CONGRESS ASSET MANAGEMENT COMPANY

Economic and Market Outlook

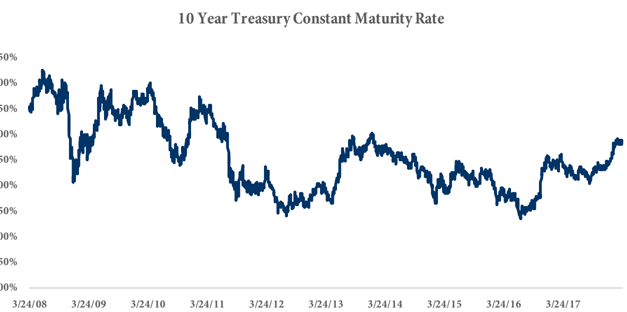
Second Quarter 2018

When train passengers pull into Boston's South Station, they are greeted by a large sign draped along a tractor-trailer advertising jobs available at the adjacent Post Office. Why is this important? It is visual evidence that job creation, perhaps the most important engine of economic growth and financial mobility, remains robust. Indeed, the economy grew at a 2.9% pace in the fourth quarter following readings of greater than 3% in the prior two quarters.

The building blocks put in place over the past few years, employment growth, low inflation, and stable energy prices have been joined by business and consumer optimism. In fact, a 3% growth rate is above the Federal Reserve's (Fed) estimate for long term potential growth of 1.8%. However, as March ended, it was difficult to remain focused on the positive economic background. News originating in Washington was focused on White House turnover, the potential negative consequences of two distinct tariff announcements, Facebook's mishandling of user data, and salacious gossip.

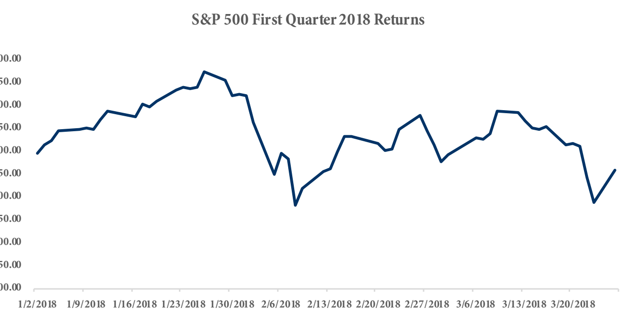
The bumpy end to the quarter erased all of January's stock market gains. Additionally, the staid bond market was down in January and February, an unusual occurrence that reflects inflation fears and uncertainty around the Fed's new management group. The U. S. ten-year bond now yields around 2.80% compared with 2.41% at year end. The S&P 500 was down about 1% during the quarter.

Interest Rates Trending Up



Source: Board of Governors of the Federal Reserve System (US)

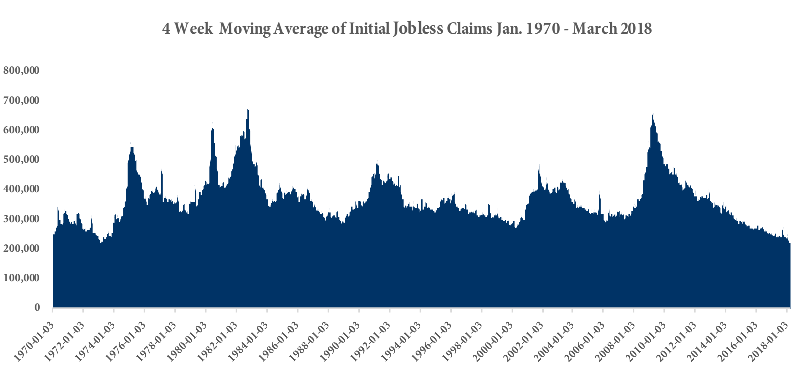
Stock Market Volatility Returns



Source: S&P Dow Jones Indices LLC

It appears that stock market volatility has returned, more than two years after the Fed first began raising interest rates. One under-reported cause may be the Fed's diminished role in the financial markets as it curtails quantitative easing measures. For an economy based on capitalism, this is positive and a return to normal market behavior. Over time the Fed's diminished role is more important than short lived Washington headlines, albeit less interesting.

It is the right time for the Fed to lessen its role. Employment is the most vital of economic data. By almost every measure, employment continues to strengthen from levels not seen in a generation. Unemployment claims, for instance, are hovering near 50-year lows reflecting record job openings.



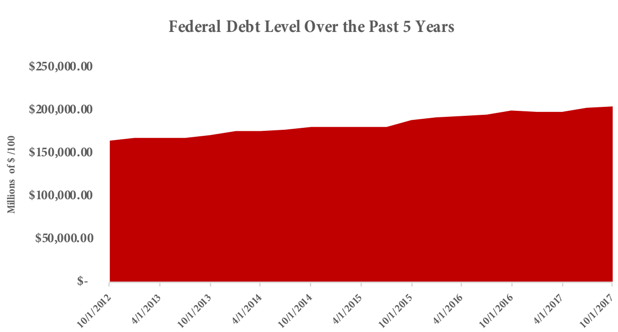
Source: US Bureau of Labor Statistics

The economy had been under repair since the financial crisis before a more consistent path was developed last year. A strong domestic structure is now supported by an accelerating global economy partially fueled by aggressive policies of the European and Japanese central banks.

While we believe growth will accelerate, some caution is warranted. The Tax Cuts and Jobs Act, signed by President Trump last December, has positive ramifications for lower and middle-class tax payers and businesses. U.S. companies will be more competitive on a global stage and a significant number of large employers have promised to share savings with their employees. Tax cuts stimulate the economy, but it is unusual for the federal government to pass a meaningful tax cut during periods of economic expansion. As such, there is a risk of heightened inflation in future years should productive capacity not increase to offset any demand pressures.

Ironically, one of Congress' few acts of bipartisanship could also generate concern down the road. Washington has little inclination to live by a budget and the recently passed spending bill destroys any hope for a balanced budget in the intermediate term. The Treasury reported that our national debt exceeded $21 trillion, up $1 trillion over the past six months and about equal to the size of our economy. That debt level is a record, both in absolute terms and relative to our economy, other than in war time. This trend bears watching.

Record High Federal Debt



Source: U.S. Department of the Treasury. Fiscal Service

There is a third potential risk – tariffs. President Trump has announced two distinct tariff proposals. Economic nationalism sells well across the political spectrum but comes with serious negative consequences that cannot be measured by pure numbers. The $50 billion tariff centered on China would, if enacted, cost far more to our economy as retaliatory measures would offset any supposed gain. We suspect the tariff trial balloons are just that and will be used to negotiate more defined trading agreements.

We remain sanguine regarding the stock market and prefer stocks to bonds notwithstanding the recent volatility and the acrimonious political drumbeat. The unbridled enthusiasm that greeted equity investors in January has been tempered even as the economy remains on solid footing. Inflation, a potential future risk, remains contained. Earnings growth measured nearly 15% during the 4th quarter of 2017. We expect earnings to increase double digits in 2018 as well, supporting current valuations.

Investment Oversight Committee
Daniel A. Lagan, CFA, President

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