

# Economic Perspectives 2<sup>nd</sup> Quarter 2017

## Executive Summary

- The final estimate of Q1 GDP indicated that the economy grew at a 1.4% rate. While this was an improvement from the initial estimate 0.7%, it marked a notable slowdown from the 2.1% pace recorded in Q4 2016. Consumer spending, which represents a majority of the U.S. economy, dropped to its lowest reading since 2013 at 1.1%.
- Inflation edged lower during the second quarter after peaking earlier in the year, as CPI decelerated to a 1.9% year-over-year rate. Declining energy prices, particularly gasoline prices, have been a source of weakness for inflation in 2017.
- After holding off in May, the Federal Reserve raised short-term interest rates another quarter point at its June meeting, citing an economy approaching full employment and inflation comfortably moving toward its target despite recent transitory weakness. The Fed has indicated intentions for one more rate increase in 2017, as well as an eventual reduction of its balance sheet.
- Job growth strengthened in the second quarter, with the economy adding 194,000 jobs per month in Q2 after averaging 166,000 in Q1 and 187,000 in 2016. The unemployment rate, at 4.4%, is near a cyclical low.
- For real-time updates on incoming economic data as it's released throughout the quarter, please visit our blog at [plantemoran.com/market-perspectives-blog](http://plantemoran.com/market-perspectives-blog).



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### Economic Dashboard

| Gross Domestic Product                        | Prior Reading | Change | Most Recent |
|---|---------------|--------|-------------|
| Real GDP QoQ - Q1 (Final)                     | 2.1%          | ↓      | 1.4%        |
| Personal Consumption QoQ - Q1 (Final)         | 3.5%          | ↓      | 1.1%        |
| <b>Employment Market</b>                      |               |        |             |
| Unemployment Rate - June                      | 4.3%          | ↑      | 4.4%        |
| Nonfarm Payrolls (Change) - June              | 152K          | ↑      | 222K        |
| Initial Jobless Claims 4-Week Avg - June      | 242.3K        | ↑      | 243K        |
| Continuing Jobless Claims 4-Week Avg - June   | 1938K         | ↑      | 1944.8K     |
| <b>Inflation</b>                              |               |        |             |
| CPI YoY - May                                 | 2.2%          | ↓      | 1.9%        |
| Core CPI YoY - May                            | 1.9%          | ↓      | 1.7%        |
| Core PCE YoY - May                            | 1.5%          | ↓      | 1.4%        |
| <b>Consumer Indicators</b>                    |               |        |             |
| Retail Sales YoY - May                        | 4.6%          | ↓      | 3.8%        |
| Consumer Credit YoY - April                   | 6.2%          | ↓      | 5.8%        |
| Personal Income YoY - May                     | 3.5%          | ↔      | 3.5%        |
| Personal Savings YoY - May                    | 5.1%          | ↑      | 5.5%        |
| Consumer Confidence - July                    | 117.6         | ↑      | 118.9       |
| <b>Business &amp; Production Indicators</b>   |               |        |             |
| ISM Manufacturing Index - June                | 54.9          | ↑      | 57.8        |
| ISM Services Index - June                     | 56.9          | ↑      | 57.4        |
| Industrial Production YoY - May               | 2.1%          | ↑      | 2.2%        |
| Small Business Optimism - July                | 104.5         | ↔      | 104.5       |
| <b>Housing Market</b>                         |               |        |             |
| Existing Home Sales - May                     | 5.56MM        | ↑      | 5.62MM      |
| Housing Starts - May                          | 1156K         | ↓      | 1092K       |
| S&P Case-Shiller Price Index YoY - April      | 5.9%          | ↓      | 5.7%        |
| <b>Leading Indicators</b>                     |               |        |             |
| ECRI Weekly Leading Index - June              | 143.7         | ↓      | 143.1       |
| Conference Board Leading Economic Index - May | 126.6         | ↑      | 127.0       |



# Overview

While it may not get the same coverage as other economic factors, productivity - the value that an average worker creates in an hour of work - has a significant impact on overall economic growth, directly affects the wages workers earn, and plays a critical role in improving the standard of living. Throughout history, new technologies such as electricity and the internal combustion engine have allowed workers to do more with less, ostensibly leading to greater productivity and improving quality of life.

