June 19 2017

MIDYEAR OUTLOOK 2017

U.S. ECONOMY AND GLOBAL CENTRAL BANKS

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KEY TAKEAWAYS

We continue to look for U.S. growth to expand near 2.5% in 2017.

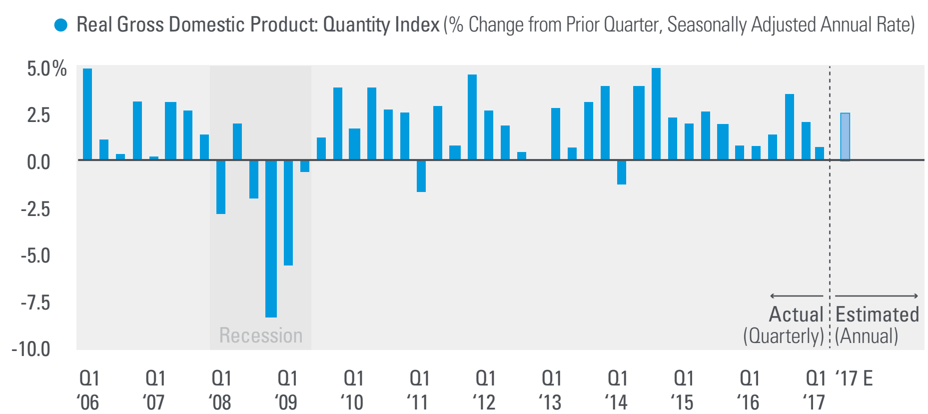
With the Federal Reserve (Fed) normalizing monetary policy, other economic drivers will have to pick up the slack, such as fiscal policy, investment in productivity, greater consumer and business confidence, and support from global growth.

Risks to our forecast include further delays in passing pro-growth policy, policy uncertainty limiting the impact of elevated confidence, and the possibility of a policy mistake.

U.S. ECONOMY: REGULARLY SCHEDULED MAINTENANCE DUE

We continue to look for the U.S. gross domestic product (GDP) to expand near 2.5% in 2017, although potential delays in passing major fiscal policies introduce some risk to the downside. This below-trend pace is still somewhat stronger than the trajectory that the economy has experienced throughout the expansion [Figure 1], as employment, income, production, and sales have failed to reach levels achieved in prior economic cycles.

1 EXPECT A SLIGHT PICKUP IN U.S. ECONOMIC GROWTH IN 2017



Source: LPL Research, U.S. Bureau of Economic Analysis 05/19/17

Shaded areas indicate recession.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Please see our *Midyear Outlook 2017: A Shift In Market Control* publication for insights on the economy, stock and bond markets, and investments for the year ahead. This week's commentary features content from that publication.

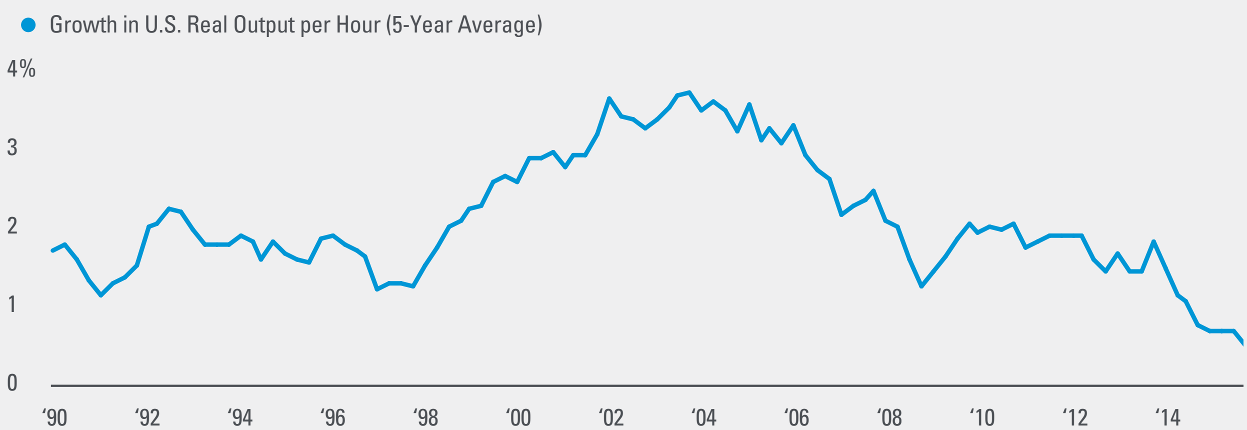
Despite the weak first quarter, we still see U.S. GDP growth approaching our 2017 forecast with potential for further acceleration in 2018. First quarter GDP growth, at 1.2%, was disappointing, but a pattern of first quarter weakness has been evident these past several years as a combination of weather-related events and perhaps an ineffective, seasonal-adjustment process has led to higher revisions and improved growth in ensuing quarters. Recent data on consumption, employment, housing, manufacturing, and services all point toward potential improvement in the months and quarters ahead following sluggish first quarter GDP growth.

