Outlook and Market Review – First Quarter 2017

The Bureau of Economic Analysis announced a revised first quarter GDP annual growth rate of 1.2% compared to the initial report of 0.7%. The U.S. economy expanded only 1.6% in 2016, which was below the low 2.1% average annual pace since the Great Recession. Consumer spending, which normally is the strongest component of growth, contributed only 0.44% to growth in the first quarter. Fixed investment, which has been slow, added 1.85% to growth. In contrast to weak GDP growth, the unemployment rate fell to 4.3% in May. Many economists are calling this full employment but it is more likely that the labor market is out of step with the rest of the economy. Industrial capacity utilization is 3.2% below the long run average and earnings growth of 2.5% in May was barely above inflation. The Labor Force Participation rate of 62.7% is near an all-time low. Full employment is also inconsistent with the year over year 1.5% inflation rate in May, measured by the core personal consumption expenditure (PCE) index. Nevertheless, even with low growth rates and industrial slack, the Federal Reserve is likely to increase the Federal Fund rate by another 25 basis points in June as a preemptive move against inflation.

While the Fed is on track to move the Fed Fund rate slowly back to a more normal level, long-term rates are not moving up. The 10-year Treasury yield is only 2.26%. Fixed investment may be strong as firms increase project financing ahead of higher potential interest rates later in the year. Housing prices remain on an upward path but housing construction has lagged. The construction industry came unglued in the housing downturn and builders are now more cautious. In addition, skilled workers are now difficult to find. If consumer spending does not rebound in the second quarter the Fed may need to pause in September when it meets to consider another rate hike.

Corporate profits fell in the first quarter. Productivity of U.S. workers is slowing due to an aging population and increased mismatching of skills needed and skill sets of existing workers. Earnings growth slowed in the first quarter as unit labor costs increased faster than inflation. Global competition, a strong dollar, and slack in domestic consumer demand prevent producers from increasing prices faster than the increase in unit labor costs. Structural changes in regulation, taxes, and skill development would help reverse declining productivity and earnings.

Growth for the remainder of the year should be in the 2% to 2.5% range. Pro-growth initiatives have met staunch resistance with congressional attention drawn to anything other than budgets, tax reform, healthcare, and relevant economic initiatives. Wages should grow at a faster rate as the tight labor market leads to more competition for skilled workers. Inflation, measured by the headline PCE index, is not likely to break through the 2% target until 2018. Oil prices remain low and wage increases are not yet pushing prices higher on finished goods. While short-term rates tick up to 1.25% by the end of the year, long-term rates should remain below 3% due to low inflation and a strong dollar. Initiatives to revive growth remain promising but are a long way from gaining political acceptance. The remainder of 2017 may be a year of transition as the political tug-of-war between growth and entitlements becomes clearer. Business spending may now offer some support for growth as businesses jockey to invest before higher interest rates develop. The financial markets and sentiment measures remain optimistic but may turn if the growth agenda does not get beyond political gridlock.

FED Watch

The Fed has a dual mandate to achieve full employment and stable prices. The traditional view supporting higher interest rates now rests on the belief that a 4.3% unemployment rate represents full employment. With the full employment goal achieved, this view expects inflation to spiral without a preemptive move by the Fed. Current economic conditions suggest that there may be a flaw in this traditional view. A 4.3% unemployment rate linked to a low labor participation rate and excess industrial production capacity may not mean the economy is at full employment. It is also difficult to explain how the low 2.5% wage and earnings growth rate is consistent with a fully employed labor market. The Fed targets a 2% inflation rate based on the core PCE index, which is about 50 basis points higher than the May rate.

The Fed shares the traditional view of current conditions, which harkens back to an old concept known as the Phillips Curve where inflation remains low until the economy nears full employment and then inflation accelerates. While this concept is not stable historically, there is reason to believe it no longer holds. Even a casual examination of the data shows that differences in the core inflation rate from period to period have no strong statistical relationship with the change in the unemployment rate. Traditional relationships that led to the Phillips Curve in the past do not hold up in recent periods.

It is true that interest rates have been artificially low for too long. The concern is that this artificial condition along with a 20 trillion dollar federal government debt may well have changed economic relationships in ways that are difficult to reverse. Nevertheless, the Fed will almost surely raise rates by 25 basis points in June and will slowly move half way to its longer run target of 3% by this time next year, which would mean two more 25 basis point moves.

