CONGRESS ASSET MANAGEMENT COMPANY

# Economic and Market Outlook

## Fourth Quarter 2017

The economy is strengthening. Ten years after the financial crisis and in spite of a divisive domestic political climate, a potent Atlantic storm season, and an increasingly rambunctious North Korea, economic growth is improving. Importantly, growth is expanding outside the U.S. as Europe and Asia are exhibiting positive economic trends. The apparent synchronized nature of this expansion will present new challenges for policy makers and opportunities for investors.

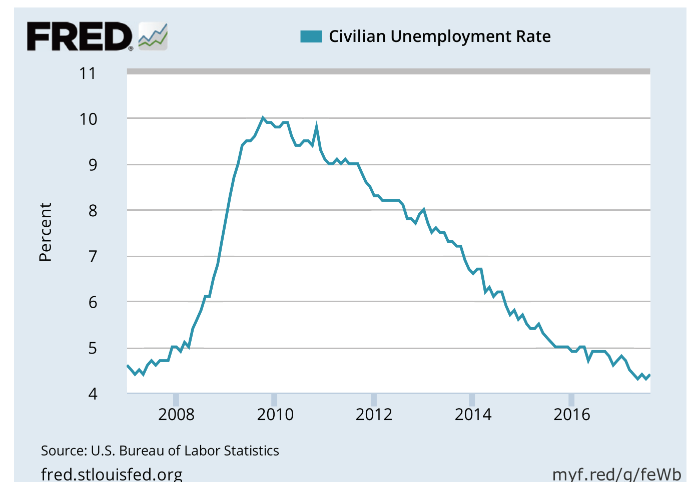
World stock markets reflect the more optimistic outlook. Most European markets have increased greater than 10% during the past year, while the Asian markets reflect returns greater than 20%. After a respectable 4.5% return in the third quarter, the S&P 500 has increased more than 18% during the past year. Global interest rates have risen as well, albeit modestly, with most European sovereigns now showing positive yields in contrast to just three months ago.

The U.S. Federal Reserve's announcement that it would begin removing the monetary stimulus it introduced in response to the financial crisis highlights the challenge faced by policy makers. Official inflation readings remain comfortably below the Fed's preferred target rate of 2%. Some large foreign central banks face similar challenges but remain more accommodative, in spite of seemingly stronger growth (though not inflation) readings. Yet, the Fed has decided to inch forward suggesting that strong employment readings will persist and caution regarding inflation is warranted. This process, often referred to as "tapering," puts the Fed in uncharted territory: withdrawing stimulus in the absence of meaningful inflation. The Fed is being prudent. As the leader of the free money world, the Fed is walking a tight rope with the world's other central bankers and investors watching for any misstep.

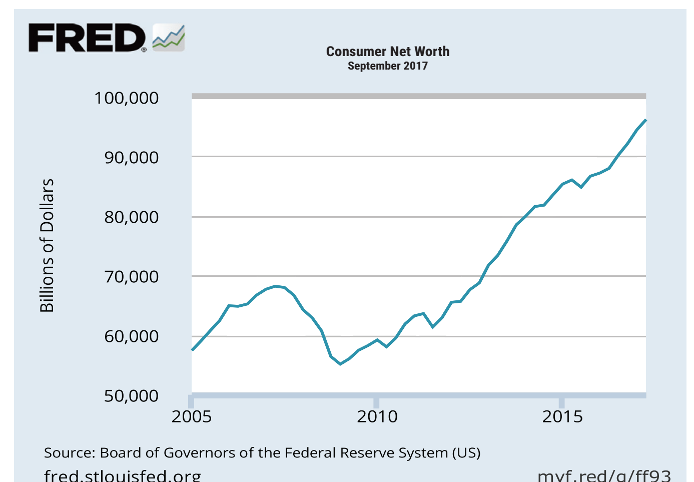
The challenge for investors is equally hazy. The economy has been lackluster, car sales have likely peaked and investors are bombarded with negative news sentiment. Adding to the challenge, high frequency economic statistics are likely to be disrupted by the recent hurricanes. Peering through the haze, we see a more robust story.

