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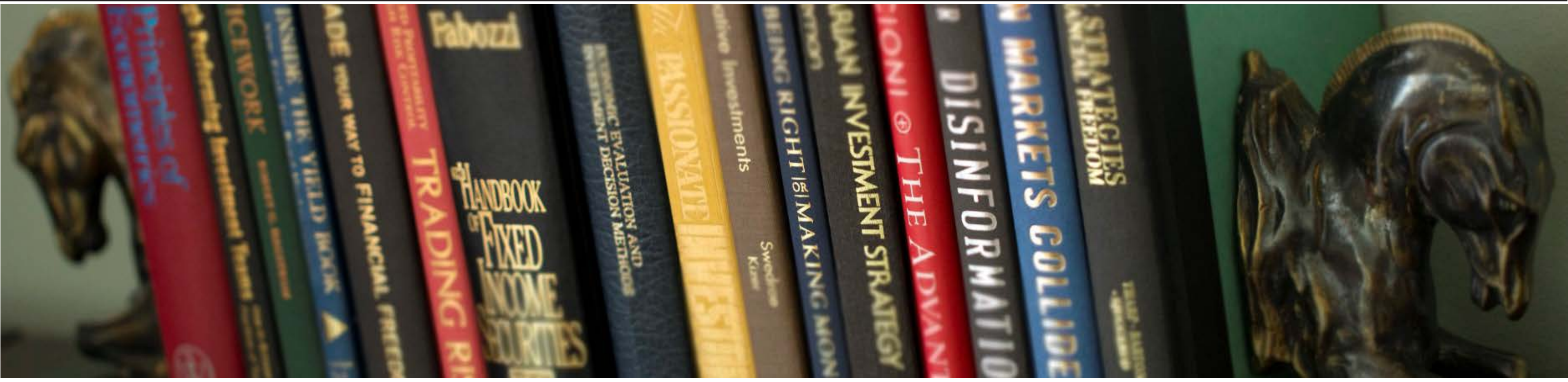
Quarterly Note

Q2 2017



Summary

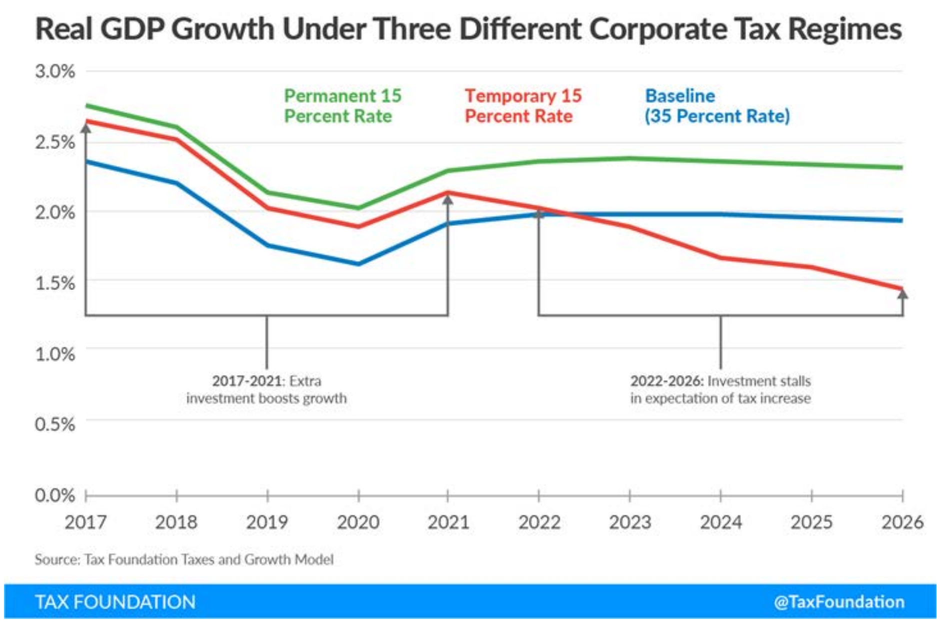
U.S. economic data broadly disappointed in the second quarter, a bit of a reality check for U.S. economic growth expectations. Following several months of surging expectations, the disappointments ranged from employment to retail sales to inflation. While the pace of U.S. growth is tenuous, there are few reasons to become overly concerned about an imminent downturn in economic activity. Markets have become pessimistic about the likelihood of comprehensive tax reform as Senate Republicans struggle to get through their health care agenda. The (somewhat unanticipated) difficulty of getting to tax reform has caused markets to question the probability of much of the GOP agenda. There is the potential for this to reverse in the second half of the year, a potentially substantial driver of growth.

Elsewhere, the French election boosted French consumer confidence and strong data in the euro area continued. Oil markets remain volatile even as OPEC has taken additional steps to mitigate the global oversupply. Anticipation of shifts in central bank policy lead to sharp moves in the currency markets with the dollar generally weakening, and a weaker dollar has implications taken as a whole, the global economy appears to be neither accelerating nor decelerating.

