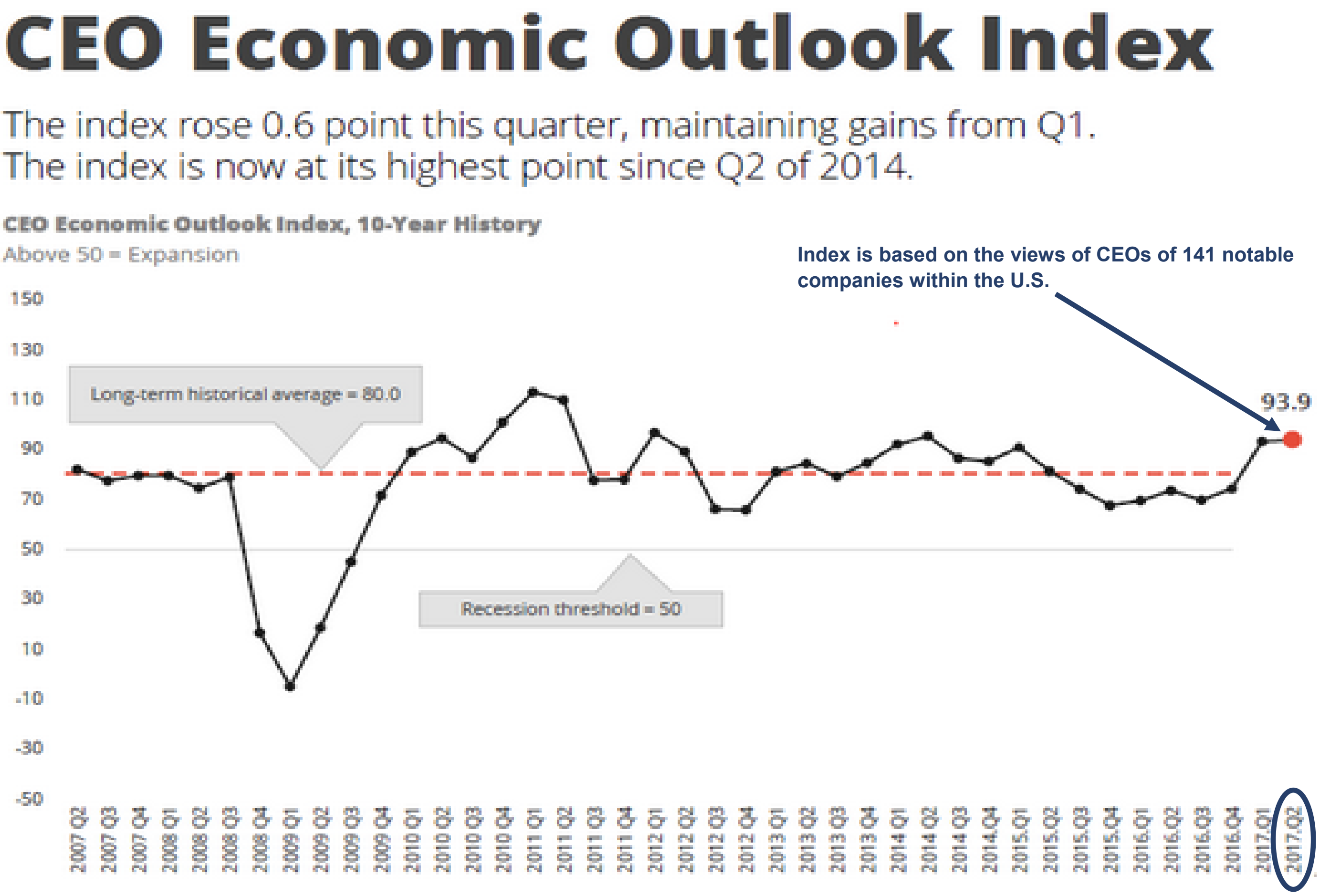
POLITICS & BUSINESS — NON-OVERLAPPING MAGISTERIA?

