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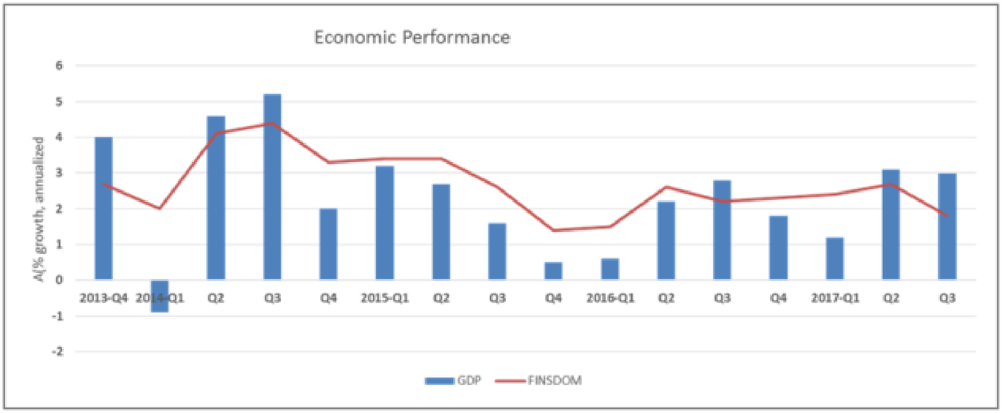
Advocacy Investing®

A RESILIENT RECOVERY

- **The economy registered a second consecutive quarter of 3% growth in the third quarter of 2017**
- **Oil prices rebound on talk of extending OPEC and non-OPEC cutbacks**
- **Post-hurricane labor markets return to trend**
- **The Fed leaves the benchmark rate unchanged, but hints at a year-end 2017 increase**
- **President Trump nominates Jerome Powell to succeed Janet Yellen as Fed Chair**
- **The global economy steams ahead**
- **The House Republicans unveil a massive tax cut package**
- **The equity markets continue to surge, with the S&P 500 in its twelfth consecutive monthly increase**

Economic performance in the third quarter of 2017 (3Q17) showed resilience in the face of the triple hurricane shock. Economic output rose by 3.0% (annualized) from 3.1% in 2Q17, exceeding market expectations—the best two-quarter performance since 2014. However, Final Sales to Domestic Purchasers (which excludes inventory changes and exports, but includes imports) rose by only 2.2%, down from 3.3% in 2Q17. Consumption Expenditures (PCE), non-residential investments, inventories, net exports and federal government spending provided positive momentum, while residential investments and state expenditures created a drag. The slight growth slowdown from 2Q17 was due to a deceleration in PCE, non-residential investment and exports, offset in part by an acceleration in inventories buildup and a decline in imports. PCE growth slowed to 2.4% in 3Q17 from 3.3% in the previous quarter, while Gross Domestic Private Investment surged to 6% from 3.9% the previous quarter—all numbers annualized. Note that these numbers are the first estimate, and that they will be revised twice during the course of the quarter.

