

ECONOMIC OUTLOOK

Summary

The U.S. economy has been growing at an underwhelming pace since the Great Recession. Government statistics show an annual gain of around 2%, compared to a rough 3% growth rate in the 90's. There are many reasons for this, but one variable worth watching is the impact demographics have on potential gross domestic product (GDP) growth. The Baby Boomers are like the "pig through the python" in terms of their outsized impact on the economy over the last 70 years. As the Boomers age into their 60's and 70's, they will be spending a lot less on goods and services and harvesting a good chunk of their accumulated wealth.

We've all probably heard the statistic that 10,000 Boomers turn 65 everyday now. But let's add a little more context to this slowly unfolding but very predictable and significant development. The first of the Baby Boomers turned 70 this year, representing about a 10% share of the U.S. population. This cohort is projected to grow from approximately 32 million to 53 million seniors, over the age of 70, by the year 2030. Their share of total population will likely increase to 15% from today's 10%.

These well telegraphed and studied demographic shifts will have a profound impact on the bond and stock markets over the next few decades. Seniors aged 65-74, own more bonds than all the investors aged 35-64. Stock ownership drops from around 57.5% (those aged-55-64) to about 49% (those aged 65-74) as

older savers look to reduce risk in their portfolios. We can find many articles stating the Baby Boomers have not saved enough to fully fund their golden years. Workers aged 65 or older are the fastest growing, by percent, segment of the labor force. Therefore, the economy will face the headwinds from diminished Baby Boomer spending and higher social cost (Social Security / Medicare) from underfunded government programs.

Positives

Capacity utilization jumps to 76.7% from 76.1% last month

Philly Fed survey jumps to 38.8 from 22 last month

Q1 GDP revised to 1.2% from 0.7% originally

Negatives

New home sales fall to 569,000 annualized from 642,000 last month

Real Personal Spending 0.2% from 0.5% last month

Car and truck sales in May come in at 16.58 million units annualized vs 16.9 million expected

EQUITY OUTLOOK

Summary

With little in the way of adverse economic news last month, global equity markets pushed higher. The S&P 500 pushed to record highs, closing the month at 2,412, up 1.4%. Year-to-date, the index gained 8.7%. International markets, while still well off record levels, nonetheless continued impressive performance. The MSCI EAFE, representing developed markets, jumped 3.7% in May; the MSCI Emerging Market index rose 3.0%.

Technology stocks set the pace for the U.S. market, gaining 4.4% in the month and leading year-to-date performance, up 20.5%. At the other end of the scale, energy stocks tumbled 3.4% and are off an average of 12.5% this year as oil seems capped at \$50 a barrel. The spread between growth and value stock investments widened to almost 11 percentage points in favor of growth year-to-date.

While reported first quarter GDP was not impressive, rising just a revised 1.2%, the Atlanta Federal Reserve forecast for second quarter growth remains in the neighborhood of 3.5%. Similarly, the corporate outlook for business conditions is improving across many industries.

As mentioned in past articles, much of the markets' move post-election could be attributed to investors' expectations of legislative changes to regulations and tax policies which

would benefit corporate profits. While little of substance on these two issues has emerged from Washington, a cyclical rebound in global growth has supported both revenue and earnings expansion, thus keeping stock market valuations from becoming overtly expensive.

We head now into the dog days of summer and wonder whether the adage "sell in May and go away" will apply this year. During this recovery, the batting record of following this advice has reportedly been less than stellar.

Positives

Economy churning at a sustainable rate

Inflation pressures remain subdued

Negatives

Prevalence of complacency un-nerving contrarians

Unknown

Wide range of policy initiative from administration

FIXED INCOME OUTLOOK

Summary

The bond market remains caught between the world that investors envisioned we would have after the election of President Trump and the realities of the economic environment we actually have. The dreams of faster growth and reflation that were ushered in by the new administration have yet to materialize. While some pro-growth progress was made on the regulatory front, difficulties in reforming the health care system and the tax code have significantly tempered much of the optimism. The hard data on the economy is proving that even the reduced optimism might be too much.

GDP growth in the first quarter of the year was an anemic 1.2%, well below the post financial crisis average of about 2%. While there may be a decent rebound in the current quarter, estimates of the entire year and for next year have been fading. Add in a number of terrorist attacks and political uncertainty in Europe, and it is not surprising to see U.S. Treasury yields give up much of the post-election gains. The initial euphoria over the Trump agenda pushed the 10-year Treasury note yield up about 2.60% in mid-March but it has now drifted back below 2.20%.

While the 10-year has closed each month of the year at an equal or lower level than the previous month, the 2-year has closed each month at an equal or higher level. This is because the Fed has remained committed to continue increasing the overnight Fed Funds rate. They have clearly stated their intention of three rate hikes this year and for 2018 and 2019 as well. So far, the markets have given them the perfect cover to do so with no significant repercussions, like a soaring dollar. While we do expect another rate hike this month, we believe further rate hikes are increasingly questionable. We are not convinced the economic environment will be supportive of more than two or three additional increases in total.

We still believe that rates should rise modestly over the course of the year, but we have pushed out our timing until much later in the year and have continued to lower our end-of-year target for the 10-year Treasury note. We believe we will be lucky if we see the 10-year Treasury note back above 2.60% by the year's end. High-quality corporate bonds continued to deliver superior returns through May and we continue to believe that they are likely to do so for the remainder of the year but at a more moderate level of outperformance.

Positives

Political stalemates even within the Republican Party and policy roadblocks

Elections and terror attacks in Europe create safe haven bid for Treasuries

Russia; North Korea; Iran; Syria

Negatives

The Fed is committed to rate increases and balance sheet reduction

Federal budget busting policies and additional Treasury borrowings

Unknowns

Elections in Europe could lead to further discord between nations

Kim Jong-un and ability to successfully deploy nuclear weapons