Domestically the renewed robustness will be led by the consumer. Demographics suggest we are in a prolonged period of elevated expenditures as the millennial generation meets its prime spending age, similar to the baby boomers in the 1990's. The generational cohorts are similar in size with the millennials now entering their household formation and family growth stage. With jobs more plentiful than they've been in a decade, confidence among this group runs high. Consumer net worth has increased nearly double digits in the past year. While millennial spending preferences may differ from prior generations, the patterns should rhyme, stoking demand for various goods and services.

### Jobs Are Plentiful

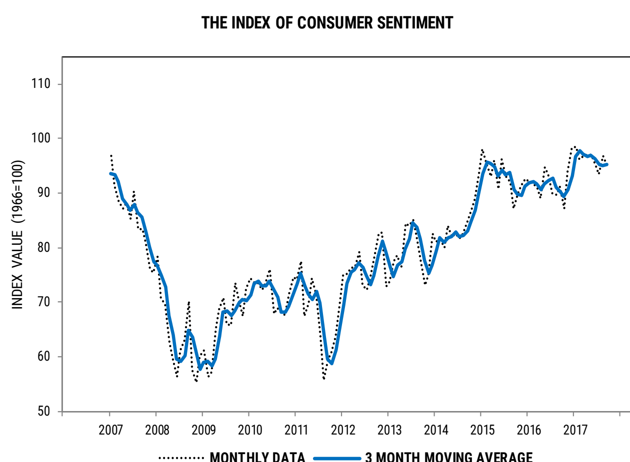



### U.S. Consumer Net Worth Is Increasing



The economy also stands to benefit from the improved balance sheets of business and consumers. In this sense, the Fed's efforts to maintain low interest rates have worked. Household debt service remains historically low at a time when small business surveys indicate that capital expansion plans are moving higher. The expanding economy shows few signs of stress.

## Consumer Sentiment Is Near Post-Recession Highs




University of Michigan September 2017

Interest rates remain at historically low levels, balance sheets are strong and confidence remains high. This backdrop supports stronger growth; it is not a falling out of bed scenario. In short, the U.S. economy appears to be gaining steam from the lackluster pace we've experienced.

One could argue that the stock market reflects this sanguine view. After all, measured by the S&P 500, volatility has been scant. The market has not experienced a 5% drawdown since the Brexit scare of June, 2016—an unusually long period of time. From our perspective, however, the economic risk is to the upside.

Europe and China appear to have turned the corner, supporting the growth scenario. After years of negative news regarding Greece, Spain, and others, we may have reached a crescendo in 2016 with the Brexit vote. These concerns have now passed. While Europe is unlikely to be confused with China, growth has begun to accelerate. Germany is experiencing a labor shortage while consumer spending has consistently grown for over three years. Spain and Italy, causes of concern not long ago, are now on solid footing. The European Central Bank remains accommodative, encouraging investment through low interest rates and an expanded balance sheet. China also seems past the 2014–2016 lull. China's growth stands close to 7%, a heady number for an economy of that size.

There are some notable short and intermediate term risks to watch. Most immediately, the hurricane season has devastated large areas of the country, likely affecting millions for years to come. History suggests that economic readings over the next few months will be weaker than non-hurricane-impacted forecasts. To the extent that these readings are more severe than currently anticipated, the markets would react negatively.

One of the primary intermediate term risks goes hand in glove with our call for a strengthening economy. Strong employment often foreshadows higher labor costs. If we are not at full employment, we are close. As such, should employment costs accelerate to a higher plateau, inflation above the Fed's preferred level of 2% could be in the offing. This would be negative for both stocks and bonds.

Political risks and machinations are too numerous to elaborate on here. From Washington, we expect more proposals on taxes, trade, and healthcare. It is impossible to determine winners and losers until legislators can agree on their own goals and objectives.

As we head into the final quarter of 2017, in spite of the hurricane effects, the economy is stronger than it has been in years. This benign growth period – characterized by stronger corporate earnings, low inflation and a receding Fed, should continue into 2018. Equities are the preferred class in this environment, with bond returns likely restricted to their inherent coupon rates assuming a continued gentle path for inflation.


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


**September 2017**



2 Seaport Lane Boston MA 02210 800.234.4516 www.congressasset.com