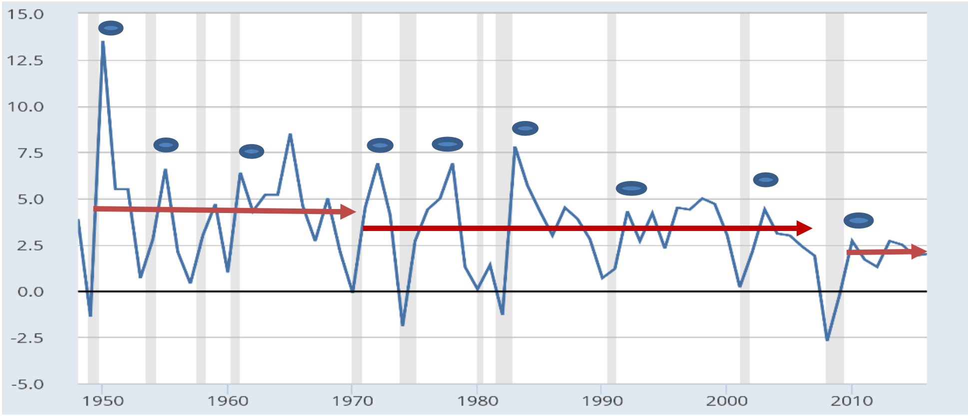
The Case for a "New" Economy

Traditional macroeconomic relationships have gone awry since the Great Recession. While many policy makers do not recognize the fundamental change in structural relationships since 2009, it is clear that the economy is not responding to traditional monetary and fiscal policies in predicted ways. Economist Larry Summers addressed this phenomena in an article published in *Foreign Affairs* last year (2/15/2016) with the title "The Age of Secular Stagnation." Summers has his detractors with respect to why the decline is in place, but there is ample evidence that a new economy is at work and structural changes must occur to renew growth. In this *Outlook*, we present the case of a "New" economy.

Data since the Great Recession

A review of current macroeconomic relationships supports the case of a "New" economy. The "recovery" from the 2009 recession is the weakest in modern history. Normally, after a downturn, the economy is at a low point and increases in activity translate to high growth rates. Post-recession recoveries tend to be about 5% or above. Since the 2009 downturn, the U.S. economy has not had any one year of growth as high as 3%. Figure 1 illustrates GDP growth since 1950. Two observations are key to the secular decline thesis. The blue oval shapes illustrate the post-recession GDP growth points on the graph. The expansion from the 2009 recession is well below any other recovery. The next observation is the successively lower average growth rate, noted by the red arrows. Economic growth has become more difficult to achieve even in an "expansion."

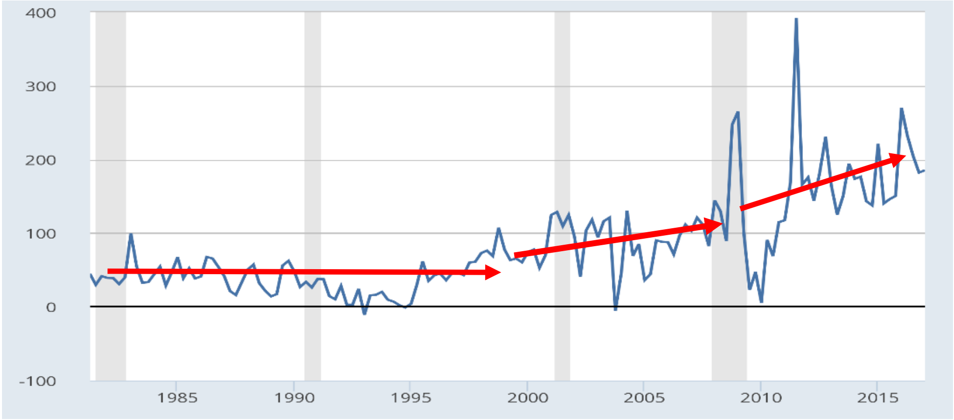
Figure 1. Real GDP Growth (Annual Percentage Rate 1950 to Present)



Source: Federal Reserve Bank of St. Louis (FRED)

The relatively poor performance of the economy since the Great Recession has not been for lack of monetary or fiscal policy stimulation. Monetary expansion has been unprecedented as measured by the expansion of the money supply. Figure 2 shows the time line of expansion of the money supply measured by M2. After the crash in 2009, the Fed rapidly expanded M2.

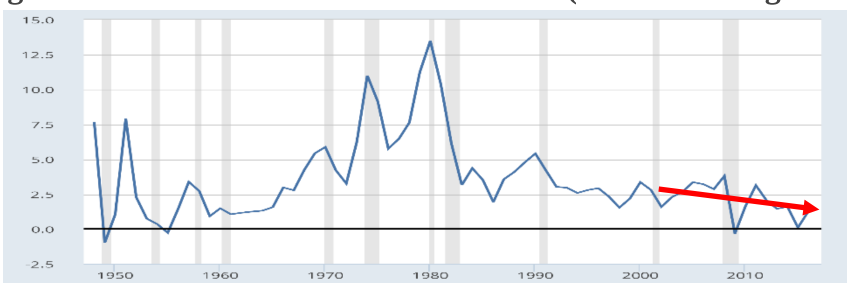
Figure 2. M2 Money Supply (Billions of Dollars) Seasonally Adjusted Quarterly



Source: Federal Reserve Bank of St. Louis (FRED)

Expansion of the money supply should stimulate economic activity directly by allowing more liquidity and "money illusion" where consumers perceive more money as more wealth and spending goes up. Only when the expanded money supply translates to higher prices does the expansion wears off. Another transmission mechanism works through lower interest rates due to higher bank liquidity, which promotes more borrowing and spending. Yet, the inflation rate fell throughout the monetary expansion period, as Figure 3 illustrates. Investment in real assets, the engine from which all real wealth ultimately originates, does not respond to lower interest rates when expectations for future cash flows are more uncertain. Higher tax rates, political uncertainty, environmental constraints on assets, increased regulation and other structural issues inhibit investment in real assets in the U.S. (and more U.S. investment in real assets abroad) even with lower interest rates. Structural changes in the economy resulted in less responsive investment to domestic lower rates.

