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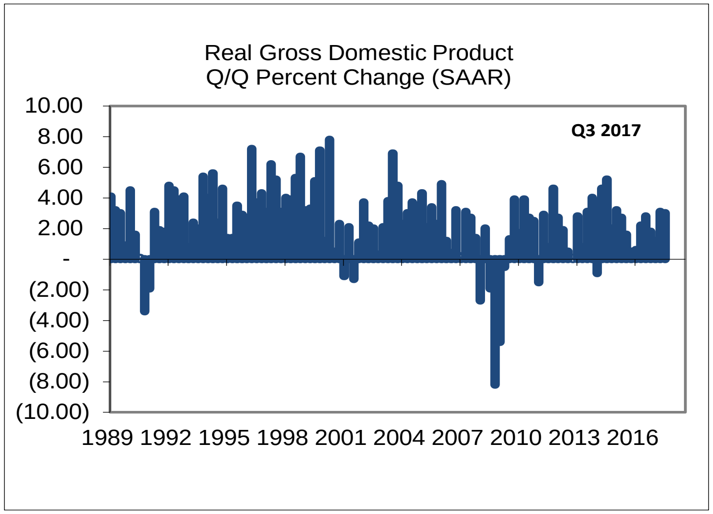
Economic and Financial Markets Monthly Review & Outlook Detailed Report

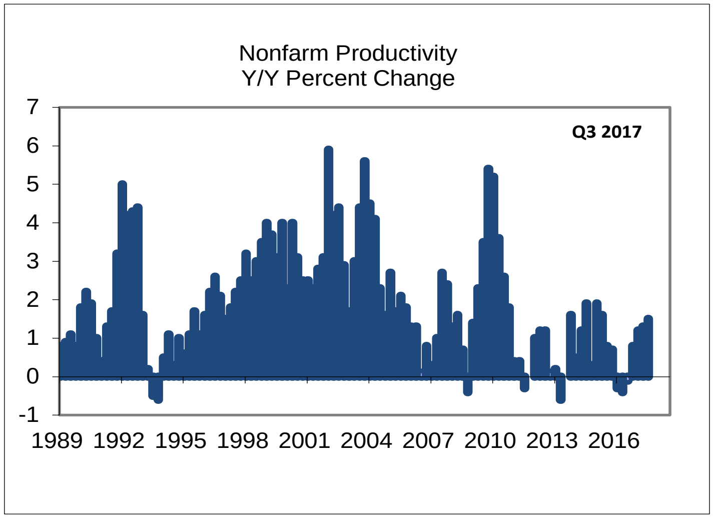
December 2017

Overview of the Economy

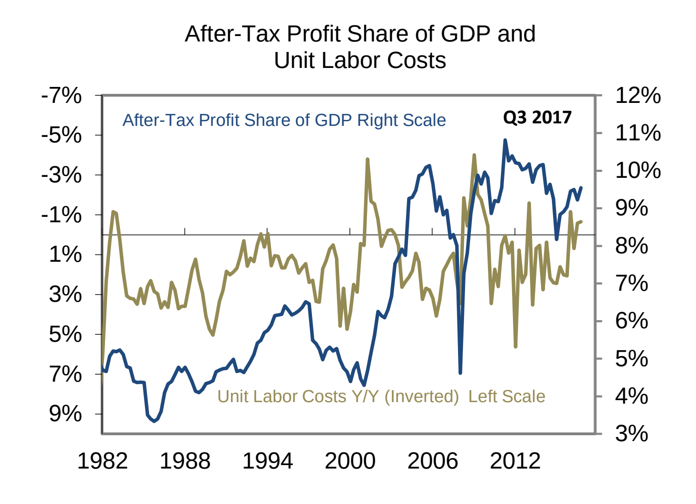
Business and economic confidence are continuing to increase from elevated levels. Financial markets continue to grind higher, reflecting expectations of continued earnings growth and fairly stable inflation rates. The speed of policy changes in Washington remains closely watched. Forecasts for gross domestic product (GDP) growth, including our own estimates, have remained relatively stable. The Federal Reserve (Fed) raised short-term interest rates in December to a range of 1.25% to 1.50%, the fifth increase since the end of the financial crisis. The Fed began a modest pace of quantitative tightening in September. Third quarter GDP growth is estimated at 3.3%, up from 3.1% in the second quarter. We anticipate full-year 2017 growth of 1.9% to 2.6%.



