ECONOMIC COMMENTARY

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Economy Gaining Momentum

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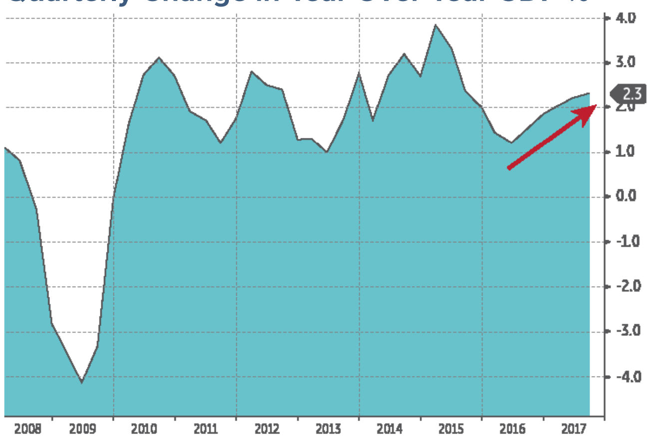
The economy shifted into a higher gear in 2017. Real Gross Domestic Product (GDP) expanded only 1.5% in 2016, but when the final numbers are in for the fourth quarter of 2017, a projected growth of 2.3% is conceivable for the full year.

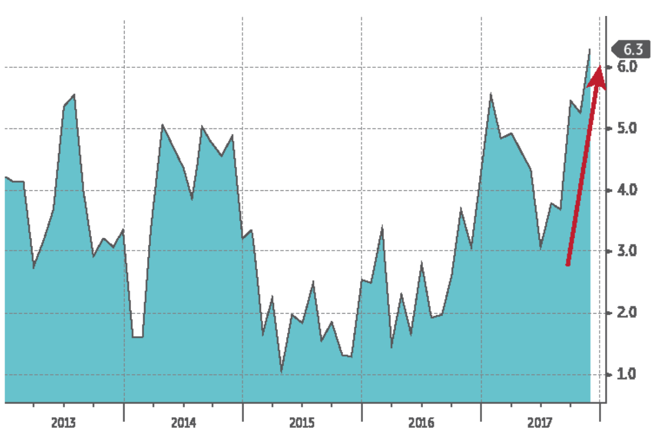
Quarterly Change in Year Over Year GDP %



Assuming fourth quarter real GDP growth of at least 2.4%, we will have seen increased growth in each consecutive quarter of 2017. This is an unusual phenomenon, last occurring in 1999 when Bill Clinton was president.

So, where do we see evidence of this growth reflected? Starting with the main driver of the economy, the consumer, year-over-

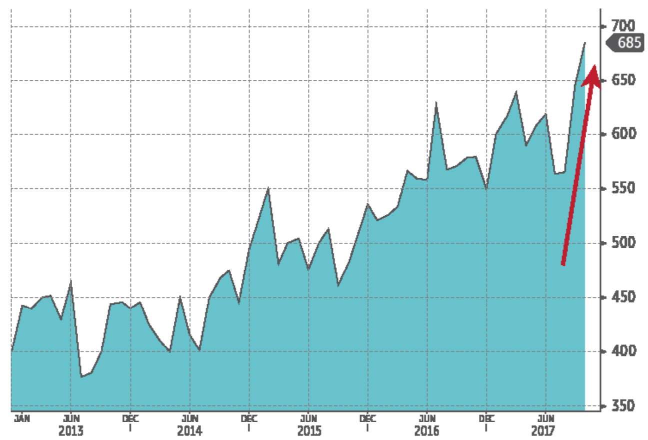
Yearly Change in Retail Sales



year growth in retail sales excluding food is currently a healthy annual rate of 6.3%, well above the long-term average of 4.3%.

New single-family home sales have continued to recover, expanding at an annual rate of 685,000 from a low of 270,000 recorded in 2011. The trend is positive, but nowhere near the bubble high of 1,389,000 recorded in 2005.

Single Family Home Sales



The nation has now reached "full employment" as the unemployment rate continued its decline to the current 4.1%. Additionally, the unemployment rate for college graduates is only 2.1%. The unemployment rate of workers with less than a high school level education has declined from approximately 16% in February 2010 to 5.2%. And, as the labor market has tightened, there are signs that lagging wage growth is ending and workers can look forward to larger increases in the future.

The consumer is optimistic about the current situation and the future, as evidenced by the Conference Board Consumer Confidence Index. This rising confidence is echoed by the near record high business confidence recorded by the National Federation of Independent Business.

To many, growing economic confidence may seem incongruent with the most contentious and partisan political climate ever witnessed in the modern U.S. Unfortunately, this partisanship and dysfunction is entrenched and is not likely to dissipate in 2018. But the economy is more powerful than any political party. A President receives more credit than is warranted for a growing economy and more blame than is justified for recessions.

