Ashdon Investment Management

Q1 2017 ECONOMIC COMMENTARY

May 2017

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- *Both US and International Markets performed strongly during the quarter*
- *Bond positions were also positive*
- *We continue to expect modest growth going forward but with reduced downside risk*

First Quarter 2017 Economic Commentary

At quarter end the broad US market was up +6.07% while international markets were up +8.53% (MSCI EAFE Index). The market held on to the quarter's gains in spite of a modest sell-off at the end of March. Bonds were also positive with the benchmark Barclay's Aggregate index advancing 0.82%. Our portfolio funds responded well to the first quarter market rally. The rally has been good for investors but we must acknowledge that the post-election rally may have brought significant returns forward and we could see modest growth from here

The pervasive weakness that we have expected since 2014 has not come to pass. It has become clear that Chinese policy changes in 2016 worked to stabilize commodity prices and prevent a dangerous deflationary spiral. The US Federal Reserve's FOMC has responded by beginning to raise rates to more normal levels. Longer maturity rates are higher as well, but remain low compared to historical levels, perhaps indicating that inflation and/or growth are expected to remain modest. However, US wages continue to grow and that could fuel both inflation and growth. We continue to believe that economic growth will remain modest with limited upside but as events over the last 6-months have unfolded, we perceive reduced downside risk from here. Even though the weakness in growth and earnings in 2016 didn't lead to a recession or market sell-off, most of the factors that restrain growth and inflation remain in place. Only time will tell how the balance shifts.

The post-election environment includes an element of exuberance for stocks based on the promise of business-friendly policies to come. Almost every investment professional we encounter believes the broad US market is overpriced and that promised policy changes will come slower than hoped. Our international manager conversations reveal a more positive view than domestic manager conversations. International managers are finding opportunity in their markets. Broadly speaking, Asian and European markets are not at peak valuations like the US market. Further, expectations of a weakening US dollar make international stocks more attractive to US investors. (Please see a previous market view on our website: "*Why The USD Could Weaken*")

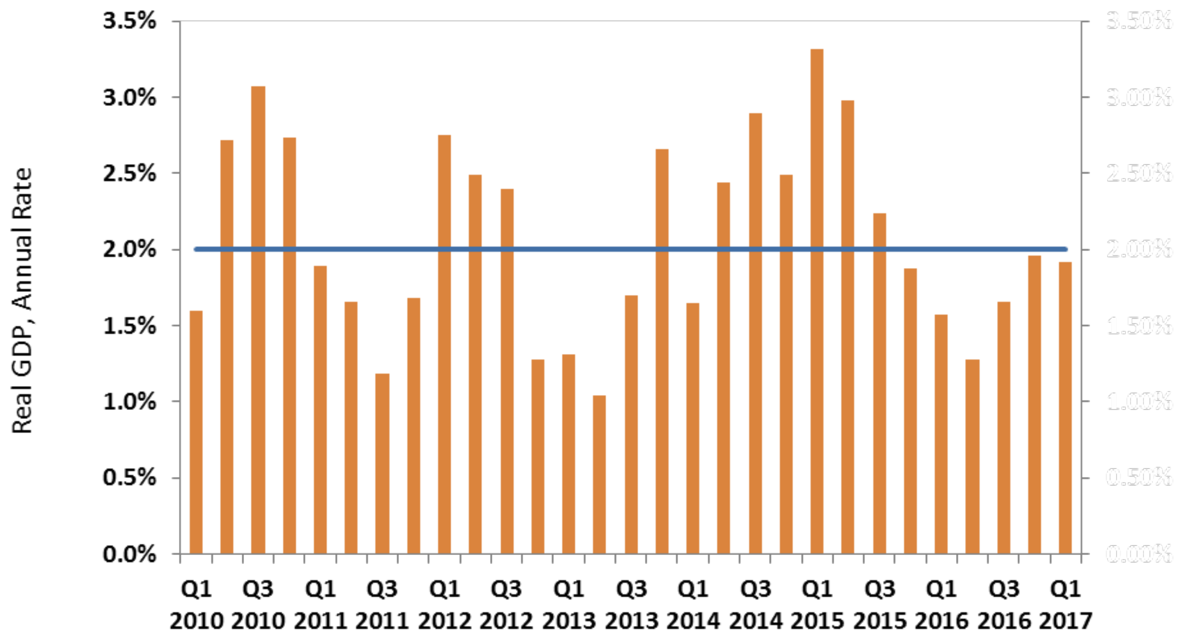
Downside risks are now diminished in our view. Modest economic growth in the US is expected to continue while Asia and Europe may accelerate. As always, our investment philosophy demands that we stay focused on "knowing what we own" and keeping options open. Our advice for allocation remains:

- *Maintain* allocations to cash and equivalents and deploy that cash patiently.
- Tilt toward low-net, even net-short, alternative strategies, where possible
- Build new positions from "dry powder" carefully.
- Hold established positions in client portfolios, if they are quality stocks that can be held for the long-term

Economy Picture

GDP

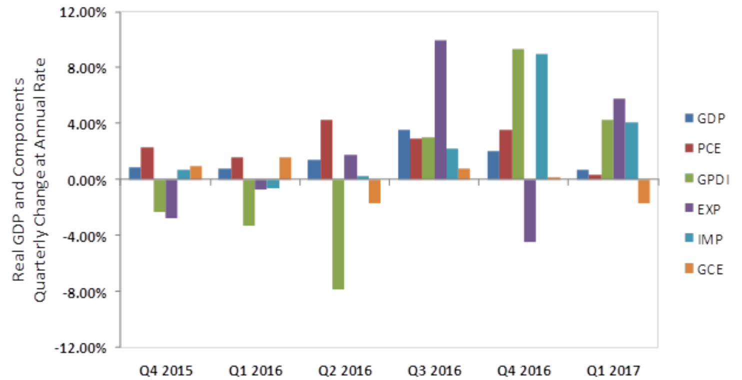
The Advanced estimate for first quarter GDP growth came in at an annualized rate of +0.7% over the previous quarter. GDP grew by +1.92% for the trailing twelve month period. This was a disappointing outcome, but consistent with the modest pace of growth we have seen for every year of the post recovery economy. Revisions from advanced Q4 estimates increased Q4 GDP to 2.1%. Upward revision may well be positive since the basic economy seems to have regained its growth trajectory after very weak patch in early 2016.



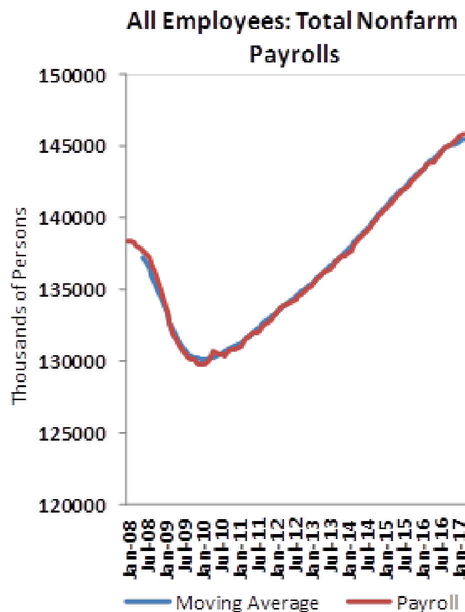
Gross Private Investment (GDPI). increased 4.3% (annual rate) continuing a three-quarter trend in growth. Non-residential fixed investment grew +10.4% while residential fixed investment rebounded +13.7%. The investment recovery has been driven in part by the recovery of oil prices. Investment growth from oil price recovery is less likely to add to GDP going forward. Consumption expenditures (PCE) were very weak, +0.3%. The weakness was broad, but Durable Goods expenditures fell -2.5%. Government consumption (GCE) fell -1.7%. Net Exports contributed again this quarter. GDP isn't the only metric for understanding the state of an economy, but the historical data does reveal larger trends. The economy shows no signs of breaking out of the "slow to moderate growth path" that we have been in since the beginning of the recovery. Our economy continues to face the headwinds of weak productivity growth and deleveraging.