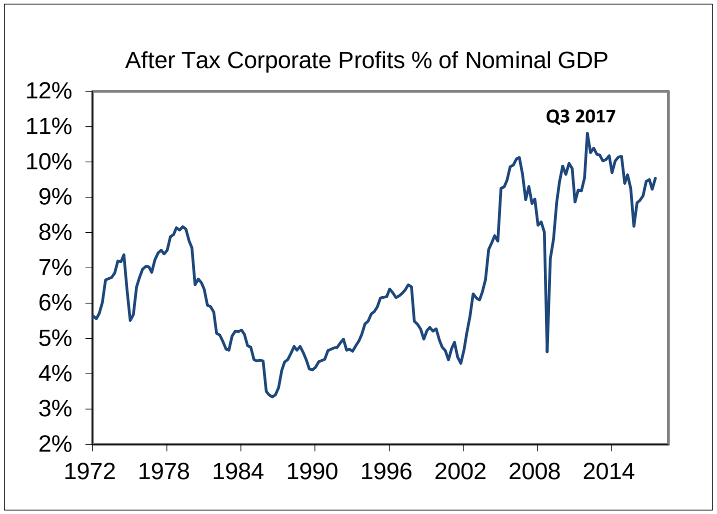
Source: Department of Commerce



Source: Department of Labor



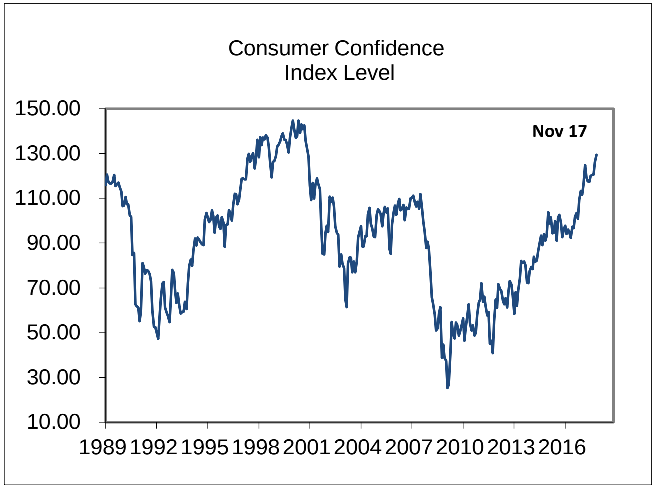
Source: Departments of Commerce, Labor



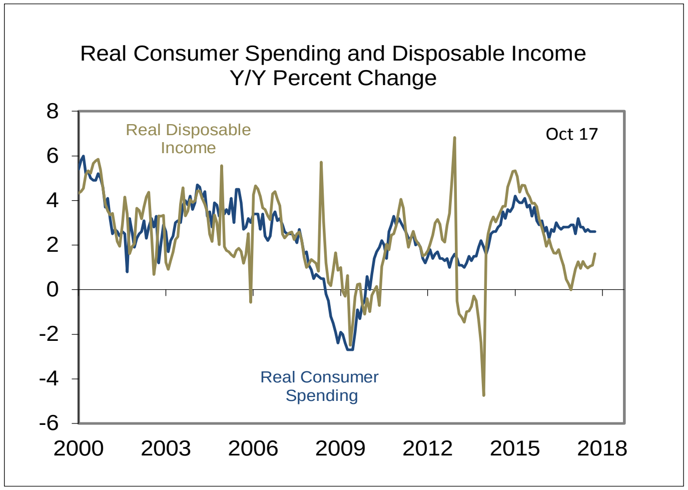
Source: Department of Commerce

Consumer Expenditures

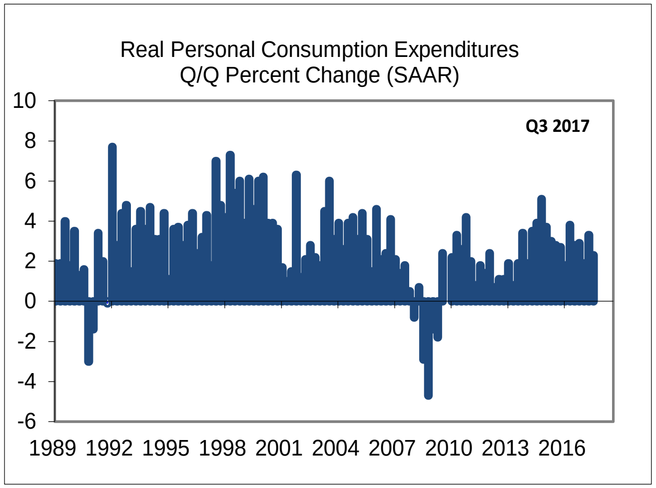
Third quarter growth in real personal consumption expenditures is currently estimated at 2.3%, down from 3.3% in the second quarter. Real income growth continues to trend around 1.0% to 2.0% after new revisions. Consumer confidence jumped to a new high level in November, remaining at levels that have only been exceeded during the tech boom of the late 1990s. Household net worth as a percent of disposable income remained at an all-time high during the second and third quarters, supported by rising equity markets and strong housing price growth. Savings rates, after new revisions, have moved close to 3%, reflecting generally elevated levels of confidence and asset values. Previous cyclical peaks in consumer confidence during the past two decades have been followed by disappointing returns in equity markets. We are seeing policy changes from the Trump administration that may have begun to boost confidence, such as tax legislation.



Source: Conference Board



Source: Department of Commerce



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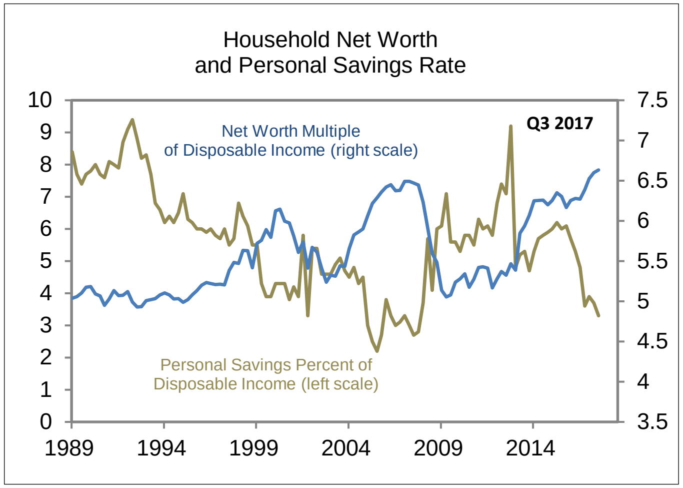
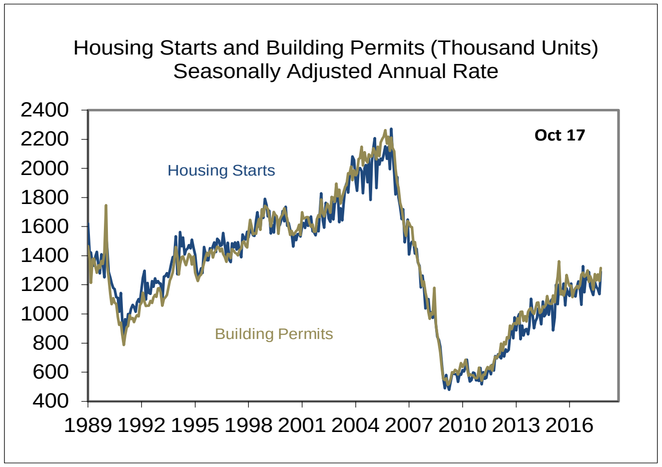


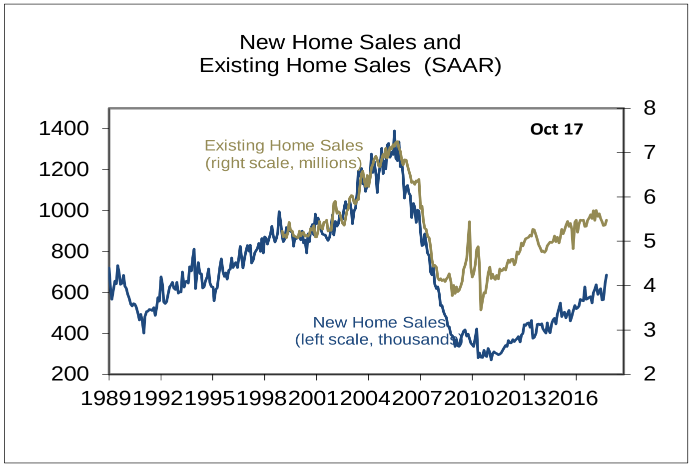
Sources: Department of Commerce, Federal Reserve

Housing

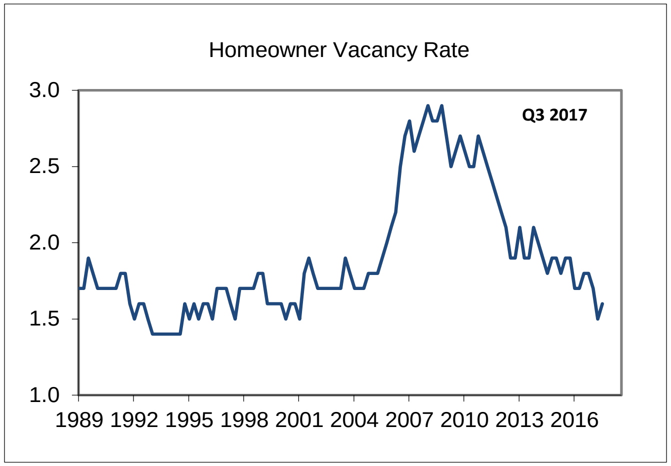
Housing data improved modestly in October. Vacancy rates remain low, housing activity (new and existing home sales) has picked up and housing prices are rising at a 6% to 7% annual rate. Mortgage rates were relatively stable during the first 11 months of the year, trending at around 4% after jumping higher after the election. While rates are higher than 2016 averages, they remain historically low and should continue as a tailwind for homebuyers. Strong home price growth in excess of income growth over the last few years, however, has contributed to a decline in the trend of homebuyer affordability, which is at its lowest level since 2008. This could eventually slow home sales.