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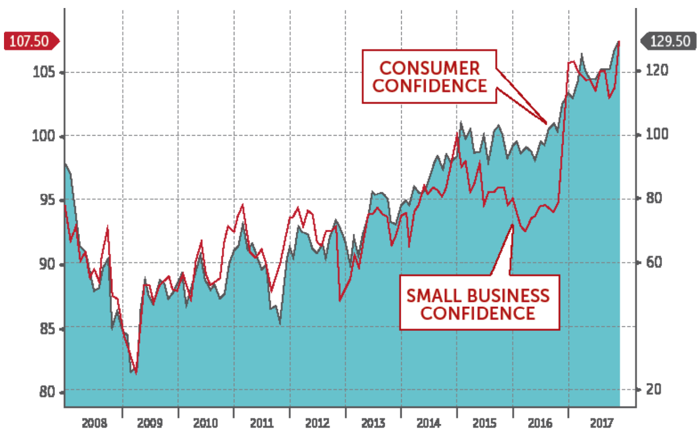
Business and Consumer Confidence



What to Expect in 2018

Looking ahead to 2018, I believe that Congress will continue to practice party-line voting and that long-term structural problems—such as healthcare costs that are double the average of OECD countries but with a lower life expectancy and declining rankings in education—will persist.

The last 50 years have seen annual real GDP range from a high of 7.30% to a low of negative 2.80%.

Now for my 2018 Projections:

1. Will the contentious political environment stall growth?

My real GDP forecast for 2018 shows moderate growth: I predict the economy will grow between 2.50% - 2.75%.

2. Will after-inflation economic growth reach the 50-year average of 2.88%?

This is a harder question to answer. While not expected to reach 2.88%, there will likely be quarters in which growth exceeds 3%, but it will not be sustained throughout the year.

As wages are anticipated to increase this will translate into consumer spending, meaning retail sales should continue to expand modestly.

3. Will Republican tax reform stimulate growth or merely expand the deficit?

Yes, and yes.

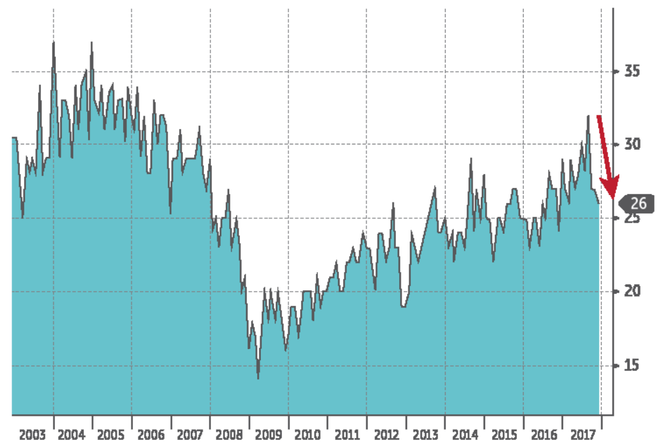
Business buoyed by continued deregulation and tax reduction will finally increase capital expenditures (CAPEX), helping to drive the economy. Exports should also increase as, except for Venezuela, all industrialized countries are projected to expand in 2018, which will positively influence U.S. exports.

Starting in February all workers will notice a reduction in tax withholdings. Studies suggest that middle and lower income workers will spend the extra money. For every dollar spent, the projected economic stimulus is $1.32. The tax cut for the upper income payers is less stimulating as the money is less likely to be spent.

The massive corporate tax cut should marginally increase capital expenditures. However, nothing is stopping other industrialized countries from following suit and lowering their tax rates below 21%, thereby restoring our prior disadvantage.

The new bill positively impacts the wealthy much more than

Capital Equipment Spending



middle and lower income workers which means the deficit is likely to expand. History demonstrates that "trickle down" economics consistently increases deficits. As a result, 2018 will be marked by divisive rhetoric where Republicans demand that entitlements are reduced to reduce the expanding deficit.

4. Will the second longest economic expansion in history end in 2018?

My recession forecasting model, based on five economic monitors, shows only a 15% probability of a recession. Only the treasury yield curve is of concern while the other four monitors are positive.

Even though I predict the economy will continue to expand in 2018, thereby becoming the second longest recovery on record, a "black swan" event could ruin the party. And, by definition, I cannot predict a "black swan" event.

Happy New Year!

Mel Miller, CFA® is Chief Economist and a member of the First Affirmative Investment Committee. He monitors economic conditions and market movements, and keeps the firm and its network advisors current on economic issues.

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Source of graphic data: Bloomberg

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