Figure 3. Consumer Price Index All Items (Percent Change from Year Ago)



(Seasonally adjusted, quarterly average

The transmission of monetary policy to spending requires banks to use reserves created by purchases of Treasury securities. Figure 4 illustrates the dramatic increase in excess reserves. Rather than stimulate spending and investing, much of the expansion sat idle as reserves.

Figure 4. Excess Reserves at Financial Institutions (Millions of Dollars)

Source: Federal Reserve Bank of St. Louis (FRED)

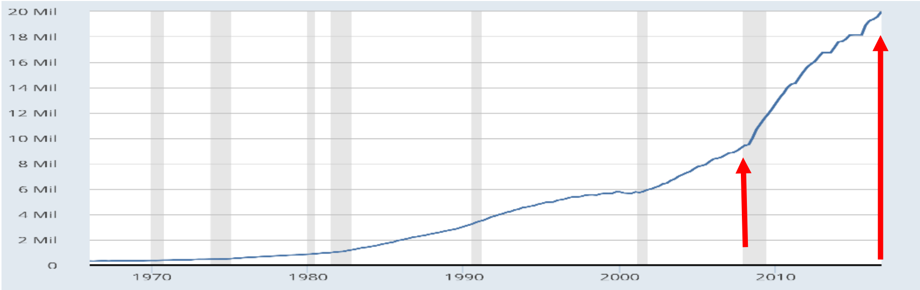
The money multiplier measures the ultimate change in the money supply that occurs due to an increase in bank reserves. Multiple deposit expansion, as banks lend out reserves that become reserves in other banks once the loans are spent, leads to a multiplier effect. The money supply expands as a multiple of the original increase in reserves. Figure 5 illustrates the dramatic drop in the money multiplier over the past two decades, especially since 2009. After 2009, the multiplier fell to less than one, again reflecting the phenomenon where financial institutions held on to reserves rather than make loans and expand the money supply. Why would banks hold on to reserves rather than try to earn a return by making loans? The logical answer is that the risk-return tradeoff was not favorable to make loans. Interest rates were historically low offering low return for risks. Bank regulations became stricter after the recession, adding to bank caution.

Figure 5. M1 Money Multiplier (Quarterly)

Source: Federal Reserve Bank of St. Louis (FRED)

When an economy is stuck in a less than full employment, fiscal policy calls for deficit spending to increase aggregate demand directly. This Keynesian approach is not the same as a lack of fiscal discipline. A Keynesian deficit is a temporary purposeful move to allow the economy to adjust back to an equilibrium and is not chronic. Since the Great Recession, deficit spending exploded with much of it adding to almost irreversible entitlement programs rather than real assets, which create wealth. This stimulation should have moved the economy forward with high rates of growth, higher inflation, and higher interest rates as the government competed for loanable funds. Figure 6 illustrates the dramatic growth in federal debt since 2008. The debt, representing accumulated deficits, grew by a staggering $10 trillion.

Figure 6. Total Public Federal Debt (Q4 2016: 19.976 trillion +)



Source: Federal Reserve Bank of St. Louis (FRED)

At full employment, Keynesian policy would call for budget cuts and surpluses. However, cutting back on entitlements to balance the budget, let alone move to a surplus, is a pipe dream in Washington D.C. The "new" economy now must find ways to stimulate growth with an overhang of 20 trillion in debt and no plan to adjust back to a normal relationship. There will be monetary contraction, not stimulation, and fiscal policy does not have much room to stimulate the economy given the accumulated debt. Only structural changes leading to higher productivity, a higher skilled workforce, incentives for productive investment, cost effective healthcare (which is about 20% of the economy), stimulation of exports, and tax reform are available to improve growth prospects. Without structural change, the secular stagnation thesis has merit.

The real rate approximates the economy's marginal productivity of capital, a concept representing the additional output from using one more unit of capital, everything else equal. Figure 7 shows the time series for the 10-year Treasury Inflation-indexed Security return. This real return measure is one proxy for the marginal productivity of capital. A decline in the marginal productivity of capital in and after a recession is expected, but the declining trend in the U.S. does not appear to be reversing. Real rates less than 1% reflects the structural problems with productivity, capital formation, and mounting federal debt with no real asset in place from the spending.

Figure 7. 10-Year Treasury Inflation-Indexed Security Constant Maturity (monthly average)

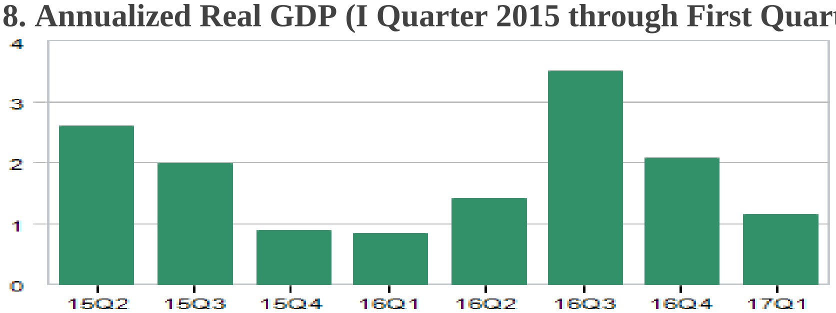
Source: Federal Reserve Bank of St. Louis (FRED)

Summary of Recent Economic Data

***Gross Domestic Product** – The pattern of weak growth in the first quarter of the year continues. After the first revision, the BEA announced that GDP growth in the first quarter of 2017 was 1.2%, compared to the initial report of 0.7%. Fourth quarter 2016 growth was 2.1% after revision. Weak first quarter growth largely stems from slower consumer spending, which has been the key driver in prior quarters. Inventories and government spending actually declined. Fixed investment was the primary growth component in the first quarter with a small improvement due to net exports.*

- Figure 8. Illustrates the GDP growth rate over the last eight quarters. Trend growth prior to the 2008 recession was about 3.2%, which the economy has not approached in any four successive quarters since the 2008 recession.

