STRATEGY INSIGHT

September 2018

People's United Advisors

Economic Overview

	1Q'18	2Q'18	3Q'18	4Q'18	1Q'19	2Q'19
Real GDP *	2.2%	4.2%	3.0%	2.8%	2.4%	2.4%
CPI (year over year)†	2.4%	2.8%	2.7%	2.4%	2.3%	2.4%
Unemployment Rate†	4.1%	4.0%	3.8%	3.7%	3.7%	3.6%

-------------------------- estimated --------------------------

* Quarter over quarter annualized † end of period

Increase from last reported Decrease from last reported

Source: Bloomberg

Peak growth in 2Q, but where do we go from here?

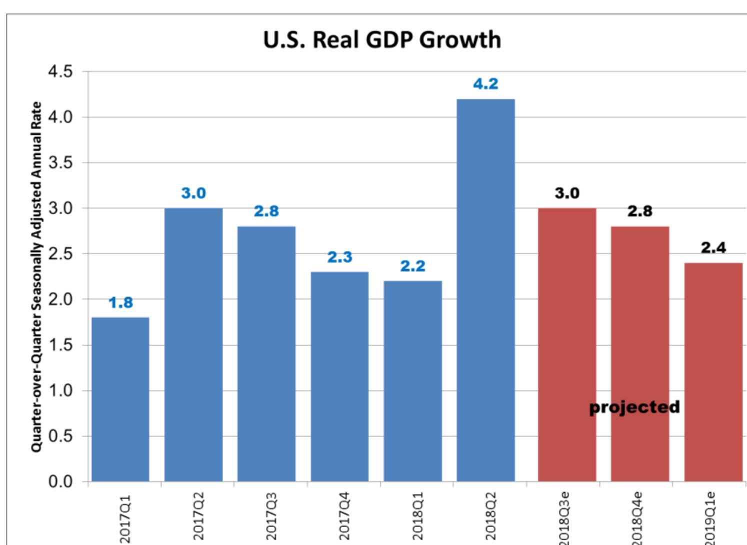
The U.S. economy expanded at a 4.2% annual rate in the April-June quarter according to the latest estimate, marginally higher than the 4.1% preliminary estimate. The spike in second quarter growth follows the pattern since 2015 where second quarter growth has been the strongest in each year. This year's second quarter growth, however, is the highest quarterly growth rate since the third quarter of 2014.

Economists do not expect the second quarter growth rate to be sustained, as is evident from the accompanying chart that shows consensus projected growth trailing off to a 2.4% rate by early 2019. Second quarter growth this year was boosted by an anomalous surge in exports that accounted for 1.1% of the 4.2% growth. Contrary to popular belief, the surge in exports was not due to a spike in soybean exports in advance of retaliatory tariffs by China. There is little doubt, however, that buying of other goods in advance of tariffs contributed to the surge as a stronger dollar would normally have dampened exports, and export growth in the quarter was the highest in four years.

The good news from the GDP report was that final sales to domestic purchasers increased from a 1.9% annual rate in the first quarter to a 3.9% rate in the second. The U.S. consumer is feeling more confident than at any time since 2000, and households are in the best financial condition since the Great Recession.

We concur with consensus projections that growth will moderate over the next several quarters. Houses, cars, and business investment are the three primary drivers of changes in the rate of GDP growth. The housing market has been anemic at best. Single family housing starts are still below levels from 30 years ago. New car purchases have slacked off the peak level of 18 million vehicles per year reached at the end of 2017 and are now running at less than 17 million. And business investment has yet to show the acceleration hoped for after the Tax Cuts and Jobs Act.

Investors should not be disappointed with moderating growth. Slower growth will stretch out the current expansion, allow the Fed to go slowly with raising rates, and prevent the sort of over-heating that causes inflation to accelerate. Until and unless we can get higher productivity through capital investment, slow to moderate growth is the safe path to sustained growth and positive capital market returns.