Source: Department of Commerce



Sources: Department of Commerce, Nat'l Assoc. of Realtors



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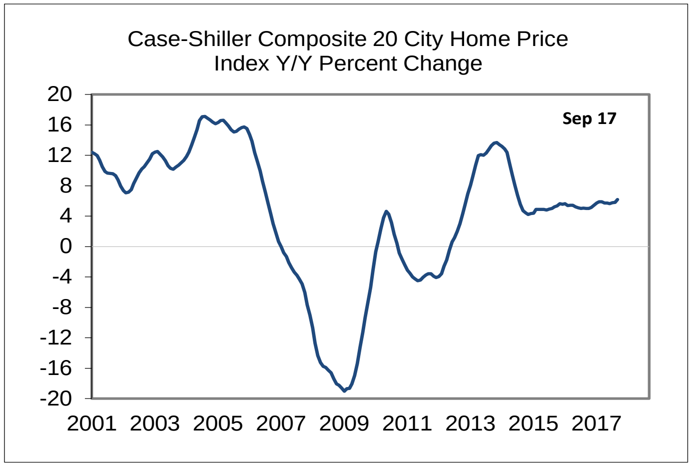
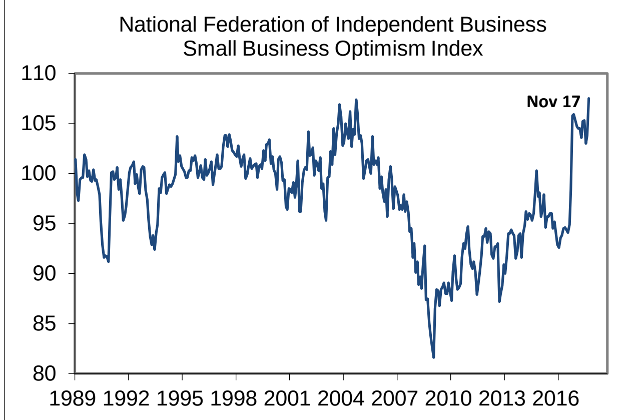


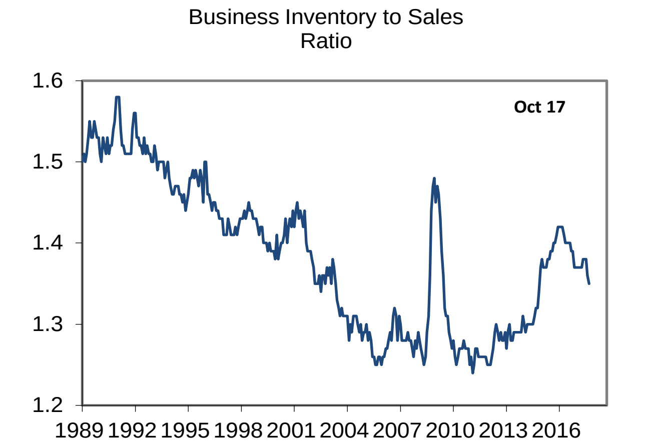
Source: Standard and Poors

Production and Investment

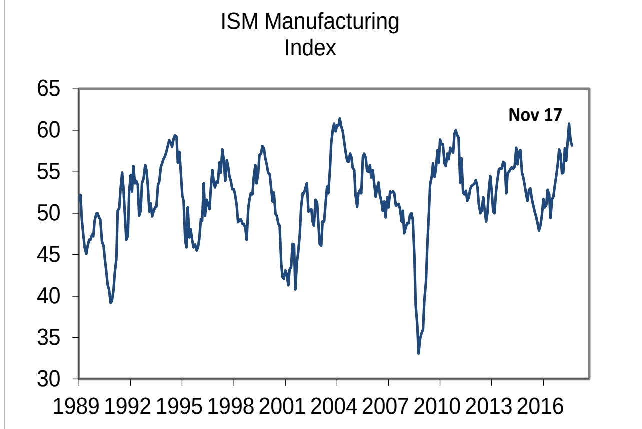
Production and investment data are consistent with moderate economic growth. Small business optimism increased smartly in November, industrial production rose modestly, and manufacturing PMI and capacity utilization were little changed. The business inventory-to-sales ratio has stabilized in recent months, remaining higher than average for non-recessionary periods over the last 20 years. This should be a headwind to investment in the near term. Private investment growth has been weak during the first three quarters of 2017, reflecting in part weak nonresidential fixed investment.



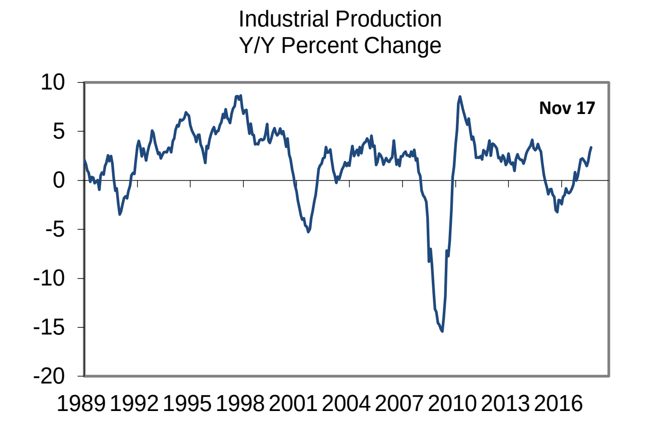
Source: National Federation of Independent Business



