Economic Summary

Morley
Capital Management

The economy continued to show signs of improvement which motivated the Federal Open Market Committee (FOMC) to raise rates three times in 2017. The latest increase in December of 25 bps in the federal funds rate brought the range to 1.25% - 1.50%. The FOMC expects to increase rates three more times during 2018. The dot plot suggests the rate will increase to 2.25% by the end of 2018, 2.70% by the end of 2019, and 3.10% by the end of 2020.

The Fed appears to believe the new normal for economic growth is below 2% per year; it raised its growth expectations by 0.4% to 2.5% for 2018. The median Fed estimate shows the economy expanding 2.1% in 2019 and 2.0% in 2020 and 1.8% thereafter. This belief is certainly in contrast to the Trump administration, who seems to believe its policies can boost the growth rate beyond 3%. The median Bloomberg estimate has the economy expanding 2.6% in 2018 and 2.2% in 2019. We believe the pro-business policies of the Trump administration will lead to stronger growth of 2.8% in 2018. Several measures bolster our position, among them, the unemployment rate was 4.1% for the third consecutive month, hitting the Fed's target; and the Fed's preferred measure of inflation, the core personal consumption expenditures index (PCE), was up 1.50% YOY in November, still below the Fed's 2% target, though the Fed believes this is transitory. Moderate inflation combined with a strong economy and a rising stock market should give the Fed room to raise rates at least two times during 2018.

The longest U.S. economic expansion lasted ten years from 1991 to 2001. The current economic expansion is in its ninth year; the third longest expansion since 1850. Several key drivers should keep the economy expanding for the foreseeable future. The Trump administration has fostered a pro-business climate, reduced regulation, tax cuts, accommodative global monetary policy with central banks gradually tightening, and growing payrolls and improving wages. U.S. household and nonprofit net worth reached a new high of $96.9 trillion in the third quarter, up from $92.81 trillion during the fourth quarter of 2016. It is not surprising that consumer and business confidence remains extremely high.

Looking ahead to 2018, we believe, as we did throughout 2017, that the major risks to the U.S. economy originate from external shocks. A primary risk factor is China, the world's second largest economy, where a slowdown due to the significant debt build-up would reverberate throughout the world. China is also a factor in a major hotspot in the world, North Korea. The U.S. is looking for China to force North Korea to change its behavior; the Trump administration is expected to apply more pressure on China if it does not exert enough pressure on North Korea. China's reaction could lead to trade wars or even military intervention, resulting in a global slowdown. A primary domestic risk is policy error by central banks; raising rates too rapidly could cause a break in the financial system as leveraged positions are unwound too quickly. Conversely, a risk exists if central banks exit the experimental monetary policy too slowly and inflation rises rapidly.

