GALLIARD
Capital Management, Inc.
ARCHITECTS OF INVESTMENT SOLUTIONS

# ECONOMIC UPDATE
## THIRD QUARTER 2017

### Quarterly Key Points

- U.S. GDP growth rebounded to a +3.1% pace in Q2, fueled by a bounce-back in consumer spending and continued business investment.
- The Fed kept its policy rate unchanged during the quarter, but signaled its intention to continue raising rates in the near-term despite low inflation.
- The Fed announced its balance sheet reduction plan will commence in October, with a gradual phase-in over the next four quarters.

### Our View

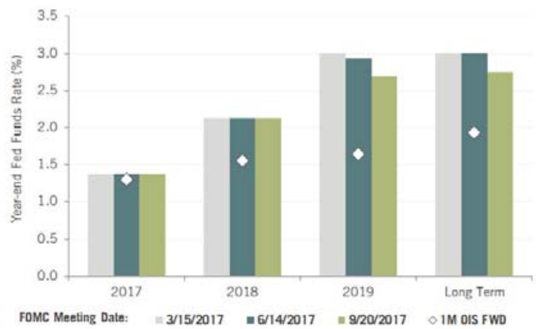
- The rebound in global growth continues to gain steam, with Europe, developed Asia, and the U.S. expanding faster than their recent trend level.
- The Fed is proving more aggressive than the market anticipated with respect to additional rate hikes given current data. A December hike seems likely at this point.
- Core inflation may well rebound from its recent decline, but shows no signs of "breaking out" above the Fed's target level anytime soon.

800 LaSalle Avenue, Suite 1100
Minneapolis, MN 55402-2054
**www.galliard.com** 800-717-1617

## FED HOLDS RATES STEADY IN Q3 BUT SENDS HAWKISH SIGNALS

Following a six-month period during which the Fed hiked its policy rate three times for a total of 75 basis points, the Fed left rates unchanged in the third quarter. Instead, at its July and September meetings, the Fed telegraphed its intentions for beginning the balance sheet reductions outlined at the June Federal Open Market Committee (FOMC) meeting (*see "Fed Sets Balance Sheet Runoff Plan in Motion" on reverse page*).

**FIGURE 1** FOMC MEDIAN YEAR-END FED FUNDS RATE PROJECTIONS (%)[1]




Notably, in speeches, public comments and published forecasts released during the quarter, the Fed – and most importantly, Chair Yellen herself – consistently struck a more hawkish tone than the market anticipated with respect to the need for additional rate hikes over the near-term. Whereas the market had largely expected the recent decline in core inflation to put additional hikes on hold for the time being, instead the Fed carefully outlined the case for continued gradual normalization of the policy rate.

In its September dot plot of policy rate projections, on average FOMC participants saw one more hike in 2017, followed by three hikes in 2018 (*see Figure 1*), moves which would bring the Fed Funds rate to 2.0% to 2.25% by end-2018. While the market remains highly skeptical of the Fed's 2018 forecast, the market-implied odds of a December hike have risen to around 80% from as low as 25% in early-September[2].

## U.S. GDP GROWTH REBOUNDS IN Q2, ADDING TO GLOBAL EXPANSION

U.S. GDP growth bounced back in the second quarter of 2017, posting a gain of 3.1% (annualized rate) versus the prior quarter. Second quarter growth was driven by a strong rebound in personal consumption (+3.3%) as well as continued strength in business investment (+6.7%). Net exports rose, aided by stronger global demand for goods and services as well as the recent decline in the U.S. dollar, which makes U.S. goods cheaper on the global market. With Q2's rebound, the first-half growth rate reached +2.1%, largely in-line with expectations and the recent trend.

The recent upturn in growth at home follows a global trend. Developed markets including Europe, Japan, Australia, and Canada are experiencing a coordinated economic expansion, somewhat above the ho-hum levels we've seen over the last several years (*see Figure 2*).

Looking ahead, survey data also suggest recent momentum in economic growth continued well into the third quarter, particularly in Europe and Japan. In the U.S., the ISM indexes of activity for the manufacturing and services sectors both reached multi-year highs in September. While the disruptions created by Hurricanes Harvey and Irma are likely to cause distortions in the data over

1, 2 Endnotes are located on reverse page

the near-term – particularly in the jobs data – the reconstruction effort should add modestly to GDP over the next year on-balance.

