First Quarter 2018

Economic Commentary

Financial market volatility has resurfaced after a long period of calm. Fundamentally the credit cycle seems to be longer than normal, but many economic indicators remain strong. Global growth rates are decent, global central bank policy rates are generally accommodative, and liquidity is good. Global inflation is still moderate, consumer consumption and housing are positive, and the labor market is strong (although showing some signs of wage pressure). The recent omnibus spending bill passed on March 23 is an 8.5 percent increase over 2017 and the bill will likely enable annual budget growth of 3-5 percent for the foreseeable future. The bill will be selectively positive for some sectors such as agriculture and defense.

The Federal Reserve (Fed) is raising rates, which is having an effect on the tone of the markets and valuation expectations. The markets are closely watching for any changes in tone from the Fed, especially as new Chairman Powell makes his own mark on policy structure. The general market expectation is that he will maintain the softer tone that the previous Chairwomen Yellen maintained with a slower approach towards rate increases and reducing the Fed balance sheet.

Businesses and consumers are projected to benefit from the tax plan and therefore the typical slowing at this later stage in the credit cycle is expected to be delayed. Key components of the tax act include a reduction in corporate tax liabilities via a permanently lower corporate tax rate of 21 percent (compared to 35 percent) and a modest reduction in personal tax liabilities. Businesses will also receive a full and immediate expensing of non-structures business investment but this will be phased out after five years. The act includes a reduction in personal marginal tax rates, a doubling of the standard deduction and child tax credit, and higher thresholds for triggering the estate tax. The estimate for consumers is that current personal taxes paid will be about $150 billion lower in 2018 and 2019. This implies a similar boost to real disposable income over that horizon, with estimates of growth in disposable income of 3 percent in 2018 and 1.6 percent in 2019. However, there are also estimates of the federal deficit to widen to 3.4 percent of GDP in FY 2018 and 4.3 percent of GDP in FY 19. The estimate in that the deficit will widen to $675 billion and $900 billion in FY 2018 and FY 2019, respectively.

Looking forward to the remainder of 2018 we remain optimistic on the economy. However, this doesn’t necessarily mean the markets will follow suit. Over the long term, fundamentals matter, but in the short term economic indicators and market performance do not always move in tandem. There are several potential risks to the economy; nevertheless, we remain positive that 2018 growth should remain strong both in the U.S. and overseas.

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