Source: Department of Commerce



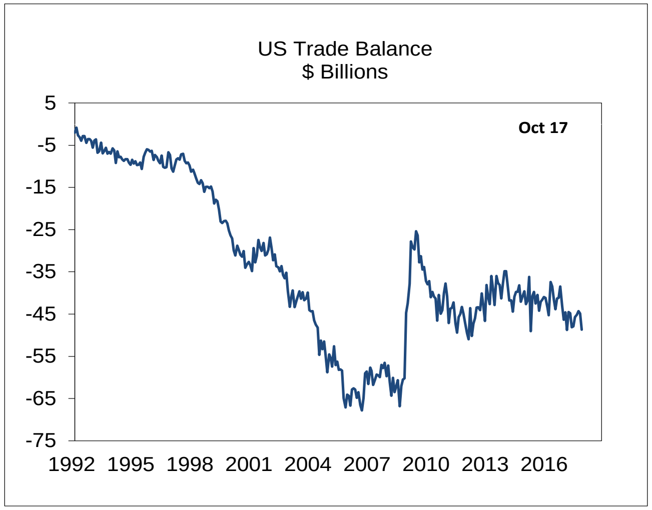
Source: Institute for Supply Management



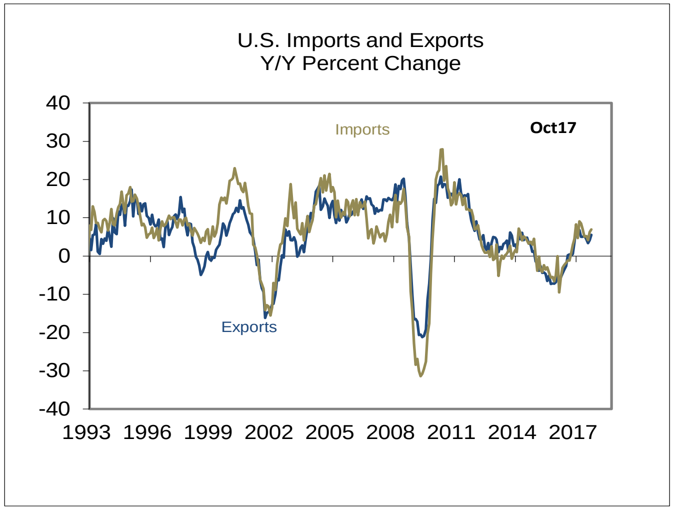
Source: Federal Reserve Board

International Trade

The trade deficit worsened in October, as imports rose moderately while exports were unchanged. Real net exports contributed around 0.4% to third quarter GDP. The dollar has weakened through the first eleven months of 2017, which, along with stronger growth readings in several foreign economies, should provide a more favorable trade backdrop in early 2018. Overall, we anticipate the trade deficit to continue its gradually widening trend. October data point to a drag on fourth quarter GDP from trade. Trade policy and the potential for greater protectionism remains a wildcard in the outlook.



Source: Department of Commerce



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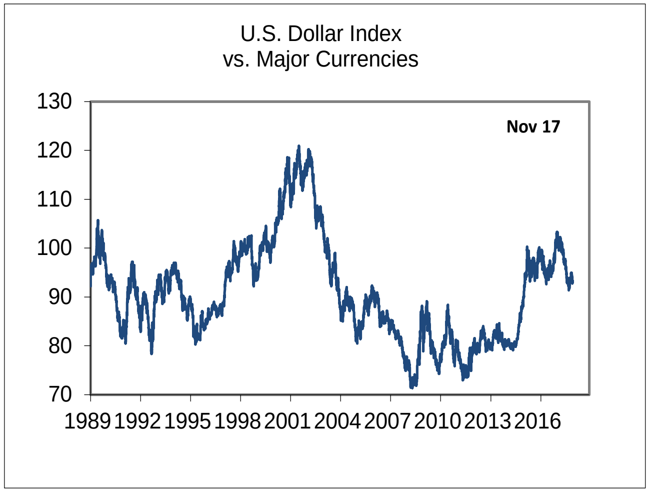
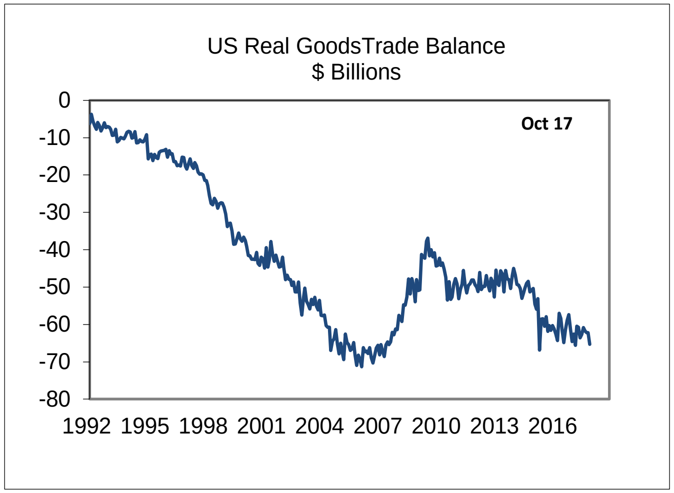


Source: Bloomberg



Sources: U.S. Department of Commerce

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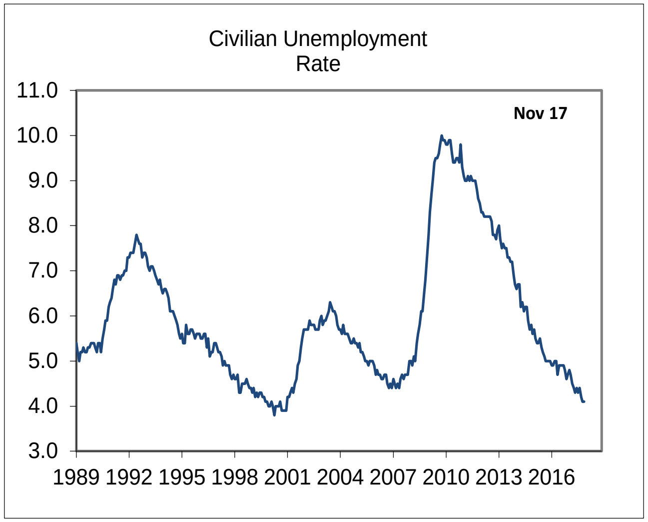
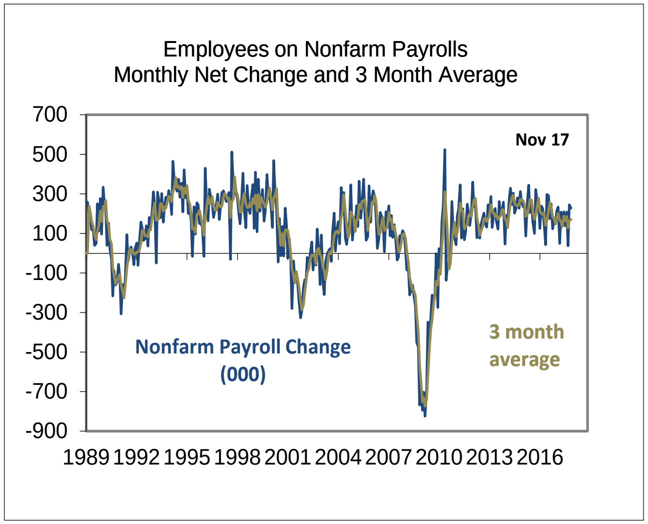
Labor Market Conditions

