GALLIARD Capital Management, Inc.
ARCHITECTS OF INVESTMENT SOLUTIONS

ECONOMIC UPDATE

THIRD QUARTER 2018

Quarterly Key Points

- U.S. GDP growth came in at 4.2% in the second quarter, driven by a strong rebound in personal consumption growth of 3.8% (vs. 0.5% in 1Q18).
- The Consumer Price Index (headline CPI) has been in the 2.7% to 2.9% year-on-year range since May – the highest since early 2013. Meanwhile, core CPI (ex-food and energy) has been in the 2.2% to 2.4% range over the same time period.
- The Fed raised its policy rate during the quarter by a single 25 bps hike at its September meeting, and continued to signal another hike in 4Q18.

Our View

- Despite weaker export (trade) and capex data, continued strong consumer spending, inventory adjustments, and business activity expansion suggest that GDP growth could exceed 3.5% in the third quarter.
- The preliminary USMCA agreement between the U.S., Canada, and Mexico has relieved some trade tension; nevertheless, we continue to see escalating trade tensions with China as a risk to global economic expansion.
- Despite continued strong fundamentals, we continue to advocate for investors to be cautious in the face of a global economic cycle in the late stages of expansion.

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U.S. ECONOMY GREW AT 4.2% PACE IN Q2, CONTINUED HIGH EXPECTATIONS FOR Q3 GROWTH

After muted first quarter growth of 2.2%, the U.S. economy grew at an accelerated pace of 4.2% in 2Q18. Growth during the quarter was marked by a strong rebound in personal consumption growth from a 0.5% q/q annualized rate in 1Q to a 3.8% q/q annualized rate in 2Q. Additionally, inventories have rebounded with both retail and wholesale inventories increasing 0.6% to 0.8% m/m in both July and August. This is in stark contrast to the -0.1% to 0.4% m/m inventory numbers in the second quarter.

Business activity is also expanding, as indicated by the Institute for Supply Management (ISM) surveys of both manufacturing and services business activity. The ISM Economy Weighted Index increased from 56.0 in July to 61.4 in September, marking a multi-decade high point. Putting it all together, the economy appears to remain on solid ground. Broad-based strength across a range of indicators has market pundits calling for Q3 GDP growth of 3.0% to 3.5%, with some calling for GDP growth north of 3.5%. Indeed, the Atlanta Fed's GDPNow estimate for Q3 growth stood at 4.1% as of 10/1/18.

FIGURE 1 ISM MANUFACTURING, NON-MANUFACTURING, AND WEIGHTED INDICES[1]

CONTINUED STRONG LABOR MARKET AND NEAR TARGET INFLATION ALLOW FED TO SEEK A 4TH HIKE IN 2018

Job creation remained robust, adding 165k, 270k, and 134k jobs in July, August, and September respectively. The effects of Hurricane Florence may have caused some distortions in the September number. The unemployment rate through September came in at 3.7%, the lowest level in nearly 50 years (since 1969). Average hourly earnings rose 2.8% y/y in September, a slight decrease from the 2.9% y/y post-crisis high in August, largely due to base effects. As wage growth continues to accelerate, perhaps the labor market is finally running out of slack.

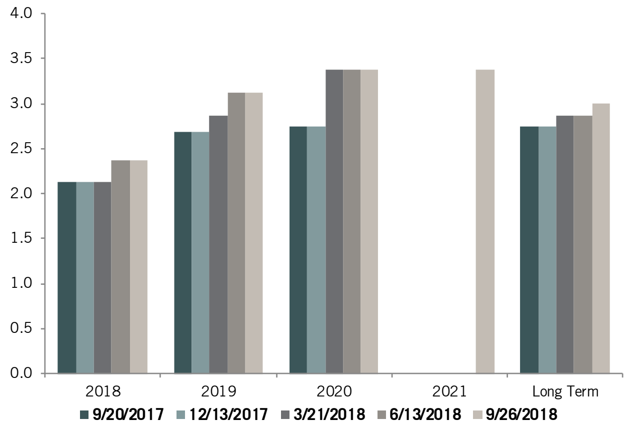
Headline inflation readings have continued to measure in the 2.7% to 2.9% range since earlier this spring. More importantly, core inflation measures, which strip out the volatile food and energy components, have remained between 2.2% and 2.4% during the same timeframe. Notably, the Fed's preferred inflation gauge, the Personal Consumption Expenditures Core Price Index (Core PCE), has struggled to reach/remain at the Fed's target level of 2.0%.

The Fed unanimously raised its policy rate during the quarter via a single 25 bps hike at its September meeting, as widely expected. Policymakers continue to react to the strong incoming data, signaling their intent to stay the course with an additional rate increase in the fourth

1 Endnotes are located on reverse page

quarter. Indeed, 8 of 9 voter dot plots indicate another rate increase before year-end. As a result, the market is now pricing a ~70% probability of a fourth rate hike at the December policy meeting. Looking beyond, the market is pricing in two hikes in 2019 while the median of FOMC members' official projections still calls for a high-water mark for the Fed Funds rate of 3.4% by the end of 2020.

FIGURE 2 FOMC MEDIAN FED FUNDS RATE PROJECTIONS (%)[1]



TRADE TENSIONS CONTINUE AS MID-TERM ELECTIONS APPROACH

As the Trump administration escalated the trade war with China throughout the quarter, developed and emerging market economies continued to lag the U.S. as evidenced by year-to-date equity and currency returns. In September, the U.S. initiated a 10% tariff on $200 billion of Chinese goods that will increase to a 25% tariff by year-end. Furthermore, the U.S. has indicated it will implement tariffs on another $267 billion of goods in the event China retaliates further. On a positive note, the U.S., Canada, and Mexico have announced a new trade agreement called the United States-Mexico-Canada Agreement, or USMCA. What many have called a re-branded NAFTA, the USMCA primarily impacts issues in the automobile, labor, intellectual property, and agriculture markets. Importantly, the agreement still needs to be ratified by all three governments. Meanwhile, mid-term elections in the U.S. will take center stage over the coming weeks.

LOOKING AHEAD

As previously noted, incoming data for the U.S. economy suggests that consumer spending and business activity remain strong. This combination likely produced GDP growth in the 3.0% to 3.5% range in 3Q. With the Fed in gradual – but persistent – tightening mode, monetary policy should eventually start to take the steam out of the expansion. Still, given the positive momentum, U.S. economic growth should remain strong for the near-term.

[1]Source: Bloomberg