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Economic Outlook

By Ronald L. Welburn, CFA

May 2017

The Outlook for the Economy

On April 28 the Bureau of Economic Analysis will release first quarter real GDP growth. It is expected to be about 1.0%, down from earlier consensus forecasts of 2.0-2.5%. Since the end of the financial crisis in 2009, first quarter GDP numbers have been consistently low, usually blamed on severe winter weather. At present however, most economists believe that the consistently low numbers are a result of unreliable seasonal adjustments made in the first quarter. Whatever the reason, we believe that the current economic data support the belief that our 2.5% GDP growth forecast for 2017 will be accurate. Such areas of the economy as housing, industrial production, exports, and now capital spending all suggest that the economy is strengthening after some weakness in the last half of 2016. New orders and backlogs are strong in corporations against a background of personal income strength among consumers where unemployment is now only 4.5%. Also consumers have been saving more with the savings rate at 5.6%. In addition, the global economy that had been trailing the U.S. is now picking up some strength, particularly in Asia and Europe. While China continues to slow as it transitions from industrial activity to more consumption, the growth rate will be approximately 6.5% from 7.0% in 2016. If President Trump can implement his tax reforms against a backdrop of less regulation and initiate his plans for an infrastructure program approaching $1 trillion, then the economy could again grow in the 3.0-3.5% range during 2018.

Parts of the economy that have boomed, such as autos, are expected to slow in 2017. March sales of autos were at a 16.5 million seasonally adjusted rate versus 17.5 million in January and February. Default rates on auto lending have also marginally risen suggesting the end of a cycle. While consumer confidence is very high overall as employment has increased, bank loan growth has slowed to a modest rate. A possible explanation could be the fact that consumers are struggling with soaring college loan debts that now exceed $1.1 trillion. Corporations however, are probably relying more on bond financing, than bank financing, given the exceptionally low interest rates on bonds. There is nothing unusual to have parts of the economy slowing while other parts are accelerating. It would be our view that housing is an area of the economy with great pent-up demand. Over the past eight years, multi-family rental units have also boomed and are now slowing as rents are becoming excessive at a time when evidence of over-building is beginning to occur. In contrast, single family housing inventories are exceptionally low as demand is picking up among the millennial population. Homebuilders cannot keep up with demand, mainly because of the difficulty of finding workers, as many immigrant workers have returned to their home countries. Mortgage rates are still historically low at 4.0%. Building permits (a measure of future demand) are up 17.0% y/y. Housing starts are currently up 9.2% y/y. Unless interest rates increase significantly, the housing outlook should be favorable.

The index of leading indicators rose 0.4% in March and are up 3.1% from year ago levels. There has been an acceleration of the leading indicators after a gradual lapse at the end of 2016. Before the election in November, a number of economic statistics had weakened particularly because of excessive regulation among small businesses. However, that has all changed since the election as business owners, like consumers, are feeling more optimistic. One important area of the economy that affected industrial activity was the energy business where oil prices fell to a low of $28 per barrel in the spring of 2016. That has all changed as oil rallied to about $58 per barrel and is currently $49 per barrel. Rig activity in the U.S. has picked up over the last six months and is mitigating the decline in production by the OPEC countries. From an economic perspective, while a recovery is to be welcomed, a return to high oil prices would accelerate inflation and damage the economy. We believe that a price range of $45-$55 per barrel would be healthy for the economy in terms of not accelerating inflation or further damaging oil industry employment. Also clean energy projects are now a more competitive factor in preventing runaway fossil fuel prices.

Overall, despite a weaker than forecast first quarter, we believe that the U.S. economy will grow by 2.5% in 2017 with the CPI at 2.5% and corporate profits up 10%.

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The Outlook for the Financial Markets

The financial markets in recent weeks have become more volatile with the 10-year Treasury trading between 2.20% and 2.60% and the S&P 500 Index between 2300 - 2400 depending on how investors feel with regard to the success of President Trump's economic policies or how investors feel about economic sluggishness and healthy recovery. The terminology is often referred to as risk/on or risk/off. While the above is happening from a trader's perspective, one must also keep in mind that from a historical perspective the bond and stock markets are both over-valued because of the generosity of global central banks in printing money since the Great Recession. In addition, the return on cash has been negative because of approximately 2.0% inflation. Buy and hold investors have done very well since March, 2009 as both bonds and stocks have risen.

The Federal Reserve has advertised two more rate increases this year as well as the possibility that it might start a program of reducing the size of its portfolio that grew from $889 billion to $4.5 trillion. There is little doubt that since the Great Recession, the Federal Reserve has gone out of its way to communicate to the markets what its intentions are. Over fifty years ago, the belief by Federal Reserve officials was to maintain maximum secrecy so as to prevent investor speculation over its intentions. Just as markets swing from one extreme to the other so do the actions of Federal Reserve officials. In view of the leverage in the modern financial system, perhaps it is the better part of valor to maximize communication. In terms of investment success, it is generally unwise for investors "to fight" the Federal Reserve.

Since the first round of the French vote on April 23, investors have chosen to trade risk/on at least for the first two days. As a result, stocks have soared while bonds and other safer investments have fallen. The belief is that the 39 year old Centrist Emmanuel Macron who got 23.7% of the first round vote to Marine Le Pen's 21.5% will win in the second round on May 7. The two losing candidates, one a Socialist and the other a Republican, are urging their voters to vote for Mr. Macron. The first poll after the vote suggests that Macron will win by 61% to 39% for Le Pen. Despite Brexit and President Trump's win, the odds would seem to favor Macron and thus no break- up of the European Union. As a result, investors feel quite confident that the current political order will remain.

The 10-year Treasury is currently trading at a 2.32% yield versus 2.41% a month ago with volatility having increased. The same applies to equities, with the S&P 500 Index currently at 2391 versus 2344 a month ago. These prices give one an idea of the current volatility in bond and stock markets. Gold also has fallen from $1292 per ounce on April 22nd to $1265 per ounce on April 25th yet is still above the price of $1246 per ounce a month ago. Essentially, the equity markets have had an upward bias for the first four months of 2017. If President Trump's policies are successful, interest rates will rise from current levels and stocks will also rise until higher interest rates bring valuations down from elevated levels. Nevertheless, a successful economic and financial outcome will help the valuation problem.

Given the above conundrum, we will maintain our conservative allocation of 50% stocks, 20% bonds, 5% gold and 25% cash.

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