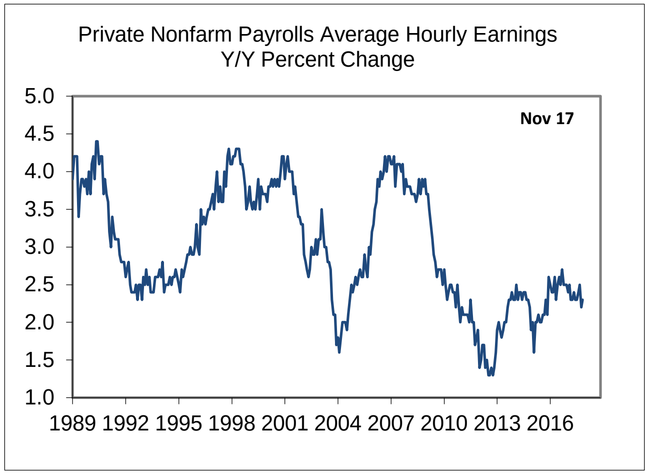
Nonfarm payrolls increased by 228,000 in November. Following the November employment report, the average payroll gain was 170,000 over the trailing three months and 178,000 over the past six months. Payroll growth should continue at a moderate pace in the coming months relative to last year's pace, with the economy at full employment. The report did not have a significant effect on expectations for the path of Fed rate hikes. Average hourly earnings remained steady in November. Unemployment remained at a new cyclical low of 4.1% in November. The unemployment rate is unlikely to fall much further. Additional demand for labor going forward is more likely to raise wages and/or increase the participation rate than reduce the unemployment rate meaningfully from current levels.



Source: Bureau of Labor Statistics



Source: Bureau of Labor Statistics



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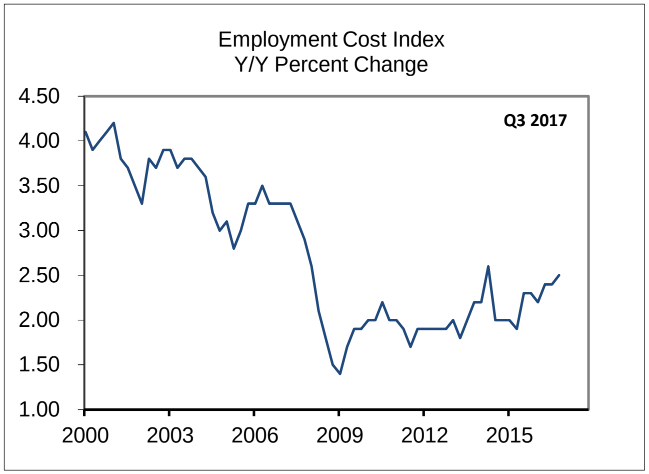

Source: Bureau of Labor Statistics

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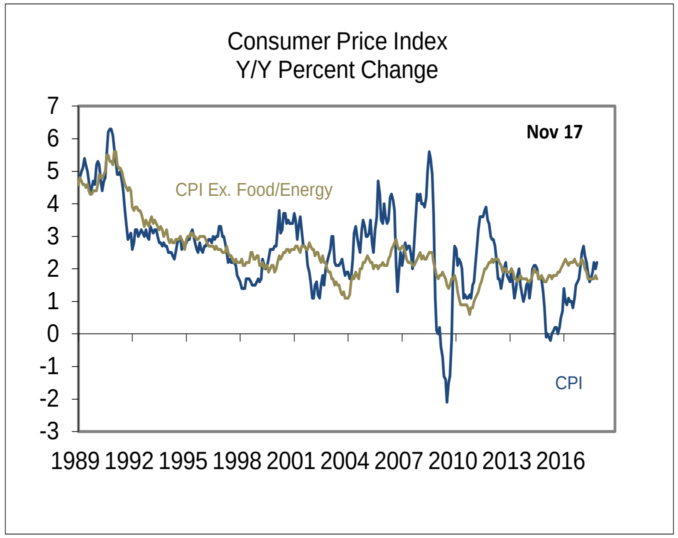
Inflation and Monetary Policy

CPI inflation increased in November to a 2.2% annual rate. Core CPI inflation (excluding food and energy costs) remained steady at a 1.7% annual rate. The difference between headline and core inflation continues to increase The PCE deflator, which typically runs below the CPI, has fallen back below the Fed's 2% policy objective, and currently sits at 1.6%. The Fed continued to tighten in December. The latest economic projections indicate it will raise the fed funds rate steadily higher in 2018 and 2019, ending 2019 at 2.7%. This stands in stark contrast to futures market pricing, which suggests about 50 basis points in additional rate moves over the next couple of years.



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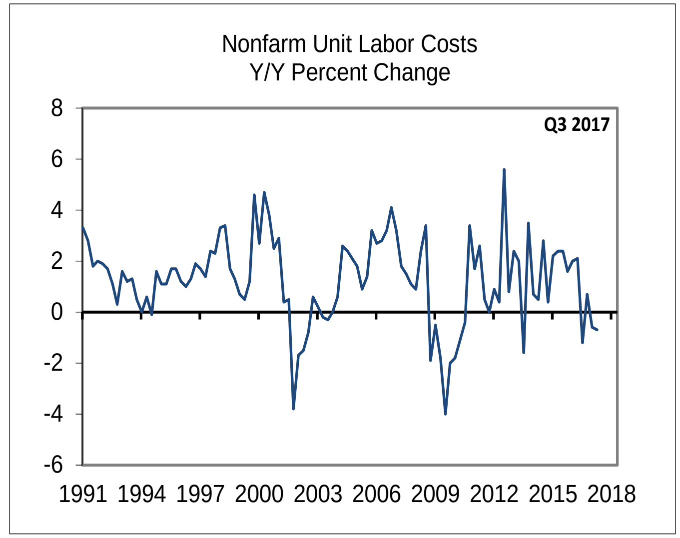
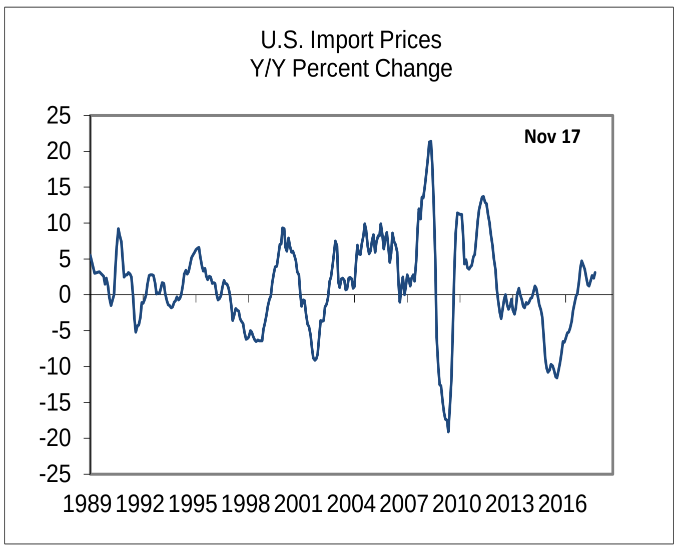
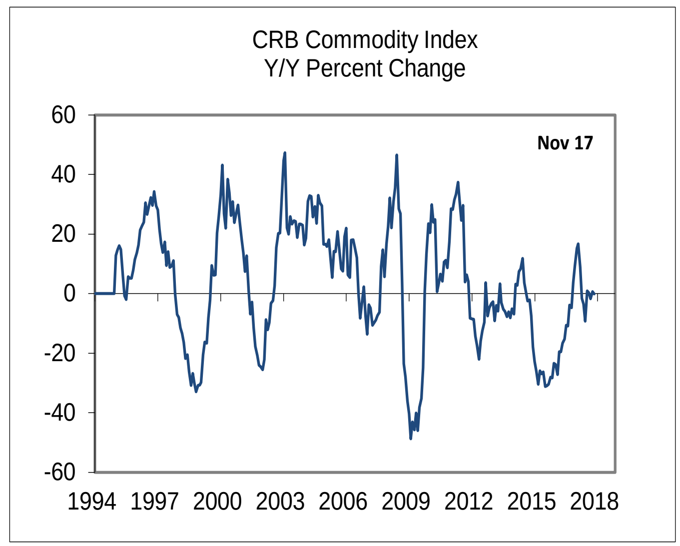