Although confidence among consumers and businesses remains very high (so-called "soft data"), measures of actual economic activity ("hard data"), such as GDP, have not been as strong in the first part of 2017. The soft data need to translate into stronger economic activity to reach our GDP growth forecast for 2017. One likely reason for this disconnect is continued policy uncertainty, although we have seen a recent pickup in business investment. While enacting effective pro-growth policy would almost certainly benefit the economy, greater policy clarity may be enough to unleash "animal spirits" and help spur growth.

The recent improvement in job growth with moderate wage gains allows for consumption growth without the need for an accommodative central bank. Meanwhile, anticipated fiscal legislation may provide further incentives for businesses to take economic risks, such as investing in property, plant, and equipment, to position for future growth. This would be a change from recent years, where many businesses used low rates to return cash to investors by issuing debt and buying back shares or paying dividends, choosing the financial risk from more debt on their balance sheets over the economic risk of investing in their businesses. An improvement in capital investment trends would also likely boost productivity, which is essential for raising living standards.

Productivity growth remains the key to any sustainable increase in the rate of economic growth over the long term. There are two primary drivers of economic growth: a larger workforce and an increase in what a member of the workforce can produce, through better training or better resources. The latter is what we call productivity and it has slowed considerably throughout the expansion [Figure 2]. There are many possible reasons for this, including diminishing returns

2 GROWTH NEEDS A PRODUCTIVITY INJECTION



Source: LPL Research, U.S. Bureau of Labor Statistics 05/19/17 from technology development and lost skills during the deep contraction in employment during the financial crisis. Business investment is a key element of improving productivity, and we have seen it pick up in the first quarter. Businesses that drive productivity will have an important role to play if we are to see improved economic growth.

Fiscal policy could also enable government spending to help drive GDP, while the Fed's gradual approach may limit upward pressure on the U.S. dollar, eliminating the potential for currency gains to interfere with export growth (a stronger U.S. dollar makes domestic goods more expensive for foreign buyers). Global GDP growth has also been trending positive so far in 2017, and further improvements could also benefit the U.S. economy by boosting exports. Considering these trends for consumption, investment, government spending, and trade, we are sticking with our forecast for near 2.5% GDP growth in 2017.

CENTRAL BANKS: THE FED POWERS DOWN

For the U.S. and global economies alike, the ability to stand on their own without central bank support will be key for financial markets over the balance of 2017 and beyond.

The Fed is powering down its support as it continues on the path to normalization. Considering the age of the business cycle and largely steady, though below-trend growth, the Fed no longer needs to employ emergency-level policy measures. We believe a third rate hike in 2017 is more likely than not as the central bank gradually removes its support. Better U.S. growth amid low unemployment will likely be accompanied by core inflation pushing somewhat above the Fed's target of 2%, supporting normalization. But there are still enough forces pushing down on inflation, including excess manufacturing capacity, a low labor force participation rate, and a more stable dollar, that an extended run meaningfully above the Fed's 2% target remains unlikely.

Job creation, which has averaged about 185,000 jobs per month so far in 2017, will likely slow at this stage of the business cycle. But even if payroll growth were to decline to a 100,000 to 125,000 monthly pace, we suspect the Fed may still hike rates once more in 2017. Wage growth at 2.5% remains below the 4.0% pace that has historically caused central bankers to raise rates aggressively, but it has improved enough to keep the Fed on its stated track.

Looking overseas, central bank policy, particularly in Europe and Japan, continues to result in low yields for developed overseas economies. With better growth emerging in many European countries, but inflation still subdued, the European Central Bank appears to be in a holding pattern—not likely to loosen further (which would benefit bonds), but also not likely to tighten until inflation starts to pick up. The Bank of Japan is in a similar situation, providing more optimistic economic assessments, but still warning that stimulus will need to be maintained at current levels. The end result is low rates overseas may keep U.S. interest rates from moving significantly higher.

CONCLUSION

We continue to look for growth to accelerate over the rest of the year beyond the approximately 2% rate we've seen for much of the expansion. While the Fed has clearly committed to policy normalization with its third rate hike in six months in June 2017, assistance from monetary support may be replaced by fiscal stimulus, better support from global growth, investment in productivity, and the impact of increased confidence if we get greater policy clarity. Despite policy normalization putting us in the latter half of the economic cycle, we believe a recession in the next 12–18 months appears unlikely, which may support equity markets, although the potential for increased volatility exists. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

RES 5954 0617 | Tracking #1-618620 (Exp. 06/18)