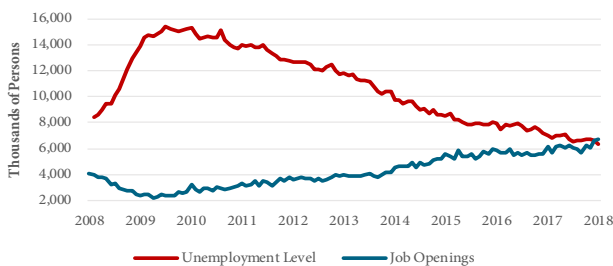




For much of the last ten years, the U.S. economic expansion has been notable for its lack of sizzle. Even the stock market, which has done well, has been unremarkable relative to other expansions. That is about to change. We have shed the “two steps forward, one step back” readings of economic data.

What’s changed? The continued development of our job market. May’s unemployment reading reached a new low for this cycle at 3.8%. As depicted in this graph, we currently have more jobs available than workers to fill them. Like a ball rolling downhill, we’ve picked up steam.

Jobs are Plentiful



Source: U.S. Bureau of Labor Statistics May 2018

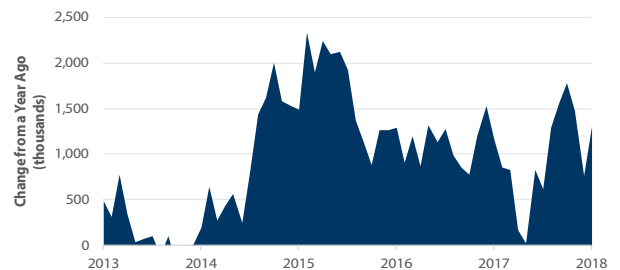
The momentum caused some volatility in financial markets, especially for bonds. Interest rates rose with the ten-year U.S. Treasury yield broaching the psychologically important 3% yield mark before falling back. Many bond market indices remain negative for the year. In contrast, stocks quelled some of the first quarter unease as the S&P 500 returned close to 3% for the quarter. Small stocks fared even better returning close to 8%.

The momentum exhibited in the second quarter is well grounded and likely to continue. The trickle of growth has become a torrent and expanded beyond the affluent. Lower income Americans are finally benefitting from tight labor markets and lower taxes resulting in higher confidence. This is captured in May’s retail sales increase of 5.9% over last year.

After some delay, the benefits of the expansion are spreading to millennials and younger demographic cohorts, who came of age during the financial crisis. Back then, weak job prospects and record student debt weighed on their confidence and ability to spend.

Things are better now. Today, millennials are forming new households at a solid pace, bolstering spending on housing and other big ticket items.

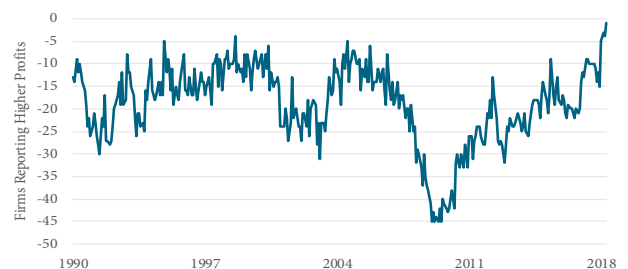
New Household Formation



Source: U.S. Bureau of the Census March 2018

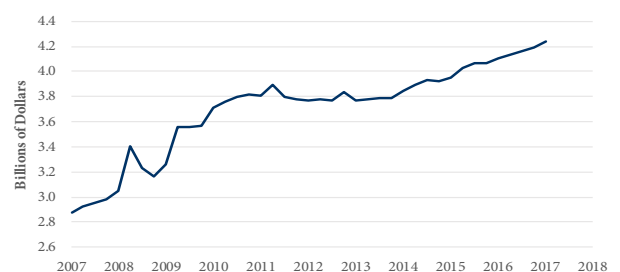
Corporate America continues to fare well. Record low interest rates, low inflation, tax cuts, and a large available work force resulted in strong 25% earnings growth in the first quarter. Small business trends are better now as optimism has risen with the improving profits outlook. To top it off, Federal spending was up 6% in May. This fiscal stimulus is sure to add fuel to the economic fire.

Small Business Profit Trends



Source: National Federation of Independent Business Small Business Optimism Report May 2018

Federal Government Outlays



Source: U.S. Bureau of Economic Analysis Total Government Expenditures May 2018

Ironically, the fiscal stimulus should be considered one of the risks to our outlook. Fiscal stimulus in a period of strong economic growth often results in inflation as government competes with business for limited resources. Indeed, the Federal Reserve (Fed) raised short term rates in June and hinted at more increases both this year and next year. Even with inflation still below the Fed's preferred 2% rate, it has continued to decrease its bond holdings, effectively taking money out of the system. Often criticized for being behind, the Fed appears to be anticipating inflation.

While domestic growth continues unabated, Europe and many emerging markets have stalled. The synchronized global expansion is now relying mainly on the U.S. and China to propel the next leg of growth. In this vein, the nascent trade war with China takes on increased importance.

President Trump is clearly putting his stamp on our trade policies by implementing new tariffs. Over time, tariffs reduce trade and increase costs. Undoubtedly, Chinese actors continue to steal proprietary technologies and new protections in that realm are long overdue. As currently constructed, however, the new tariffs are as hurtful to Canada and Mexico as they are to China.

The tariffs themselves are not significant enough on their own to cause major concern but they do set a tone and act as a harbinger of what may come. As the U.S. has indicated more tariffs will follow, this has led to fears of a full-blown trade war.

The tailwind from lower corporate taxes enacted late last year are now being offset by these tariff concerns, resulting in companies delaying capital projects and taking a more conservative view of the future. This has been less of a concern for small companies that produce and sell in the domestic market. That could change, however, as investors recognize that even small companies are indirectly tied to global markets.

Other than trade policy, most of the potential negative economic stimuli have offsetting positives. For instance, the European Central Bank remains accommodative

and has indicated it is likely to remain so throughout this year. Low European interest rates should help keep U.S. rates lower than they otherwise may be. Also, the Japanese economy appears to be stronger than it has been in decades and, along with China, provides meaningful opportunities for growth in Asia.

The U.S. economy enters the summer firing on all cylinders. The two primary risks in our view are: unforeseen inflation and a tariff induced slow down. The Fed is doing its part on inflation. As for tariffs, we believe cooler heads will prevail as the importance of global trade has been acknowledged by the administration even as the sabre rattling has intensified.

The foundation built over the last decade remains intact and strong enough to weather the current storm. An economy in full employment can withstand many challenges. That and accelerating growth keep us positively disposed to equities. Bond volatility may continue but the ten-year treasury at 3% appears attractive.

**Investment Oversight Committee
Daniel A. Lagan, CFA, President**

July 2018



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