UNION

MONTHLY UPDATE AND COMMENTARY
MARCH 2018

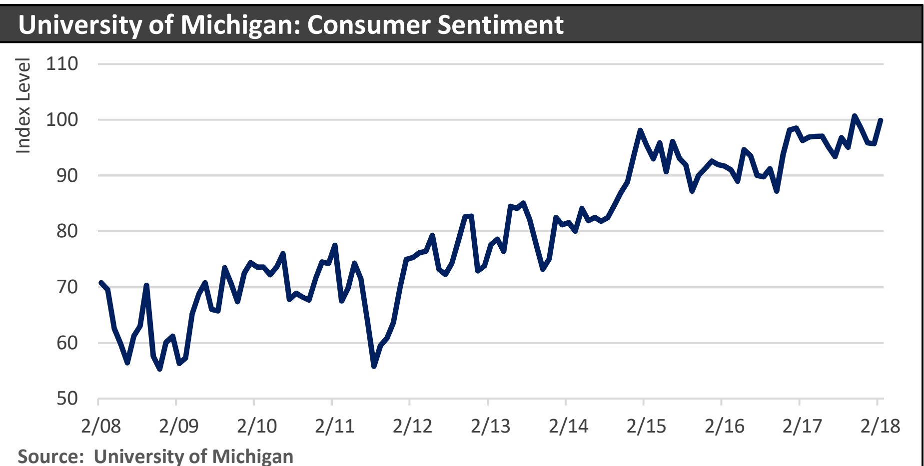
Recap: The U.S. economy entered 2018 with healthy momentum after posting its best year of growth in five years in 2017. The strong start to 2018 appeared fairly broad-based. Manufacturing clearly led the way as new orders remained exceptionally strong and the backlog of unfilled orders increased. The factory sector appeared to be benefitting from stronger global economic growth and a weaker dollar.

Consumer confidence rose in February, with the gain coming from the expectations series. The rise in expectations likely reflected the surge in the stock market earlier in the month as well as growing optimism about tax reform. Rising consumer confidence has helped explain the persistent drop in the saving rate. Consumers have become much more optimistic about their employment prospects and have been willing to spend a larger proportion of their take-home pay. Attitudes have also been bolstered by the run-up in the stock market and rising home prices.

A tightening labor market delivered the biggest annual increase in wages - 2.9% in 2017 - since the end of the recession, a new signal that American workers have begun to enjoy pay raises long missing in a steady but tepid expansion. The financial markets have been looking for the Fed's new leadership to take a slightly more hawkish tone in the face of rising wages and input costs. All told, economic data and fiscal policy developments have cemented the case for the Federal Reserve to continue to normalize interest rate policy. With a neutral Fed funds rate in the neighborhood of 2.5%, three interest rate hikes in 2018 should be sufficient to keep a lid on inflation and allow any remaining labor market slack to be absorbed.

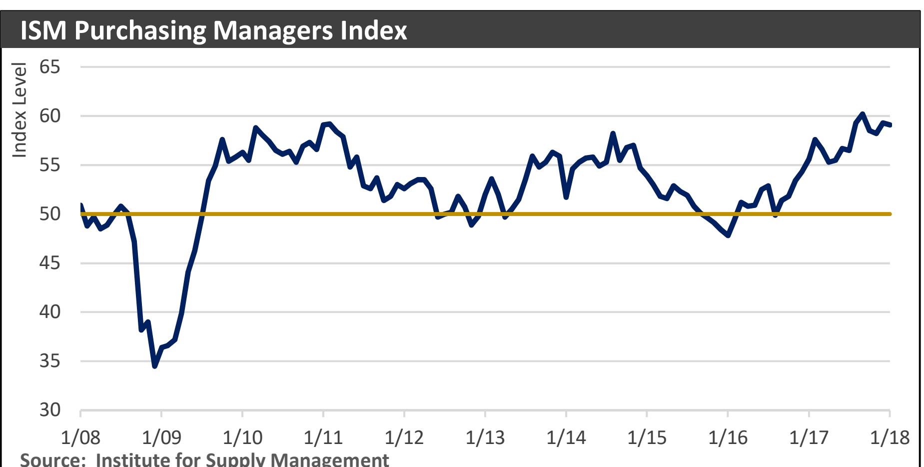
Consumer Confidence: A gauge of consumers' confidence in the economic outlook rebounded in February as low unemployment and optimism about the new tax regime outweighed financial-market volatility for American households.