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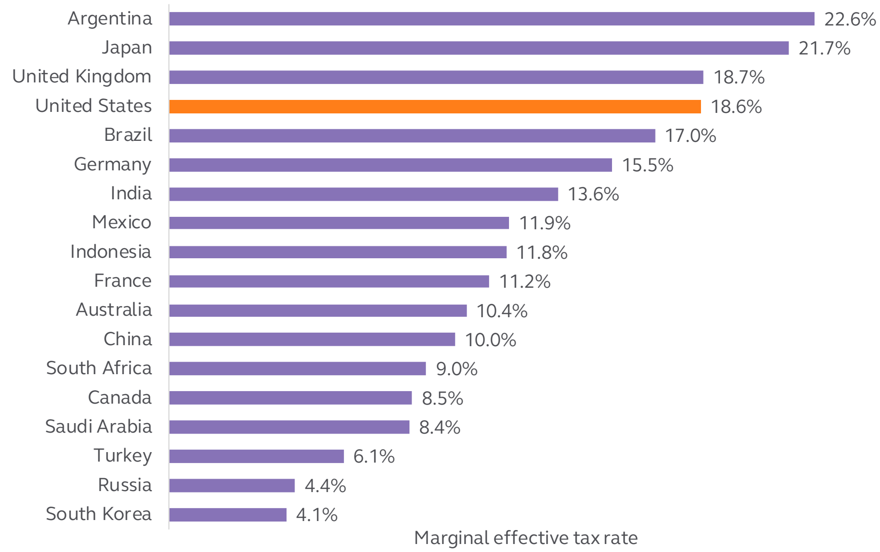
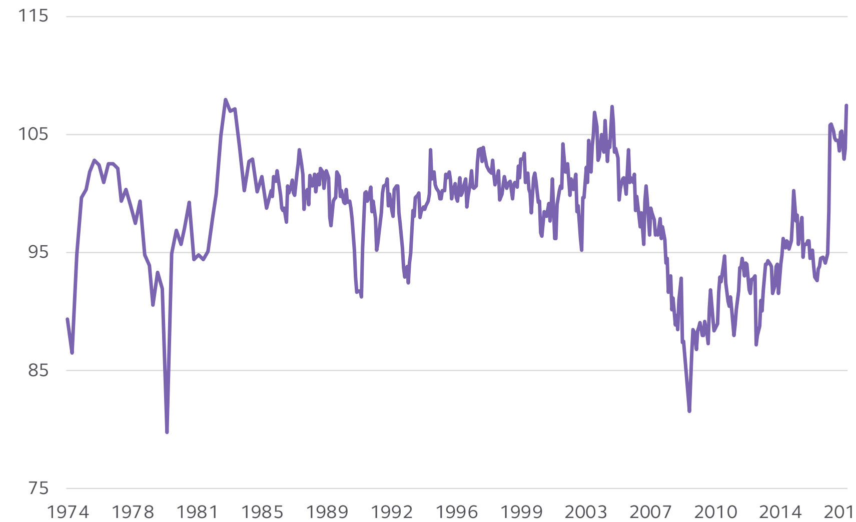
Corporate Tax Rate



Source: Tax Foundation

Small Business Optimism



Source: NFIB Small Business Economic Trends (November 2017). Copyright of the NFIB Research Center.

Highlights

The new tax law creates a single corporate tax rate of 21% and repeals the corporate alternative minimum tax; unlike tax cuts for individuals, these provisions do not expire. The top U.S. tax rate in 2017 was 35%, the highest rate of any large, developed country. According to the Tax Foundation, combining the new rate of 21% with state and local taxes, the new statutory rate will be 26.5%, just below the weighted average of 26.9% for EU countries.

According to the Congressional Budget Office (CBO) the effective tax rate for U.S. companies, defined as the tax paid on investments earning the market rate of return after taxes, was 18.6% in 2012, the fourth highest marginal effective tax rate in the G20.

Outlook

The reduction in the corporate tax rate should reduce incentives for corporate inversions, in which companies shift their tax base to low tax jurisdictions, often through mergers with foreign firms. The reduced rates should lead to greater corporate profits, which should boost the economy.

Highlights

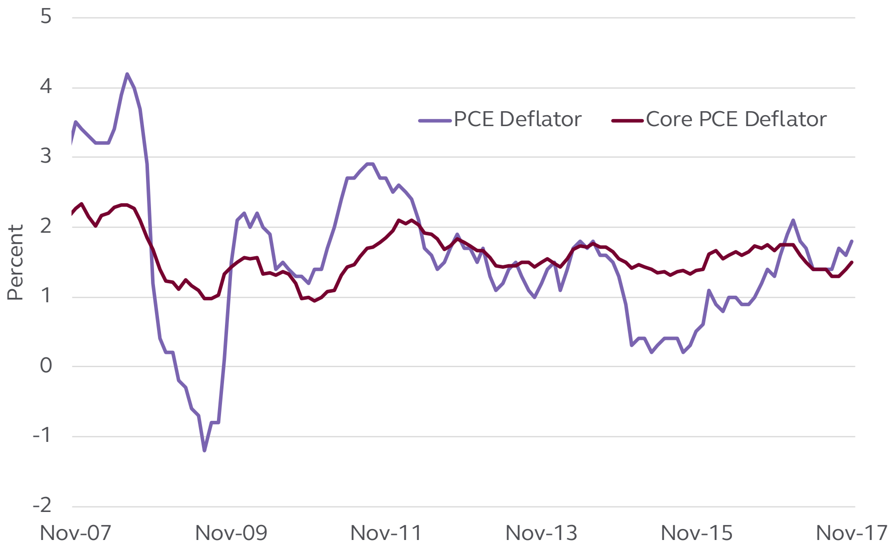
The Index of Small Business Optimism gained 3.7 points to 107.5 in November, the second highest reading in the 44-year history of the survey conducted by the National Federation of Independent Business (NFIB); the highest was 108.0 points in July 1983. Expectations about future business conditions, real sales gains and the environment for business expansion accounted for 80% of the increase in the Index.