Figure 8. Annualized Real GDP (I Quarter 2015 through First Quarter 2017)



Source: Bureau of Economic Analysis

- Table 1 provides the quarterly breakdown of GDP since the second quarter of 2015. The first quarter 2017 reduction in consumer spending and the strong fixed investment spending are clearly out of the ordinary. The decline in inventory investment in the first quarter should help increase inventory investment and GDP in the second quarter.

Table 1. Contributions of GDP Components to GDP Growth (Annualized % Change)

	Q1 2017	QIV 2016	QIII 2016	QII 2016	QI 2016	QIV 2015	QIII 2015	QII 2015
Consumption	.44	2.40	2.03	2.88	1.11	1.53	1.84	1.94
Fixed Investment	1.85	.46	.02	-.18	-.15	-.03	.92	.70
Residential	.50	.35	-.16	-.31	.29	.40	.43	.49
Nonresidential	1.34	.11	.18	.12	-.44	-.43	.49	.21
Inventories	-1.07	1.01	.49	-1.16	-.41	-.36	-.57	.52
Net Exports	.13	-1.82	.85	.18	.01	-.45	-.52	.08
Government	-.20	.03	.14	-.30	.28	.18	.34	.57

Source: Bureau of Economic Analysis

- Downward revisions to fourth quarter wages and salary income provide a potential explanation for the weak first quarter consumer spending.

- Corporate profits slumped in the first quarter following moderate fourth quarter growth (see Table 2 below).

Table 2. Corporate Profits (Percentage Change)

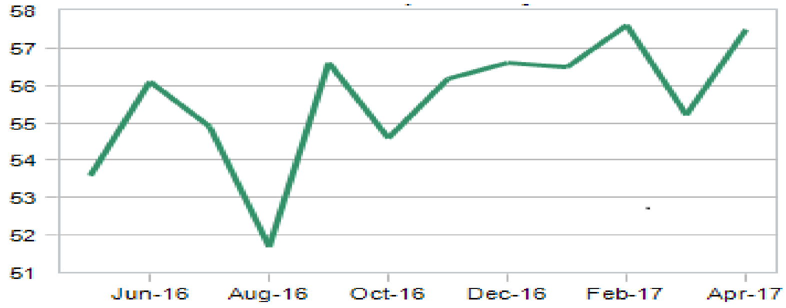
	Q I 2017	Q IV 2016	Q III 2016	Q II 2016	Q I 2016	Q IV 2015	Q III 2015	Q II 2015
Profits before Tax	-0.24	1.65	2.85	4.94	3.98	-6.65	-3.05	0.23
Profits after Tax	-0.31	3.68	2.61	5.56	8.93	-11.63	-3.21	1.69

Bureau of Economic Analysis (First Revision)

Production, Manufacturing and Sales – *The ISM nonmanufacturing index, a key indicator of future economic activity, rebounded in April from weak performance in the first quarter. Nonfarm productivity fell in the first quarter, continuing a pattern of low U.S. productivity. Productivity is volatile but trend growth has been only 1.5% over the current expansion. Higher productivity growth supports a stronger expansion but improved productivity will require time. Low productivity stems from labor mismatching, weak business formation, regulation, low labor costs, and an aging population. Tight labor markets should help provide an incentive for businesses to invest in productivity enhancements.*

- The ISM nonmanufacturing index improved to 57.5 in April, implying underlying momentum in the economy for the second quarter. The ISM index improved from 55.2 in March to 57.5 in April, making up for most of the decline in March. The business activity index rose from 58.9 to 62.4. New orders increased from 58.9 to 63.2. Figure 9 below illustrates the ISM Nonmanufacturing Index over the past year.

Figure 9. ISM Nonmanufacturing Index (Index > 50 Indicates an Expansion)



Source: Institute in Supply Management

- The GDP-weighted average of the ISM nonmanufacturing and manufacturing surveys increased from 55.4 in March to 57.2 in April, which is among the highest since 2015.

- As the table below shows, nonfarm business productivity fell by 0.6% in the first quarter. Since productivity is volatile, the weakness in the first quarter is likely overstated. A number of temporary factors weighed on GDP growth and productivity. On a year-ago basis productivity growth was up 1.1%, matching the gain in the final three months of 2016. Unit labor costs increased by 3% at an annual rate in the first quarter. The gain leaves unit labor costs up 2.8% on a year-ago basis.