The most recent spike in productivity came in the '90s with the proliferation of computers (illustrated in the chart below); yet, since early 2000, productivity growth has fallen well below the historical average. In what has been referred to as the "productivity paradox", new technologies of the last decade have seemingly failed to make workers meaningfully more productive.

Economists continue to debate what exactly has caused this slowdown in productivity growth, but no consensus exists. One explanation is that

productivity is improving, but the government just isn't measuring it properly. Others argue the slowdown is driven by the fact that many of today's innovations (social media, online shopping, etc.) are taking place outside of the workplace. A third, and more pessimistic view, is that this phenomenon may be permanent, as innovations today are simply not as impactful as those of the past.

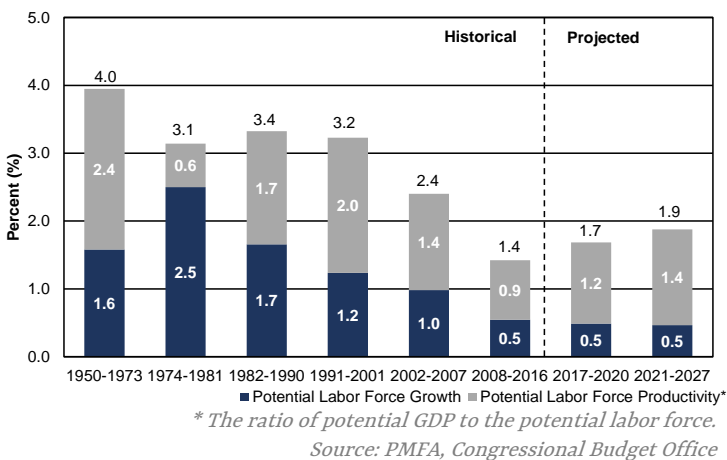
Productivity has a strong influence on corporate profitability and a firm's ability to increase wages. When productivity growth falls, employers tend to have less capital on hand to hire new workers or pay existing employees more. This may, in part, explain why wage growth has been so modest despite a very tight labor market. However, productivity gains is not the only factor that impacts economic growth - the total number of workers (or increases in the size of the labor force) is the other influencing factor for growth.

As we look forward from here, estimates for both growth in the size of the labor

force and increases in productivity are expected to be below historical averages - which translates into modest expectations for economic growth in the coming years. The Fed estimates for economic growth in the coming years would project similarly modest expectations of growth just north of 2.0%. Of course, the potential for greater growth in productivity through major technological advancements leaves the door open for GDP growth to potentially surprise to the upside in the coming decades.

For now, most economic indicators remain supportive of continued growth in the coming quarters. Consumer and business sentiment remains high, the labor market is healthy, and overall financial conditions remain loose despite the recent hikes in the Fed funds rate. All of which are likely to contribute to future business investment and consumer spending, and support economic growth throughout 2017.

## CBO'S ESTIMATE OF AVERAGE ANNUAL GROWTH OF POTENTIAL GDP



## Insights

Economic growth is largely driven by increases in either the size of the workforce or the productivity of those workers. With low birth rates and baby-boomers retiring, the growth rate of the U.S. workforce is projected to be historically low. Therefore, a pickup in productivity growth will likely be an essential requisite for the economy to return to its long-run growth rate.

Projections from the Congressional Budget Office (CBO) call for growth to pick up modestly over the next two decades. According to their estimates, the workforce is projected to grow by a mere 0.5% per year, with productivity growth doing the heavy lifting as it expands to an expected growth rate of 1.4% - both of which are below historical averages.

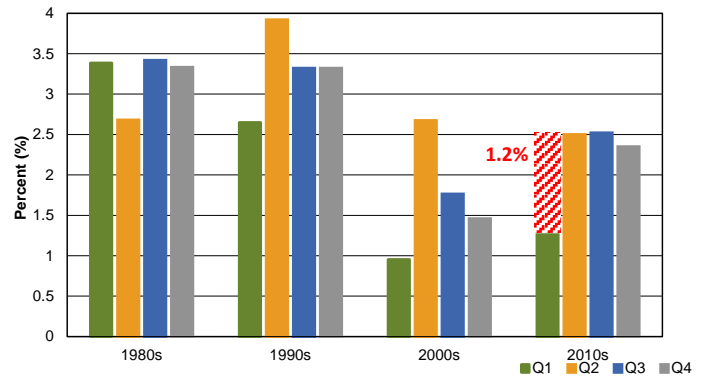


# Gross Domestic Product

|                          | Q3 Final | Q4 Final | Q1 Final |
|--------------------------|----------|----------|----------|
| Real GDP QoQ             | 3.5%     | 2.1%     | 1.4%     |
| Personal Consumption QoQ | 3.0%     | 3.5%     | 1.1%     |