The NFIB states that its indicators clearly anticipate further upticks in economic growth, perhaps pushing up toward 4% growth for the 4th quarter. The NFIB believes the change in Washington D.C.'s management team dramatically improved expectations.

Outlook

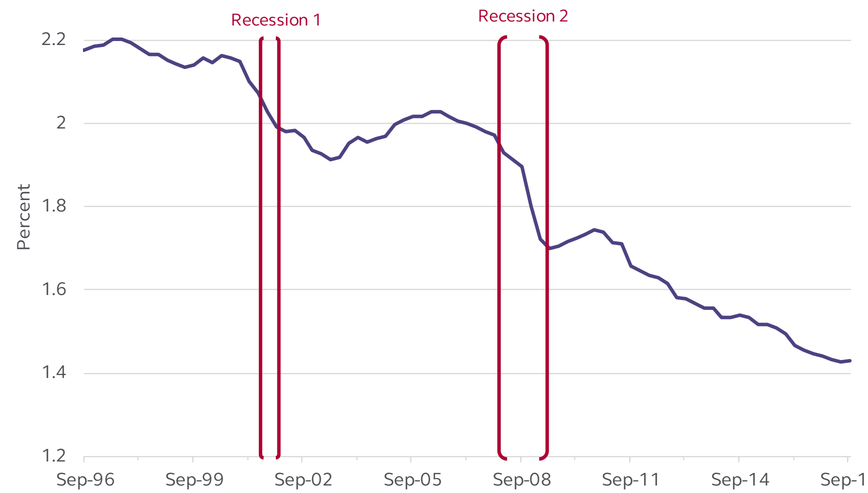
Consumer and business confidence are key drivers of the economy. Confidence shown since the 2016 election by small businesses as they predominantly endorse the Republican agenda should bode well for an improving economy.

Inflation



Source: Bureau of Economic Analysis

M2 Money Velocity



Source: Bloomberg

Highlights

The Fed's most closely watched inflation indicator, the Core PCE Deflator, continues to report price increases well below the 2% policy target, including 1.5% in November. The broader measure, PCE Deflator, which includes energy and food prices, has also moderated.

Expectations for future increases in inflation persist, although they have fallen throughout the year along with current core inflation readings, according to the Philadelphia Federal Reserve Bank.

Outlook

Persistently low core inflation readings are fueling the debate among the FOMC members regarding future interest rate policy decisions. Many members see the weakness in the core numbers to be transitory and expect cyclical pressures to take over lifting inflation toward the 2% target. One committee member expressed concerns that longer-term pressures may continue to hold prices in check. Market participants will likely use inflation as a determinant of how far they believe the FOMC can raise rates.

