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Economic Outlook

By Ronald L. Welburn, CFA

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The Outlook for the Economy

On Friday October 27, the real GDP for the third quarter will be announced. The statistics will be affected by the hurricane damage and as a result will be somewhat lower than would otherwise have occurred. Our expectation is that economic growth will be reported at 2.5% including a subtraction of 0.5% for the hurricane damage. This compares to growth of 3.1% and 1.2% for the second and first quarters. Overall, the basic trend of growth should not be affected by the hurricanes and recovery activity will be recorded in the fourth quarter bringing growth to an estimated 3.0%. While much economic commentary seems to believe that the 2.0% economic growth rate that has occurred since the Great Recession is embedded in the future because of structural changes, including demographics, we believe that it could be higher. The combination of tax cuts and reform along with a significant reduction in business regulations, as well as a major infrastructural program, could speed up economic growth as envisioned in the Trump Administration's legislative agenda. While legislation has been delayed in 2017 because of the failure to overturn Obamacare, a new health law in 2018, if properly developed, could lower costs and improve health care efficiency.

The second quarter result of 3.1% GDP growth suggests that a positive change could be underway in the U.S. economy. Not only was there higher growth that led to higher employment, but the share of investment increased while the government sector modestly declined. For example, consumption accounted for 2.24% of the total growth of 3.1%, while investment was 0.64% and net exports were at 0.21%. State and local government spending fell as did nondefense federal spending. There was however, a surge in defense spending of 4.7% as the Trump Administration seeks to strengthen the defense sector after years of slower growth. The above figures represent only the second quarter and it remains to be seen if the above pattern becomes a trend. One should point out however, that government entitlements are not included in the GDP accounts.

The fiscal federal deficit for 2017 (the year ending in September) was just announced at $666 billion or 3.5% of GDP. This was the highest deficit since fiscal 2013 and compared to 3.2% of GDP last year. Government spending increased 3.0% whereas tax revenues grew by only 1.0%. The primary reason for the rise in deficits is the usual suspects; entitlements in the form of Medicare and Social Security, as well as other social programs, and some damage from the hurricanes. Obviously, it would not appear to be the right time for the government to be planning a tax cut program. Nevertheless, unless one believes in austerity programs (higher taxes or spending cuts), the only other way to solve a deficit problem is to increase tax revenues through higher economic growth. As mentioned above, we believe that reform of government through less regulation and lower taxes, will increase economic growth. Higher government spending on defense and infrastructure however, would not be inimical to economic growth in our opinion.

While we are in the ninth year of economic growth, economic statistics, including corporate earnings, are doing quite well with little sign of recession on the horizon. We believe however, that inflation is creeping up, and that it is wise for the Federal Reserve to maintain its policies of interest rate normalization with an interest rate hike expected in December and more in 2018. Also, a program to reduce the Federal Reserve's balance sheet of $4.5 trillion is in effect as of October. In this regard, we will closely monitor President Trump's nominations for the additional Federal Reserve positions to be filled in November.

With regard to inflation, the CPI increased 0.5% in September and is up 2.2% y/y while the producer price index (PPI) increased 0.4% and is up 2.6% y/y. Import prices added 0.7% in September and have increased 2.7% y/y. Energy prices have also recently risen as inventories have declined although some of that activity could be related to the hurricanes with significant refinery capacity temporarily closed. Also, there are increasing labor shortages that have affected the housing industry and some manufacturing activities that have caused price increases. In addition, the U.S. dollar has fallen 7.0% in 2017 and falling currencies generally raise inflation rates. While there are counter arguments such as intensive competition that hold down prices, we believe that inflation should be closely monitored as an early recessionary indicator that reflects itself through higher interest rates.

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At present, we remain positive on the U.S. economy with a forecast of 2.5% real GDP growth in 2017 with the CPI at 2.0% and corporate profits up 10.0%. For 2018 we believe that GDP can advance by 3.0% with CPI inflation of 2.5% (up from our earlier forecast of 2.0%) and corporate profits up by 8.0%. If the corporate tax rate falls to 20% because of new tax legislation, corporate profits would gain by an additional 10.0%. The latter belief accounts for much of the current stock market rally.

The Outlook for the Financial Markets

The past four weeks have seen a modest increase in interest rates; essentially flat commodity prices, with agricultural commodities down and industrial metals up; the U.S. dollar recovering and equity prices continuing their apparent indomitable rise. Specifically, 3-month Treasury bills yield 1.10% versus 1.02% a month ago while 10-year Treasury bonds yield 2.38% compared to 2.25% last month. 30-year mortgage bonds currently yield 3.92% versus 3.85% a month ago. In contrast, long-term high quality corporate bonds have been flat yielding 3.83% while yields on long-term municipal bonds have modestly retreated from 2.82% to 2.81%. Overall, the price moves in bonds have been modest when one considers the proposed tightening monetary policy by the Federal Reserve and the recent news of the widening of the federal financial deficit. As mentioned previously, inflation has been on the upswing during the third quarter. These developments are worrying for bond investors but they are no doubt very reluctant to sell because of the need for income. In addition, the bond bull market is a long one dating back to 1981 and it is difficult to adjust to what might be changing trends.

The CRB index (427) fell modestly over the past month but oil ($51.90 per barrel) rose 2.7% as global supplies fell against the backdrop of the OPEC supply cut and demand increased largely from the emerging market countries. While the U.S. rig count dropped modestly over the past month, it remains our view that U.S. supplies from shale oil fields will continue to hold down oil prices. We believe that oil will sell within a range of $45 - $55 per barrel. If this happens, it will act as a counter force to rising inflation. Copper also rallied 8.2% to $3.16 per lb. as China's economy grew 6.8% in the third quarter and they buy 40% of the worlds' copper. Gold fell 1.2% to $1,277 per ounce over the past month as the U.S. dollar strengthened. The U.S. dollar index (93.7) increased 1.7% over the past month.

Equities, as measured by the S&P 500 Index (2575), advanced 2.9% and currently sell at 19.8 times our $130 per estimate for 2017, representing a gain of 10%. At present, we continue to forecast a gain of 8% to $140 for 2018 bringing the P/E multiple to 18.4. A corporate tax cut to 20% from the current 35% would add another 10% bringing S&P earnings to $154 per share and resulting in a P/E multiple of 16.7. Given the complexities of achieving this legislative goal and making allowances for the fact that many companies do not pay 35% because of various loopholes, one must recognize that the latter earnings figure is somewhat speculative. Given the high valuations of stocks overall and the probable higher interest rate environment looking ahead, we would continue to maintain a conservative approach to asset allocation.

At present, we believe that it is prudent to maintain an asset allocation of 52% equities, 20% bonds (corporate and municipals), 3% gold and 25% cash.

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

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