Table 3. Productivity, Compensation, and Unit Labor Costs (III Q through I Q 2017)

	I Q 2017	IVQ 2016	IIIQ 2016	IIQ 2016	IQ 2016	IVQ 2015	IIIQ 2015
Nonfarm Business							
Output per Hour	0.6	1.8	3.3	-0.1	-0.7	-2.0	1.8
Compensation per Hour	2.4	3.0	3.7	6.1	-0.9	3.1	2.9
Unit labor Costs	3.0	1.7	0.2	6.2	-0.3	5.7	0.8
Manufacturing							
Output per Hour	0.4	2.0	-.05	-0.8	1.3	-1.6	2.3
Compensation per Hour	2.5	4.2	4.1	7.6	-5.3	7.9	3.8
Unit Labor Cost	2.1	2.2	4.7	8.4	-6.5	9.6	1.5

Source: Bureau of Labor Statistics

- Overall, productivity increased at an average annual rate of 0.6% from 2011 to 2016, well below the long-term rate of 2.1% from 1947 to 2016.

- Total nonfarm unit labor costs increased 3% at an annualized rate. On a year-ago basis unit labor costs rose 2.8%. Manufacturing unit labor costs rose 2.1% at an annualized rate in the first quarter, up 4.3% on a year-ago basis. Higher unit labor costs are squeezing profit margins since producers are not able to pass along cost increases through higher prices due to foreign competition, strong dollar and slower consumer demand.

- The 1% increase in industrial production in April was the third consecutive monthly increase and largest gain since February 2014. At 105.1% of its 2012 average, total industrial production in April was 2.2% above its year-earlier level.

- Capacity utilization for the industrial sector increased 0.6% in April to 76.7%, which is 3.2% below its long-run (1972–2016) average. The 4.3% unemployment rate suggests that the labor market is at full employment, but low capacity utilization suggests that slack exists.

- Advance estimates of retail and food services sales for April 2017 increased 4.53% from one year ago. Total sales for the February 2017 through April 2017 period were up 4.7% from the same period a year ago, suggesting a stronger second quarter. Table 4 provides monthly changes in retails sales on a year-ago basis. The long run average monthly change is 4.29%.

Table 4. Change in U.S. Retail Sales on a Year-ago Basis

	Apr. 2017	**Mar. 2017**	**Feb. 2017**	**Jan. 2017**	**Dec. 2017**	**Nov. 2017**	**Oct. 2017**
Year-ago % Change	4.53%	4.94%	4.85%	5.54%	4.23%	3.4%	3.84%

Source: Census Bureau

Unemployment and Labor – *The headline unemployment rate fell to 4.3% in May with many analysts interpreting this to be full employment. The unemployment rate that includes marginally attached and part time workers fell to 8.4%. Normally, as the unemployment rate falls wages rise and the participation rate increases to allow healthy payroll increases. However, payrolls increased by only 138,000 jobs in May and the labor participation rate fell to 62.7%. The lack of robust wage increases is abnormal, suggesting that the economy may not have reached full employment. This observation combined with the low capacity utilization rates and very slow growth suggests that the economy has room to improve.*

- Payroll gains slowed sharply in May to 138,000 jobs. March and April also had a downward revision by 66,000 jobs. While job growth is slowing, monthly increases of about 100,000 per month would keep up with growth in the labor force.

- The unemployment rate fell to 4.3%, but the Labor Force Participation rate also fell to 62.7%.

- Average earnings rose by 2.5% on a year-over-year basis in May, in line with recent monthly increases. Wages are barely keeping up with inflation, which is not the norm at full employment.

- The average workweek of 34.4 hours has had little change in the last few quarters. Table 5 summarizes the key labor market conditions.

Table 5. Summary of U.S Labor Market Conditions

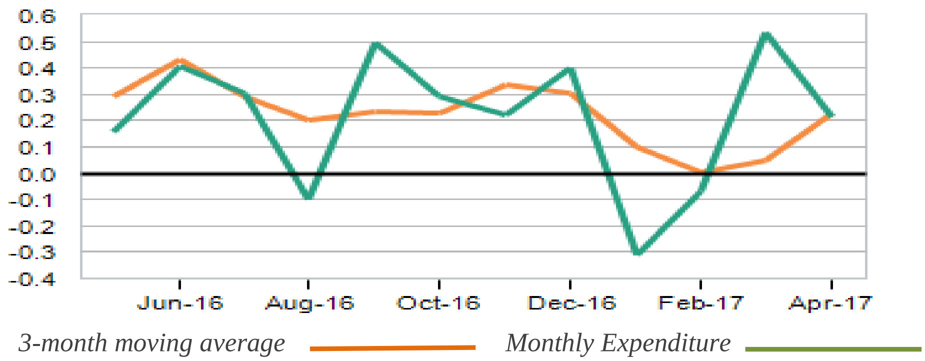
	May 2017	Apr. 2017	Mar. 2017	Feb. 2017	Jan. 2017	Dec. 2016	Nov. 2016	Oct. 2016
Nonfarm Payrolls (change in thousands)#	138	174	50	232	216	155	164	124
3-mo. Moving Average Payrolls (change in thousands)#	121	152	166	201	178	148	179	183
Average Hourly Earnings (monthly % change)#	0.2	0.2	0.1	0.3	0.2	0.3	0.0	0.3
Average Workweek (hours)*	34.4	34.4	34.3	34.3	34.4	34.4	34.3	34.4
Unemployment Rate (%)*	4.3	4.4	4.5	4.7	4.8	4.7	4.6	4.8
Labor Force Participation Rate (%)*	62.7	62.9	63.0	63.0	62.9	62.7	62.6	62.8

Source: Bureau of Labor Statistics
#Data from the Establishment Survey
** Data from Household Survey*

Income, Consumption, and Savings **–** Consumer spending paused in January and February but rebounded in March and April. Real disposable income increased 1.7% in the first quarter after falling 0.3% in the fourth quarter. The savings rate increased to 5.2% in the first quarter after reaching a cyclical low in December. It will take time for consumers to repair household budgets and slow tax returns will push a spending recovery into later months. In general, consumer budgets are not as strong as analysts expected coming into 2017. A rebound in consumer spending must occur in the second quarter if growth is to reach 2.5% or more. Tax cuts and infrastructure investments that would spur higher consumer spending are not likely to make it through the legislative process in time to affect 2017 income, saving and spending.