Tax and Infrastructure

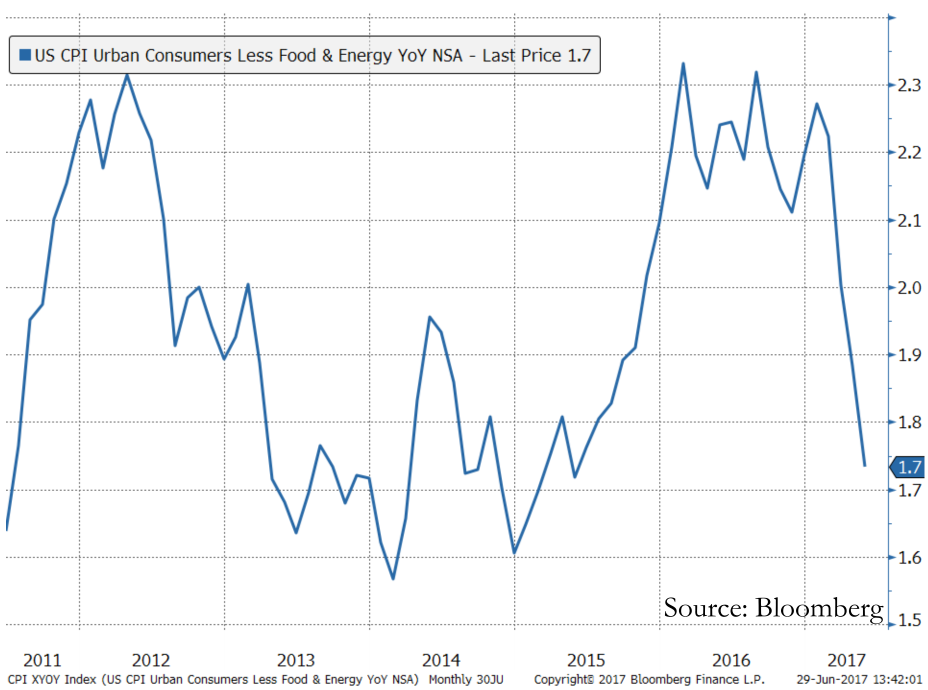
Temporary tax reform is the "least best" option, but given the vagaries of the reconciliation process, it may be the only option available. The reconciliation process is fairly confusing, but suffice it to say that it allows for fewer votes to pass budget-related legislation. This allows the GOP to pass their ideal version of the bill without input from Democrats. There are, however, limitations to deficit increases that can be added during the reconciliation process. This limitation may force a tax cut to "sunset" after a 10-year period (although a 20-year time frame has been floated as well).

What does a temporary tax cut act like? For the first several years, it is very similar to a permanent one. But this is mostly due to the front loading of investments. Because there is a finite amount of time to take advantage of the lower tax rates, investment early makes the most sense for businesses. As the end of tax break period approaches, investment falls and becomes a growth drag relative to no tax break at all. In other words, a temporary tax cut may be a short-term positive, but the benefits would fade quickly.



Regulation

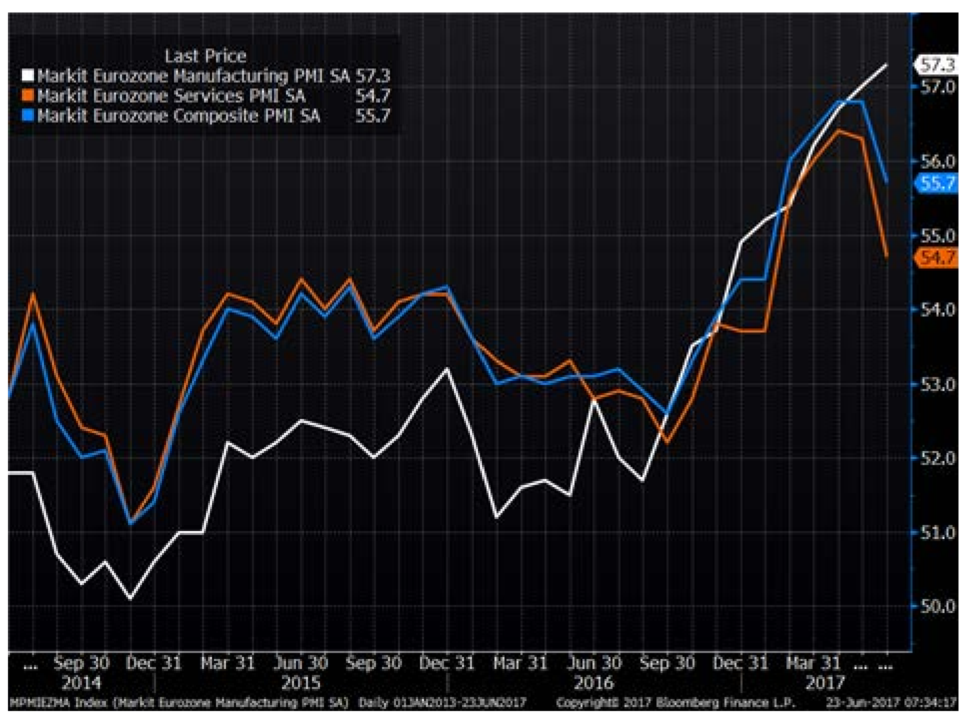
The Administration's two-for-one rule (every new regulation must be offset by eliminating two) has had a tangible impact on slowing the issuance of new regulations. By avoiding the legislative process, this—and other rules—keep the reduction of the regulatory burden portion of the agenda on track. There is a significant amount of "dark matter" regulation—this being a series of largely unwritten rules that could be described as "suggestions" from regulatory bodies that are interpreted by industry leaders as binding. These will be more difficult to undo because of their opaqueness and lack of availability in a register (where regulation would be). Their repeal, or pseudo-repeal, will take more time and garner less praise, but will nonetheless be an important part of the process. Overall, the regulatory atmosphere should continue to be positive toward business with some acceleration likely in the future as the Administration gets a handle on the "dark matter" and finishes staffing.