The consumer-sentiment index was 99.9 in February, up from 95.7 in January. This rebound came after sentiment had dropped for the prior three months, although from an elevated level. The rise in the latest index could be the first sign of the boost to consumers from lower taxes and would suggest that, even if consumption growth slowed in the first quarter, spending should continue to grow at a solid rate in the coming months.



Source: University of Michigan

ISM Manufacturing Index: The Institute for Supply Management (ISM) index of manufacturing rose in January, marking the 17th straight month that the index has been in expansionary territory. The headline index saw increases in all major sub-indices with the exception of the employment series. The spread between new orders and inventories – a good leading indicator of activity – widened further in December suggesting that the manufacturing would likely hold onto

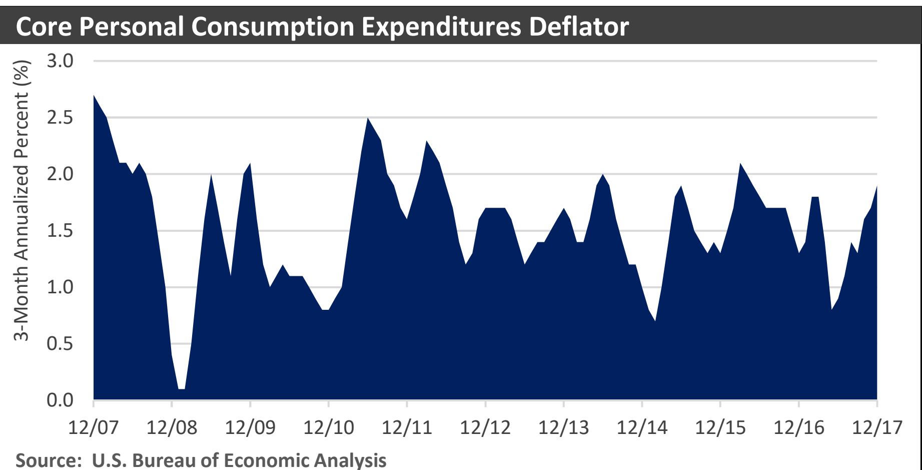


Source: Institute for Supply Management

recent gains. With tax stimulus boosting bottom lines and supporting demand, growth in manufacturing should continue in 2018.

Non-Manufacturing Index: The Institute for Supply Management's (ISM) non-manufacturing index saw a two-month pullback. It was somewhat anticipated after the index reached the highest level in over a decade, in October. Among the main subcomponents, business activity and new orders fell while the employment and supplier deliveries indices rose. The elevated level of the supplier deliveries index, which indicated slower deliveries, would suggest that supply-chain disruptions remain a factor. Healthier momentum should resume in 2018 as robust fundamentals continue to underpin strong demand for services, while a rebounding energy sector has served to provide an additional boost. The stimulus delivered through the tax reform package should further aid the expansion of this sector in 2018 as it boosts demand and enhances business profitability.

