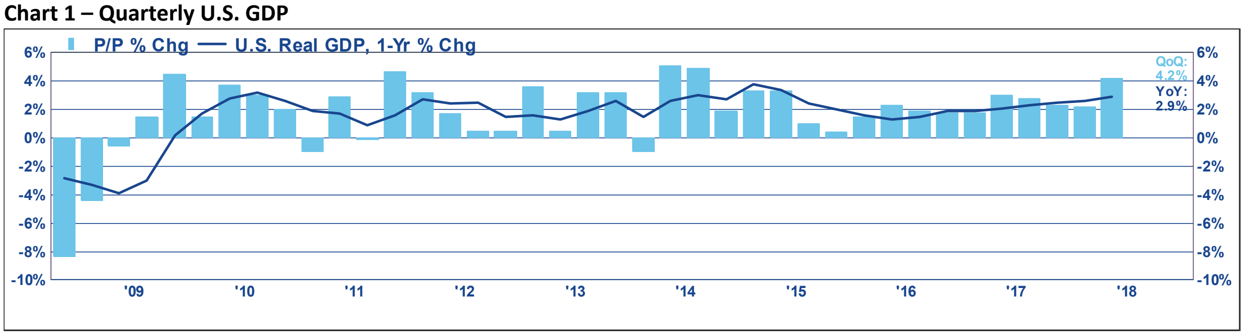
Economy

"Our economy is strong." This is the statement of Federal Reserve Chairman Jerome Powell at a recent press conference. Justifying this statement is the fact that the U.S. economy grew at a 4.2% annual pace in second-quarter 2018, the fastest rate since third-quarter 2014, and the U.S. economy is forecasted to grow 3.1% for full-year 2018. If the 3.1% growth rate is realized for full-year 2018, it would mark the strongest U.S. economic annual growth rate since 2005 (+3.5%).

Chart 1 – Quarterly U.S. GDP



Just how well is the U.S. economy doing? Listed below are some segments of the economy that in the third-quarter reached all-time highs or approached levels not seen in quite some time:

- For the week ending September 15th, weekly initial jobless claims of 202,000 was the lowest level since December 6, 1969. To put this in perspective, the U.S. civilian labor force back in December 1969 consisted of 81.6 million people. Today, it consists of 161.9 million people.
- The NFIB Small Business Optimism Index reached an all-time 45-year high level of 108.8 in August, surpassing the previous mark set in July 1983 of 108.
- The Conference Board reported consumer confidence in September hit 138.4, which is the highest level since October 2000 (135.8).
- The ISM reported manufacturing activity in August reached 61.3%, which is the highest level seen since the May 2004 rate of 61.4% and the February 1984 rate of 61.3%.
- The unemployment rate in September of 3.7% is the lowest since the December 1969 rate of 3.5%.
- The Department of Labor's July JOLT report showed job openings reached a level of 6.9 million. This is the highest level ever recorded since the report began in 2000 and surpasses the number of people unemployed in July of 6.3 million.

For the third time this year, the Federal Reserve in September upwardly revised their 2018 U.S. GDP forecast to 3.1% from 2.8%. They also raised their 2019 U.S. GDP forecast to 2.5% from 2.4%. In September 2017, the Federal Reserve's U.S. GDP forecasts for 2018 and 2019 stood at 2.1% and 2.0% respectively. Clearly, consumers and businesses are benefiting greatly from the pro-growth fiscal policy passed in December 2017 as well as from the pro-business policies of the Trump administration.

This economic momentum is expected to continue into 2019, albeit at a slower pace, and should continue to be supportive of corporate earnings growth.

Capital Markets

The primary drivers for solid U.S. equity total returns in the third-quarter were declining tariff concerns and strong corporate earnings. Trade concerns began to decline in July when the U.S. and European Union agreed to hold trade talks and then significantly declined later in the quarter when the U.S. announced it had reached trade agreements with South Korea, Mexico, and Canada. As can be seen in Table 1, these trade agreements especially benefitted large-cap indices (Dow Jones & S&P 500) as the clouds of tariff uncertainty were greatly lifted on multi-national companies. Trade tensions with China appears to be the principal remaining headwind.