Source: Federal Reserve Board



Source: Bureau of Labor Statistics



Source: Reuters

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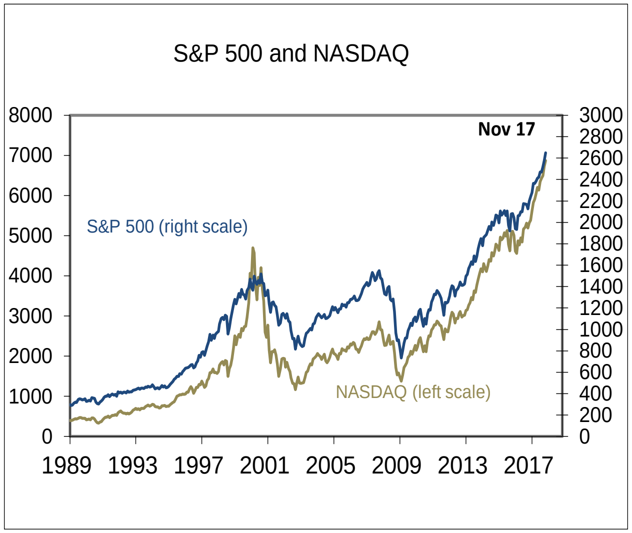
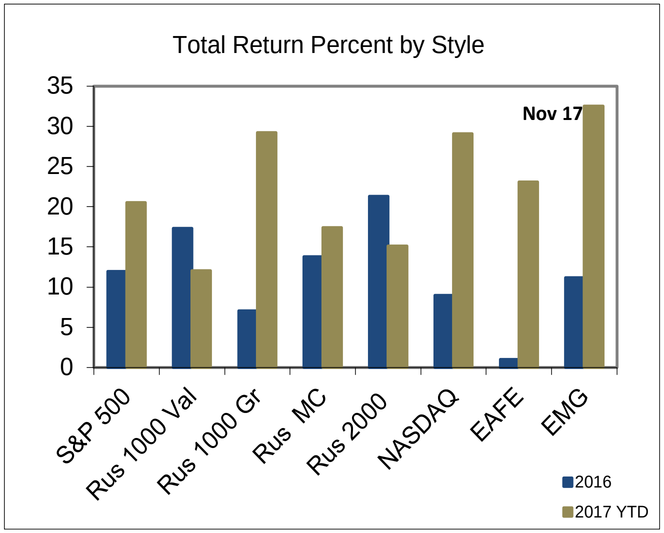
Equity Market

U.S. equity markets experienced very positive performance in November. The Russell 2000 ® Index of small cap stocks returned 2.9%, the S&P 500 ® Index of large cap stocks 3.1%, and the Nasdaq Composite Index returned 2.4%. Implied and realized volatility remained depressed during the month, returning to a record low in mid-December. During November, telecom stocks led the market with returns of 6.0%, while Materials stocks had the worst sector performance at 1.0%. Technology has been the standout performer year-to-date through November, returning 38.9%, while telecom lost 6.6%. Domestic markets in aggregate have lagged international equities so far in 2017, a reversal of the past several years.



Source: Bloomberg



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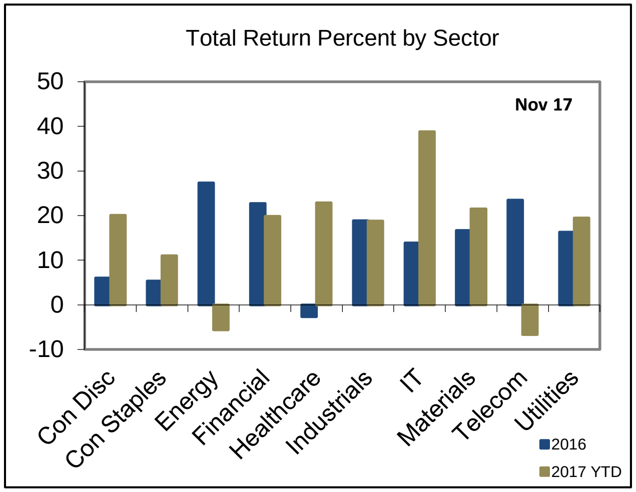
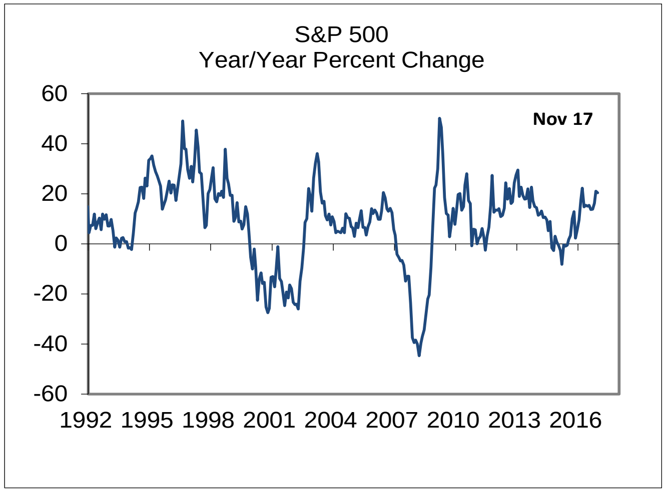