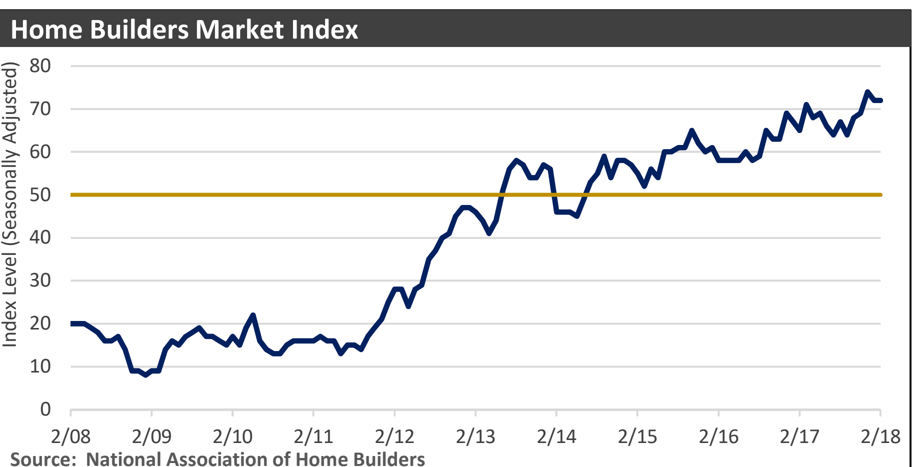
Inflation: Inflation should edge up in the first quarter with the PCE deflator advancing to 1.9%. Higher commodity prices, including energy, have provided a lift, but core inflation has strengthened in recent months. PCE inflation should climb above 2% in the second quarter, but further improvement will be limited by a modest retreat in oil prices and slow reflation in the core index. Inflation has also risen on the producer side, as the Producer Price Index (PPI) for final demand rose broadly in January, by 0.4%.



With inflation trending upwards recently as prices firm, the Fed will likely continue its tightening policy and raise rates three times this year.

Labor: For 2017 the U.S. economy created just under 2.2 million jobs slightly above its 2016 performance of 2.1 million. The unemployment rate fell 0.6 percentage points, double the pace of decline in 2016. The challenge in 2018 will be how to continue to add jobs when there are fewer people looking for them. The low unemployment rate should mean faster wage growth as employers offer higher compensation in order to attract and retain talent. They will have more room to do so with the cut in the corporate tax rate.

Housing: Housing starts jumped 9.7% in January, with multi-family starts surging about 24% and single-family starts rising about 4%. Building permits rose 7% in January, with all the gain coming in multifamily units. All regions except for the Midwest saw increased activity in January. Starts have been a historically volatile series, but the jump confirmed high homebuilder confidence as improving job and wage growth, along with low for-sale inventory, meaning builders have been selling homes just as fast as they can be built.



Existing home sales fell for the second straight month, declining 3.2% to a 5.38 million-unit annual pace in January. Resales declined both in the month and

over the year in all regions, reflecting tight inventories. All major regions saw declines in January. Nevertheless, median prices in all regions remained up comfortably from a year ago. The seemingly inconsistent story of weakening sales activity with rising prices would reflect the continued tight supply conditions.

Optimism in the housing market has remained within reach of the 18-year high hit in December. And, positive fundamentals such as a healthy labor market and accelerating wages will support demand, while tight inventories and rising prices will incentivize new homebuilding.

Still, there could be a few downside risks over the near-term housing outlook. The changes to the mortgage interest deduction and the state and local tax deduction as part of the Tax Reform Act will impact housing demand in higher-priced and higher-taxed regions. The additional uncertainty could have led to a slight pullback in builder confidence in January. That uncertainty has added to the challenge of a shrinking pool of construction workers, and rising mortgage rates.

Business Investment: Several favorable developments (tax cuts, improved business confidence, a better global backdrop, firming oil prices and a softer U.S. dollar) together would make a compelling case for stronger capital spending by businesses. A gain of about 9% is expected. Equipment spending, in 2018, should be relative to about 5% from 2017. On a cautious note the economic cycle has been elongated and a number of downside risks could still derail the expected pick-up.

Trade: The U.S. trade deficit in goods and services expanded 5.3% from the prior month to a seasonally adjusted $53.1 billion in December, the highest since October 2008. This occurred as stronger global growth increased demand for American-made products while robust U.S. consumer spending boosted imports even more.

