Praying for Houston, the Caribbean, and Florida

As we publish our initial market Commentary, Hurricane Harvey has pummeled Houston and the surrounding areas, and Hurricane Irma has torn through and left devastation in her path through the Caribbean and barrels toward Florida later today. The flooding is intense, the damage has been and will continue to be massive, and there will be tremendous human and economic suffering as the rains subside and the waters all-too-slowly recede. We take hope in the fact that Americans are a tough, resilient, and generous people. Please consider offering whatever assistance you can to those in need.

With the Labor Day holiday in the rear view mirror and as summer draws to a close, we witness a slight reversal of the economic trends of earlier this year. Until the past 4-5 weeks, the stock market continued to rally and volatility was virtually non-existent, while the economy seemed to be slowing down. The global economy now seems to be expanding, but volatility has (at least mildly) awakened and the stock market has faded. The Q2 revenue and earnings season was very solid and the economy is growing, so what's going on?

We think four things: (1) August and early September historically are the slow trading season, with low trading volume, so the market can move on relatively minimal activity; (2) there is a general consensus that rates will slowly rise (at some point), thus applying a higher discount rate to future earnings and thereby driving lower valuations; (3) the market increasingly recognizes that valuations generally have stretched well past underlying fundamentals; and (4) the market is beginning to price in the realization that much of President Trump's perceived "pro-growth" agenda is in danger, or at the very least will not be enacted until much later this year, if not well into next year. We've been anticipating #s 3 and 4 for most of this year.

Congress will meet only twelve days in September, and the forced priorities will be to increase the debt ceiling and pass a continuing resolution on the budget – there will be little to no time to make progress on tax reform, infrastructure spending, or health care reform. And that's assuming there might be even a modicum of accommodation between the President and the two parties, which there may not be. President Trump has, through executive order, "undone" a variety of legal and regulatory executive orders put into place by President Obama, and by and large Trump's actions have been perceived as pro-growth. But real, long-term progress needs to come legislatively, which means compromise of which there may not be any. Political opposition and social divisiveness is as high as we can remember, and to be seen as even contemplating cooperation with "the other side" could be deadly in next year's mid-term election cycle.

Other than an expected short-term spike in oil and gas prices, the long-term effects of Harvey remain unknown. Without minimizing the human suffering and the loss of life and property, we simply note that the long-term overall economic effects of most natural disasters tends to be over-estimated by the markets. It may be intense in the short-term, but it tends to be transitory. This coming fall, we are likely to see more than just a change in the weather, and we believe perhaps it has already started. We continue to believe that Q4 will see an increase in volatility and perhaps a (long overdue) market correction.

With that as a backdrop, looking out over the current economic and investment landscapes, here is what we see.

The Current Economic & Market Landscape

- The global economy remains solidly positive right now:
    - For the first time in ten years, all of the world's major economies (45 of them, as tracked by the OECD – Organization for Economic Cooperation and Development) are "in sync" – that is, they are all growing positively at the same time;

- The International Monetary Fund (IMF), in its July update, projected global economic growth of 3.5% in 2017, up from 3.2% in 2016;
- The current estimate for US Q2 GDP growth is 2.6%, down slightly from the initial estimate of 2.7%; the estimate for all of 2017 remains at 2.3% (source: The Wall Street Journal);
- US manufacturing remains well in expansionary mode, and a generally weak dollar drove a nearly 6% increase in US exports in the first half of 2017 – the best since 2013;
- Inflation remains disconcertingly low – the projection for 2017 comes in at just 1.8% as measured by CPI. Despite this, the consensus projection is that the Fed will begin in September to reduce the $4.5 trillion in assets it purchased over the past ten years to stimulate economic activity and pump up the stock market. The Fed is also expected to increase short-term rates at least one more time in 2017, probably in December;
- Wages continue to grow more slowly than employment levels – the tangible consequence of low inflation, automation, and globalization;
- Republicans in Congress seem increasingly willing to "decouple" from President Trump in an attempt to enact tax reform, but we remain skeptical of significant progress prior to year-end;
- In the US, Q2 revenues and earnings were solid: Earnings were up 12.1% year-over-year, with an estimated earnings beat rate of 73.5%, well above the long-term average of 64%; Revenues were up 5.1%, and 69% of companies beat expectations, well above the long-term average of 59% (source: Thomson Reuters);
- The Eurozone Q2 2017 GDP growth is estimated at 0.6%; following Q1 growth of 0.5%, and estimates for all of 2017 are roughly 2% (source: TradingEconomics);
- China's (official) growth rate for Q2 was again stable at 6.9%. The People's Bank of China continues to slowly push up rates in an attempt to control massive debt build up and highly speculative real estate prices.

The Towerpoint Wealth Economic & Market Outlook

The global economy is growing. Manufacturing in particular is expansionary in most major regions of the world. Oil and commodity prices have rebounded over the past several weeks in response.

The primary risks to continued growth are geopolitical (i.e., North Korea), natural (Hurricanes Harvey and Irma), increasing divisiveness, acrimony, and partisanship in Washington and in the overall US society, and the perceived or actual stalling of Trump's agenda. Low inflation remains a trouble spot but does not seem to be worsening at this time.

The local economic impact of Hurricanes Harvey and Irma is likely to be fairly massive in the short-term, and it will probably take Houston and the Caribbean years to fully recover. Outside of Houston, however, other than an anticipated spike in national gas prices by perhaps $1 per gallon or more, the long-term effects are likely to be fairly transitory.

On the investment side we maintain our general market forecast:

- The global macro-economic environment remains benign and is beginning to show signs of further expansion;
- Global inflation is low but may be stabilizing – this may give the US and ECB more flexibility to begin to "normalize" policies and rates;

- The Trump agenda is stalled – investors will eventually price slower growth into the markets – this may have already begun;
- Despite solid earnings, low rates, and the recent minor sell-off, equities still look expensive to us, but we remain constructive for the year, with EAFE and EM markets continuing to outperform the US. The US dollar trend is the wild card for US investors (continued weakening will help non-US returns);
- The US yield curve continues to flatten as long-term rates slide as a result of low inflation and anticipated lower growth. We do not anticipate the yield curve to invert;
- At these rates and credit spreads, the public credit markets still look very expensive to us;
- We continue to think there are opportunities to be had in the private equity and private credit spaces for investors who can access them. Heavy inflows, however, have compressed anticipated premiums to the public markets;
- Oil and commodity prices have jumped recently as the global economy has accelerated, and oil and gas prices are likely to spike in the wake of Harvey, but we continue to anticipate a fairly marginal year for commodities and real assets;
- While we are generally constructive on the global economy and overall market performance, the public markets are not cheap and we still expect mid-single digit performance for globally diversified portfolios.

Summer is almost over, and we believe increased market activity and volatility will soon be upon us. And we pray for Houston, the Caribbean, and Florida.

Warm Regards,

Joseph F. Eschleman, CIMA®

President

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