ECONOMIC UPDATE AUGUST 2017

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Once again stocks powered higher in July and their indices continued to reach new highs. The S&P 500 had a 2.1% gain for the month which brought its year-to-date return to 11.6%. The small cap stocks in the Russell 2000 index were up 0.7% bringing its year-to-date gain to 5.8%. International stocks in the FTSE index continued their outperformance and returned 3.0% in the month and 17.4% year-to-date. Emerging markets stocks were even stronger with a 5.4% return for the month and a 20.4% year-to-date return. Yields on the ten-year US Treasury remained pretty steady and finished the month at 2.3%. The Barclays Aggregate Bond Index gained 0.4% in July to post a year-to-date return of 2.8%.

Consumers and businesses have remained confident, pushing stock prices higher, even as discussions on healthcare have not made any headway in the president's agenda to repeal and replace the Affordable Care Act. Further hard discussions are likely as September approaches and passing a budget and dealing with the debt ceiling become priorities. After that, tax reform should take center stage. Based on the lack of compromise in the healthcare debates, tax reform may be harder to achieve than initially believed. It could be reduced to tax cuts or take longer than expected. These hiccups could create uncertainty and reduce investor confidence resulting in higher stock market volatility. Current volatility is at record lows, and the S&P 500 has not seen a 10% pullback in more than 18 months.

Initial estimates for second quarter GDP growth were 2.6%. Consumer spending increased which is a reflection that Americans are still optimistic and not afraid to spend money. This is the 96th month of economic expansion following the Great Recession. This is now the third-longest economic expansion in US history – the only ones longer were in the 1990's and 1960's for 120 months and 106 months, respectively. Although long in number of months, this expansion has only averaged annual growth of 2.1% which is much lower than the 3.3% average growth recorded from the 1970's through the 1990's.

Corporate earnings reports continue to paint a positive picture. Growth has been broad based and the S&P 500 is expected to show earnings growth of 9.2% and revenue growth of 5.0% for the past twelve months. As companies have reported, the estimates have increased from the intial estimate of 7.9%. By the time all 500 companies have reported, growth could top 10%. Even more encouraging, 69% of companies have beaten their revenue expectations which is a very high percentage and a difficult variable to manipulate.

After raising rates in March and June, the Federal Reserve is expected to pause and not raise rates again until December as inflation has fallen below the 2% target for three consecutive months. In the meantime, the Fed plans to reduce its balance sheet by reducing its holdings of Treasuries and mortgage backed securities which were purchased to boost the economy. Longer term rates have remained low amid the short-term increases leading to a flattening yield curve. Eventually we expect the increases on short-term instruments to pressure long-term rates higher although not at the same magnitude as the increase in short-term rates. Higher yields will benefit income oriented investors when they can derive more income from bonds rather than more volatile sources.

We continue to recommend that investors remain diversified and include exposure to multiple asset classes. Oversized stock positions may be reduced while stock prices are near their highs depending on tax consequences and other factors. Building exposure in international stocks could be attractive for some investors as those economies are perking up from prior years. If you have questions about your investments, please talk with your advisor.