The trade deficit took a toll on U.S. economic growth during the fourth quarter. Net exports subtracted 1.1 percentage points from the overall GDP growth. Trade deficits in goods with China, Mexico and Canada—which collectively accounted for more than half of total U.S. goods imports and exports—all widened in 2017, compared with the prior year.

The Trump administration has made narrowing the trade deficit a goal, but that has been difficult to do when the domestic economy has expanded and consumers' appetite for foreign-made goods has strengthened.

Dollar: The U.S. dollar should continue to soften against the major and emerging currencies. While the Federal Reserve should continue to raise interest rates on a regular basis, that tightening has appeared to be less supportive of the dollar than rate hikes at the earlier stages of the cycle.

Fiscal Policy: By doubling down on deficit-financed fiscal stimulus at a time of economic strength, Washington has embarked on its own grand experiment. On the positive side, the infusion of government funds will be dramatic over the next two years, totaling roughly $300 billion. Moreover, government spending has tended to carry larger economic fiscal multipliers than tax policies where more leakage occurs. Put another way, this will be spending that occurs directly in the economy via projects, equipment purchases and contracts, rather than the push-and-pull dynamics of tax policy which has been partially offset by increased savings behavior and the elimination of deductions.

On the down side, recent double-dose of fiscal stimulus would be deficit-financed at a time when debt has already risen relative to the size of the economy. Intensifying aging population pressures will escalate entitlement payments and challenge the government's tax base. This will occur at a time when a greater share of tax revenue will be directed towards already-rising interest payments. Fiscal policy will need to become a drag on the economy down the road as an offset to this stimulus. The greatest risk could be that the next economic downturn will likely occur alongside more hamstrung government finances. This could limit the extent to which Washington can respond with stimulus measures when it will be needed most.

Global: A synchronous economic upswing would appear to be underway in the global economy. The rate of growth in global industrial production strengthened to a six-year high last year and estimations have indicated that global GDP grew more or less in line with its long-run average in 2017.

Real GDP in the Eurozone rose 2.3% (annualized rate) on a sequential basis in Q4, and the year-over-year rate of economic growth in China remained unchanged at 6.8% in the fourth quarter. There are not yet many “hard” data releases for Q1-2018, but the “soft” data for January that were available have suggested that growth has remained resilient in most major economies thus far. The global economy likely grew near its long-run average of 3.5% last year, and similar growth rates are expected for 2018 and 2019. The steady slowdown that has been underway in China for the past seven years will continue in 2018. That said, the 6.5% growth rate for China forecast for 2018 has continued to place it among the fastest growing major economies in the world.

Global Trade: International trade flows rebounded in 2017 to grow at their fastest pace since 2011, but there has been little prospect of a sustained return to the rapid rates of increase that were common before the global financial crisis. The rise in trade flows have reflected a broader rebound in economic activity around the world. High rates of trade growth would be good for the global economy, since they reflect a more efficient distribution of production around the world and facilitate more intense competition.

However, a return to the situation of pre-crisis years, when trade grew at twice the rate of economic output would seem unlikely. That would be because one driver of strong trade growth before the crisis appeared to be leveling off. From the 1980s on, businesses broke up production processes that had been concentrated in their home countries and spread them around the globe, partly in an effort to reduce wage costs. That created global value chains and boosted the volume of imports and exports as parts moved across borders before coming together as a final product.

But that process appeared to have slowed, mainly due to rising wages in developing economies, and automation that made it cheaper to manufacture goods in developed economies. The outlook for trade would also depend on political decisions as some governments have considered protectionist measures in response to voter discontent with stagnant real wages in developed economies. Although the effects on global trade flows of a number of political developments have yet to play out, world trade should be on track to make a good start to 2018.

Outlook: The U.S. economy has entered a more mature phase, but this does not mean that a recession is around the corner. Indeed, forward-looking economic indicators have pointed to ongoing strength. Business cycles end when imbalances build up and rising interest rates expose vulnerabilities. Risks have increased in sub-sectors of household and corporate credit, but so far have remained relatively small and insulated from the broader economy. Still, with delinquency rates trending up on the household side and leverage at all-time highs on the corporate side, these are the hot spots to watch out for as interest rates push higher. All told, as long as interest rate hikes remain relatively gradual, the economic expansion is likely to continue.