### FED SETS BALANCE SHEET RUNOFF PLAN IN MOTION

In a move carefully choreographed over the last three FOMC meetings, the Fed at its September meeting officially announced that its balance sheet normalization plan would commence in October. The plan calls for the Fed's portfolio to shrink via maturities and principal paydowns, capped at up to $10 billion per month in the current quarter. The maturity cap amount will be raised step-wise over the subsequent four quarters, reaching $50 billion/month by 4Q18. The Fed has communicated it is unlikely to use adjustments to the plan as a policy tool, except in the event of a severe shock to the economy. Assuming no changes, the plan will reduce the Fed's balance sheet by approximately $1.4 trillion by the end of 2021 (*see Figure 3*).

Given the methodical communication and gradual phase-in period, the market's reaction continues to be muted. That said, the additional supply of Treasuries and MBS that must be absorbed by private investors is not insignificant, particularly when viewed against a backdrop of a potentially more aggressive Fed and the possibility of a tax cut package that could itself raise the U.S. Treasury's borrowing needs by $150-$200 billion per year.

### LOOKING AHEAD

Most estimates of GDP growth in Q3 suggest the U.S. economy grew at a 2.5%-3.0% pace during the quarter. Even stronger recent survey and activity data point to solid momentum coming into the final quarter of the year. In all, full-year growth in the 2.5% range seems achievable.

**FIGURE 2** GDP GROWTH FOR SELECTED DEVELOPED ECONOMIES[3]

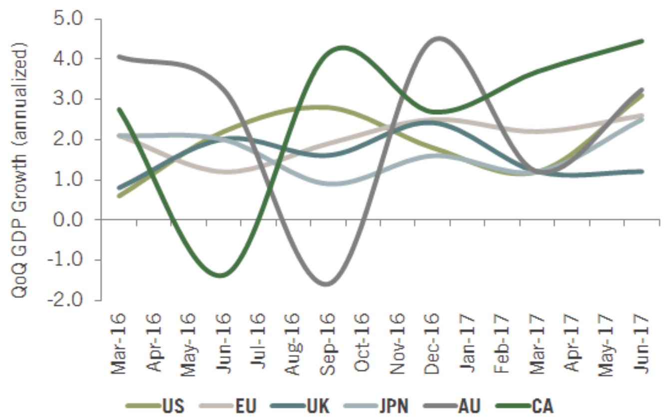
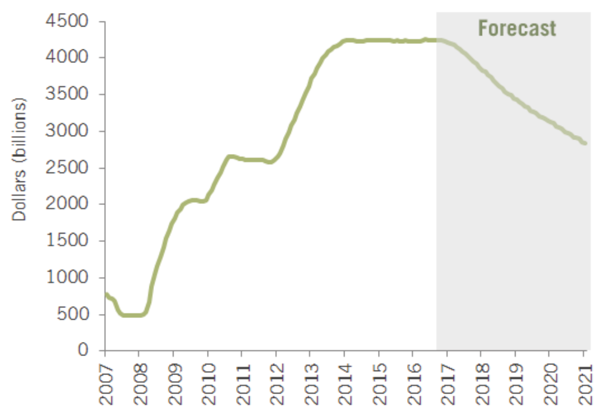



**FIGURE 3** FEDERAL RESERVE BALANCE SHEET[4]




With the Trump Administration's tax cut plan starting to make its way through the legislative process, the prospects for real fiscal stimulus are looking up – at least looking ahead into 2018.

Don't fight the Fed – for now. The Fed seems intent on raising rates once more in 2017 and, unless data significantly weakens in the coming months, probably a couple more times in 2018. However, we judge it unlikely that the Fed will raise its policy rate above 2% unless growth and/or inflation show signs of breaking out to the upside.

[1]Source: Federal Reserve, Bloomberg | [2]Source: Bloomberg | [3]Source: Bloomberg | [4]Source: Federal Reserve, Capital Economics