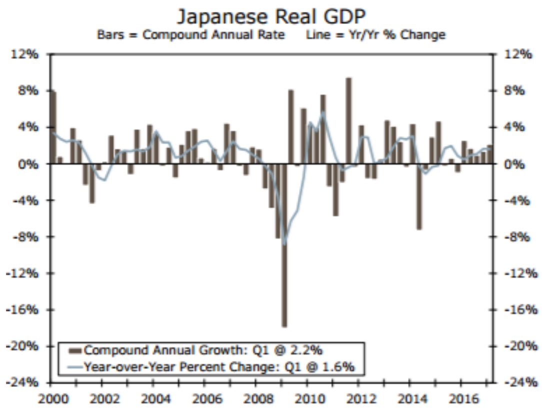


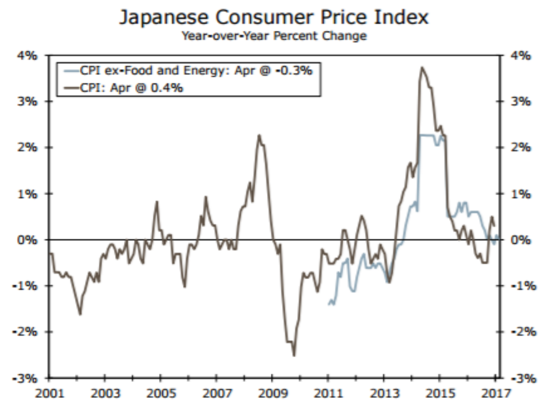




## JAPAN:

In 2013, President Shinzo Abe came into office promising reflation on the back of Quantitative Easing and a 2% inflation target. Since then, the median nominal GDP (including inflation growth) has been 1.7% annually. While this appears recession-like to historic readings in the U.S., when compared to -0.1% a/r from 1998 to 2012, it is a dramatic improvement. The actual level (not growth rate) of nominal GDP had peaked in 1997 and did not make a new high until last year. Additionally, the most recent unemployment rate was down to 3.1% (though up from 2.8% in the prior quarter) which is down from 4.3% at the end of 2012. By most measures, Abe's tenure has been a relative success.

Though inflation is still quite low (+0.4% in May unchanged from April-see chart below right), deflation pressures appear to have abated. Despite a tightening job market, wage gains have lagged (another global disease) though female labor force participation gains are providing further income growth support. Overall, the 1Q reading shows the economy expanded at an annual rate of 2.2% (chart below left) which represents the fifth consecutive quarter of expansion.




The largest overall positive contributor came from consumer spending which grew at an annualized rate of 1.4%, enough to add 0.8 percentage points to the overall growth rate. Business investment grew at a 1% a/r, up for the third consecutive quarter. Confidence appears to be back and spending is at a pace not seen in years.

## EMERGING MARKETS:

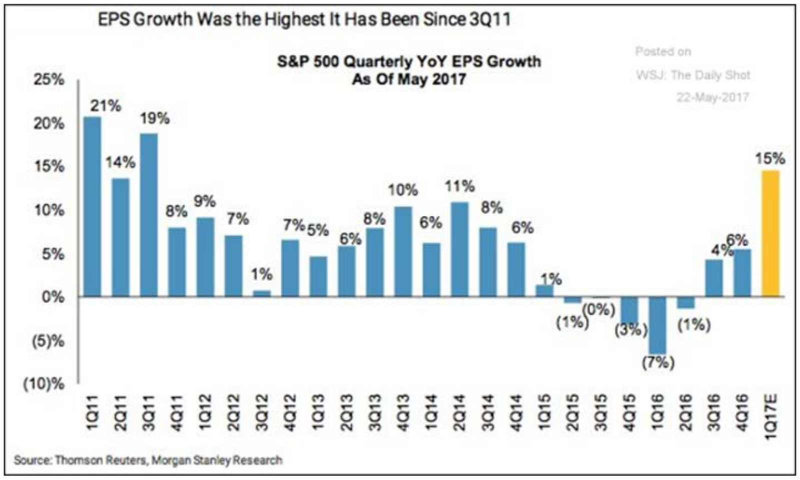
Reversing the trend following the series of financial crises in 1997-98, developing economies have binged on external debt (mostly denominated in U.S. dollars) over the past seven years. The outstanding amount of external debt in the most important developing economies in the world has soared by $1.8T to reach a level of $5.7T. The abilities of these economies to service this debt is far better today than twenty years ago due to the stream of foreign exchange that their exports earn and, should exports weaken, the war chest of foreign reserves that have been accumulated over the past decade.

Global vulnerabilities are mixed, however, and repayment risk is especially high in countries with large external deficits and low levels of foreign-exchange reserves. This has been masked this year due to the weak dollar, but if the dollar appreciates faster than expected, some corporate borrowers, especially those who derive their revenues largely in local currencies, could find themselves in a currency mismatch. Still, we expect the recent solid growth in emerging economies in aggregate to continue and they are buoyed by stronger demand from developed international markets along with a break from the long decline in commodity prices outside of oil. For the full year, we are looking for developing economies in aggregate to grow near 4.5% up from the 4.2% level achieved in 2016. As always, the U.S. dollar remains the largest wildcard but these economies appear less vulnerable than in recent years.

