Economic Outlook

By Ronald L. Welburn, CFA

August 2017

The Outlook for the Economy

On July 28 the Bureau of Economic Analysis will announce second quarter real GDP growth. We believe the growth rate advanced by 2.5% compared to 1.4% in the first quarter. While some sectors of the economy such as autos and department store sales have weakened in the first half of 2017 others have strengthened such as housing and manufacturing. Also the global economy has strengthened over the first six months of 2017 in China, Europe, India and Southeast Asia. Looking ahead, the U.S. economy could continue to strengthen despite having reached what is considered full employment at the 4.4% unemployment level. Over the past eight years of 2.0% growth, capital spending has been generally weak because of a number of structural problems related to low capitalization rates (currently 76.6%), regulatory and tax problems, and management decisions to buy back stock instead of investing for the future. Under the new Administration attempts are being made to reduce government regulations that have exploded over the last eight years, as well as to reduce the level of corporate taxation, including the repatriation of corporate profits held abroad. In addition, a major program of infrastructure repair is planned with the help of private capital. The above legislative programs have been held up in Congress by the failed attempts so far to repeal and reform Obamacare. Health care is 18.0% of GDP and the problem of providing a new health care solution for the uninsured has divided Republicans. We are confident that a new program will eventually be determined at which point the new Administration can advance the above agenda. When the legislative programs advance we believe that economic growth will also advance. Higher capital spending in future years will be the catalyst for getting to 3.0% or higher economic growth rates.

The current outlook for business appears positive to us. The leading economic indicators increased 0.6% in June and are in an uptrend after slowing down in 2016 when the economy only grew by 1.6% in that year. Contributions to the leading indicators came from higher building permits, a rise in new orders for business, and the shape of the yield curve. We also believe that from a long term point of view, low inflation is good for the economy. At present, the consumer price index (CPI) is at 1.6% y/y and has modestly fallen over recent months. The producer price index (PPI) is at 2.0% y/y and has also fallen modestly over recent months. Energy costs are an important part of the direction of inflation and so the revolution in energy production that took part in the U.S., both in oil and natural gas, through fracking and horizontal drilling, has not only reduced general inflation but also reduced the power of the OPEC countries to control oil prices. The U.S. is now becoming a growing influence in energy export markets, particularly in liquid natural gas. Over time, this change will help improve the outlook for the U.S. that has a current deficit of $450 billion or 2.6% of GDP. Also good news was a 0.4% rise in industrial production, up 2.0% y/y. Finally, the ISM Manufacturing Index rose to 57.8 in June versus 54.9 in May while the Non-Manufacturing Index (services) increased to 57.4 from 56.9 in May. In the former, growth in new orders and production improved while in services, growth in business activity and new orders remained strong. Overall, the outlook for business remains firm.

Federal Reserve monetary policy as stated by Janet Yellen, Chairwomen, is that a gradual policy of raising short-term interest rates will take place after increases in March and June bringing the federal funds rate to 1.0-1.25%. In addition, a gradual program of reducing the size of the Federal Reserve's balance sheet of $4.5 trillion will occur in late 2017. The latter action will undoubtedly raise longer term interest rates. The big question in investors' minds is, *how will the economy and financial markets react to the major change from easing monetary policy to tightening it?* The easing of monetary policy was successful in avoiding deflation during the aftermath of the Great Recession and in that sense the Federal Reserve is to be congratulated. There were some mitigating side effects however, such as the asset inflation in stocks and bonds and the harmful effects on pension fund investors with close to zero low interest rates. Such side effects are inevitable as we don't live in a perfect world. However, the same worries will apply as monetary policy is tightened. In 1937 the Federal Reserve tightened during the recovery from the Great Depression and GDP fell by 10.0% with the stock market falling by 40.0%. The Federal Reserve is no doubt aware of these facts and will act accordingly.

Our forecast for 2017 remains that the U.S. economy will grow by 2.5% in 2017 with the CPI at 2.0% and corporate profits up 10.0%. For 2018 we believe that GDP can grow by 3.0% with CPI inflation at 2.0% and corporate profits up 8.0%. The main caveat is the lack of success of the new Administration's legislative agenda.