- The U.S. economy expanded at a 1.4% annualized rate during Q1, down meaningfully from 2.1% the prior quarter. In contrast to past quarters, business investment was the driver of GDP in the first quarter, rising 3.7%.
- While first quarter GDP largely disappointed, the outcome was not out the norm. In fact, weakness in the first quarter has been a recurring phenomenon over the last two decades.
- As shown in the chart to the right, since the 1990's, Q1 GDP growth has lagged growth in the other three quarters by approximately 1% on average. This outcome suggests a potential flaw in the seasonal adjustment calculations that distort Q1 results. As we move into the second half of the year, GDP growth is expected to meaningfully pick up in the remaining quarters.

## SEASONAL ADJUSTMENTS CONTRIBUTE TO WEAK Q1 GDP?



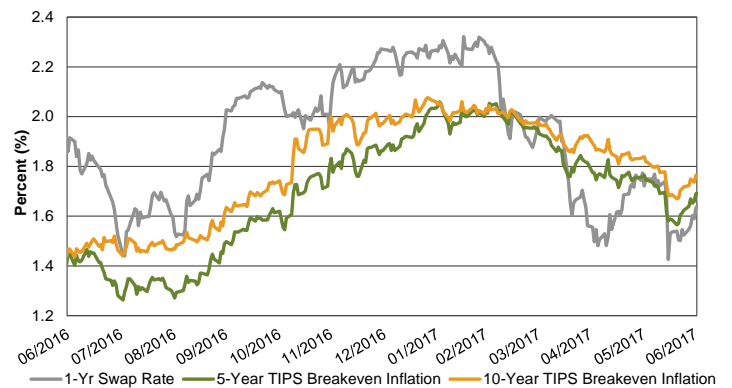
Source: PMFA, Bureau of Economic Analysis

# Inflation

|                          | March | April | May  |
|--------------------------|-------|-------|------|
| Consumer Price Index YoY | 2.4%  | 2.2%  | 1.9% |
| Producer Price Index YoY | 2.3%  | 2.5%  | 2.4% |

- CPI decreased 0.1% for the month of May—the second decline in three months, while the year-over-year change decelerated to 1.9%. Core CPI, which removes the impact of more volatile food and energy prices, decelerated to 1.7% over the last 12 months.
- The primary driver of recent weakness in inflation was from a 2.7% fall in energy prices, as gasoline prices dropped 6.4% in May – the largest drop in over a year. Core inflation got a modest tailwind from higher rents, while declining prices for cellular plans and vehicles more than offset that increase.
- Inflation expectations, as measured by breakeven inflation rates – which compares the yield on nominal Treasuries to the yield on Treasury Inflation-Protected Securities (TIPS) – have fallen back to pre-election levels. Increased uncertainty concerning the timing of the President’s expansionary agenda and the ability for economic growth to accelerate was a likely contributor to much of the reversal in expectations since earlier in the year.

## BREAKEVEN INFLATION EXPECTATIONS REVERSE THEIR POST-ELECTION BUMP



Source: PMFA, Bloomberg

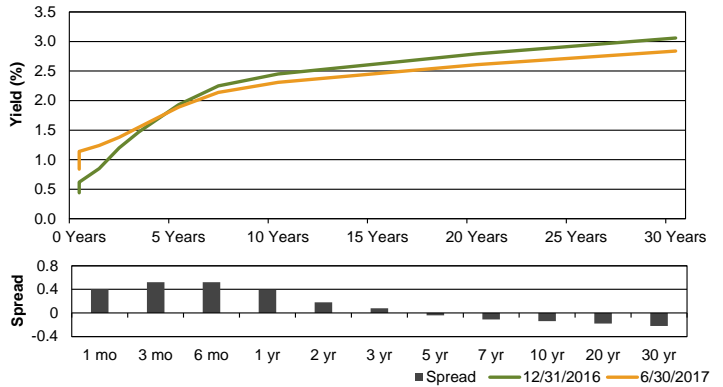


# Interest Rates

| Treasury Yields as of | 12/31/16 | 3/31/17 | 6/30/17 |
|-----------------------|----------|---------|---------|
| 3-month               | 0.51%    | 0.76%   | 1.03%   |
| 2-year                | 1.20%    | 1.27%   | 1.38%   |
| 10-year               | 2.45%    | 2.40%   | 2.31%   |