Table 1 - Equity Total Returns – Period Ending September 28, 2018

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	-0.70	7.41	17.48	25.17	21.70	17.72	15.72
Russell 2000	-2.41	3.58	11.51	15.24	17.12	11.07	11.11
S&P 500	0.57	7.71	10.56	17.91	17.31	13.95	11.97
S&P 400	-1.10	3.86	7.49	14.21	15.68	11.91	12.49
Dow Jones Industrial	1.97	9.63	8.83	20.76	20.49	14.57	12.22
MSCI Developed	0.87	1.35	-1.43	2.74	9.23	4.42	5.38
MSCI Emerging	-0.53	-1.09	-7.68	-0.81	12.36	3.61	5.40

One reason equity returns were so strong in 2017 was due to the expectation that the passage of pro-growth tax reform would lead to stronger corporate earnings. These earnings expectations are being realized in 2018. After posting y/y quarterly earnings growth of 24.8% in first-quarter 2018, the S&P 500 Index posted y/y earnings growth of 25.0% in second-quarter 2018. For full-year 2018, S&P 500 earnings are forecasted to grow a robust 20.3%. Next year, earnings are forecasted to slow from this year's torrid pace but are still estimated to grow at a respectable pace of 10.4%. It should be noted that earnings estimates for 2019 have been on the rise, and the combination of low double-digit earnings growth and solid economic fundamentals should continue to provide support to U.S. equity markets.

As reflected in Table 2, bond returns were essentially flat last quarter. The Bloomberg Barclays U.S. Aggregate rose +0.02% as the rise in treasury yields were offset by declines in corporate credit spreads. Yields rose across the entire yield curve last quarter with shorter-term bonds rising at a faster pace than longer-term bonds resulting in a further flattening of the yield curve. The 2-yr rose 29 basis points (bps) to 2.81% from 2.52% while the 10-yr rose 20 bps to 3.05% from 2.85%.

Table 2 – Fixed Income Total Returns – Period Ending September 28, 2018

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays High Yield	0.56	2.40	2.57	3.05	8.15	5.54	9.46
Barclays Municipal 5-Year	-0.55	-0.20	0.10	-0.60	1.16	1.85	3.37
Barclays Michigan Muni	-0.49	-0.01	0.09	0.95	2.49	3.96	4.43
Barclays Municipal	-0.65	-0.15	-0.40	0.35	2.24	3.54	4.75
Barclays Inter Gov't/Credit	-0.40	0.21	-0.76	-0.96	0.91	1.52	3.22
Barclays Aggregate	-0.64	0.02	-1.60	-1.22	1.31	2.16	3.77

Offsetting these rising yields, was the tightening of corporate credit spreads as the strong economy and rising earnings boosted bond investor confidence last quarter. The Bloomberg Barclays U.S. Aggregate Corporate (A) credit spread tightened 16 bps to 88 bps while spreads on the Bloomberg Barclays U.S. Corporate High Yield Index tightened 48 bps to 334 bps.

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Near-Term Outlook

Entering fourth-quarter 2018, while inflation, rising yields, and trade fears persist, the near-term focus clearly shifts to the outcome of the mid-term elections. Approaching and exiting election day, market volatility is likely to modestly increase as both parties eloquently postulate their ideologies in a mature, respectful and gracious manner, and market participants begin to draw conclusions on the pending make-up of Congress.

Presently, it is looking like the mid-term elections in November will result in a split Congress with Democrats controlling the House of Representatives and Republicans keeping control of the Senate. If realized, the key questions to be answered are how effectively a split Congress can govern, and what impact may it have on fiscal policy and President Trump's agenda.

Although a political shift in the November winds may have a short-term effect on stock markets, the longer-term effect should still be dependent on the projected direction of economic fundamentals and earnings growth, which we expect to remain constructive in the near-term.

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Sources: FactSet, U.S. Dept. of Labor, U.S. Dept. of Commerce, National Federation of Independent Business, The Conference Board, Institute for Supply Management, and The Federal Reserve Bank

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