# BAM Economics Update First Quarter 2017

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The economy continued GDP growth at less than 2% in the first quarter of 2017. Short-term treasuries continued to move up while longer rates moved down, thus continuing a flattening of the yield curve. The jobs picture continued to improve although the economy appears to be getting close to full employment meaning it is getting harder to find qualified workers. In June, the Federal Reserve (FED) raised interest rates for the third time in June since December 2016 which is the first time it raised the fed funds rate. In its statement, the FED stated that it anticipates an additional rate hike in 2017. Inventory of existing homes available for sale continues to fall.

Real gross domestic product (GDP) increased at an annual rate of 1.2 % in the first quarter of 2017, according to the "second" estimate released by the Bureau of Economic Analysis. In the fourth quarter of 2016, real GDP increased 2.1 %. The increase in real GDP in the first quarter reflected positive contributions from nonresidential fixed investment, exports, residential fixed investment, and personal consumption expenditures (PCE). This real GDP increase was also offset by negative contributions from private inventory investment, state and local government spending, and federal government spending. Imports, which are subtracted when calculating GDP, increased. The current GDP forecasts for the second quarter of 2017 published by the Atlanta FED as of June 16 (GDPNow) and the New York FED as of June 9 (Nowcast) are 2.9% and 1.9%, respectively.

The U.S. unemployment rate fell to 4.3% in May from 4.4% in April, according to the Labor Dept., and is at the lowest level since 2001. The economy created a net 138,000 jobs in May as the manufacturing, government, and retail sector lost jobs. However, the economy also created 66,000 fewer jobs than previously reported in March and April. Over the past three months, job gains have averaged just 121,000 per month—the weakest increase since 2012, which indicates that it is getting harder to find qualified workers. Though the unemployment rate fell, that happened because 429,000 people dropped out of the labor force. The rate fell last month because the number of employed Americans grew faster than growth in the labor force. On its own, the rate suggests that the U.S. is at or near what economists consider full employment—a healthy level that won't stoke a surge in wage inflation. The Fed projects that unemployment over the long run will average 4.7% to 5%. The underemployment level fell to 8.4%, the lowest level since November 2007.

Stubbornly low supply levels held down existing home sales in April. The National Association of Realtors (NAR) released existing home sales numbers for April 2017. Sales were down 2.3% to a seasonally adjusted annual rate of 5.57 million units from a downwardly revised 5.7 million units in March. Despite last month's decline, sales are still 1.6% above a year ago level and at the fourth highest pace over the last year. Lawrence Yun, NAR chief economist, says every major region except the Midwest saw a retreat in existing sales in April. "Last month's dip in closings was somewhat expected given that there was such a strong sales increase in March at 4.2%, and new and existing inventory is not keeping up with the fast pace homes are coming off the market," he said. "Demand is easily outstripping supply in most of the country and it's stymieing many prospective buyers finding a home to purchase."

Inventory has fallen year-over-year for 23 straight months, implying that demand is outweighing supply. This persistent shortage of properties available for sale, which is increasing house prices, remains an obstacle to a robust housing market. In April, the median number of days a home was on the market hit a new low of 29 days, according to NAR. This is down from 34 days in March and 39 days in April 2016 and is especially true in the lower and mid-market price range. The median existing home price for all housing types in April was 244,800, up 6% from a year earlier. This marks the 62nd consecutive month of year-over-year gains. Also, while the 30 year fixed mortgage rate appears to be stabilizing after rapidly rising since the election, it remains above 4%. According to Freddie Mac, the average 30-year mortgage rate declined for the first time in six months to 4.5% in April from 4.2% in March. The average mortgage rate for 2016 was 3.65%.

The Conference Board *Consumer Confidence Index,* which had decreased in April, declined slightly in May. Consumers' appraisal of current conditions held steady in May. Those saying business conditions are "good" edged down from 30.8% to 29.4%, but those saying business conditions are "bad" was unchanged at 13.7%. Consumers' assessment of the labor market also remained positive. Those stating jobs are "plentiful" declined marginally from 30.3% to 29.9%, however, those claiming jobs are "hard to get" decreased from 19.4% to 18.2%. Consumers were less optimistic about the short-term outlook in May. The percentage of consumers expecting business conditions to improve over the next six months decreased from 25.1% to 21.3%. However, those expecting business conditions to worsen declined marginally from 10.4% to 10.1%.