U.S. Economy

The U.S. should return to its now typical growth of around 2% in the second quarter as consumption rebounds and business investment continues to grow. There are some caveats to the U.S. economic outlook though. Autos, long a tailwind to U.S. growth, slowed in the first quarter, and there are few signs of a reversal in the second quarter. Broadly, consumption should recover in the second half of the year with a nascent recovery in the second quarter. The Atlanta Fed's current forecast (as of June 29) for second quarter growth is 2.9%, with a robust 3.2% estimated leap in consumption, the principal driver. This might be a bit aggressive for a rebound in consumption, but it confirms the underlying rebound occurring. Disappointing jobs and wages were a theme of the second quarter as the 3-month moving average of private jobs created declined to 126,000. However, it is worth remembering that the Fed has made clear a decline in job creation is expected. Inflation figures remained tepid as well, predominately due to lower costs for wireless services. However, many of these disinflationary pressures will be persistent and take a while to dissipate. This dynamic should allow for GDP growth in the same 2-3% range.

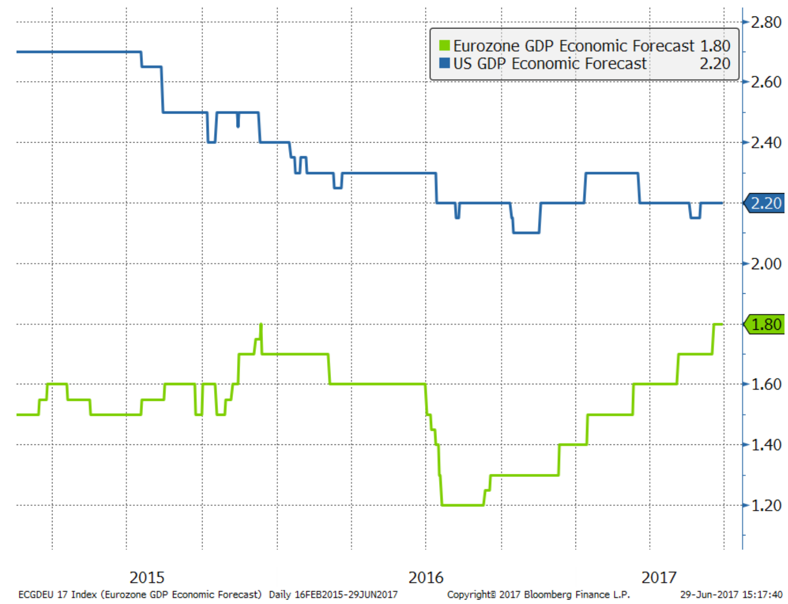
Source: Bloomberg



Source: Bloomberg

International

There were a couple of major hurdles that the European Union needed to get through before its recovery could be given an all clear. These included the French election (which unsurprisingly went to Macron) and the latest Greek bailout. Now, the European Central Bank (ECB) can concentrate, at least in the short term, on the euro area economy's underlying fundamentals.



Source: Bloomberg

Europe's current position looks somewhat similar to portions of the U.S. recovery: stronger growth with stable and low inflation. This combination should allow the ECB to surprise somewhat to the dovish side, keeping monetary policy loose while tweaking around the edges. Estimates for 2017 growth in the Eurozone bottomed in early 2016 at 1.2%. Since then growth estimates have been consistently revised higher.

ECB President Mario Draghi prefers to maintain the current level of stimulus without increasing it, meaning that as the euro area economy recovers, the current level of stimulus will be too much and will need to be scaled back.

This was interpreted as the first move of the ECB toward a "taper" of QE or the removal of some accommodation—a reasonable assumption, though the timeline and specifics were ambiguous at best. There will be considerable debate in coming weeks around the timing of this "stealth" tightening, but—for now—the debate is pure speculation. The ECB is unlikely to move quickly, and this speech is only an initial step toward preparing the markets for the eventuality.

Takeaways

The U.S. economy remains on target for growth similar to previous years, though U.S. growth could accelerate in 2018 as regulatory actions begin to take hold and tax policy provides businesses with clarity. Europe and the rest of the world are beginning to see their economies stabilize, perhaps sustainably. With a synchronized, but slow global expansion underway, central banks are beginning to undo, or simply scale back, some of their extraordinary stimulus. Thus far, markets have taken the announcements well. However, this will be a long, arduous process, requiring attention over the next several years.

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