## MARKETS:

Throughout the early stages of the new administration, we have remained more circumspect on the impact on corporate earnings of fiscal initiatives for 2017 and the ability of a very divided Congress to move forward quickly on its aggressive pro-business agenda. Though this view has so far been correct, earnings gains for 1Q and estimates as we enter the 2Q earnings season have met or exceeded analyst's objectives.

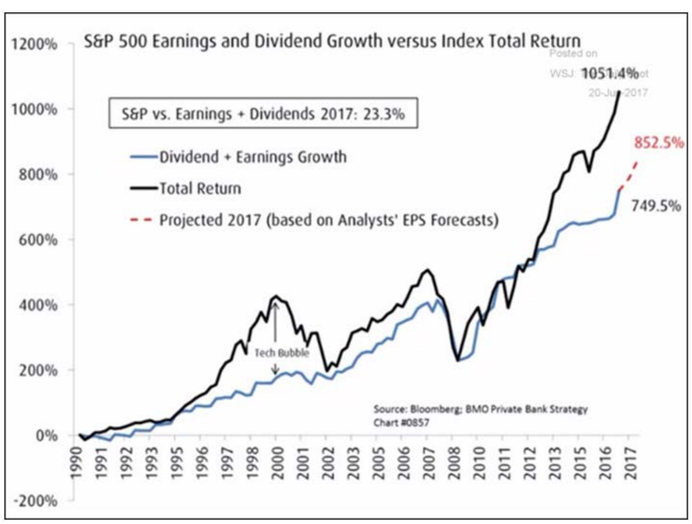
Consensus estimates at the start of the year were for a 12% annual gain in earnings to a full year total of $131 from the $118 level of most of the prior three years. According to data provided by Thomson Reuters, earnings per share growth for the S&P 500 moved ahead 15% in the first quarter, a pace not achieved since 3Q 2011 (see chart on top of the following page). As we enter the reporting season for 2Q, expectations are for another strong quarter with gains that may approach 10%. Clearly, our below consensus call for a 6% gain to $125 has upside risk but we are not changing our view just yet.




Earnings were previously penalized by the collapse of the energy sector but are now benefitting from a reversal of this. Indeed, over 40% of earnings gains for 1Q came from the energy sector and similar upside pressure is expected for 2Q. The second half of the year will start to move past these easy year-over-year comparisons and may also suffer marginally from energy prices that are now below the levels of a year ago. Nonetheless, the rebound in earnings over the last two quarters has been very welcome to a market that still appears very extended on most all valuation metrics.

Over long periods of time, the total return of the S&P 500 should be the product of earnings growth plus the dividend return. The lever that alters the relationship is the price/earnings (P/E) multiple that investors are willing to pay. Generally, periods of low interest rates and low inflation (as we have experienced) should increase these valuations, but more often than not, it is the behavioral actions of market participants that may cause the dislocation between these trends. We have been in such a period for a few years.

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 this expansion in the P/E multiple from 11x to almost 19x forward expected earnings. The black line in the chart below shows the S&P 500 total return over the last 25 years. The blue line depicts the combination of earnings and dividends over that same period. Though highly correlated, they may deviate for long periods such as the period from 1996-2002 before the correlation re-emerges. As you can see, this trend has again dislocated with the S&P currently over 23% above this trend line.



After pausing in March, the post-election rally continued in 2Q with a gain of 3.1% in the S&P 500 bringing the return for the year to 9.3%. In the major indices, there has been a massive gap in performance with growth stocks outperforming value by over 9%. These gains have been concentrated in a handful of stocks, mostly in the Technology sector, with Apple, Amazon, Facebook, Microsoft and Alphabet (Google) accounting for about a quarter of the total return. As these are larger companies, it is no surprise that the Russell 2000 index of small cap companies has trailed so far this year with a gain of 6.0%.

The strongest equity returns continue to be found outside the U.S. markets with the MSCI EAFE index of developed countries enjoying a year-to-date return of 13.8% and the MSCI Emerging Market index up 18.4%. Both have been major beneficiaries of continued weakness in the U.S. dollar.

The calls for the end of the bond bull market were again premature in the 2Q period with the Barclays Aggregate Bond Index gaining 1.45% for the quarter and 2.27% for the year. The Barclays High Yield Index gained 2.1% during the quarter and is now up 4.9% for the year and a whopping 12.7% over the trailing 12-month period.

Extended market valuations alongside a slow growth economy and a Federal Reserve intent on normalizing interest rates present greater challenges for investors. At Coho Partners, we remain true to our investment philosophy of protecting on the downside and providing outperformance over the market cycle with lower-than-market volatility. As such, we will continue to execute on the investment process, emphasizing companies that exhibit stable and growing earnings, cash flow and dividends.

Rick S. Wayne, CFA

Eric Hildenbrand, CFA

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