Since I last wrote, mainstream news has been dominated by disquieting stories about North Korea's nuclear ambitions, conflict in Syria, the U.S.' proper role with respect to climate change, important votes pertaining to Europe's future, fractiousness over healthcare and travel restrictions, all sorts of Russian things, distracting tweets and the ongoing scrap between our executive branch and the press as to which side might be more fake. Against this backdrop, it's not surprising that certain of our clients are fearing for their portfolios.

Yet, CEOs remain optimistic:



A WORD ABOUT THE "TRUMP TRADE"

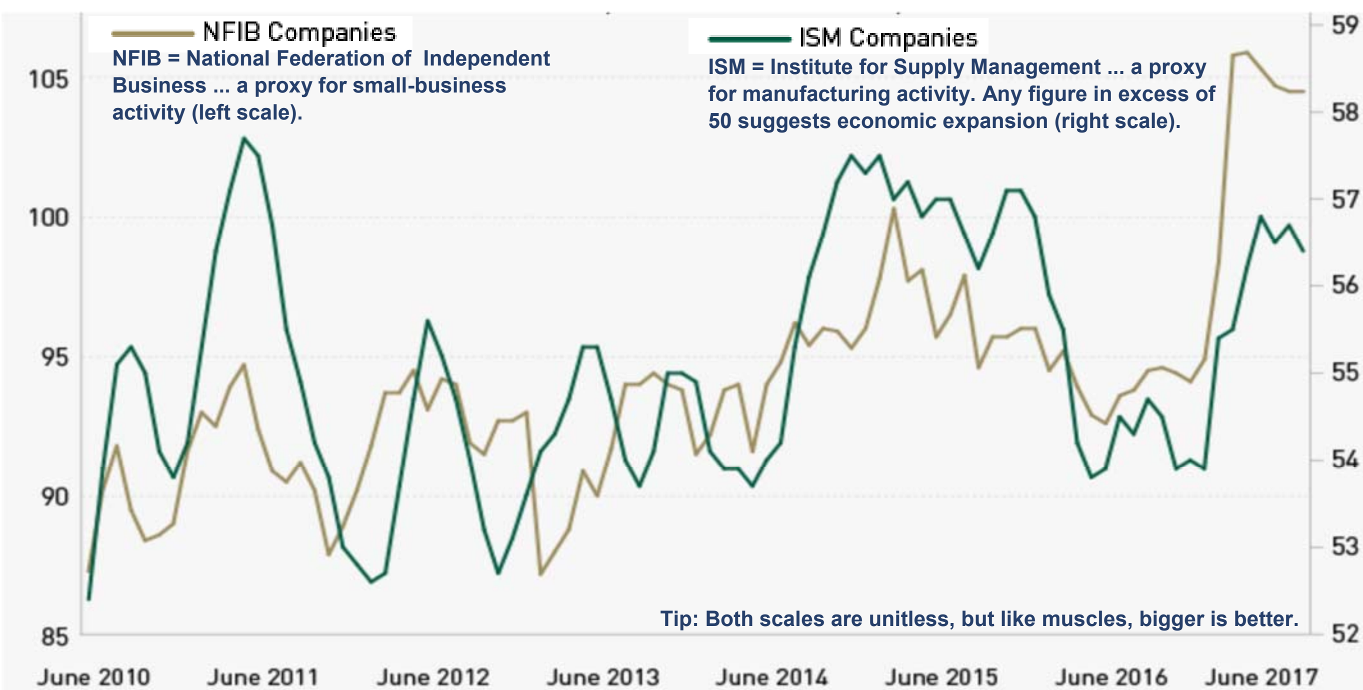
After President Trump was elected to office, the "Trump trade" took form. In short, investors were stoked that the new administration, backed by a Republican majority in both chambers of Congress, would be able to ease tax and regulatory burdens, improve our healthcare system and, in addition to other pro-growth initiatives on the Republican agenda, revitalize our nation's infrastructure. To the extent forecasters and investors expected these pro-growth initiatives to come to fruition, they baked their estimated impact into economic forecasts and stock prices.