By Ronald L. Welburn, CFA

The Outlook for the Financial Markets

Over the past month bond prices have fallen, along with the U.S. dollar, while commodities and equities have risen. The 10-year Treasury bond currently yields 2.33% versus 2.20% a month ago while long-term high quality corporate bonds yield 3.88% compared to 3.82% last month. Long-term municipal bonds yield 2.74% compared to 2.71% last month and 30-year mortgage bonds yield 3.85% versus 3.82% a month ago. 3-month Treasury Bills yield 1.15% compared to 1.00% last month. There has been a modest across the board rise in interest rates as economic growth rates have picked up from first quarter levels. Also one could conclude that the Federal Reserve has made it plain that monetary policy will continue to tighten as a process of normalization from the excessively low rates of the last few years takes place. In addition, they have in recent weeks talked about plans to start reducing their balance sheet by selling bonds and mortgages in late 2017. The U.S. dollar Index at 94.0 has fallen from 96.4 just a month ago. A falling currency usually results in higher commodity prices and a rise in inflation, particularly in large importing nations. Gold has also modestly risen in price to $1252 per ounce, up from $1246 a month ago.

The CRB (441) commodities index has been flat over the past month as falling food commodities have offset rising non-food commodities. Oil however, has risen to $47.89 per barrel from $44.24 per barrel, a rise of 8.2% as a substantial decline in oil inventories was announced. This could have been accounted for by some lagging economies recently starting to turn around. Copper at $2.84 per lb. is up 7.5% over the past month for the same reason, particularly as it applies to China, which accounts for 40% of copper demand. Even the Baltic Dry Index (980), a measure of shipping demand for mainly commodities that has been depressed throughout the whole recovery period has rallied from 903 a month ago, a gain of 8.5%.

Equities, as measured by the S&P 500 Index (2477), increased by 2.4%, a new high, also reached by other stock indices such as the Nasdaq and the Russell 2000. Foreign equities, as measured by the Morgan Stanley EAFE Index (1925), also advanced by 2.7% as a part of the continued rise in equities. The S&P 500 is up about 10.5% so far in 2017 despite all the political wrangling and geopolitical risks. This is primarily because the profits recession of 2016 ended and corporate earnings have been improving in 2017. Our forecast of a 10.0% gain brings S&P 500 earnings to $130 per share. At the current price, the price to earnings ratio is 19.0, certainly on the high side of historical valuations although perhaps explained by the still very low level of interest rates. Based on our tentative 2018 forecast of $140 per share earnings, the P/E multiple would be 17.7 times. Based on the current Federal Reserve strategy of tightening interest rates, an above average risk would appear to apply to both bond and stock holdings.

We remain confident in the continuance of the economic expansion but worry about the tense political background in regard to passing legislation to improve economic conditions as well as health care. We will continue to maintain a conservative asset allocation of equities at 52%, bonds 20%, 3% gold, and 25% cash. The change in Federal Reserve monetary policy in regard to its balance sheet adds a new level of risk in our opinion, although its achievement of normalization is an admirable goal.

Ronald L. Welburn, CFA, has over fifty years' experience in the investment field. Mr. Welburn is a graduate of Harvard College and has a Master's degree in Finance from the Wharton School of the University of Pennsylvania. Please direct all inquiries to Ameraudi Asset Management Inc. 19 East 54th Street, New York, NY 10022 Telephone: (212) 833-1090 Fax: (212) 319-4949 www.ameraudi.com

---

Ameraudi Asset Management Inc. is a New York State and Florida registered investment advisory company providing professional investment management services to high net worth investors. Ameraudi is a wholly owned subsidiary of Interaudi Bank, a New York State chartered, FDIC insured bank. Since 1983, Interaudi Bank has provided traditional commercial and private banking services to thousands of domestic and international clients, which has been personal, flexible, secure, efficient and technologically advanced. Ameraudi Asset Management now brings this level of commitment to the area of investment advisory services.

This newsletter is for informational purposes only, and not to be construed as investment advice. The information contained herein has been obtained from sources believed to be reliable, but the accuracy of the information cannot be guaranteed. Investment programs sponsored by Ameraudi Asset Management are not FDIC insured. Any money or securities deposited to participate in the program are not deposits or other obligations of Interaudi Bank and are not guaranteed by Interaudi Bank. These investments involve risks, including the possible loss of the principal amount invested.