Figure 1: **A Sustained Economic Performance**

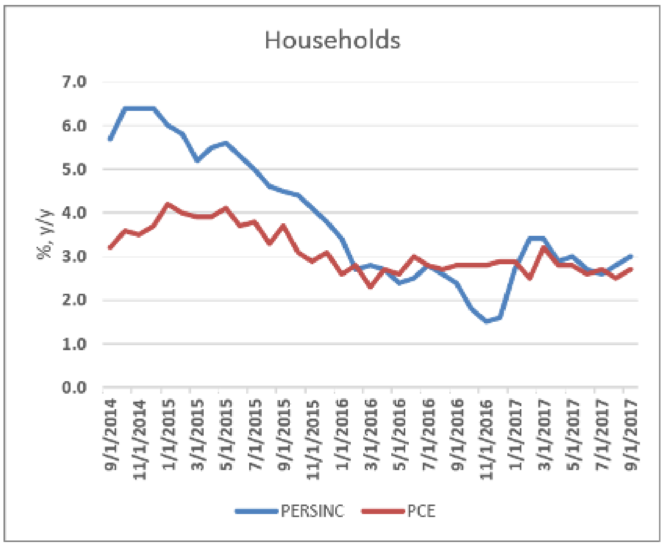


The acceleration in the economy has been confirmed by a robust set of data releases. The household sector showed solid gains, supported by record-high levels of consumer confidence. Retail sales rose by 1.6% month-on-month (m/m) in September, and Personal Income and PCE increased by respectively 0.4% and 1.0% m/m. The University of Michigan Consumer Confidence index was flat at around 101 in October, while the Conference Board measure surged to 125.9 at the end of October from 119.8 the previous month, reaching its highest level in 17 years. On the production side, Industrial Production and Manufacturing rose by respectively 0.3% and 0.1% m/m in September. Durable Goods increased by 2.2% m/m (+0.7% ex-transportation). September Factory Orders gained 1.4% m/m. Early-month surveys were overall positive: the Empire State index of manufacturing activity rose to 30.2 in early October from 24.4 the previous month, while the Philadelphia measure rose from 23.8 to 27.9 over the same period. Late-month surveys were equally strong. The ISM-Manufacturing scored 58.7 at the end of October, from 60.8 the previous month. The Markit PMI-Manufacturing rose from 53.1 to 54.6 over the same period, and the broad-based Chicago PMI jumped to 66.2 from 65.2 the previous month. Services remained strong, with the end-October Markit PMI Services stable at 55.3 and the ISM-NonManufacturing rising to 60.1 at the end of October from 59.8 the previous month.

Exports and imports rose by respectively 1.1% and 1.2% m/m in September and the trade deficit widened to $43.4 billion. The dollar has recovered from its 2017 lows, gaining 2.7% from its low on September 19th, and 1.5% in October—however; it remains 7.5% below its year-end 2016 level.

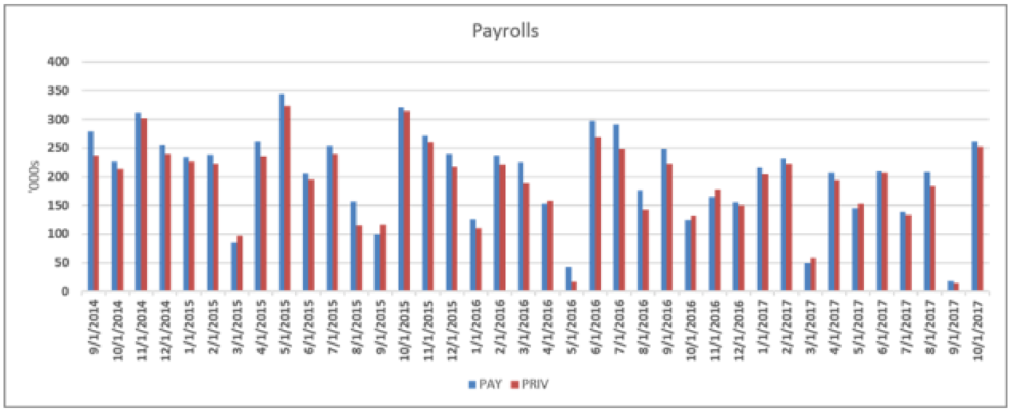
The housing market was stable in September, with flat Housing Starts and Existing Home Sales and rising New Home Sales. Housing prices, as measured by the Case-Shiller 20-city index, rose by 0.5% m/m in July (5.9% y/y). Construction spending rose by 0.3% m/m in September.

Figure 2: Households Maintain Spending



Oil prices have recovered, with crude prices (West Texas Intermediate, WTI) gaining 4.8% in October to $54.15/barrel (bbl), their highest level since July 2015. Brent crude also rose to over $60/bbl, also the highest price since July 2015. Oil markets have tightened, as excess supply conditions are fading. At the same time, pronouncements by the Saudis and the Russians about extending the current output curbs for several months have provided additional support to the crude markets. Additionally, the tense standoff between the Iraqi government and the regional Kurdish government over a botched Kurdish independence referendum raised the level of geopolitical risk, but the Iraqi government seems to have regained control of the disputed Kirkuk oil fields. Oil prices (WTI) jumped further to almost $57/bbl at the beginning of the second week of November, probably in response to the power struggle news in Saudi Arabia. Oil prices seem to have found support in the $53-56/bbl range in the medium term, but could be constrained by the so-called "shale wall" of $60/bbl.