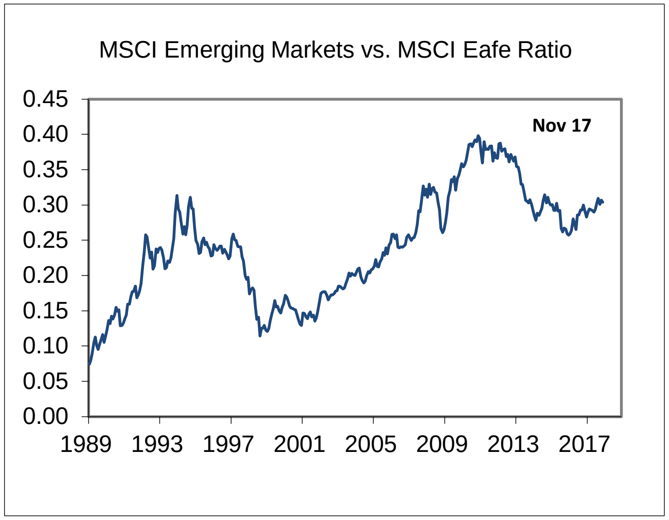
Source: Bloomberg. Based on the S&P 500 Index.



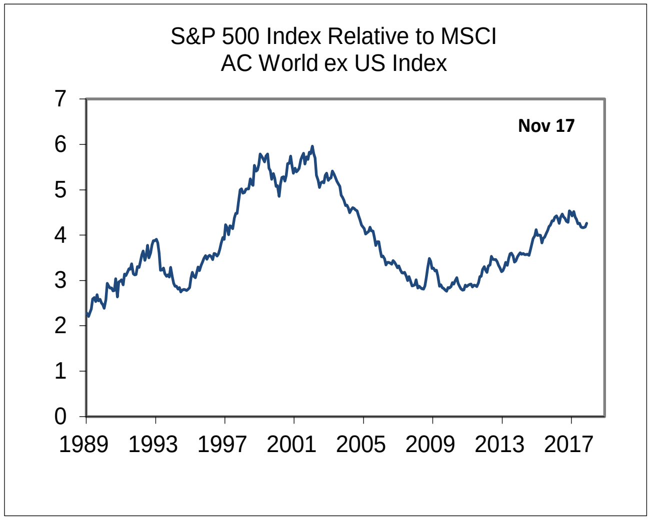
Source: Bloomberg

International Markets

International equities underperformed U.S. stocks in November. EAFE (Europe, Australasia, Far East) returned 1.05% and emerging market equities returned 0.20%. Emerging markets have been the clear winners year to date, returning 32.53% versus 20.49% for the S&P 500. If international stocks maintain their performance advantage over U.S. equities through the remainder of the year, it would be the first time since 2012 that international stocks outperformed the U.S. for a calendar year. Dollar weakness is unlikely to remain a continued source of foreign stock outperformance over the balance of the year, but better growth measures and ongoing policy support, as well as valuation differentials, suggests continued foreign stock outperformance.



Source: MSCI Barra



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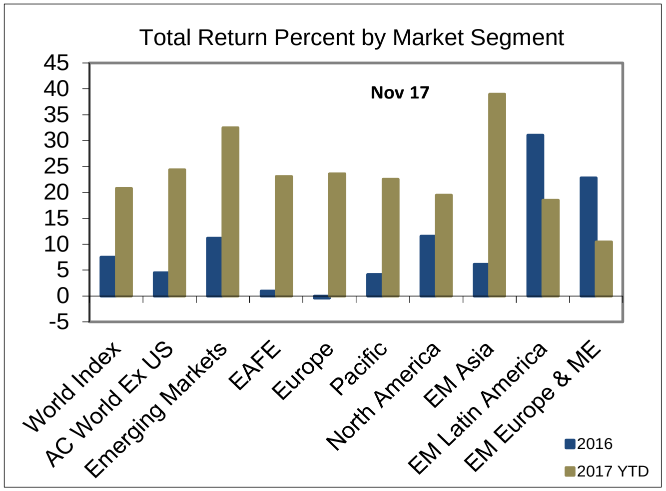

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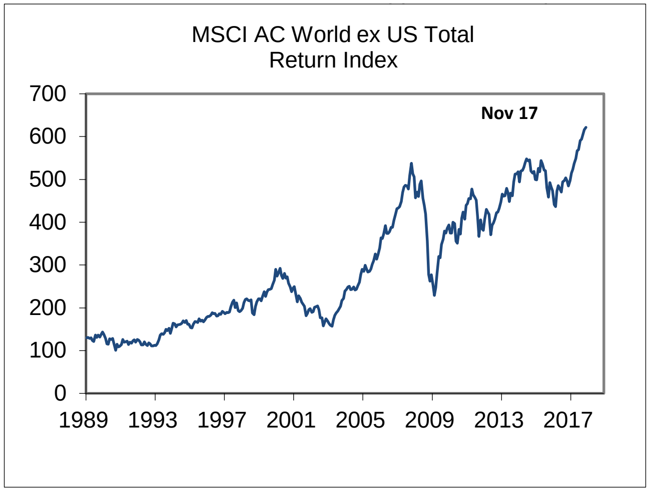
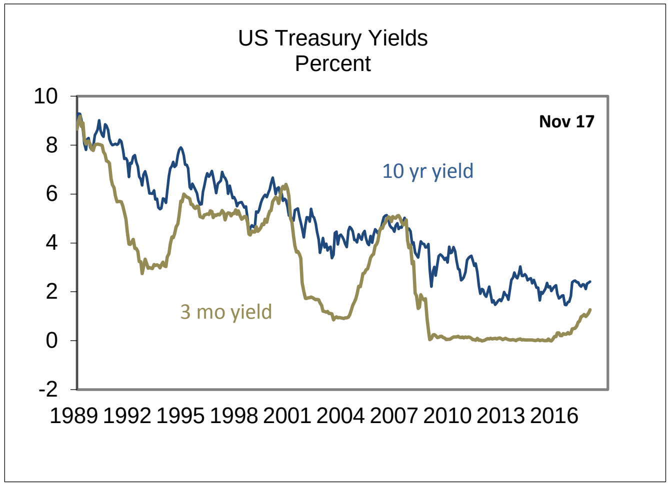