IMF REMOVES CERTAIN TRUMP-TRADE ASSUMPTIONS FROM U.S. FORECAST

A few days before the end of the second quarter, the International Monetary Fund (IMF) announced that it had removed the incremental impact of President Trump's plans to reduce taxes and boost infrastructure spending from its 2017 and 2018 forecasts for U.S. growth. More specifically, the IMF shaved its 2017 growth forecast from 2.3% to 2.1% and reduced its 2018 forecast from 2.5% to 2.1%. For 2019 and 2020, the IMF continues to project that growth within the U.S. will taper off to 1.9% and 1.8%, respectively.

Citing an aging population, low productivity growth and a labor market that is already at full employment, the IMF's revised growth projections for the U.S. cast some doubt on the Trump administration's budget proposal that shows U.S. growth rising to 3% by 2020 and then remaining at that level through 2027. Regardless of whether the current administration is eventually able to implement the policy initiatives on its agenda, market participants have become more circumspect as to whether various pro-growth initiatives will be adopted.

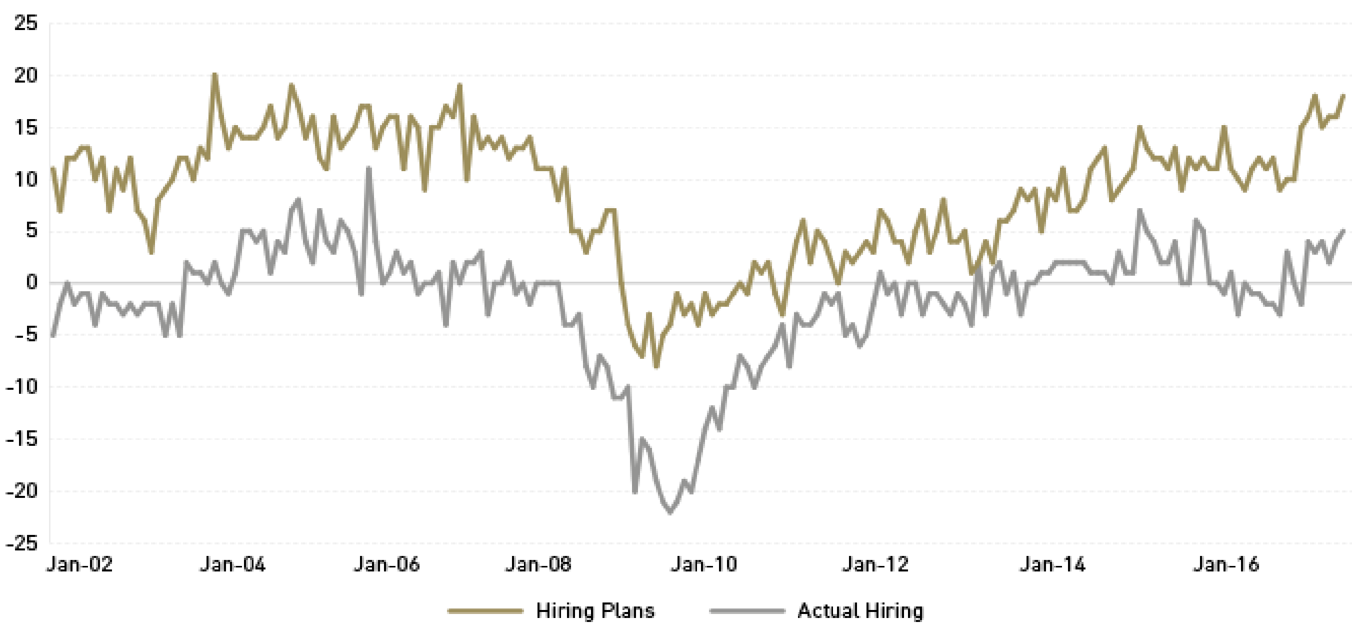
BUT SMALL BUSINESSES AND MANUFACTURING DATA ARE *ALREADY* HEALTHY



HIRING PLANS LOOK PRETTY HEALTHY, TOO

In addition to small business and manufacturing activity within the U.S. already cooking along pretty well, the unemployment rate now stands at only 4.3%, a figure many economists consider to more or less represent full employment. Since the composition of business is always in some structural state of flux and because there are always some workers who are frictionally unemployed as they look to better their employment situations, the notion of full employment necessarily includes an allowance for workers who are "structurally" or "frictionally" unemployed. Consequently, that 4.3% figure roughly equates to full employment.