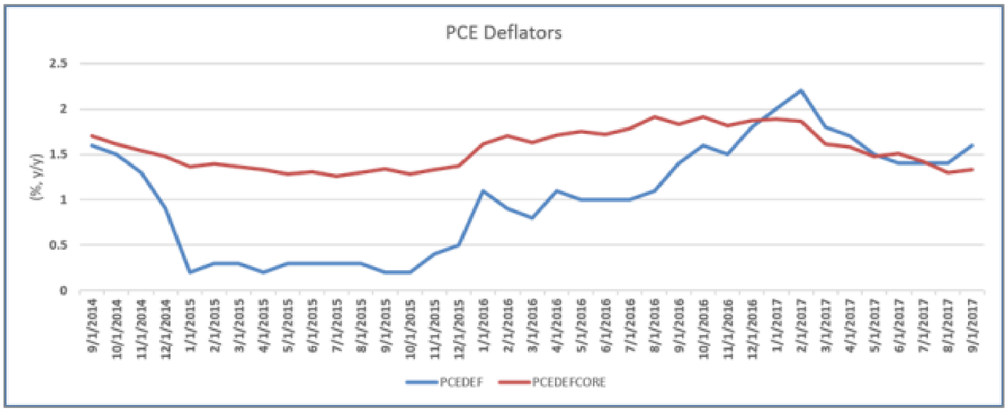
Figure 3: **Post-Hurricane Labor Markets Back to Trend**



Fading Hurricanes Impact: The October Employment Report was mixed-to-positive. As expected, payrolls rebounded after the triple hurricanes effect dissipated. Payrolls increased by 261,000 (the private sector added 252,000 positions). The number was significantly below market expectations of 325,000; however, the total for the previous two months was revised upward by 90,000. The three-month average registered at 162,000, the same as the 10-month average year-to date (ytd). The goods sector added 33,000 positions (mining, -2,000; manufacturing, +24,000; construction, +11,000), private services 219,000 and government 9,000. Average hourly earnings and average weekly hours were flat. The separate households' survey was mixed. While the unemployment rate (U3) fell to 4.1% from 4.2% the previous month, the labor participation rate declined by 0.4% to 62.7%, its May 2017 level. On the positive side, the broader unemployment and underemployment index (U6), fell to 7.9%, its lowest level since 2007, mostly as a result of people moving from part-time to full-time jobs. The high frequency data continues to underscore a tight labor market, with the late October weekly Initial Jobless Claims number down under 230,000. Overall, we are facing continuing tightening in the labor markets, offset by a puzzling lack of response in wage inflation.

Fed on Track but Yellen Shown the Exit: There were no surprises from the Federal Open Market Committee (FOMC), which met on October 31st-November 1st. The FOMC statement reiterated its view that the economy is on solid ground, with falling unemployment, sustained household spending and a pickup in business expenditures.

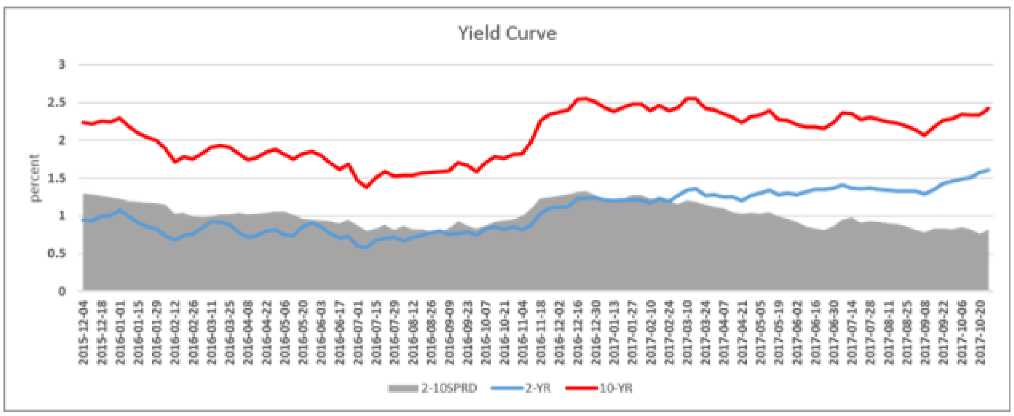
Figure 4: Weak Inflation



The statement acknowledged the fact that inflation continues to underperform—and is in fact softening, with the Core PCE Deflator running at 1.3% y/y, significantly lower than the 2% Fed target. The benchmark Fed Funds rate was left unchanged. However, the statement did not indicate any hesitation in pursuing the path of gradual monetary tightening, with one more .25% (25 bp) increase in the benchmark rate expected at the December meeting. The Fed also indicated that the balance sheet normalization process is proceeding apace. The 10-year Treasury's yield climbed to a 7-month high of 2.42% at the end of October, having gained 35 bp from its 2017 low on September 8th, and the yield curve flattened further. The latest payrolls number are encouraging for the Fed and could actually accelerate the pace of interest rate increases from an expected three, to four increases in 2018, which would bring the Fed Fund's rate to 2.5% by the end of 2018.

