ADVISOR PERSPECTIVES

Facts and Fear

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The economic headlines have been somewhat disappointing over the past few weeks. First, the Federal Reserve failed to raise interest rates in September, partly out of fear that global conditions were eroding. Congress seems headed for another senseless impasse over the debt ceiling. Emerging markets are feeling added pressure. And some think the U.S. job engine has shifted into a lower gear.

Underneath all this, we find a number of positives in the American economic landscape that should help to keep the expansion on track. International influences haven't been helpful, but there are some good domestic story lines that deserve more attention.

Key Economic Indicators

	2015				2016				Q4 to Q4 change			Annual change		
	15:1a	15.2a	15:3f	15:4f	16:1f	16:2f	16:3f	16:4f	2014a	2015f	2016f	2014a	2015f	2016f
Real Gross Domestic Product (% change, SAAR)	0.6	3.9	2.0	2.6	2.8	2.7	2.6	2.6	2.5	2.3	2.7	2.4	2.5	2.7
Consumer Price Index (% change, annualized)	-0.9	3.5	0.3	2.1	1.9	1.9	2.0	2.1	1.2	0.8	2.0	1.6	0.2	1.9
Civilian Unemployment Rate (%, average)	5.6	5.4	5.2	5.1	5.0	5.0	5.0	5.0				6.1*	5.3*	5.0*
Federal Funds rate	0.11	0.12	0.10	0.15	0.40	0.45	0.65	0.70				0.09*	0.12*	0.55*
2-yr. Treasury Note	0.60	0.61	0.65	0.71	0.87	0.96	1.13	1.23				0.46*	0.64*	1.05*
10-yr. Treasury Note	1.97	2.17	2.20	2.30	2.40	2.50	2.60	2.70				2.54*	2.16*	2.55*

a=actual
f=forecast
*=annual average

Key Elements of Forecast:

- Third-quarter consumer spending, buoyed by strong auto sales, should nearly match gains seen in the second quarter (+3.6%). Auto sales rose to 18.1 million units in September, the best performance for the expansion. Combined with positive contributions from sales of non-durables and services, this paints a picture of strong consumer demand on the back of solid employment gains and lower energy prices.
- There are three factors holding back the business sector. First, corporate profits moved up on a sequential basis in the second quarter. But the year-to-year change in corporate profits during the same period is barely positive. Growth in the last five quarters is entirely from domestic industries, while foreign operations are holding back total profit growth. The tepid profit reading does not bode strongly for business spending. Second, the factory sector is suffering from setbacks due to a strong dollar and weak global demand. Third, weak energy-related spending reflects the impact of low energy prices.
- Although sales of existing homes slipped in August, the drop follows three consecutive monthly gains. New home sales posted the strongest monthly increase in the current expansion. A limited supply of homes for sale and increased hiring suggest that a moderate strengthening of home-building activity is within reach, given the low mortgage-rate environment.
- A drop in exports and an increase in imports resulted in a large trade deficit in August. July-August trade data and the projection for September imply that trade will be a net negative for third-quarter gross domestic product (GDP). The upward trend of the trade-weighted dollar, since its low in May, places export growth at risk.
- Risks to global economic growth from China have not changed from the last monthly outlook. Market sentiment over China has settled somewhat, but some emerging markets are experiencing currency pressure and capital flight. That is also playing into an uncertain trade picture.
- A likely reduction in inventories during the third quarter, after a large accumulation in the first and second quarters, will also cause real GDP growth to slow in the third quarter.

- The September employment report was weaker than expected. Private-sector payroll job creation slowed to a 109,000 average in the last two months, following an average increase of 220,000 in the May-July period. The unemployment rate held steady in September, but the employment-population ratio stands at the lowest level for the year. These numbers are disappointing, but it is premature to predict it is the beginning of a serious slowdown in hiring conditions.
- Inflation readings are far below the Fed's 2.0% target, and market expectations of a higher policy rate have been moved to a later date. Inflation expectations have also diminished in recent weeks. Energy prices have moved up slightly, but the dollar's strength is holding down inflationary pressures. Further improvements in the labor market should help to lift inflation in the months ahead.