Hiring plans and actual hiring data continue to improve, January 2002–May 2017



Although businesses might hire fewer workers than they currently expect, the only reason businesses expand their workforce is in response to increasing demand for their wares. In that sense, the upward slope of the gold line in this chart is encouraging to investors.

POSITIVE SIGNALS FROM THE FED'S JUNE 14TH MEETING

When I referred to the Business Roundtable CEO Economic Outlook Index last quarter, I mentioned that index had logged its largest increase in CEO optimism since the fourth quarter of 2009 and that it had moved well above its long-term average for the first time in almost two years. Based on the tenor of current news, I imagine plenty of folks would be surprised to know that CEO sentiment has improved further.

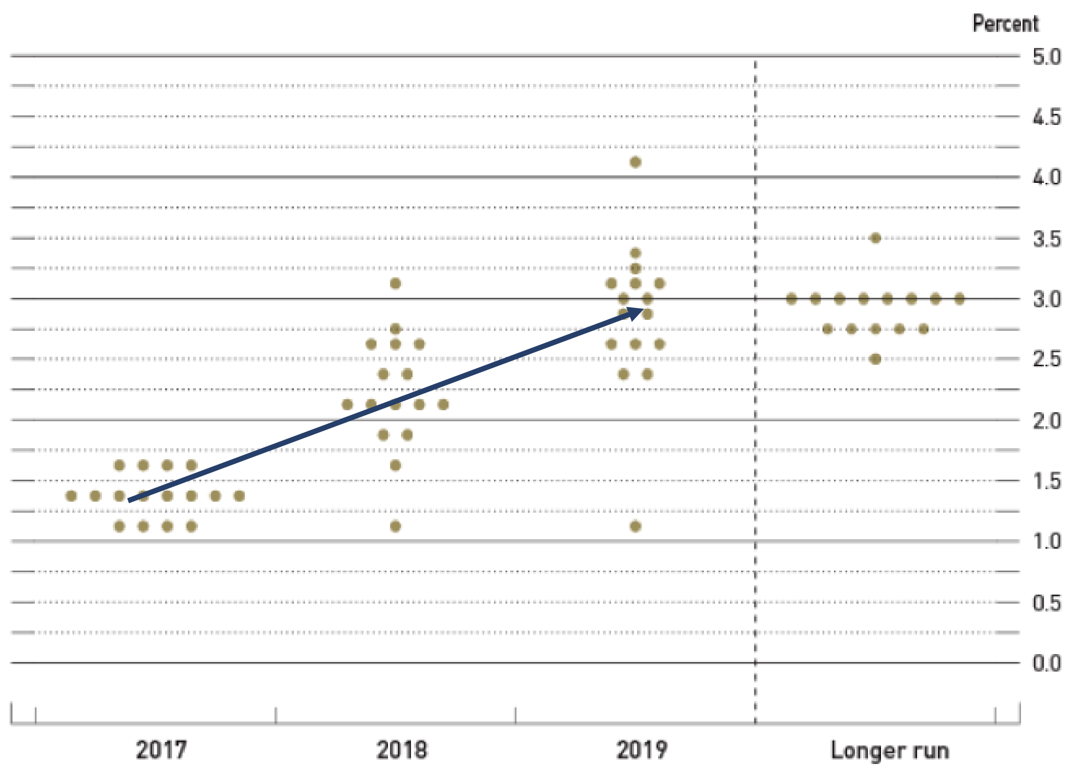
Yet, the Fed's recent decision to raise its benchmark Federal Funds rate (the rate at which banks loan short-term funds to one another) by .25% lends support to the notion that the optimism expressed by those 141 CEOs may be well founded.

While rising interest rates pose an undeniable drag on borrowers, economic activity and asset valuations, that negative nugget of truth is more than offset by the fact that the Fed is inclined to raise rates *only* when it believes the U.S. economy is relatively healthy. This is why stocks have often *risen* in value while the Fed has been raising rates. As with the gold line on the previous page, the Fed's recent rate hike represents another important vote of confidence in the U.S. economy even though this particular vote will also result in a bit of incremental headwind.