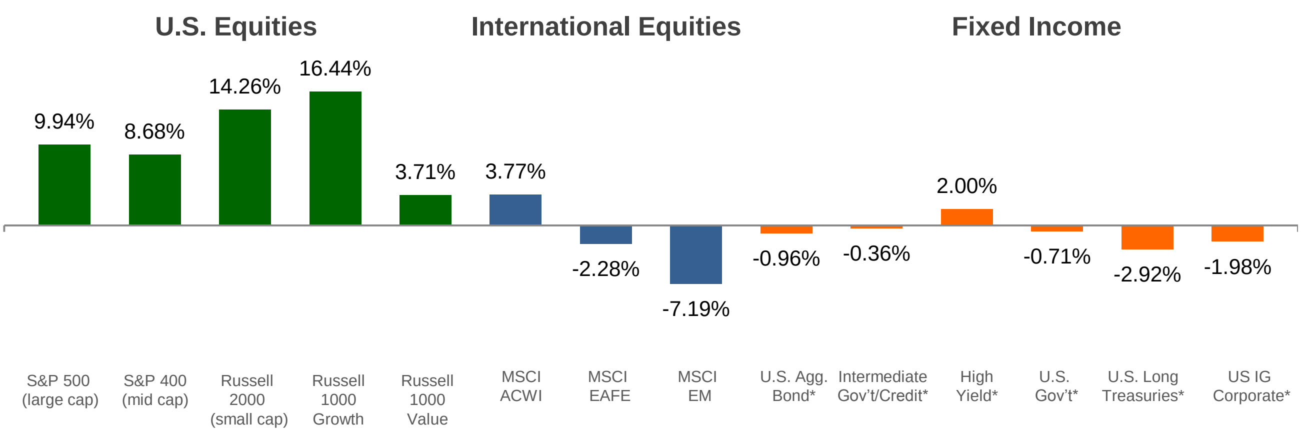


Source: Bureau of Economic Analysis and Bloomberg

Equity: "Sell in May and go away, and come on back on St. Leger's Day."

- If you had followed this old adage, you would have missed a 10% gain in the market since the beginning of May, giving the market a year-to-date gain of over 8.5% through the end of August. You would have also missed celebrating the longest bull market in history – August 21. And, you would have missed the record closing high set on August 29.
- Historically, corrections have taken four to six months to end, and this one was no exception. The market left the critical resistance level of 2800 behind in mid-July and the next critical level of 2840 behind in mid-August. Concerns do persist about the lack of breath and depth in the market. The FAANG stocks plus Microsoft are responsible for about 51% of the market gains. In addition, only three sectors – Tech, Consumer Discretionary, and Health Care – have beaten the market (the next largest gain was by 5%+) and are the only three to see an increase in multiples year to date.
- Second-quarter earnings were up over 25% year to year, versus expectations of 20% at the end of the second quarter. Although tax cuts contributed a significant portion of the gains, the strength in sales growth supported strong organic earnings growth and improving margins. Revenues were up almost 10% over a year ago, versus estimates of 7%.

Market Returns: Year-to-date as of August 31, 2018



Source: Bloomberg *Bloomberg Barclay's indices

Fixed Income: Bond Market Searching for Powell Doctrine

New Fed Chief + untested policy path = uncertainty = ultimately higher risk premiums

- **New Fed Chair Powell had the opportunity to speak at Jackson Hole to further lay out his governing philosophy with respect to monetary policy.** While his comments were not as indicative of a "hike until it hurts" type of mindset as the bond market had previously feared, he clearly laid out a bias towards active normalization ["hiking"] of the fed funds rate in an environment where a fair amount of uncertainty surrounds the key variables that govern policy decisions. This also suggests that the Fed will continue on the path it had previously laid out, absent disappointing data.
- **At current rates, the Fed Funds rate only needs to be hiked another 2-3 times to risk inverting the front end of the yield curve**, which has spurred a great deal of discussion and argument as to whether an inverted curve (where short maturities yield more than longer maturity Treasuries) continues to be a strong indicator of recession.
- **We are of the opinion that the continued flattening of the yield curve, whether the 2 year-10 year slope or the 3 month-5 year slope, is a cause for concern when it comes to market expectations and economic prospects**. Curve inversion has real implications for economic growth – credit availability contracts as it gets less cost effective for banks to lend. To that end we have been reducing credit exposure in portfolios as a risk reduction measure ahead of potential liquidity impairments caused by too-aggressive Fed rate hikes.

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