- Real spending rose only 0.2% in April following an upward revision of 0.5% in March. Figure 10 illustrates the monthly spending pattern over the last year.

Figure 10. Personal Consumption Expenditure (Real % Change)



- Revisions to fourth quarter savings and income data suggest that consumers have a smaller financial cushion than expected. The revised saving rate was 0.6% lower in the fourth quarter and the revised real gross domestic income growth was 2.4% from 1.4%.

- Real spending rose modestly in April. Spending was up 0.2% on the heels of March's upwardly revised 0.5% growth from 0.3%.

- Income growth matched spending growth in April, keeping the saving rate at 5.3% for the third straight month. The saving rate hit its lowest level since 2008 in December.

- The labor market will continue to tighten as payroll increases exceed the 100,000 monthly job gain needed to absorb the increase in the working-age population. With tight labor markets, wage growth normally attracts more workers to the labor force creating higher income and higher spending. Yet, wage growth has been below 1% and many of the available workers left to enter the work force do not have the desired skills for employment.

- Strong equity values and rising housing values offer "unrealized" wealth to households that normally leads to higher spending. These components of wealth are also fragile and require confidence in the future to prompt spending.

Inflation *– Inflation continues to hover around the Fed's 2% target. On an annual basis, the GDP deflator in the first quarter was 2.22% while the CPI increased 2.2%. The Federal Reserve's preferred measure of inflation, the PCE index, increased 1.7% in the first quarter on a year-ago basis. While inflation normally tends to pick up as the economy reaches full employment, wages and prices have been slow to adjust to a strong labor market. Inflation expectations remain only slightly above the 2% Fed target, suggesting that global competition and weak consumer demand will keep a lid on inflation.*

- The quarterly GDP Implicit Price Deflator data over the past eight quarters appear in Table 6. The deflator is volatile from quarter, but it remains low over many quarters.

Table 6. GDP Implicit Price Deflator Annual Percentage Change

	Q I 2017	Q IV 2016	Q III 2016	Q II 2016	Q I 2016	Q IV 2015	Q III 2015	Q II 2015
Implicit Price Deflator	2.22	2.10	1.41	2.29	0.46	0.91	1.22	2.25

Source: Bureau of Economic Analysis

- Table 7 summarizes monthly changes in the (PCE) and (CPI). Prices dipped in March but overall inflation has been relatively stable. The CPI increased a tad above 2% but the Fed's preferred measure, the PCE, has been lower than that.

Table 7. PCE and CPI Inflation Measures (Monthly and Year-ago % Change)

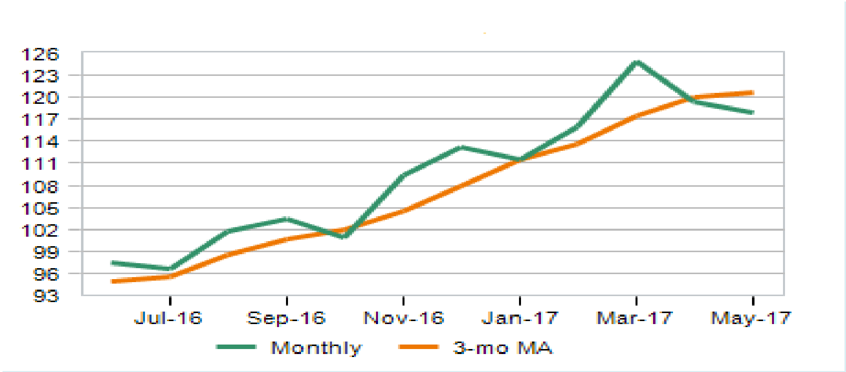
	April 2017	March 2017	Feb. 2017	Jan. 2017	Dec. 2016	Nov. 2016	Oct. 2016.
Monthly % Change							
Core PCE	0.2	-0.1	0.2	0.3	0.1	0.0	0.1
PCE	0.2	-0.2	0.1	0.5	0.2	0.1	0.2
Core CPI	0.1	-0.1	0.2	0.3	0.2	0.1	0.1
CPI	0.2	-0.3	0.1	0.6	0.3	0.2	0.3
% Change one-Year-Ago							
Core PCE	1.5	1.6	1.8	1.8	1.7	1.7	1.8
PCE	1.7	1.9	2.1	1.9	1.6	1.3	1.4
Core CPI	1.9	2.0	2.2	2.3	2.2	2.1	2.2
CPI	2.2	2.4	2.8	2.5	2.1	1.7	1.6

Source: Bureau of Labor Statistics

***Sentiment and Confidence** – The Conference Board's Consumer Confidence Index trended up over the last year but weakened in May. The current conditions component of the University of Michigan Consumer Sentiment index is near an all-time high. The leading indicator series of the Conference Board offers a more mixed picture. The series is not predictive without a sustained trend, which has not yet materialized.*

- The Conference Board's Consumer Confidence Index fell 1.5% in May to 117.9. Confidence remained strong despite April's downward revision. On a year-over-year basis, confidence is up by 25.5 points. Figure 11 illustrates the positive longer run trend.

