CONGRESS ASSET MANAGEMENT COMPANY

Economic and Market Outlook

Third Quarter 2017

Contradictory forces seem to be at play in the domestic markets. On the one hand bonds rallied during the quarter with the ten-year yield falling to 2.15%, down from 2.40% in late March. The fall in yields would seem to indicate concerns for our economic vitality. On the other hand, stock returns indicate a more robust view of the future with the S&P 500 continuing to climb, up about 3% for the quarter. Movements in both markets merit comment.

In part, the bond rally likely reflects the subdued inflation readings reported over the past two months. Yet, the rally comes in the face of the Federal Reserve's fourth interest rate hike since December 2015 and confirmation that it is likely to begin shrinking its balance sheet later in the year. By shrinking the balance sheet, the Fed will start to unwind its quantitative easing programs. In so doing, it will also increase the inventory of government bonds available to investors…So why such a strong bond rally?

The world is still hunting for yield. A recent survey of sovereign debt indicated that the bonds of 13 countries sported negative yields out to five years. Argentina—a country that has defaulted seven times in 200 years—experienced robust demand for a recent 100-year bond issue. This hunt is driving foreign investors to U.S. shores for both yield and safety. According to Bloomberg, foreign central bank holdings of U.S. Treasuries stand at close to $3 trillion.

In contrast to bonds, the stock market eschewed economic concerns and rallied, once again with limited volatility. Corporate profits were up 12% over the prior year, which provided heft and supported the rise. The rally was broader than just the big tech companies, too. In fact, bolstered by the still expansionary policies of many central banks, stocks rallied globally with Europe up 18%, Japan up 22%, and emerging markets up 24%.

The hunt for yield drives down the cost of U.S. debt and indirectly supports the stock market as investors unhappy with low-yield options willingly take on more capital risk in an effort to increase their own capital base. For more than a year, stock market investors have been spreading their funds around and driving up global stock markets as a result. The coordinated efforts of the world's central banks may have finally hit the tipping point. The United States, Europe, and Asia appear to be growing at modest yet sustainable rates.

Even with the extraordinary efforts of the Fed and other central bankers, the Fed's 2% inflation bogey has proved elusory. Fortunately, its second goal of full employment is closer to reality and, in conjunction with benign inflation and stronger housing, underpins our mostly positive view on the economy and stock market.

The unemployment rate is hovering in the mid-4% range and after a pause, total employment costs are rising, albeit at a still-manageable rate. Meaningful employment has broad salubrious effects on consumer sentiment and importantly, household formation and housing.

The housing market remains stalwart. Affordability, thanks to employment gains and continued low mortgage rates, is constructive. The level of home ownership remains well below the record high level attained prior to the recession, implying that imbedded demand exists for both new and existing homes. Until now builders have avoided exuberance with the supply of new homes remaining fairly constant for the last few years. Absent a spike in interest rates, the housing market should continue to provide an impetus for growth.

Businesses also benefit from low inflation and interest rates. Companies, from banks to technology firms, are flush with cash. Many that had been reluctant to invest out of concern for the durability of the expansion appear more willing to spend. Corporate profit margins remain elevated and with full employment, companies have the wherewithal and need to make investments that improve productivity and competitiveness.

As the rally in bonds shows, however, there are concerns. The vexing issue in our mind is consumer spending. Total labor income is up, which generally leads to a higher level of consumer spending. That connection has weakened. Consumers have increased their level of savings and altered their spending patterns away from more expensive goods. It is a trend that does not appear to be ending. Also, manufacturing remains in a "fits and starts" mode and purchases of big ticket items remain subdued. After a multi-year run the pace of new car sales has slowed, driving down the market for used vehicles.

We believe the risk of deflation is less important. The Fed's preferred inflation rate of 2% is arbitrary and may not capture

efficiencies and product improvements rendered by new technologies. Still, tight employment presents an intermediate risk that inflation could surpass the 2% mark. Much depends on how companies react—do they take higher wages out of profits or pass them on to the consumer?

Politics remains a hot topic. Rhetoric and action are two different things however, and we do not envision a growth-crushing return to nationalism at the expense of cross-border trade. Since last year's Brexit vote, we have experienced a contentious U.S. election cycle and its aftermath, significant Russia noise, North Korean belligerence, and China's smiling aggression. Yet global growth appears to be solidifying—a positive for trade and diplomacy.

The stock market's measured return so far this year highlights that the remnants of the financial crisis are receding at a quickening pace. The Fed's balance sheet reduction can be interpreted as a signal that the world's largest central bank is prepared to partially return the economic reins to consumers and businesses thus allowing more rational investing, spending, and savings decisions. The timing is propitious. Corporate earnings are growing at a reasonable rate, inflation is in check, and the consumer is in solid economic shape with good job prospects. The U.S. stock market remains the preferred asset class.

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