The New Kid in Town: President Trump decided against re-appointing Fed Chair Janet Yellen for a second 4-year term (her term ends in January 2018). However, his choice of a successor, Jerome Powell, currently a Fed board member, is a compromise one. Powell, the first non-academic in this position in 40 years, is a lawyer and former investment banker. He is considered to be largely aligned with Yellen on monetary policy. Yellen was anathema to the Republican Party's more extreme elements, who were pushing for higher interest rates and more political controls on the Fed. The longer-term impact of the Powell appointment to the Fed is still unclear, but the collective nature of Fed decision-making on monetary policy should contribute to a high degree of continuity. On the other hand, the Fed Chair had greater leeway on financial regulation, and Powell will almost certainly push for a more laisser-faire attitude—a stance likely to be welcome by the banks, but fraught with longer-term risk. Powell (who is expected to be easily confirmed by the Senate) takes the helm at a critical time. First of all, he will face a difficult choice regarding interest rates in 2018 and beyond. Tightening too fast could tip the economy into a recession—potentially through a shock to the financial markets. At the same time, delaying the normalization of monetary policy could feed further in the current financial assets bubble, laying the groundwork for a sharper correction down the road. Powell will also have to deal with political pressures from a skeptical GOP and an unpredictable president. In addition to Powell, the Trump administration must fill three Fed Board of Governors vacant positions. Those choices will be significant in determining the longer-term direction of monetary policy.

Figure 5: <u>The Yield Curve Flattens</u>



The global economy continues to improve as it settles into a virtuous cycle of rising consumer and business spending, strong consumer and business confidence, steady financial conditions and synchronized growth. Global growth is expected to reach 3.5% in 2017 and continue at a similar pace in the first months of 2018. Conditions in the eurozone continue to improve: the Markit PMI manufacturing has reached its highest level in over six and a half years, and unemployment is at its lowest in eight years. The Chinese economy is more subdued, growing at an annualized pace of 6.7-6.9% in the past three quarters of 2017. The Caixin PMI Manufacturing rose to 51.6 at the end of October from 51 the previous month and the Caixin PMI Composite remained stable at 51. The Chinese Communist party Congress, (which meets every five years) further consolidated the position of President Xi Jin Ping. No major policy measures were announced, although the official line is a shift in economic emphasis from fast-pace to balanced growth.

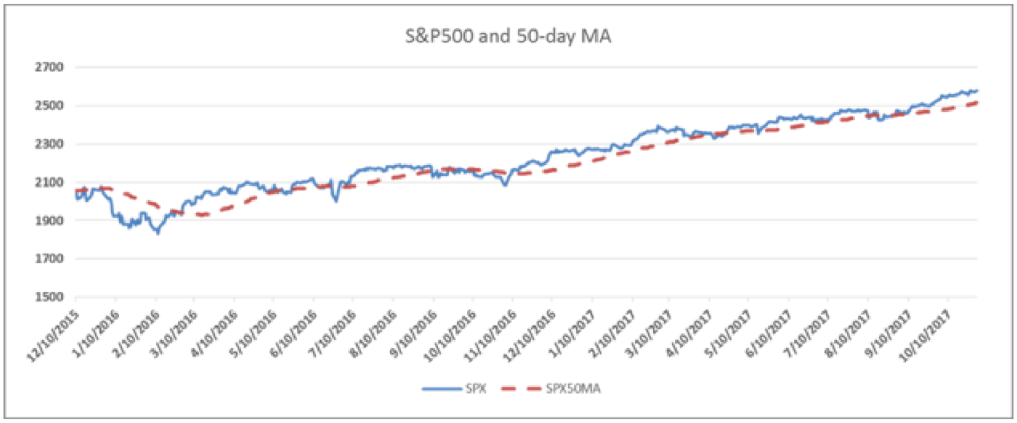
The major central banks are still concerned about low inflation, which doesn't seem to be able to break the generally accepted target of 2%. This has created some dissonance in monetary policy. The Federal Reserve Bank has officially begun tightening monetary policy, while the European Central Bank has announced that it will continue its sovereign asset purchases for the next twelve months, albeit at a slower pace. The Bank of Japan has cut back on its assets purchases. Despite facing a slowing economy, the Bank of England raised its benchmark rate for the first time in a decade.