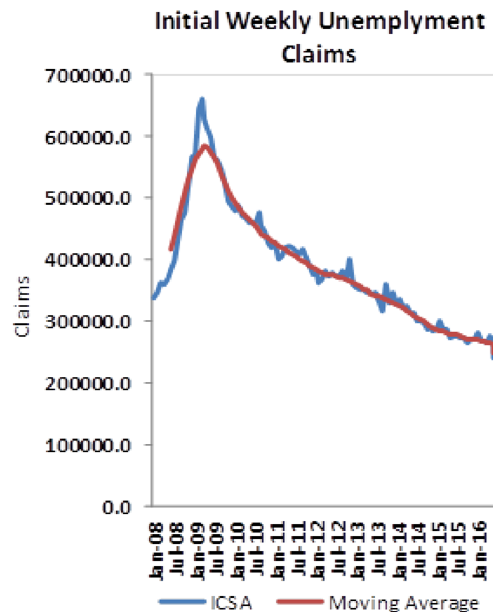
Unemployment

The US employment situation is largely positive. Data for job creation and for unemployment claims – the two central data series for understand the state of US labor – both show a robust employment picture. While our charts are focused on the recent economic cycle, a longer term view shows that job growth in current economy has fully eclipsed the peak number of employed persons from any other cycle. While there are technical issues with measures of the unemployed, there is no doubt that we are nearing "full employment" in the US economy.



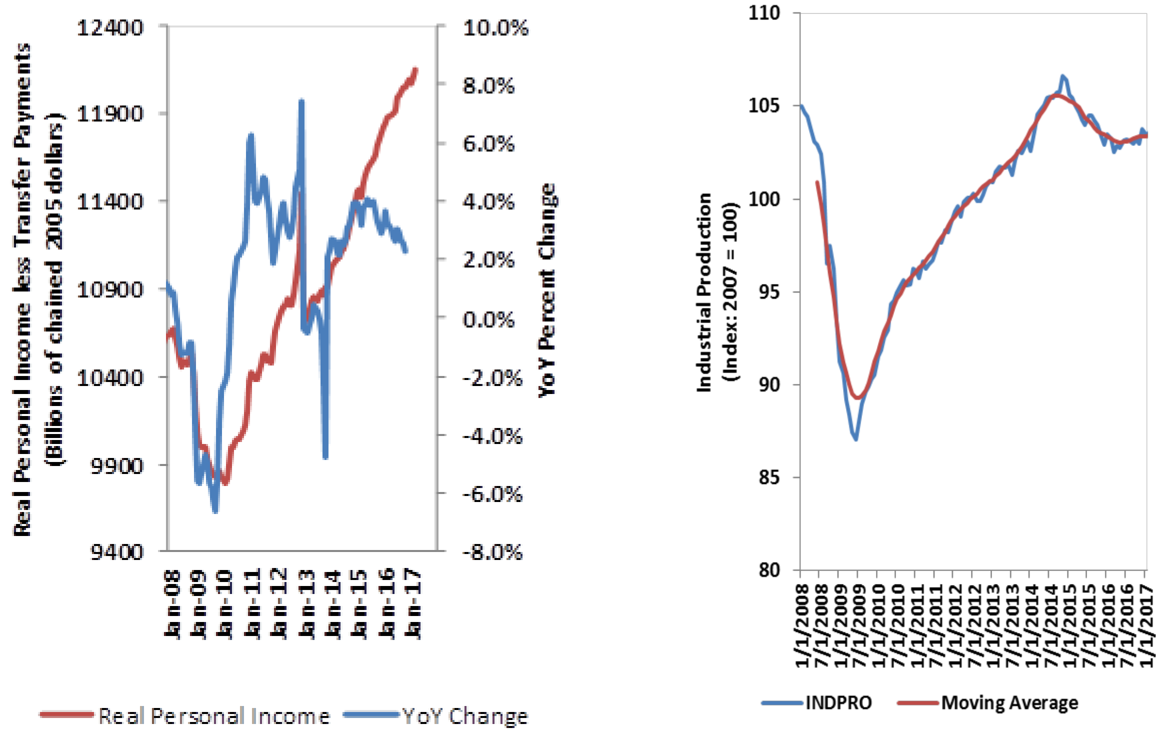
We have featured Real Personal Income (less Transfer Payments) as a key measurement of wages for workers. We chose this metric as it is the measure of income used by BEA to gauge recession risks. Additionally, this measure focuses on wages paid for work, so it measures the worker's compensation for economic production. Wage growth continues. This is encouraging because wage growth is needed for deleveraging and for consumption – the driver of our economy. However, the wage growth rate for this cycle may have peaked. The growth rate reached 4% in 2015, but has now decelerated to 2.25%. Perhaps wages will reaccelerate now that corporate profits have begun to grow again (see below). However, low productivity growth, the 35-year wage gap, and low aggregate demand continue to resist wage-push inflation. We will watch wages closely.