At its June meeting, the FED raised the target range for the federal funds rate by a quarter of a percentage point at its June meeting, bringing the benchmark rate to a range of 1.0% to 1.25%. The FED also stuck to its projection of another rate hike later this year, followed by three more quarter-point increases in 2018. Despite the recent drop in inflation, the FED statement also indicated that it is "monitoring inflation closely" and it slightly lowered its inflation estimate for this year.

The FED also presented its plan to shrink its balance sheet. The plan is to taper reinvestments or principal and interest gradually, and then let bonds mature off the balance sheet over the next few years. The FED was not expected to announce this plan at its June meeting. But by announcing this plan, the implication is that the process could start as early as this fall. The next meeting is scheduled for July 25-26. In determining the timing and size of future adjustments to the target range for the federal funds rate, the FED will assess realized and expected economic conditions relative to its objectives of maximum employment and 2% inflation.

## Stock Market

The broader equity markets continued their climb and ended the first quarter higher than the fourth quarter of 2016. For the quarter, the NASDAQ outperformed both the S&P 500 and the Dow with gains of 9.9%, 5.5% and 4.6%, respectively. For 2016, the S&P 500 was up 9.5 % (2238.83) while the Dow was up a greater 13.4 % (19762.60) and the NASDAQ composite was up 10% to 5371.89. Of the 10 sectors represented in the S&P, nine sectors saw positive performance for the first quarter, as measured by the SPDR sector ETFs. The best performing sector was Technology (10.8%), followed by Consumer

Discretionary (8.39%) and Health Care (8.29%). Other gainers for the quarter were Utilities (6.38%), Consumer Staples (6.14%), Materials (5.81%), Industrials (5.14%), Real Estate (3.50%) and Financials (2.52%). The only underperforming sector was Energy (-6.53%). For 2016, the top performing sectors were Energy (28.01%), Financials (22.69%) and Industrials (19.95%). Only Healthcare underperformed for the full year with a return of -2.83%.

In Fixed Income, the yield spread between two- and 10-year notes narrowed to about 78 basis points in mid-June, the least since September, bringing it within range of the lowest levels since 2007. The two-year yield, at 1.35%, is among the most sensitive to impending FED policy decisions. Spreads between five-year yields and longer maturities also shrank, touching the tightest since March. This narrowing began after a weaker-than-forecast inflation report bolstered confidence in long-dated debt. A flatter yield curve can be a sign of diminished confidence in the economic outlook and slower growth. The benchmark 10-year yield, at 2.15%, posted its lowest closing level of 2017. Oil prices remained above $50 for January and February but declined in March to the high 40's. In the last several days of the quarter, oil rallied to close at $51.75/bbl for the quarter. So far in the second quarter, oil prices have moved in a range from $53 to $44/bbl, spending a majority of the time below the $50/bbl mark. Gold has been on an upward trajectory from the 2016 close of $1151.85/ounce. Gold has increased this year by 8.5% through mid-June.

## Conclusion

Market participants bet that President Donald Trump will continue to push for legislation that includes corporate tax cuts, as well as financial and environmental deregulation and infra-structure spending. Participants expect these changes will be positive for economic growth. While the U.S. macroeconomic cycle should get a boost from the proposed fiscal stimulus, corporate tax reform and de-regulation-both the passage, timing and efficacy of these measures-are far from certain in the near term. Many market participants including the FED are not currently modeling significant improvements in economic activity caused by expected changes in policy. For example, it appears that the U.S. economy is at or getting close to full employment, which means that employers cannot find many more available and qualified workers for open jobs. Employers may have to raise wages to retain existing workers. It will also be harder for the economy to grow at a faster pace as the number of new jobs slows. Both the New York FED and Atlanta FED's forecast of GDP growth for the second quarter have been on the decline. Capacity utilization for the industrial sector edged down 0.1 percentage point in May to 76.6%, a rate that is 3.3 percentage points below its long-run (1972–2016) average. Manufacturing output declined 0.4% in May; the index is little changed, on net, since February. U.S. retail sales recorded their biggest drop in more than a year in May.

We think that, fundamentally, volatility for equities in short term is high as many valuations remain stretched. We expect an increased level of geopolitical risk related to the new U.S. administration which will cause volatility in global markets. Additional FED rate increases, without increased economic activity may cause markets to pause. We have tempered our near term investment return expectations for 2017 as we learn more about Trump's evolving policies and how they are likely to drive market performance and continue to search for buying opportunities which take advantage of anticipated market corrections.

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