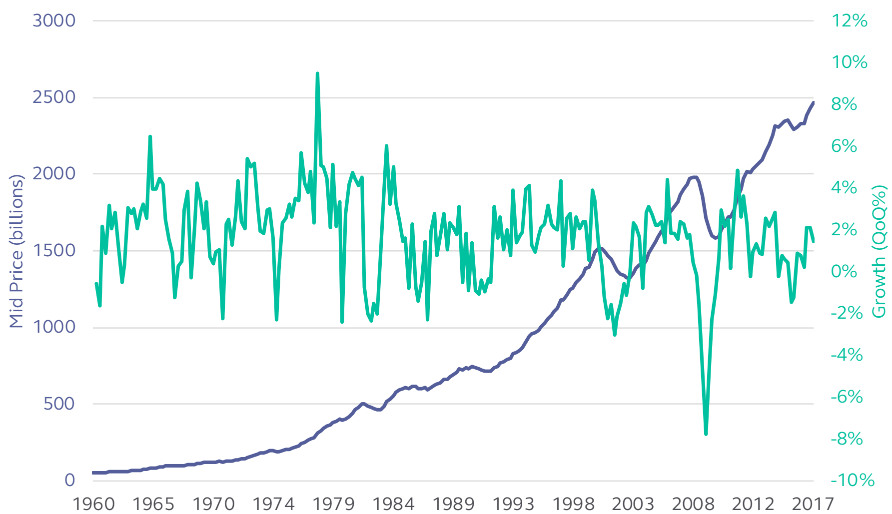
Highlights

Over the past two decades there has been a significant decline in M2 Money Velocity as the result of two major recessions and the economic recovery efforts that followed. In the face of weak GDP and possible deflation during the dot-com bubble and the Great Recession, the Fed injected the economy with money through its accommodative monetary policy and quantitative easing programs to help spur economic growth. The recovery programs, however, instead of trickling through the economy to the consumer in the form of wage growth and increased lending, had a less than desired effect on money velocity as many businesses used the increased money supply to pay down debts and, due to increased financial regulation, parked excess reserves in financial assets.

Outlook

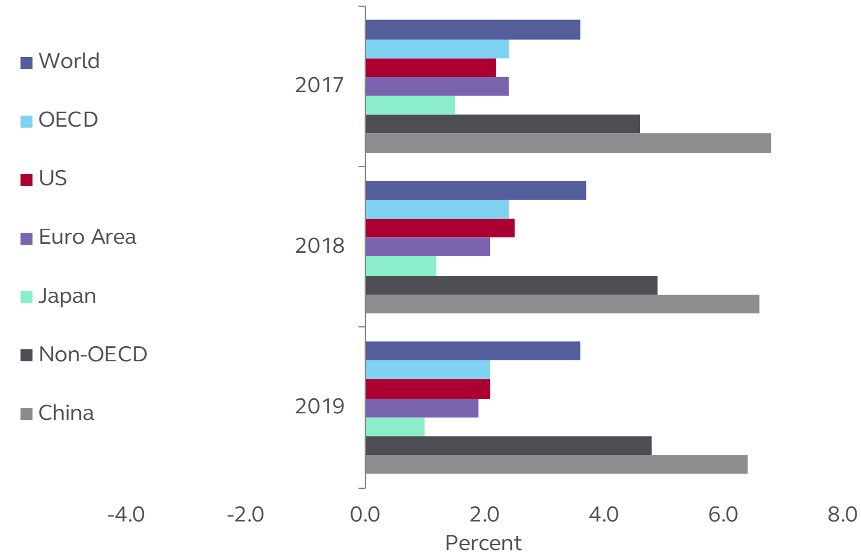
Now that the shock of the recession is abating and the economy is far into its recovery, we expect to see the velocity of money slowly increase as consumer spending and bank lending begin to increase. Already we have seen a very slight increase in velocity in Q3'2017 which is reflective of wage growth beginning to outpace inflation in Q2'2017 and the announcements of the Fed unwinding its balance sheet. Further, we are expecting the increase to continue as the effects of the rollback in certain financial regulations help spur bank lending and the expected net positive effects of the Tax Cuts and Jobs Act increase consumer spending.

Capital Expenditures



Source: Bloomberg

Global Growth



Source: OECD Economic Outlook 2017

Highlights

The Bureau of Economic Analysis (BEA) defines capital expenditures as expenditures made to acquire, add to, or improve property, plant, and equipment (PP&E). PP&E includes land, timber, and minerals, structures, machinery, equipment, special tools, other depreciable property, construction in progress, and tangible and intangible exploration and development costs.

The new tax law allows full expensing of short-lived capital investments for the next five years, 20% per year, rather than current law requiring them to be depreciated over time.

Outlook

Immediate expensing should make capital spending more attractive, providing a boost to the economy.

Highlights

Global growth in 2017 is estimated to have accelerated to 3.6%, surprising on the upside and led by an estimated 6.8% in China, 6.7% in India, and 2.2% in the U.S.

