2017 Mid-Year

Economic Review and Outlook

The economy expanded at a real, annualized rate of 2.6% in the second quarter, while first quarter growth was revised down to 1.2% (vs. the previous estimate of 1.4%). The expansion was in line with analyst expectations from the beginning of the quarter and consistent with the post-Financial crisis pattern of weak first quarters followed by stronger growth in the second quarter.

Q2 Review

Following President Trump's election, we commented on the remarkable divergence between consumer and business sentiment relative to actual economic data. Sentiment, which is measured through surveys, received a boost from President Trump's pro-growth campaign platform. Expectations of fiscal stimulus, tax reform and deregulation buoyed business and consumer optimism following the election. However, just over six months into its presidency, the new administration has been unable to deliver on most of its agenda. In short, gridlock in Washington embodies one of the more prominent differences between private-citizen Trump operating a commercial enterprise and President Trump governing the world's sole superpower.

Irrespective of whether the new administration executes its pro-growth agenda, there remains the question as to its likely effectiveness eight years into the current economic expansion – since 1900, the average expansion has been just under four years in duration. As such, we've contended that accelerating growth this late in the cycle will prove difficult. As of now, our premise remains untested as the gears of democracy grind slowly.

What we can say with certainty is that the economy is in approximately the same condition as prior to the election. Though real (inflation adjusted) growth has slowed somewhat over the last two quarters, labor markets and the construction sector continue to be pillars of economic stability. In this environment, consumption levels remain a swing factor – determining whether annualized growth rates begin with a "1" or a "2" each quarter. By most measures, our "good, but not great" growth outlook remains intact, and absent an exogenous event (be it geopolitical or a natural disaster), looks as if it has room to run.

On that note, economic growth in developed markets outside of the U.S. and emerging markets has improved in 2017. Indeed, for the first time since 2011, the Global Purchasing Managers Index is now higher than that of the United States and readings for each broad region, including the U.S., are above 50 (the threshold defining expansion vs. contraction). It's also worth noting that the International Monetary Fund is forecasting nominal global GDP growth of 5.7% in 2017, which would be the highest level since 2011. A more vibrant global economy leads to increased commerce and reduces headwinds for domestic growth. Yet, even with a better global backdrop we are not anticipating a meaningful acceleration in U.S. growth, as poor demographic trends and high debt levels will continue to weigh on economic activity.

Takeaways

Below is a summary of key points from second quarter economic data. A more detailed review of the data, including our insights into the current state of the economy and what to expect going forward is included in the pages that follow.

- **Personal Income & Consumption** – Consumption improved during the second quarter, but remained below the average growth rate of 2016. Wage and salary growth continue to expand at only a modest rate, leaving consumers reliant upon savings and borrowing to boost consumption levels.
- **Labor Market** – The labor market continues to be a steadying force in the economy (albeit with a slowing pace of new job growth). An aging labor force will increasingly affect the broader labor market.
- **Inflation** – Current data continues to disappoint those anticipating an inflationary breakout.
- **Manufacturing** – Despite optimistic sentiment data, strong growth in manufacturing remains elusive.
- **Housing & Construction** – Housing and the broader Construction sector are in good shape, though their influence on economic growth is expected to decline.