The U.S. economy is well set on a steady growth path, with a strong global economy as background. We have seen over the past two quarters steady pace of growth in PCE and a revival of business expenditures. Oil prices remain in a Goldilocks range—neither too high to deter consumption nor too low to lead to cutbacks in the energy industry. However, longer-term trend (potential) growth is projected to be around 2%, and the 3% pace of growth is likely to be unsustainable. Economic growth in the medium term should return to a 2.0-2.5% trend pace.

The main uncertainties and risks are on the political and policy side. The massive tax bill presented by the House GOP is only the first step in a complex and politically fraught process. While the White House and the GOP leadership want to push it through before the end of 2018, the proposed legislation faces a massive lobbying effort. In any case, the bill is only the opening salvo in a long process. With the deep tax cuts envisaged, the target of an increase of the deficit by $1.5 trillion over the next decade is unlikely to be achieved. Most non-partisan analyses fault the legislation for its accounting gimmicks and its "magical thinking," and estimate that the deficit could be as much as twice as high than the bill's target. Beyond the tax bill, the legislature is facing another budget showdown on December 8th, when the compromise reached on spending and debt legislation between President Trump and the Democrats last September ends.

Political Risks:
Catalan Independence Referendum: the Catalan independence movement seems to be in retreat, with the Catalan chief minister in exile and Madrid taking administrative control. However, the situation is far from resolved.
Trump Asia Trip: President Trump is attending an ASEAN summit and visiting South Korea among continued tensions with North Korea.
NAFTA: The United States is threatening to end talks aimed at renegotiating NAFTA.
Iran Nuclear Deal: The ball is now in the U.S.Congress' court.
Saudi Power Struggle: The Saudi Crown Prince Mohammad Bin Salman (aka MBS) continues his attempts to consolidate power with the arrest of 11 senior princes and a number of government ministers on corruption charges. Such heavy handed tactics could lead to a reaction within the large Saudi Royal family and raise concerns about the Kingdom's policies.

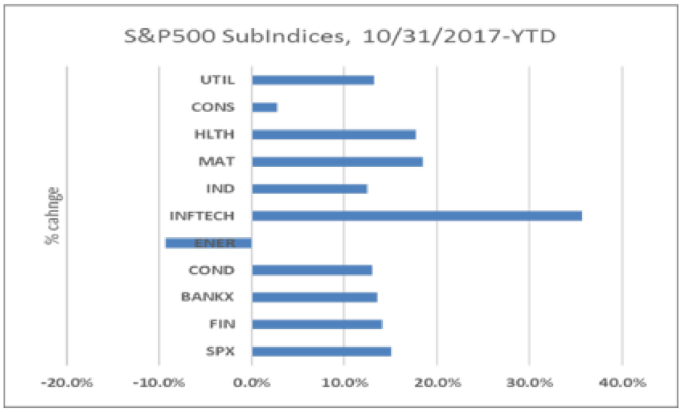
Figure 6: A Sustained Bull



From Record to Record: The markets capped their strongest month since February 2017, with the S&P500 capping 12 straight months of growth—the first time this has happened since 1935. The index ended at 2,775 at the end of October, just shy of the record 2,781 reached on September 18th, gaining 2.3% over October and up 15% ytd—and ending the first week of November at a new record of 2,584. The 12-months forward earnings Price/Earnings ratio stands at about 17.9, up from its 15.6 five-year average. The VIX market volatility index stood at 10.2 at the end of October, its lowest level since mid-September. Five technology stocks-Facebook, Apple, Amazon, Google and Microsoft—accounted for over half of the market gains. The legal action against members of President Trump's campaign team briefly tamped the markets in the last days of October, but the markets quickly resumed their upward trend. Equity valuations have been boosted by strong global and U.S. economic growth, steady earnings and expectations of corporate and personal tax cuts—although the impact of potential tax cuts should have been largely discounted already.

The markets reacted coolly to the tax package proposed by the House Republicans. While the proposals cut the corporate tax rate from 35% to 20%, it leaves many details unresolved. In any case, it is likely to be the subject of an epic legislative battle, and the final product is likely to look very different. Given the political pressures on the White House and the GOP to achieve any legislative victory before end-2018, some form of legislation is likely to be approved on party lines by using the legislative maneuver known as "reconciliation." However, a rushed legislation and ideologically charged legislation is likely to be deeply flawed. Nevertheless, the corporate tax cut should favor the large corporations, especially those which face large tax bills.