ABOUT THE FED'S "DOT-PLOT"

The Federal Open Market Committee is that portion of the Fed that's charged with making key decisions with respect to interest rates and monetary policy within the U.S. As such, it can consist of as many as 19 voting members. Periodically, each member is invited to indicate what he or she thinks an appropriate level for the Federal Funds rate (a key, short-term lending rate) will be at

Federal Open Market Committee assessment of appropriate fed funds rate, 2017–onward (as of June 14, 2017)



the end of the current year, at the end of the subsequent two years, and beyond. The Fed then aggregates the respective indications from each member to create a given "Dot Plot" such as the one the Fed released after its June 14th meeting. While the dots in any given plot do not represent actual Fed policy, the aggregated dots do provide some sense of where the FOMC's individual members feel short-term interest rates may be heading.

IMPORTANCE OF THE SLOPE OF THE FED'S MOST RECENT DOT-PLOT

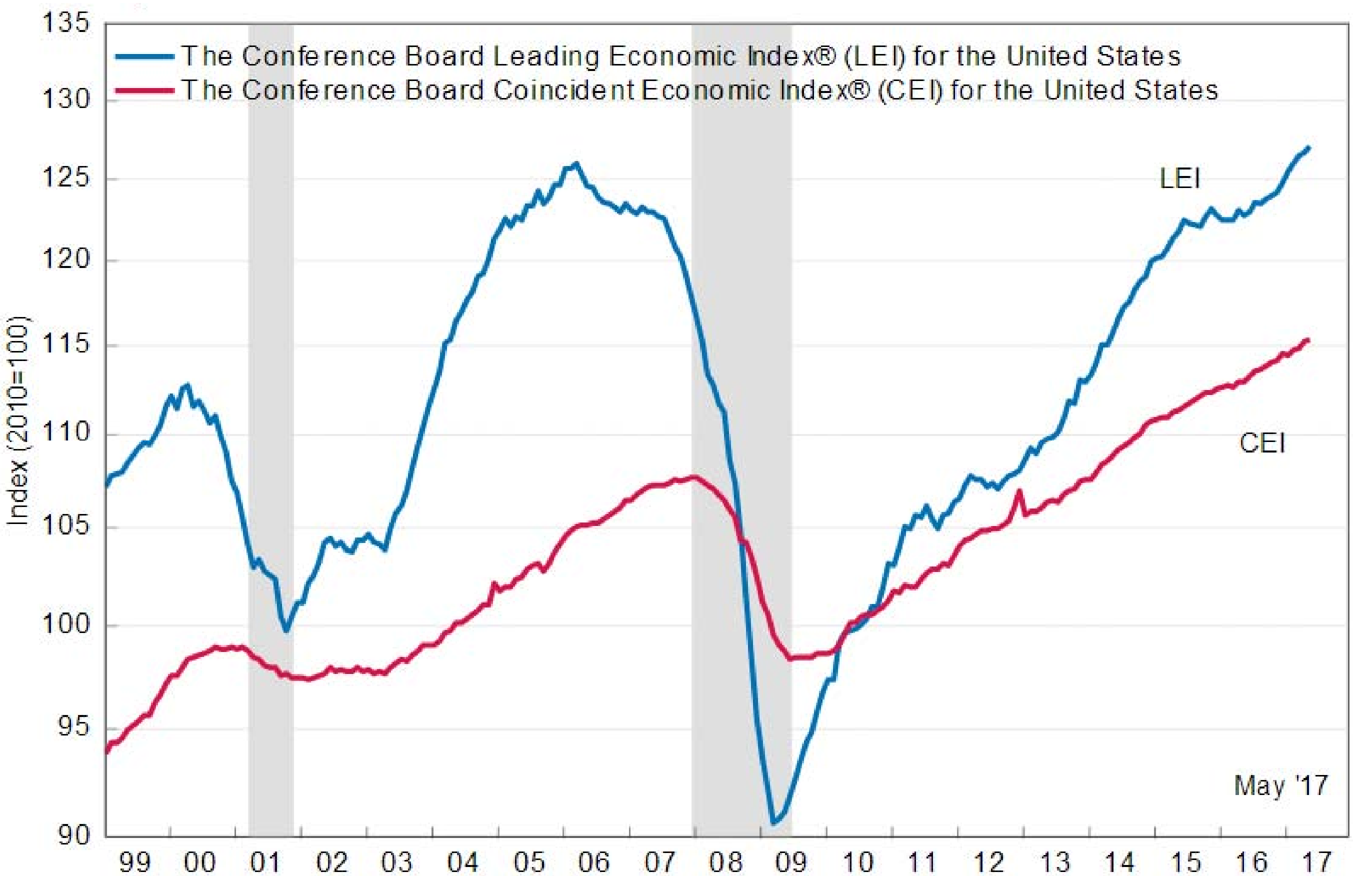
Some of you may recall that even though the economy was struggling after the meltdown of 2008/9, stock prices would often surge in response to any hint the Fed might aim for a lower Fed Funds rate (to stimulate the economy). In those days, investors were more focused on receiving economic stimulus from the Fed than they were on the fundamental health of the underlying economy.

