AMERAUDI | ASSET MANAGEMENT

Economic Outlook

By Ronald L. Welburn, CFA

October Letter 2017

The Outlook for the Economy

Investors are facing a growing conundrum as the Federal Reserve has announced a program to begin reducing the size of its $4.5 trillion balance sheet while also further raising interest rates to continue its program of monetary normalization. One more rate increase this year is a probability (December) with three mentioned as a possibility for 2018 depending upon the rate of inflation and the strength of the economy. At present, the federal funds rate trades at 1.0% - 1.25%. Both the economy and stock market are in their ninth year of recovery from the 2008 financial crisis that brought about the Great Recession. While the economy at present appears resilient enough to maintain real GDP growth of 2.0% or higher, consistent with its path since the ending of the crisis, the stock and bond markets could be vulnerable to higher interest rates because of the record levels of valuation based on the prior activity of the Federal Reserve in both lowering interest rates and initiating a program of quantitative easing to boost the economy. Along with the growing economy, earnings are continuing to advance after a brief interruption in 2016 and we look for further improvement in 2017 as well as in 2018. The Federal Reserve, through the leadership of Chairwomen Janet Yellen, has well- advertised in advance its change in monetary policy to avoid a possible shock to the financial markets. Beginning this month through October 2018, the balance sheet reduction will involve a $10 billion run-off of the portfolio ($6 billion of Treasury Securities and $4 billion of Agency Securities, primarily Mortgage Backed Securities) with an increase of $10 billion every quarter, capped at $50 billion per month. At that point, the Federal Reserve Open Market Committee will decide if any further changes are needed to maintain appropriate monetary policy depending upon the state of the economy.

The U.S. economy grew 3.1% and we expected another 3.0% growth number in the third quarter but the three hurricanes, Harvey, Irma and Maria, will have negatively affected economic growth because of the deflationary impacts of hurricane damage. As a result, we now expect third quarter economic growth of about 2.5%. Nevertheless, economic growth will be positively impacted in the fourth quarter because of restoration of the damage and building improvements. Overall, we continue to expect 2.5% real GDP growth for 2017 which compares to 1.6% in 2016.

A summary of economic statistics suggests that economic growth is still strong with the weaker statistics affected by the hurricanes. The ISM Manufacturing Index rose to 59.8 in August versus 56.3 in July while the Non-Manufacturing (Services) Index increased to 55.3 versus 53.0 in July. The leading indicators increased by 0.4% in August led by building permits, the yield curve, consumer expectations, and the ISM new orders. Inflation rose in August probably because of oil price increases based on the number of refineries out of service in the Gulf coast as a result of Hurricane Harvey. 25% of U.S. oil refinery capacity is based in the Gulf coast. The CPI advanced by 0.6% and is up 1.9% y/y. Gasoline (3.3% of the CPI) increased 6.3% and is up 10.4% y/y. The producer price Index (PPI) increased 0.2% in August and is up 2.4% y/y. Building permits advanced 5.7% in August and are up 8.6% y/y. Housing is strong but negatively impacted by rising costs of materials and a shortage of labor that leads to rising housing prices. This particularly impacts the millennial generation (76 million people between ages 19-35) who have on average $40,000 of student debt while earning on average $38,000). The housing supply available for sale has become smaller as many people are unwilling to sell because of the cost of replacement housing and are therefore staying in place. The only answer to the dilemma is for builders to build more homes that are affordable to the millennial generation, namely smaller homes. Retail sales (+0.2%) in August were weaker than prior months because auto sales fell by 1.6% but were still up 3.6% y/y. Industrial production fell 0.9% in August largely because of unseasonably mild East Coast temperatures that drove down utility output by 5.5%, along with a hurricane related drop of 4.8% in oil and gas well drilling. Industrial production should recover in coming months. Overall, the fourth quarter economic statistics should be stronger than in the third quarter that were affected by the hurricanes.

Our forecast for 2017 remains that the U.S. economy will grow by 2.5% in 2017 with the CPI at 2.0% and corporate profits up 10.0%. For 2018 we believe that the GDP can grow by 3.0% with CPI inflation of 2.0% and corporate profits up 8.0%. The main caveat will be the Republicans' failure to pass their stated agenda of nullifying Obamacare, achieving tax reform and infrastructure spending.

The Outlook for the Financial Markets

During September interest rates were modestly higher, commodities were modestly down, with the exception of oil, equities were higher and the U.S. dollar was flat. Interest rates rose in September anticipating the Federal Reserve's move to normalize monetary policy by reducing the size of the central bank's balance sheet. The change in policy was widely advertised to prevent shocking the financial markets. 10-year Treasury bonds are currently 2.25% compared to 2.16% a month earlier. Long-term high quality corporate bonds currently yield 3.83 versus 3.80% a month earlier while long-term municipal bonds yield 2.83% compared to 2.75% last month. 30-year mortgage bonds now yield 3.85% versus 3.74% a month earlier. 3-month Treasury bills are little changed with yields at 1.02% versus 1.00% last month. Looking ahead, one would expect yields to move higher particularly with a wider government deficit and a modest uptick in inflation primarily emanating from oil prices.

Commodities, as measured by the CRB Index of commodities (429) were down 1.4% in September with weak agricultural prices and a fall in copper ($2.92 per lb.) of 3.6% from recent elevated levels based on Chinese demand. Gold at $1293 per ounce was flat for the month despite increased tensions with North Korea over its missile program and threats to drop a hydrogen bomb over the Pacific ocean. The U.S. dollar was also flat at 92 based on the U.S. dollar Index. Foreign currencies have been strong in 2017 as many emerging market economies, as well as Asian and European ones, have shown increased strength. While the U.S. dollar is down 7.0% in 2017 it should be viewed more as foreign strength than U.S. weakness.

Both U.S. and foreign equity markets were modestly higher in September with the S&P 500 Stock Index up 2.4% and the foreign index up 2.6%, as measured by the Morgan Stanley EAFE Index. Earnings were generally strong in the second quarter, inflation was modest and interest rates were supportive. The P/E ratios are 19.2 and 17.8 times our earnings estimates of $130 per share and $140 per share for 2017 and 2018 respectively. The earnings yields are 5.2% and 5.6% respectively using the inverse ratios to compare them with fixed bond yields. Nevertheless, given many other valuation measures such as the equity valuations to gross domestic product, a Warren Buffet favorite, the stock market has had higher valuations only in the year 2000. So if indeed the Federal Reserve goes ahead with its normalization policy as currently stated, equities could have a significant correction in the near-term.

As a result of current market valuations, particularly in the face of the stated goals of the Federal Reserve to raise interest rates through a policy of monetary normalization, we believe that it is prudent to maintain a conservative asset allocation of 52% equities, 20% bonds, 3.0% gold, and 25% cash.

Ronald L. Welburn, CFA, has over fifty years' experience in the investment field. Mr. Welburn is a graduate of Harvard College and has a Master's degree in Finance from the Wharton School of the University of Pennsylvania. Please direct all inquiries to Ameraudi Asset Management Inc. 19 East 54th Street, New York, NY 10022 Telephone: (212) 833-1090 Fax: (212) 319-4949 www.ameraudi.com

---