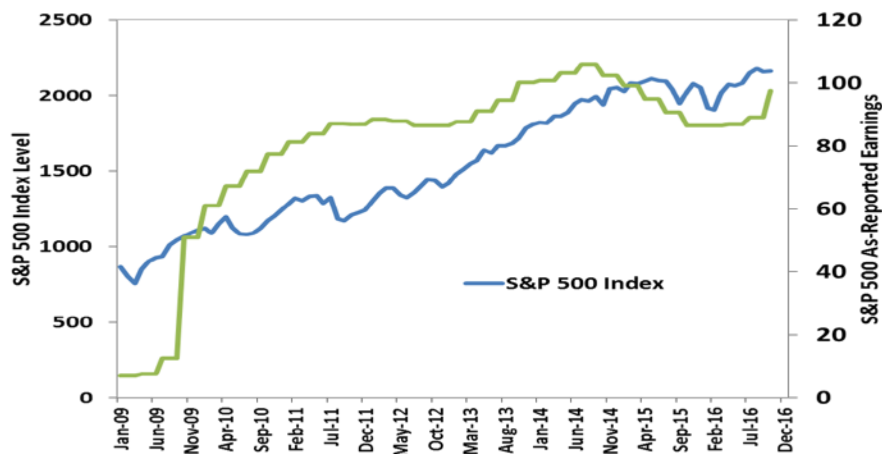




Industrial Production

Industrial production continued to grow last quarter. Production of Durable Goods, Electrical and Gas Utility output, and Business Equipment continued on trend while Mining (including energy) spiked sharply higher. Levels of production remain 5% below their peaks, consistent with the idea that the broader economy is operating below its capacity – an idea supported by lagging Capacity Utilization. The recovery in earnings echoes the recovery in production. This state of affairs presents a head wind to economic growth, but it also keeps the economy from overheating and keeps pressure off inflation.

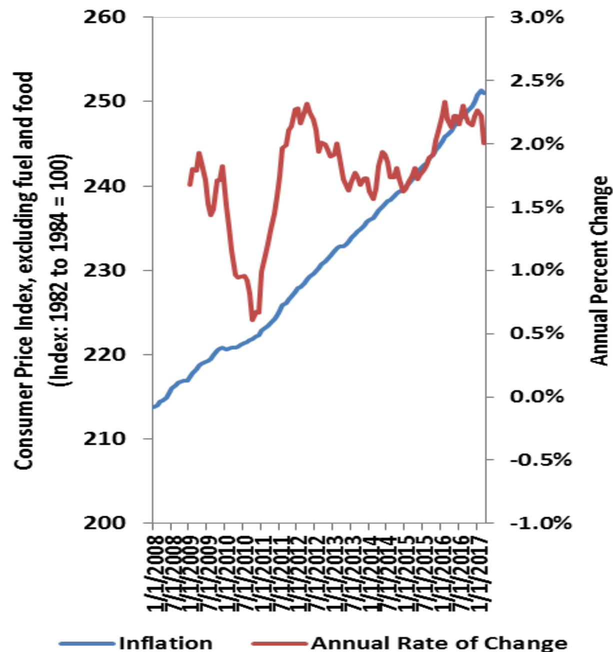




Inflation

There are multiple forces that drive inflation. Inflation typically comes to be in environments where there is ‘too much money chasing too few goods”. Through this economic cycle, many had the opinion that the central banker’s policies would flood the economy with “easy money” and drive out-of-control inflation. That did not come to pass as we have discussed in previous commentary. Conditions are now significantly different. New proposals for fiscal policy, including proposed changes to tax policy tend to contribute to inflationary forces. Further, wages have been growing for some time. Resulting consumption growth is another inflationary force. The US and global economies have low capacity utilization (that is, room to grow). Earlier in the cycle, we all had concerns for deflation, because the emerging world was in decline. Now, the emerging world is growing, led by China. That deflationary sink is now gone.

At this point, we still judge that the FOMC and other central bankers have time to keep rates low. But there is less room than before. Our view is that the FOMC is a match for the job to manage inflation, We are less sanguine about the success of the political leadership.



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