Today, I'm happy to report the converse situation exists. Like a recovering drug addict who eventually starts caring more about his overall condition than how much longer he must wait for his next dose of Methadone, investors have returned their focus to traditional fundamentals rather than when the next dose of monetary stimulus might be administered. In short, they now tend to regard any Fed action to normalize (raise) short-term interest rates as an important vote of confidence in the U.S. economy. When investors sense confidence from the Fed, they have tended to bid equity prices higher, just as they have already been doing.

While it's unambiguously clear that the Fed would like to continue raising short-term rates over the next few years, it is far from certain the Fed will be able to act on those intentions. For example, if the U.S. were to become involved in some major conflict or if the Fed were to sense that the U.S. economy were languishing, the Fed would almost certainly shelve its rate-hike intentions for a while. So, while the latest dot-plot from the Fed does not represent Fed policy, the apparent upward trajectory of short-term rates over the next few years provides some measure of comfort to investors that, for now, members of the FOMC think the U.S. is in good enough shape to remain on a path to normalized interest rates. It's also worth noting that the Fed's expectation of inflation, as measured by the Personal Consumption Expenditures (PCE) index, is that it will approximate 2% during 2018 and 2019 which, incidentally, happens to coincide with the figure the Fed had been targeting.

INDEX OF LEADING ECONOMIC INDICATORS ALSO LOOKS GOOD

Because the economic opinions I read more or less point to a fairly healthy state of economic being within the U.S. economy and because the calls I receive are more or less concerned with when and/or whether I see the wheels falling off the economic bus, I checked the Conference Board's Leading Economic Index® to see if it senses any clouds on the economic horizon. Not only had that index (blue line) advanced higher than I expected it to have, it also appears to be distancing itself from the Board's Coincident Economic Index which is also rising. (The Board's coincident index aims to measure things that more or less confirm the economy's current state of being.) Both facets of what I just wrote are positive, but it's worth noting that the Conference Board's index figures are based on data that runs only through the end of May.



Shaded areas represent recessions as determined by the NBER Business Cycle Dating Committee.
Source: The Conference Board

For those who might be trying to remember what the Conference Board includes in its leading-economic-index stew, the ingredients are:

- Average Weekly Manufacturing Hours Worked,

- Average Weekly Initial Claims for Unemployment Insurance,
- Manufacturers' New Orders for Consumer Goods and Materials,
- Institute of Supply Management's Index of New Orders,
- Manufacturers' New Orders for Non-Defense Capital Goods (excludes aircraft),
- Building Permits for New Private Housing Units,
- Stock Prices as measured by the S&P 500,
- Leading Credit Index™,
- Interest-Rate Differential between 10-Year Treasury securities and the Fed Funds rate, and
- Average Consumer Expectations for Business Conditions.