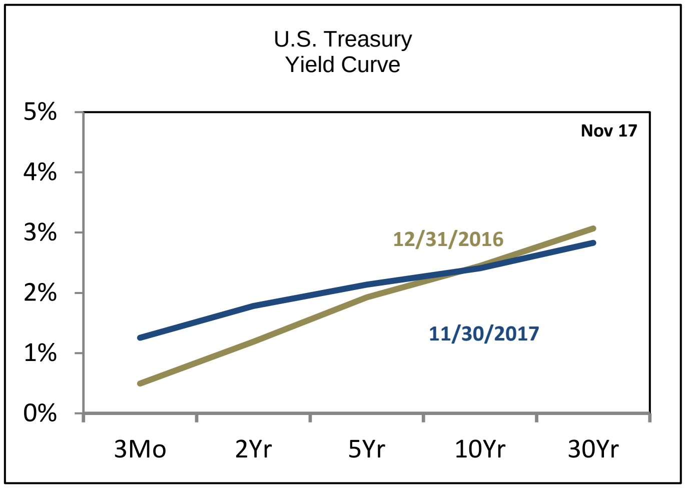
Source: MSCI Barra

Fixed-Income Market

The U.S. Treasury yield curve flattened slightly in November, with the 2-year yields increasing around 0.18% and 10-year yields increasing around 0.03%. Short-term rates have risen in 2017, reflecting continued Fed tightening. 10-year Treasury yields rose from 2.44% on December 31 to a high of 2.63% on March 13, declined to 2.17% on April 18 and ended November at 2.41%. Investment grade credit spreads increased slightly in November The best-performing fixed income sector in November was the TIPS sector, returning 0.13%. The key drivers of long-term interest rates over the past 5 years have been equivalent foreign bond yields and longer-term expectations for the Fed Funds rate. Both of these factors are likely to be a near term source of upward pressure on yields.



Source: Bloomberg



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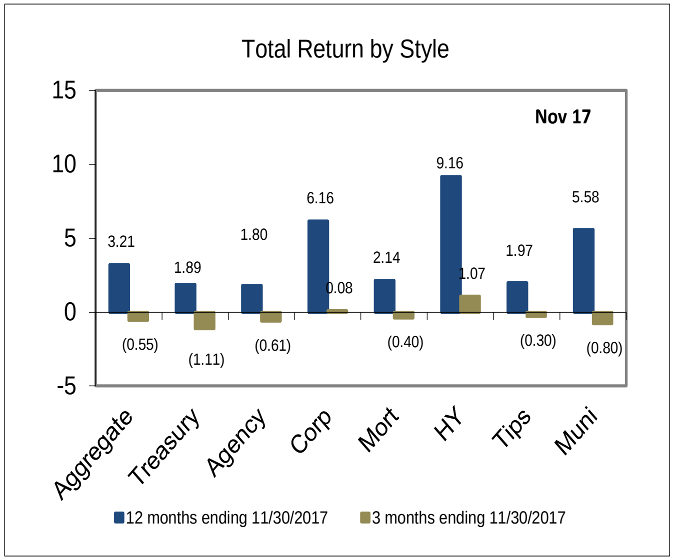
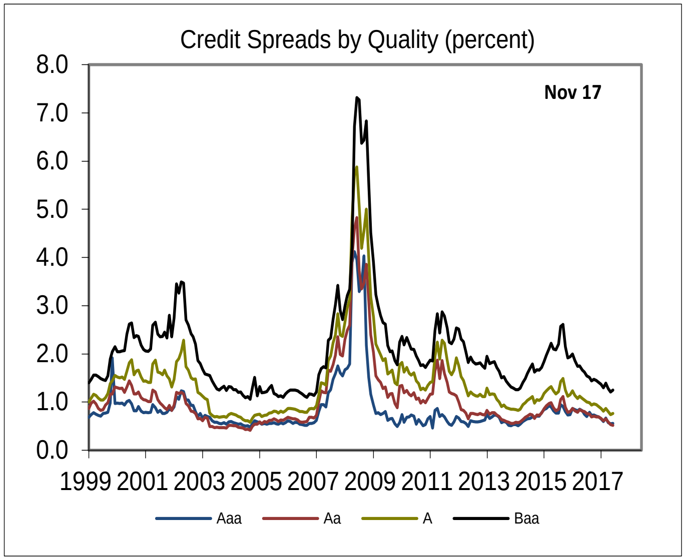


Source: Barclays Capital. Based on the Barclays U.S. Aggregate Bond Index.



Source: Barclays Capital. Based on the Barclays U.S. Aggregate Bond Index.

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Economic, Rates and Earnings Forecast

	2016 (A)	2017 (F)	2018 (F)	2017 Bloomberg Consensus*	2018 Bloomberg Consensus*
Real GDP (Q4/Q4)	1.8%	1.9% - 2.6%	1.0% - 2.0%	2.60%	2.60%
Personal Consumption Expenditures	2.8%	1.8% - 2.5%	1.0% - 2.0%		
Investment	0.9%	1.0% - 3.0%	1.5% - 2.5%		
Net Exports ($)	-$586B	-$611B	-$620B		
Government Spending	0.4%	0.0%- 1.0%	1.0%- 2.0%		
Unemployment Rate* **	4.7%	4.2%	4.0%	4.40%	4.00%
CPI* **	2.1%	1.5% - 2.5%	1.5% - 2.5%	2.10%	2.10%
CPI Excluding Food and Energy* **	2.2%	1.5% - 2.5%	1.5% - 2.5%		
Fed Funds* **	0.50% - 0.75%	1.00% - 1.50%	1.25% - 2.00%	1.50%	2.20%
10 Year Treasury* **	2.44%	1.75% - 2.75%	2.00% - 3.00%	2.42%	2.88%
Corporate Earnings (S&P Operating)	$106.26	$124.00	$128.00	$125.03**	$144.54**
Trade Weighted Dollar* **	102.21	90 - 100	95 - 105		
*Bloomberg - December 18, 2017					
**Standard and Poors - December 15, 2017					
***End of Period Level					

(A) Actual

(F) Forecast

Index Definitions

The **Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

The **MSCI EAFE Index** is an equity index which captures large and mid cap representation across Developed Markets countries around the world, excluding the U.S. and Canada.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 21 Emerging Markets (EM) countries

The **MSCI ACWI (All Country World Index) Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

The **MSCI ACWI (All Country World Index) Index** ex U.S. is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the United States.

The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

The **MSCI EM (Emerging Markets) Asia Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Asia.

The **MSCI Europe Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe.

The **MSCI Europe & Middle East Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe and the Middle East.

The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Latin America.

The **MSCI North America Index** is designed to measure the performance of the large and mid cap segments of the U.S. and Canada markets.

The **MSCI Pacific Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in the Pacific region.

The **Russell 1000® Growth Index** is a market-capitalization-weighted index that measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 1000® Value Index** is a large-cap value index measuring the performance of the largest 1,000 U.S. incorporated companies with lower price-to-book ratios and lower forecasted growth values.

The **Russell 2000® Index** is composed of the 2,000 smallest stocks in the Russell 3000® Index and is widely regarded in the industry as the premier measure of small-cap stock performance.

The **Russell Midcap Index** measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap is a subset of the Russell 1000® Index.

The **S&P 500® Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.

Disclosure

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Past performance does not guarantee future results.

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