SUMMER 2017

A Time for Patience

SUMMARY

Beneath the political turmoil in Washington, D.C., the fundamentals of the U.S. economy remain stable as we continue on our path of slow but steady growth since the expansion began eight years ago. While first-quarter numbers were disappointing, this is consistent with the pattern of recent years: a weak first quarter followed by strength in the rest of the year. In fact, we forecast that U.S. growth over the full year will be faster than last year, and faster still in 2018. The economy should be strong enough to withstand the Federal Reserve’s continued tightening of interest rates. This coupled with improving conditions in Europe and China means that 2017 is shaping up to be a promising year for the global economy.

GROWTH IS COMING

Don’t be misled by the weak economic growth reported for the first quarter of 2017, which was just 0.7% on an annualized basis. In recent years, the first quarter’s data has been consistently lower than the rest of the year’s. Since 2010, first-quarter growth has averaged just 1.0% annualized, while the remaining three quarters averaged 2.5%.

No one is sure whether this is a quirk in the data or reflects actual seasonality in the economy. J.P. Morgan believes that 2017 will behave similarly. Our current forecast is that growth for the entire year will come in at 2.2%, a healthy improvement from last year’s 1.6%, and improve even further to 2.5% in 2018.

This may disappoint some investors who expected the economy to surge as dramatically as the stock market did after last year’s election. But these were never realistic expectations. The stock market’s enthusiasm was driven by what economists call “soft data”—surveys of consumer and business confidence that show how people in the economy are feeling. Yes, some soft data has a real effect on the economy, because when people feel confident, they spend more money. But it takes time for that effect to show up in the “hard data”—statistics that reflect actual economic activity.

1Bureau of Economic Analysis
The initial burst of optimism was largely due to President Trump’s pro-business agenda. Now some of that excitement is wearing off as he is experiencing the reality of getting his policies enacted by a polarized Congress and fractured Republican party. We are still confident that parts of the Trump agenda will go into effect. Despite an initial announcement by the White House, corporate tax rates might go down from 35% to 25% or 20%, instead of his desired 15%, and it might not happen until late this year or early next year. But he is already pushing through aggressive deregulation, and other policies remain on the table, such as repatriation of foreign earnings, infrastructure spending and personal tax cuts. All of this would be good for business and could add an extra 2%–3% to corporate earnings.

It isn’t all about what happens in Washington. The economic expansion was on a solid footing even before the election. U.S. consumers continue to spend. Wages are rising, as evidenced by the rise in the U.S. Employment Cost Index, while housing continues to gradually recover. This is now the third-longest economic expansion on record, and it shows no sign of nearing an end. While it has also been one of the slowest expansions, slow growth has kept inflation in check and prevented the economy from developing the kinds of excesses that could lead to trouble ahead.
UNWINDING THE FED’S PORTFOLIO

Of course, the trillion-dollar question is how the Fed will respond to these improving conditions. The Fed has long wanted to restore interest rates to normal levels. Economists disagree on what “normal” means, but it’s certainly higher than the near-zero and even negative rates we’ve seen around the world since the financial crisis. Expect the Fed to continue with its gradual tightening strategy for at least another year or two—not because it thinks the economy is growing too fast, but to get interest rates high enough so it can cut them again to fight the next recession, whenever it comes.

The Fed has other tools at its disposal besides just raising rates directly. It has also signaled it will start unwinding the enormous bond portfolio it acquired through quantitative easing, which played a big role in jump-starting the recovery. In all, the Fed grew its balance sheet to more than $4 trillion in government bonds from 2008 to 2014. But you can’t sell $4 trillion of bonds without moving the market. All those new bonds will put upward pressure on interest rates. So the Fed will act gradually, by no longer reinvesting the proceeds when its bonds mature. No one knows exactly when the Fed will begin, or how quickly it will act, but this together with rate hikes will be an additional headwind to the economy.

CHART 2: SOLID ECONOMIC FUNDAMENTALS

U.S. personal consumption has remained strong since the economic recovery began, and wages have been rising steadily for the past two years.
GLOBAL RECOVERY

While the U.S. economy was the global engine of growth in the early years of the expansion, other economies are now pulling their weight, too. The outlook is finally improving for Europe after years of weak conditions. We are projecting 2% growth in the Eurozone this year, with corporate profits of 10% or more— which would be even higher than U.S. earnings, which are projected at 7%–8%. The European Central Bank has announced it will continue its quantitative easing through December, if at slightly lower levels than before. While European markets have lagged behind those of the U.S. markets, this was largely due to political fears that now seem to be receding as France appears to be moving further away from supporting its anti-Europe populists.

The world’s second-biggest economy, China, is also a source of optimism. After bottoming out at 6.7% in early 2016, China’s growth rate rose to 6.8% in the fourth quarter and a surprising 6.9% in the first quarter of 2017. We are seeing positive data across the board—from retail sales to industrial production to capital spending. China allowed interest rates to rise early this year, although it pulled back slightly when the prospects dimmed for immediate U.S. tax reform. Inflation remains just slightly above 1% (vs. a targeted 3% inflation rate). The government felt confident enough about the economy to place new restrictions on the housing market to prevent overheating. And the Chinese government is continuing to stimulate its economy through massive infrastructure programs. It has just announced it will build an entirely new city from scratch, not far from Beijing, which will be more than double the area of New York City. Meanwhile, the United States is still debating whether to fund a few highways and bridges through tax credits or direct spending.

WHAT THIS MEANS FOR YOU

Although U.S. equity markets are near record levels, profits are rising and the bull market still has room to run. You can expect interest rates to rise, and should position your portfolio accordingly. Global growth is picking up, which is a timely reminder of the importance of global diversification. Rather than overreacting to quarterly data, investors should remained focused on their long-term goals and maintain a diversified strategy that includes the world’s major equity and fixed income markets.