Figure 11. Consumer Confidence Index (1985 = 100)



Source: Conference Board

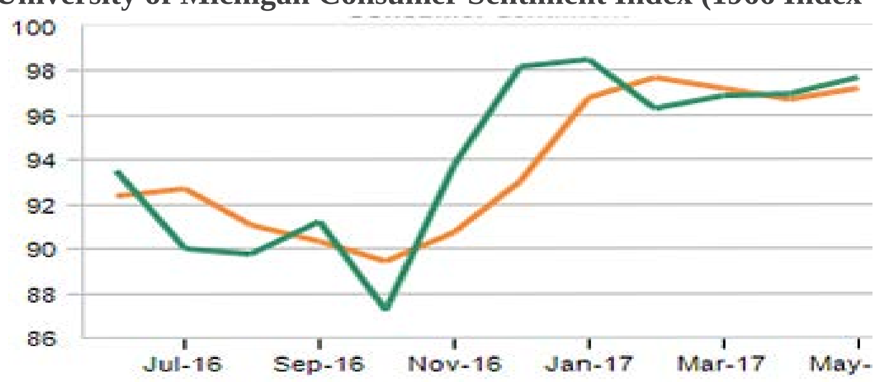
- The University of Michigan Consumer Sentiment Index gained slightly in May. Sentiment remains high despite a small decline in present conditions in May. Current conditions remain near a decade high. Expectations are still slightly below their January 2015 highs. Compared to May of last year, sentiment is 2.4% higher.

- The current conditions component of the University of Michigan survey is barely below the 12-year high of 113.

- Near-term inflation expectations in the Michigan survey increased slightly in May. The 12-month inflation expectation of 2.6% is slightly higher. The five- to 10-year inflation expectation was 2.4%.

- Figure 12 shows the monthly University of Michigan index and 3-month moving average over the last year.

Figure 12. University of Michigan Consumer Sentiment Index (1966 Index = 100)



3-month moving average *Monthly Expenditure*

- The Conference Board index of leading indicators rose 0.3% for the second consecutive month. A downward revision in March brought the indicators from 0.4% to 0.3%.

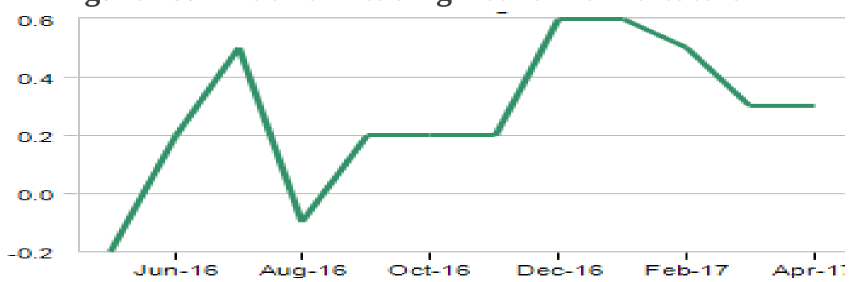
- Among the components of the index, the average work week added 0.07% after subtracting 0.13 % in March. Jobless claims added 0.1%, while consumer goods orders were essentially neutral. The ISM new orders index provided a small boost, adding 0.04%.

- The financial market component provided mixed signals for the leading index in April. Stock prices were essentially neutral while the interest rate spread (10-year Treasury bonds less federal funds) added 0.16% in April following 0.19% in March.

- The ISM new orders added 0.04% in April after boosting the index by 0.03% in March.

- Figure 13 below shows the monthly movement of the Index of Leading Economic Indicators. The indicator series does not provide a clear signal without a clear trend.

Figure 13. Index of Leading Economic Indicators



Source: Conference Board

***Housing** – Housing prices have rebounded from the 2008-2009 collapse and low inventory signals additional price increases going forward. The CoreLogic index is now only 1.2% below the peak reached in 2006. Labor shortages in skilled construction are constraining new housing inventory. The downside for housing comes from tighter lending standards and fragile household income growth.*

- The CoreLogic Home Price Index in April matched the March increase of 1.6% in April. The index growth in March and April represents the fastest rate of monthly growth in more than four years. On a year-ago basis, the price index is now 6.9% higher. The index is only 1.2% below its peak in April 2006. The index has increased on a year-over-year basis every month for the past five years.

- The Pending Home Sales Index fell 1.3% in April but it is only 3.3% below its year-ago level. The index remains close to the peak reached in mid-2016. A lack of inventory is partly responsible for slower pending sales.

- The S&P CoreLogic Case-Shiller Housing Index was flat in March while the year-over-year growth in the index was 5.2% for the 20-city composite index. Days on the market for the median home are now shortening. Approximately half of homes on the market sold in under a month.

- Housing starts declined in the first quarter but remained ahead of the first quarter last year. Building permits of privately owned housing units were 2.5% higher in April and 5.7% ahead of one year ago.