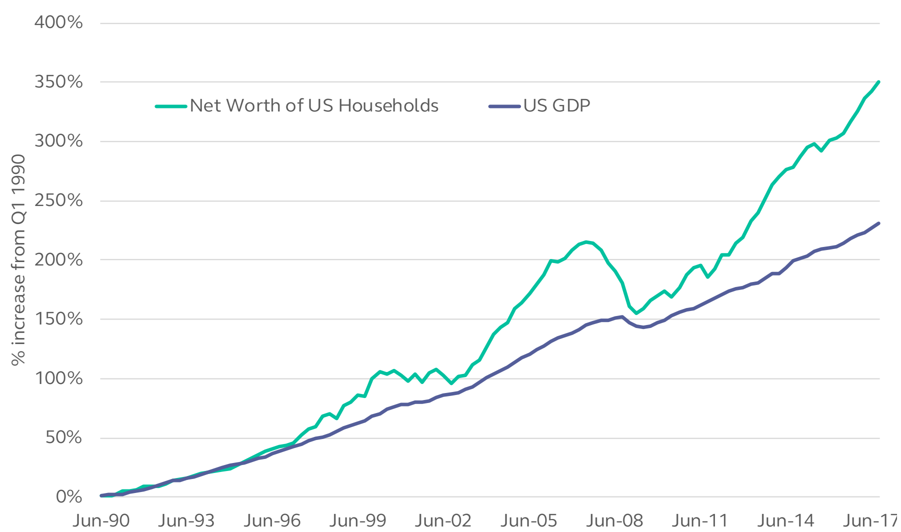
Monetary conditions remain accommodative, inflation pressures are modest, and unemployment is low; all providing solid underpinnings to continued growth. Policy stimulus of major economies are in varying phases: U.S. policy rates have been on the rise since the end of 2015 and the economy is slowly and systematically being weaned from quantitative easing; the European Central Bank is scaling back its monetary easing by reducing bond purchases; Japan has reduced the amount of government debt it buys though continues to target a zero rate for its 10-yr bond; and China's fiscal stimulus of its budget expansion to 3% of GDP from 2.3% last year is intended to prevent a sharp slowing of growth.

Outlook

The International Monetary Fund expects global growth to increase to 3.7% in 2018; India and China are again expected to lead with GDP increases of 7% and 6.6%, respectively. The Organisation for Economic Co-operation and Development projects growth at a more modest 2.4%.

As the economic growth cycle matures, the momentum of the global economy will be tested to determine the extent to which it can withstand less accommodative policies.

Household Net Worth



Source: Federal Reserve

Highlights

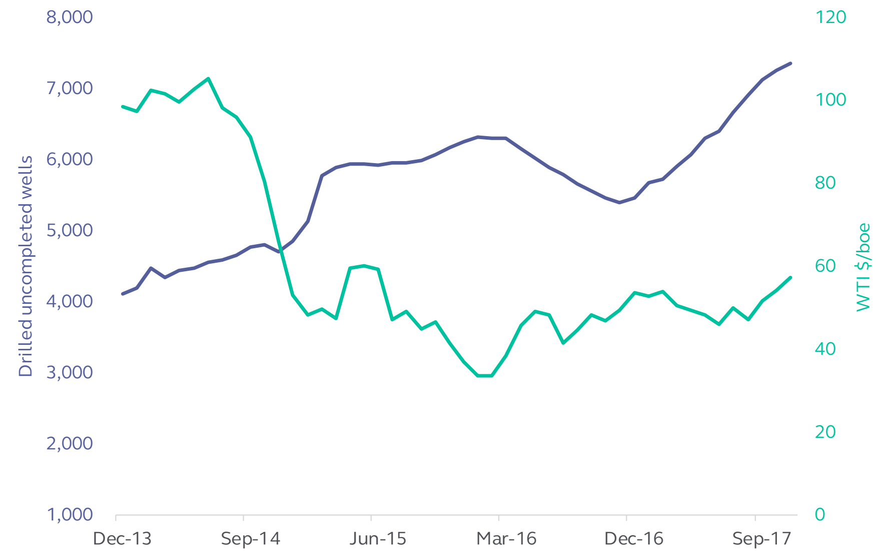
The Fed reported that the net worth of U.S. households and nonprofit organizations increased to $96.9T in the 3rd quarter of 2017 from $92.8T in the 4th quarter. The increase was driven by a $1.4T gain in financial assets and a $444.1B increase in the value of real estate. Looking back, net worth was $87.2T at the end of 2015 and $84.2T at the end of 2014.

