BAM Second Quarter 2017 Economics Update

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The Economy

Real gross domestic product (GDP) increased at an annual rate of 2.6% (advanced estimate) in the second quarter of 2017. In the first quarter of 2017, real GDP increased 1.2% (revised). For the first half of 2017, real GDP increased 1.9%. According to the BEA, "The increase in real GDP in the second quarter reflected positive contributions from personal consumption expenditures (PCE), nonresidential fixed investment, exports, and federal government spending that were partly offset by negative contributions from private residential fixed investment, private inventory investment, and state and local government spending. Imports, which are a subtraction in the calculation of GDP, increased." The economy got a big boost from a rebound in consumer spending, the largest source of the nation's economic growth. Spending rose 2.8% in the second quarter as Americans bought more groceries and clothes and paid more for health care. They spent less on new cars and trucks, however.

Price pressures eased sharply in the spring after a rapid buildup in late 2016 and early 2017. The PCE index is the Federal Reserve's preferred method of gauging inflation. Both the consumer price index (CPI) and the producer price index (PPI) reported weak gains in July. The slowdown in inflation could prompt the central bank to raise interest less aggressively if the trend persists.

After declining earlier in the year, the unemployment rate has shown little movement in recent months. The second quarter of 2017 ended with a June unemployment rate of 4.4%, which was a 0.1% increase from the prior month and down from 4.9% in June 2016. The May 2017 unemployment rate of 4.3% was the lowest the rate has been in 16 years. The unemployment rate for March 2017 was 4.5%. In July 2017, the unemployment rate dropped back to 4.3%. Both the July unemployment rate, and the number of unemployed persons, at 7.0 million, changed little in July. A more encompassing rate which includes discouraged workers and the under-employed, was also unchanged in July at 8.6%. The drop in July was a result of employment increases in food services and drinking places, professional and business services, and health care.

It's important to watch where the jobs are coming from. For example, in July, job creation was strongly tied to part-time, which gained 393,000 positions, while full-time positions fell by 54,000. Wage growth is also important to watch. Wage growth remained sluggish in July, with average hourly earnings increasing by 0.3% month-on-month (as expected) and 2.5% year-on-year (compared with 2.4% expected). In theory, wages should be growing at a faster pace than this because the low unemployment rate suggests that the supply of workers available for hire is limited.

According to the National Association of Realtors, "Total existing-home sales, which are completed transactions that include single-family homes, townhomes, condominiums and co-ops, decreased 1.8% to a seasonally adjusted annual rate of 5.52 million in June from 5.62 million in May. Despite last month's decline, June's sales pace is 0.7% above a year ago, but is the second lowest of 2017 (February, 5.47 million)." Only the Midwest saw an increase in sales.

Commenting on the decrease, the NAR said, “Low supply kept homes selling at a near record pace but ultimately ended up muting overall activity”. The Spring slowdown is sales activity translated to a pullback in existing sales in June, according to NAR chief economist Lawrence Yun. "Closings were down in most of the country last month because interested buyers are being tripped up by supply that remains stuck at a meager level and price growth that's straining their budget," Yun said. "The demand for buying a home is as strong as it has been since before the Great Recession. Listings in the affordable price range continue to be scooped up rapidly, but the severe housing shortages inflicting many markets are keeping a large segment of would-be buyers on the sidelines."

The median existing-home price for all housing types in June was $263,800, up 6.5% from June 2016 ($247,600). June's median sales price surpasses May as the new peak and is the 64th straight month of year-over-year gains. Properties typically stayed on the market for 28 days in June, which is up from 27 days in May but down from 34 days June 2016. According to Freddie Mac, the average commitment rate for a 30-year, conventional, fixed-rate mortgage declined for the third consecutive month, dipping to 3.90% in June from 4.01% in May. The average commitment rate for all of 2016 was 3.65 percent.

After rallying in the first quarter of 2017, the Consumer Confidence Index fell in June 2017 to 117.3, down from a reading of 125.6 in March 2017. In July, the Index rose to 121.1, a 16 year high, despite expectations for a decline. "Consumers foresee the current economic expansion continuing well into the second half of this year," Lynn Franco, The Conference Board's director of economic indicators, said in a statement. Consumer confidence, measured by the Consumer Confidence Index (CCI), is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of saving and spending.

Consumer sentiment is a statistical measurement and economic indicator of the overall health of the economy as determined by consumer opinion. Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The MCSI uses telephone surveys to gather information on consumer expectations regarding the overall economy. This index, which declined 5.1 index points from its January peak to 93.4 in July, rose to 97.6 in the first half of August. This rise is due to a more positive outlook for the overall economy, as well as more favorable personal financial prospects.

