

ECONOMIC & MARKET REVIEW

Second Quarter 2017

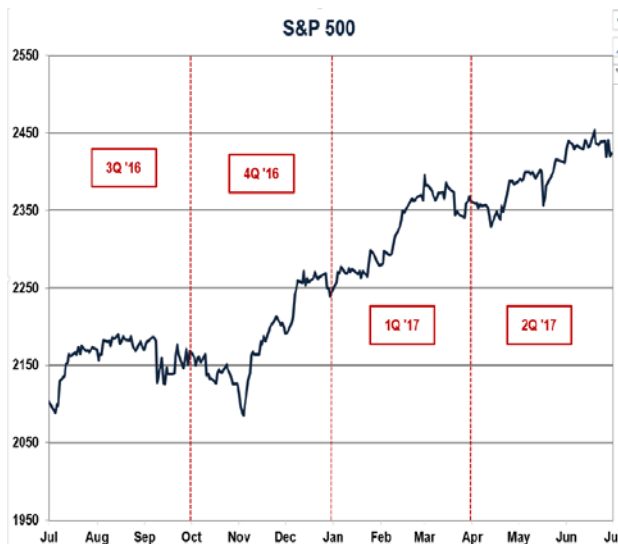


Confounding equity market bears, stock markets continued marching onward and upward in the second quarter, though at a slower pace. The S&P 500 rose 3.09% in the quarter, but trailed both emerging markets, up 6.27% (MSCI Emerging Markets Index), and developed international, up 6.12% (MSCI EAFE). Bonds also had a positive return, up 1.45% (Barclays Aggregate).

Second Quarter and Trailing 12 Months Performance

	<u>2nd Quarter</u>	<u>Last 12 Months</u>
S&P 500	3.09%	17.90%
Russell 2000	2.46%	24.60%
Barclays Agg.	1.45%	-0.31%
MSCI EAFE	6.12%	20.27%
MSCI EM	6.27%	23.75%

On June 14th, the Federal Reserve increased rates 0.25% to 1.00%-1.25%. This was the second rate hike this year and the third in the last seven months. The Federal Reserve, recognizing growth to be consistent, feels the necessity to move rates away from zero. Their intention is to raise rates in a deliberate but modest way. In addition, the Fed indicated they will begin shrinking the size of their investment portfolio later this year. Both the raising of short-term rates and reducing of the size of their portfolio—now \$4.5 trillion—is a clear testament to the growth and sustainability of the U.S. economy. While economic growth has not been spectacular, it has been consistent. It is time for the Fed to unwind what they themselves said was an “emergency” driven monetary policy as a result of the economic collapse beginning in 2008. My hunch today is that they will start shrinking the balance sheet in September 2017 and another rate hike would occur in December 2017.



Source: FactSet, Cavanal Hill Investment Management. As of 6/30/2017.

“Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, and labor market conditions will strengthen somewhat further. Inflation on a 12-month basis is expected to remain somewhat below 2 percent in the near term but to stabilize around the Committee's 2 percent objective over the medium term. Near-term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely.” Federal Reserve Press Release 6/14/17.

Employment is one way to gauge the overall health of the economy. With the unemployment rate at a remarkable low of 4.3%, it confirms economic conditions are solid. With more and more people working, you would expect that eventually wages would be under upward pressure. Wages have moved up, but the move has been quite modest...at least for now. Not everything is perfect though. New car sales are slowing, after several record breaking years. Also in some cities, existing home sales are soft. In many cases the softness is related to a lack of supply and/or sharply higher prices over the last few years, which have slowed sales.

World economic growth is finally beginning to match growth in the U.S. This is the first time since the meltdown we have had global synchronized growth. Until now, it has been solely a U.S. story. With the rest of the world aiding growth, it makes the probability of a continuation of the growth cycle more likely. China has been a concern as the planners there have tried to slow growth. Concerns were raised that the Chinese economy would slow too much and stall. That has not happened.

President Trump's pro growth agenda, which included corporate tax cuts, repatriation, reduced regulations and an infrastructure spending plan, have been either delayed or derailed. My thought is delayed, but we will know more this fall.

Finally, earnings have improved and are expected to grow throughout 2017. This is not just a financially engineered improvement...issuing debt to buy back your stock or increase the dividend (though there is some of that). Top line revenues have also jumped. I think the equity market continues to grind higher in the second half of the year, with interest rates slowly moving up also. That doesn't mean we won't have a correction, as we are overdue. But with inflation MIA, earnings good, unemployment

low and economic growth modest but steady, the porridge is not too hot nor too cold, but just right.



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