Recently enacted tax changes have created upside opportunities for consumer spending, business investment and residential investment—all stronger in 2018 relative to 2017—while the increase in growth has been accompanied by a rise in inflation estimates for the PCE deflator. Better growth and higher inflation expectations, along with a recent jump in labor compensation, have moved market expectations to three federal funds rate increases.

All in all, economic momentum has remained decent and price pressures are rising – both themes that lend support for a March interest rate hike. Moreover, the risk that possible signs of ‘overheating’ may compel the Fed to step up with a more rapid pace of hikes – a move that could stress vulnerabilities in sub-sectors of household and corporate credit – remain in place.

With growth picking up and the threat of deflation receding in most economies, central banks are removing policy accommodation. The Fed has hiked rates by 125 bps over the past two years, and 75 bps of further tightening by the FOMC in 2018, should occur. The ECB has been dialing back its bond buying, and could end its quantitative easing program late this year before beginning a slow process of rate hikes next year. The Bank of Canada and the Bank of England hiked rates last year, and both central banks should tighten further this year. The downward trend in the dollar should continue as ongoing Fed tightening starts to become less supportive of the dollar and as foreign central banks start to catch up to the Fed with their own removal of policy accommodation.

Index Performance as of 2/28/18

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Russell								
3000 Value	-0.04	-4.79	-1.30	-0.03	-1.30	7.39	8.02	11.93
3000	0.29	-3.69	1.39	2.40	1.39	16.22	10.59	14.37
3000 Growth	0.60	-2.64	4.02	4.77	4.02	25.52	13.15	16.78
1000 Value	0.10	-4.78	-1.09	0.35	-1.09	7.75	8.02	12.05
1000	0.41	-3.67	1.62	2.75	1.62	16.70	10.77	14.56
1000 Growth	0.70	-2.62	4.27	5.09	4.27	26.11	13.51	17.04
Mid Cap Value	-0.65	-4.93	-2.74	-1.54	-2.74	5.47	7.07	12.03
Mid Cap	-0.36	-4.13	-0.52	0.40	-0.52	11.95	8.00	13.01
Mid Cap Growth	0.00	-3.14	2.34	2.89	2.34	20.60	9.33	14.24
2000 Value	-1.88	-5.00	-3.83	-4.75	-3.83	2.96	8.02	10.59
2000	-1.23	-3.87	-1.36	-1.76	-1.36	10.51	8.54	12.19
2000 Growth	-0.65	-2.85	0.94	1.06	0.94	18.44	8.92	13.72
Standard & Poors								
S&P 500	0.51	-3.69	1.83	2.96	1.83	17.10	11.14	14.74
Consumer Disc	-0.29	-3.46	5.55	8.10	5.55	22.15	12.90	17.34
Consumer Staples	-0.50	-7.76	-6.30	-4.22	-6.30	-0.32	5.03	9.86
Energy	0.26	-10.82	-7.42	-2.90	-7.42	-2.80	-2.40	-0.35
Financials	-0.05	-2.78	3.51	5.54	3.51	19.94	15.77	17.37
Health Care	0.04	-4.45	1.90	1.25	1.90	14.31	7.01	16.08
Industrials	0.16	-3.95	1.15	3.07	1.15	16.28	11.69	15.14
Information Technology	2.19	0.10	7.73	7.74	7.73	36.26	20.14	22.22
Materials	-0.56	-5.26	-1.33	0.58	-1.33	15.98	7.21	11.39
Real Estate	1.05	-6.71	-8.47	-8.94	-8.47	-3.02	2.20	6.97
Telecom Services	-0.27	-7.06	-6.55	-1.15	-6.55	-5.01	3.79	5.02
Utilities	0.50	-3.86	-6.81	-12.53	-6.81	-1.99	6.45	9.50
Other U.S. Equity								
Dow Jones Industrial Avg.	1.02	-3.96	1.69	3.64	1.69	23.10	14.16	15.02
Wilshire 5000 (Full Cap)	0.26	-3.75	1.41	2.56	1.41	16.21	10.40	14.19
International Equity - Broad Market								
MSCI EAFE	-0.43	-4.51	0.28	1.89	0.28	20.13	5.65	7.06
MSCI EM	-1.16	-4.61	3.34	7.05	3.34	30.51	8.97	5.02
MSCI Frontier Markets	0.26	-1.49	4.16	7.41	4.16	29.23	6.90	8.59
MSCI ACWI	-0.11	-4.20	1.20	2.84	1.20	18.79	8.33	10.08
MSCI ACWI Ex USA	-0.69	-4.72	0.59	2.84	0.59	21.63	6.24	6.31
MSCI AC Asia Ex Japan	-0.76	-4.98	2.21	4.97	2.21	31.93	9.92	8.10
International Equity - Country Region								
MSCI Brazil	-0.66	-2.01	14.48	19.74	14.48	22.95	12.91	-0.08
MSCI BRIC	-1.54	-5.30	5.56	8.59	5.56	36.36	11.20	6.41
MSCI China	-2.34	-6.40	5.28	7.30	5.28	46.71	12.63	11.03
MSCI Europe	-1.26	-5.88	-0.79	0.70	-0.79	20.54	4.27	6.59
MSCI India	0.19	-6.70	-3.49	1.22	-3.49	21.17	4.06	8.69
MSCI Japan	1.22	-1.51	3.01	3.73	3.01	21.77	9.69	10.44
MSCI EM Latin America	-1.52	-3.61	9.07	13.91	9.07	21.10	7.65	-1.68
MSCI Russia	-0.52	0.93	13.62	16.86	13.62	27.99	16.53	0.80