- Long-term interest rates were range bound during Q2, as the 10-year Treasury yield hovered between 2.1% and 2.4%. Ultimately, the 10-year yield ended the quarter at 2.31%, modestly down from the beginning of the quarter.
- The Federal Open Market Committee (FOMC) voted to increase the federal funds rate by 0.25% in June, marking the third rate increase in just six months, after only one increase in the previous decade. Currently, median expectations from the Fed’s projections are calling for one additional rate hike in 2017; however, further tightening may result from the anticipated reduction in the Fed’s balance sheet later this year.
- Since the beginning of the year, the U.S. Treasury yield curve has flattened as the market has discounted future economic growth. Longer-term yields have lowered along with inflation expectations, giving back most of the post-election boost from late last year.

## U.S. TREASURY YIELD CURVE FLATTENS



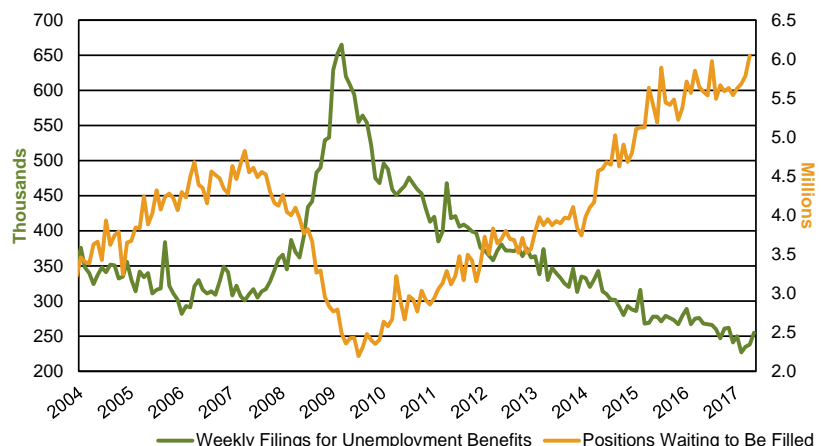
Source: PMFA, U.S. Department of the Treasury

# Employment

|                           | April | May  | June |
|---------------------------|-------|------|------|
| Unemployment Rate         | 4.4%  | 4.3% | 4.4% |
| Nonfarm Payrolls (Change) | 207K  | 152K | 222K |

- Following a stronger than expected June reading, growth in nonfarm payrolls strengthened in Q2, as the economy added an average of 194,000 jobs over the past three months – higher than the prior quarter’s average monthly pace of 166,000 new jobs.
- The unemployment rate moved lower in Q2, ending the quarter at 4.4% in June after reaching its lowest level in a decade at 4.3% in May.
- Eight years into the U.S. economic expansion, unemployment has declined sharply to 4.4% –below the Fed’s own estimate of full employment. With weekly jobless claims near a 44-year low and the number of positions waiting to be filled at its highest level on record, employers are struggling to find qualified new hires. The tight labor market is likely to support increased wage growth which has remained somewhat lackluster throughout the current expansion.

## EMPLOYERS STRUGGLE TO FILL OPEN POSITIONS



Source: PMFA, Labor Department, Bloomberg



Past performance does not guarantee future results. All investments include risk and have the potential for loss as well as gain.

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Sources for the Economic Dashboard include PMFA, Bureau of Economic Analysis (BEA), Bureau of Labor Statistics (BLS), U.S. Department of Labor, U.S. Census Bureau, Federal Reserve, The Conference Board, Institute for Supply Management (ISM), National Federation of Independent Business (NFIB), U.S. Department of Housing and Urban Development, National Association of Realtors, Standard & Poor's (S&P), and the Economic Cycle Research Institute (ECRI).

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