Of course, any forward-looking indicator such as the Conference Board's Leading Economic Index could flash a false alert or it could fail to flash an alert that is warranted, but I would note that this index did inflect downward somewhat prior to our previous two recessions.

I hate to be spewing caveats all the time, but careful thinking compels me to mention that equity valuations don't necessarily rise simply because we're not in the midst of a recession any more than they necessarily fall because we are. Stock valuations *have* mostly behaved this way, but the relationship between recessions and stock valuations can be influenced by many other factors.

NON-OVERLAPPING MAGISTERIA?

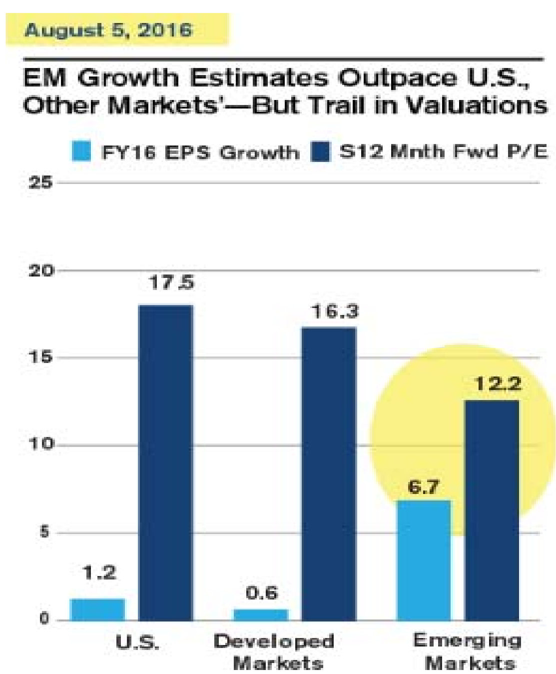
Last quarter, I suggested that economic growth and corporate profitability seem likely to sustain securities prices for the balance of 2017 even though important stimulus measures such as tax reform and an infrastructure package had already stalled. In general, I believe this remains the case today. None of this suggests that a recession is not brewing or that assets prices won't suddenly deflate by some uncomfortable extent for some reason or reasons, but for the time being the political environment and business environment seem as though each may be part of some distinct, non-overlapping magisteria. (After quite a long time, I am relieved to have finally found a legitimate use for what is likely the fanciest phrase I know.)

THE CASE FOR MAINTAINING EXPOSURE TO EMERGING-MARKETS EQUITIES

In June, the Fed raised its short-term interest-rate target by .25% for the third time in 7 months. When yields on 10-year Treasury securities have risen by more than 1.00% over the past 25 years, domestic equities tended rise and emerging-markets equities tended to rise even more.

RISING RATE PERIOD	AVG. CHANGE	10/15/93-11/7/94	1/18/96-6/12/96	10/5/98-1/20/00	11/7/01-4/1/02	6/13/03-6/14/04	6/1/05-6/28/06	12/30/08-6/10/09	10/7/10-2/8/11	7/26/12-12/27/13	7/8/16-12/16/16
Yield Increase (bps)	173	286	150	263	122	176	134	187	134	157	123
MSCI Emerging Markets Index (%)	30.18	40.96	9.98	96.34	28.08	28.77	33.21	43.43	2.27	14.25	4.45
S&P 500 Index	15.97	2.22	11.42	46.59	3.07	14.66	6.71	9.41	14.89	42.09	8.65
Barclays Govt/ Credit Index	-3.39	-5.15	-4.08	-3.38	-3.09	-3.64	-1.49	-2.08	-3.94	-2.14	-4.88
10-Year U.S. Treasury	-9.65	-12.55	-7.82	-11.17	-6.77	-9.48	-5.00	-13.59	-9.93	-10.63	-9.59

Last summer, earnings per share (EPS) growth in the U.S. was almost non-existent, but U.S. equities were trading at fairly expensive price-earnings (P/E) valuations. Earnings within the U.S. are now growing much faster, but the relationship of earnings growth to the price of emerging markets equities has improved even more markedly. Emerging markets now account for almost 70% of global growth versus 20% in the 1970s, so expect them to become increasingly important.



Happy 4th - Glenn Wessel