- The figure below illustrates the pattern of housing starts over the past year. Even with strong housing demand, the supply of new homes has been sluggish.

Figure 14. Housing Starts by Month (Thousands of units)

Source: U.S. Census Bureau

***Balance of Trade –** The growing U. S. current account deficit reached $186.6 billion in the first quarter of 2017 and is on a path to reach over $500 billion for the year. U.S. economic conditions are generally better than in the rest of the world and this condition, along with a stronger dollar, leads to higher U.S. imports relative to exports. The other side of the current account deficit is a capital account surplus, which helps keep long-term interest rates low and assists in financing our large domestic public debt. A continuation of the decline in the current account represents a drag on U.S. economic growth that is likely to continue.*

- The nominal trade deficit widened by $2.3 billion in April to $47.6 billion. The goods deficit widened by $2.3 billion, while the services surplus fell by $13 million.

- Overseas consumer demand appeared weak over the month. Automotive exports remained on a downward trend, falling 4.1% after declining in the previous two months. Consumer goods exports posted a second consecutive drop, falling 4.3%.

- Nominal imports rose for a second month, gaining 0.8%. Goods imports rose 0.9%, while services imports edged up 0.2%. Among goods imports, consumer goods imports rose 4%, while food and beverage imports gained 3.3% and capital goods gained 1.8%. Imports of industrial supplies fell 3.4%, breaking a five-month streak of gains. Automotive imports also declined, dropping 2.2% after posting a large gain in March.

- The trade balance has accumulated a deficit of $186.6 billion in the first four months of 2017, compared with a deficit of $164.5 billion in the same period a year earlier. Exports are up 6.1% and imports are 7.5% higher. Figure 15 shows the current account deficit since 2006.

Figure 15. U. S. Current Account in Millions of dollars

Source: FRED (Federal Reserve Bank of St. Louis)

***Global Issues** – Global growth is likely to make a modest rebound in 2017. Key factors contributing to global growth include easy money conditions and a delayed impact of Chinese stimulus measures taken early in 2016. Stable commodity prices have also helped growth. Global growth may fade somewhat unless fiscal stimulus takes place in the U.S. with infrastructure investment. Business investment remains slow due to uncertain political directions, anti-globalism sentiment, and increased tensions from developments in the Middle East and the Ukraine. Businesses in emerging markets have relied heavily on dollar-denominated debt, and an appreciating dollar could make servicing these obligations difficult. The global equity market rally continued in the first quarter due to prospects for higher growth and international trade. Oil prices remain low at about $48 a barrel and prospects for higher global growth has not yet translated into a trend of higher prices.*

United States – The U.S. economy grew 1.6% in 2016. The economy averaged only 2.1% annual growth since the end of the Great Recession. The U.S. dollar fell about 2% in the first quarter against a basket of broad currencies. Fed tightening of monetary policy should lead to a stronger dollar, but this has not been the case so far.

Eurozone – Europe is staging a recovery with 2% growth in the fourth quarter and 1.8% GDP growth in the first quarter. Differences in growth rates among Euro members is decreasing with growth in both Italy and Portugal. Improved economic performance will likely frustrate the "Euro-skeptics" hoping to build on the Brexit movement. With prospects of improved growth, the ECB policy meeting on June 8 will face a decision of whether or not to scale down the large stimulus plan that is in place. Inflation remains low, falling from 1.9% annual rate to 1.4% in May.

Unemployment remains about 1.3% above the 8% target used for full employment in the Eurozone.

China - China continues to follow an expansionary fiscal policy initiated early in 2016. The focus has been to curb debt and promote more growth within China with infrastructure investment. Nevertheless, the economy slowed in April. The World Bank estimates growth of 6.5%, a downward revision from the 6.7% estimate. Worries for a hard landing in China seem misplaced to this point, but high debt remains a concern.

Japan – Japan grew at a low 1.2% annualized rate in the fourth quarter. Progress has been slow, but the World Bank forecasts GDP growth of 1.5% in 2017. Inflation remains well below the Bank of Japan’s 2% target. Much of Japan’s problems are chronic. World trade conditions no longer sustain an export-driven strategy of persistent trade surpluses and the aging population coincides with declining productivity.

Emerging Economies - Emerging economies are vulnerable to higher interest rates as developed economies expand and reverse monetary easing. Stronger commodity prices should help emerging economies going forward. The World Bank estimates 2017 growth to be 4.1%.

India – India’s economy grew 7% in the fourth quarter. The economy is adjusting to the decision late in 2016 to demonetize the 500 and 1,000 rupee notes.

Brazil – Brazil continues to be in a deep recession for the second straight year. Progress on inflation is one bright spot as the inflation rate fell from 11% to 4.8%, which allows the central bank to lower rates.

Latin America and Caribbean – The World Bank estimates growth for this area to be only 0.8% in 2017. Several countries are likely to be in recession, to include Brazil and Argentina.

Middle East and North Africa – As oil prices improve the prospects for growth look better in this region. The World Bank recently revised growth rates to 2.1% for the Middle East and 2.6% in the Sub-Saharan Africa region.

South Asia – In the recent growth estimate revisions, the World Bank lowered growth forecast for South Asia to 6.8% in 2017. India continues to be the strongest economy in this region.