Household wealth has been growing at a much faster rate than the economy, primarily due to the rise in equity markets where prices have been driven by rising confidence and low interest rates.

Outlook

As wealth increases households feel more confident and tend to spend more, resulting in greater GDP growth and leading to a virtuous cycle of rising confidence and rising wealth. If rates rise too much or an event derails the equity markets, there is a risk that the cycle may be broken.

Crude Oil



Source: Bloomberg

Highlights

Oil producers manage leaseholds, logistical bottlenecks and specific capital programs by drilling, though not completing oil production wells.

During times of stronger pricing, oil producers are incentivized to maximize production by completing wells and bringing them into service. Alternatively, when oil prices are weak, producers will hold back production by not completing wells.

Outlook

This growing inventory of drilled but uncompleted wells (DUCs) has potential implications for the size and timing of domestic supply in response to a persistent or significant rise in oil prices without requiring significant changes in active oil rigs.

We expect high DUC inventory will provide a cap to WTI oil prices., keeping prices below $65 per barrel of oil equivalent (boe).

A macroeconomic outlook is prepared, offering a base case and two tail scenarios.

	Base Case (75%)	Tail 1 (10%)	Tail 2 (15%)
	Modest growth	**Prolonged weakness (w/high chance of recession)**	**Inflation / Stronger than expected growth**
	GDP growth forecast for 2018 is 2.80%. The world economy has been gaining momentum. The Trump Administration has fostered a pro-business climate. Reduced regulation and tax cuts are positive drivers for the economy. Increased growth will lead to modestly higher interest rates. Major trade wars will be avoided, but there will be volatility around trade deals. Political turmoil around Russia remains, but does not directly affect the President. Core PCE will stay below the Fed target of 2%. China grows in the 6% range. Europe continues to recover. North Korea is handled through diplomacy. Low global rates make U.S. term rates attractive and mute their rise.	The major risk comes from the world's second largest economy, China. A slowdown due to the significant debt that has built up in China reverberates throughout the world. A trade war develops with China over their failure to control North Korea. Other trade wars develop in North America. This leads to a significant global slowdown. The slowdown spills into the U.S. economy. The current recovery is growing old and rising inflation and interest rates lead to a recession. Global conflicts and terrorism that disrupts growth presents another risk. The equity markets decline, reducing household wealth. The Fed raises rates too soon and must reverse course.	President Trump is successful in enacting his pro-growth policies, while not causing disruptions with his trade negotiations. Growth surprises most economists and GDP growth exceeds 3.50%. Stimulus programs are effective and China grows at a believable rate near 7%. The UK and EU come to amicable terms on the UK exit. Growth in the European economies improves to above trend. Japan's growth accelerates as monetary stimulus works. The threat of terrorist attacks is reduced and the Middle East problems improve. The North Korean threat is solved peacefully. The drop in the unemployment rate leads to rapid wage growth. The Fed is slow to react to inflation. The rise in interest rates does not damage the economy.
GDP	2.80% in 2018	Below 0.50%	Greater than 3.50%
Change in Rates	2Yr 2.60%, 10Yr 2.90%	Sharply lower / -150 bps (10Yr UST)	Sharply higher / +100 bps (10Yr UST)
Change in Curve	Curve flattens 2-10s	Bull flattener	Bear steepener
Volatility	Moderate	Higher	Higher

M2 Money Velocity (the nominal GDP/M2 ratio) is the frequency at which transactions are occurring between individuals in an economy and can be used to provide insight into whether consumers and businesses are saving or spending their money. This economic indicator includes the velocity of currency in circulation, savings deposits, CDs, and money market deposits and has been used as a barometer to the expected growth of inflation within an economy.