At its June meeting, the FED raised the target range for the federal funds rate by a quarter of a percentage point, bringing the benchmark rate to a range of 1.0% -- 1.25%. Commenting on their action, the FED stated that it “seeks to foster maximum employment and price stability. The Committee continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, and labor market conditions will strengthen somewhat further. Inflation on a 12-month basis is expected to remain somewhat below 2 percent in the near term but to stabilize around the Committee's 2 percent objective over the medium term. Near-term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely.” The next FED meeting is September 19th and 20th. With recent weak CPI and PPI releases for July, consumer prices and pipeline pressures remain subdued. This subdued pressure calls into question a rate hike in September.

Stock Market

The broader equity markets continued to climb and ended up for the second quarter of 2017. For the quarter, the Dow outperformed the S&P 500 with gains of 3.3% and 2.6%, respectively. For the first half of 2017, the performance for both the Dow and the S&P 500 were nearly identical with gains of 8.0% and 8.3%, respectively. For 2016, the S&P 500 was up 9.5% (2238.83) while the Dow was up a greater 13.4% (19762.60). The NASDAQ Composite outperformed the S&P 500 but underperformed the Dow with a quarterly gain of 3.87%. However, for the first half of 2017, NASDAQ Composite significantly outperformed both the Dow and the S&P 500 with a gain of 14.07%. Of the 10 sectors represented in the S&P, all but one sector experienced positive performance for the second quarter 2017, as measured by the SPDR sector ETFs. For the second quarter, the best performing sector was Health Care (7.03%) followed by Industrials (5.16%). Other gainers for the quarter were Financials (4.24%), Materials (3.16%), Technology (3.08%), Consumer Discretionary (2.31%), Utilities (2.15%), and Consumer Staples (1.42%). For the second quarter in a row, the only underperforming sector was Energy, with a loss of -6.61%. For the first half of 2017, Healthcare was the largest gainer (15.90%), followed by the Technology sector with a 14.21% gain. The Energy sector was the only laggard for the first half of 2017, showing a loss of about -12.71%.

In Fixed Income, the Barclays U.S. Aggregate Bond Index rallied through the second quarter of 2017, ending up about 1.45%, after finishing up about 0.82% for the first quarter of 2017. Through the full year of 2016, the index was up a total of about 2.6%. After bottoming in July 2016, the 10-year note began to rally through the third quarter, and strongly accelerated through the fourth quarter to end 2016 at 2.45%. However, in the first quarter of 2017, the 10-year note fell slightly to end the quarter at 2.40%. For the most recent quarter (2Q 2017) the 10-year note again fell slightly to end the quarter at 2.13%. The long end of the yield curve continued to flatten through the quarter as U.S. Treasury yields decreased slightly, the 10-year note decreased by about 9 basis points, while the 30-year bond decreased by 18 basis points, ending the quarter at 2.31% and 2.84%, respectively.

While inflation pressures increased in the first quarter of 2017, pressures seemed to abate in the second quarter as gold futures prices experiencing slight losses from the prior quarter of about $7.60 with a closing price of about $1241.60 per ounce. Oil prices weakened through the quarter, decreasing by about $3.21/bbl to end the first quarter at about $50.54/bbl. $46.02

After rallying through the second half of 2016, the WSJ Dollar Index declined through the first quarter of 2016, decreasing by about 2.88 to 90.38. The WSJ Dollar Index continued its decline through the second quarter of 2017 decreasing by about 2.64 points to 87.74.

Conclusion

After the November election and through the first half of this year the broader markets moved higher based on expectations that the Trump agenda--lower regulation and taxes, changes to healthcare policy and increased expenditures on infrastructure--would fuel economic activity. Until the last few weeks, the broader indexes melted to record highs, as many economic indicators were signaling potentially higher economic growth. In addition, many companies were reporting second quarter results with earnings growth in the double digits fueled by revenue growth that exceeded the broader economy. However, these impressive results were not broad in nature. Many technology, healthcare, and industrial names have exceeded expectations while many retailers and transportation names (e.g. autos, rail, and airlines) have suffered.

While the broader markets remain near record highs, volatility has increased as share prices of many companies remain stretched. Also weighing on markets are heightened geopolitical risks and national politics which have stymied the president's agenda. In addition, the FED has stated that they will continue to tighten, either through further Fed Funds hikes or decreasing their balance sheet. This has caused the yield curve to flatten, as market participants have become concerned that further monetary tightening may lead to slower economic activity. Finally, since the Trump agenda has stalled in Congress, concerns have heightened regarding the upcoming fiscal budget negotiations and when the debt limit will be raised.

At Bowen Asset, we believe that uncertainty creates opportunity and we continue to identify buying opportunities created by market corrections. In addition, we believe that during times of volatility, stock picking becomes more important to achieving investor goals. We continue to search for asset managers who can outperform the broader markets over the long term.

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