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	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Fixed Income								
Barclays U.S. Aggregate	0.37	-0.95	-2.09	-1.64	-2.09	0.51	1.14	1.71
ICE BofAML US 3M Trsy Bill	0.03	0.09	0.21	0.33	0.21	0.99	0.48	0.31
Barclays U.S. Gov't	0.43	-0.74	-2.06	-1.76	-2.06	-0.52	0.37	0.91
Barclays U.S. Credit	0.39	-1.51	-2.43	-1.65	-2.43	2.12	2.17	2.77
Barclays High Yield Corp.	0.11	-0.85	-0.26	0.05	-0.26	4.18	5.19	5.34
Barclays Municipal	0.06	-0.30	-1.47	-0.44	-1.47	2.50	2.22	2.57
Barclays TIPS	0.55	-0.97	-1.82	-0.92	-1.82	-0.18	0.79	-0.11
Barclays Gbl Agg Ex USD	-0.17	-0.85	2.16	2.44	2.16	10.50	3.40	0.85
Barclays Global Aggregate	0.06	-0.89	0.29	0.64	0.29	6.01	2.45	1.23
JPM EMBI Global Div	0.37	-1.99	-2.03	-1.31	-2.03	4.39	5.75	4.50
Alternative Investments								
Alerian MLP	-3.03	-9.69	-4.49	0.04	-4.49	-15.22	-10.39	-3.48
Bloomberg Commodity	-0.12	-1.73	0.22	3.21	0.22	1.58	-4.69	-8.08
FTSE NAREIT Equity REIT	0.59	-7.71	-11.57	-11.76	-11.57	-10.12	0.39	5.76
S&P Global Natural Res.	-0.40	-5.08	-0.11	5.60	-0.11	18.93	5.73	2.42
S&P N. Amer Natural Res.	-0.74	-9.83	-7.71	-2.46	-7.71	-2.99	-2.89	-1.45

Sources: *Bloomberg, Institute for Supply Management, Department of Commerce, European Central Bank, National Bureau of Statistics of China.*

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