Figure 7: S&P500 SubIndices



The S&P500 broke easily through 2,500 and is now testing resistance levels at around 2,580. While the global macroeconomic and policy environment is favorable, most of the positive news has been already discounted, so it seems that the market is running on fumes. At these lofty valuations, a correction, albeit a modest one, becomes more likely.

October Data Releases

Economic Data Releases-October 2017	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP(3Q17 % Annualized, First Est)	3.1%	2.5%	3.0%	19.0%	2.9%
PCE Deflator(%, y/y) (Sep)	1.4%	1.7%	1.6%	1.6%	1.7%
Core PCE Deflator (% ,y/y)	1.3%	1.3%	1.3%	1.3%	1.5%
CPI (%. m/m) Sep	0.4%	0.6%	0.5%	0.3%	0.7%
Core CPI (%, m/m)	0.2%	0.2%	0.2%	0.1%	0.3%
Employment					
First Time Claims ('000) (last week October)	234	233	229	235	240
Non-Farm Payrolls ('000), October	15	320	261	200	371
o/w Private Sector	15	320	252	260	368
Balance of Payments					
Trade Deficit $ billion) (Sep)	$42.80	$43.50	$43.4	$42.30	$44.20
Exports (% m/m)	0.4%		1.1%		
Imports (% m/m)	-0.1%		1.2%		
Current Account Deficit ($ billion, 2Q17)	$123.10				
Dollar Index-eom (Oct)	93.08		94.49		
Oil Prices-eom (WTI, $/bbl) Oct)	$51.67		$54.41		
Industrial & Manufacturing					
Corporate Profits (y/y) 2Q17	8.1%		7.4%		
Bus Inventories (Sep)	0.3%	0.7%	0.7%	0.3%	0.7%
Empire State (Oct)	24.4	20.00	30.2	18.00	24.10
Philadelphia (Oct)	23.8	20.20	27.9	15.00	25.80
Chicago PMI (Oct)	62	62.0	66.2	58.0	65.0
Markit PMI Mfg (Oct)	53.1	54.5	54.6	53.5	54.5
ISM Mfg (Oct)	60.8	59.5	58.7	58.6	61.1
Industrial Production (% m/m, (Sep)	-0.7%	0.2%	0.3%	-0.9%	0.8%
Manufacturing (% m/m) (Sep)	-0.2%	0.4%	0.1%	0.0%	0.6%
Durable Goods (m/m) (Sep)	1.7%	1.0%	2.2%	-0.3%	2.3%
Durable Goods, ex transp (m/m)	0.7%	0.5%	0.7%	0.1%	1.0%
Durable Goos, Core Capital (m/m)	1.3%	0.5%	1.3%	0.0%	0.6%
Factory Orders (m/m) m/m (Sep)	1.2%	1.2%	1.4%	0.4%	1.6%
Services					
Markit PMI Services (Oct)	55.3	55.9	55.3	55.0	55.9
ISM Non-MFG (Oct)	59.8	58.6	60.1	56.0	60.0
Consumer Spending					
Retail Sales (% m/m) (Sep)	-0.1%	1.8%	1.6%	0.7%	2.6%
UMich Consumer Sentiment (end-Oct)	101.1	101.0	100.7	98.0	103.5
ConfBd Consumer Confidence (end-Oct)	119.8	120.6	125.9	119.0	122.9
Personal Income (%, m/m) (Sep)	0.2%	0.4%	0.4%	0.0%	0.5%
Personal Consumption Expenditures (%, m/m) (Sep)	0.1%	0.9%	1.0%	0.6%	1.1%
Housing Market					
Housing Starts ('000) (Sep)	1183	1170	1127	1150	1210
New Home Sale ('000) (Sep)	561	555	667	540	590
Existing Home Sales (MM) (Sep)	5.35	5.30	5.39	5.10	5.40
Construction Spending (%, m/m) (Sep)	0.1%	0.0%	0.3%	-0.5%	0.5%
Case Shiller-20 (%, m/m) (Aug)	0.4%	0.5%	0.5%	0.1%	0.6%
Case Shiller-20 (%, y/y)	5.8%	6.0%	5.9%	5.7%	6.3%

Dr. Pakravan has been a senior economic strategist in global financial markets for 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.