Economic Review

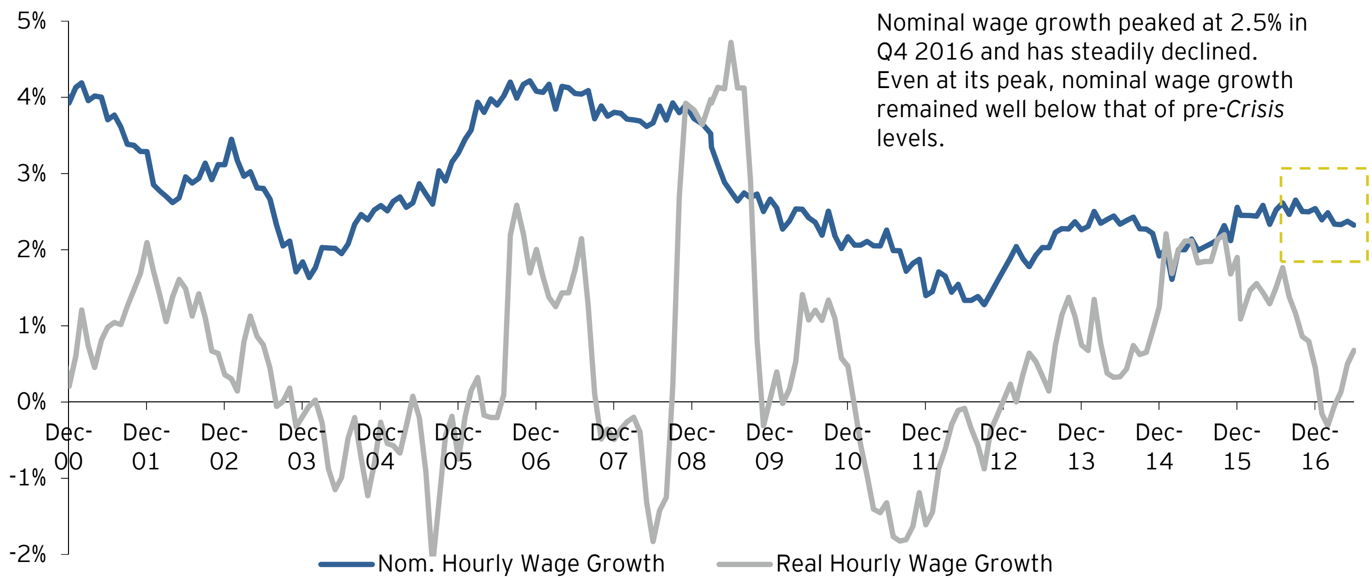
PERSONAL INCOME & CONSUMPTION

The Federal Reserve (Fed) has cited a low unemployment rate as a potential factor that could lead to wage inflation - a key reason, they contend, for normalizing monetary policy. We do not pretend to know better than the Fed, but we would point out the following:

- There is currently no evidence of wage inflation and, in fact, short-term trends indicate wage growth is slowing, not accelerating.
- If wage inflation were to emerge, it would erode the income inequality gap that has grown in recent years (and garnered much attention of late). There are two ways to close this gap: make rich people poorer or poor people richer. For most of the country, higher wages would be a positive outcome. Also, this would be a preferable path versus increasing taxes on the rich to redistribute wealth through government programs.

As the chart on the following page highlights, as of the most recent June data, Nominal Hourly wages have increased by only 2.3% year-over-year. Real (inflation adjusted) data looks better, but only because inflationary pressures abated over the first half of 2017. Compared to pre-*Financial Crisis* nominal growth rates of more than 4%, the current pace of wage growth remains lackluster.

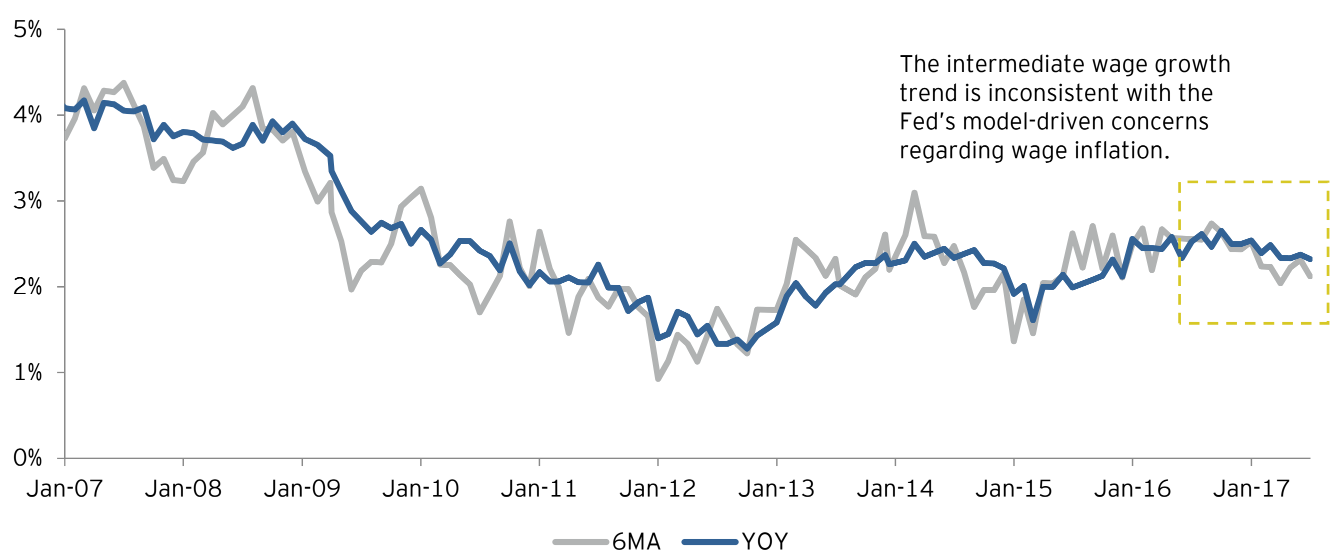
Real vs. Nominal YOY Hourly Wage Growth
(Production and Non-Supervisory Personnel)



Sources: Bureau of Labor Statistics and Covenant Investment Research.

Moreover, the higher resolution, six-month trend of nominal hourly wage growth has declined from 2.65% in September of 2016 to 2.12% as of this past June. While there may not be a causal relationship, we note that the Fed has hiked interest rates three times over this period.

Nominal Average Hourly Wage Growth
(Production and Non-Supervisory Personnel)



Sources: Bureau of Labor Statistics and Covenant Investment Research.

So why is the Fed so concerned about impending wage inflation? The Fed's anxiety stems from their reliance on financial models such as the Phillips Curve which describes an inverse relationship between unemployment and wage inflation. With unemployment below the threshold that the Fed believes stimulates inflation, the Phillips Curve model calls for increasing interest rates. What's troubling about the Fed's loyalty to this model is that it generally has not functioned as expected since the 1970's.

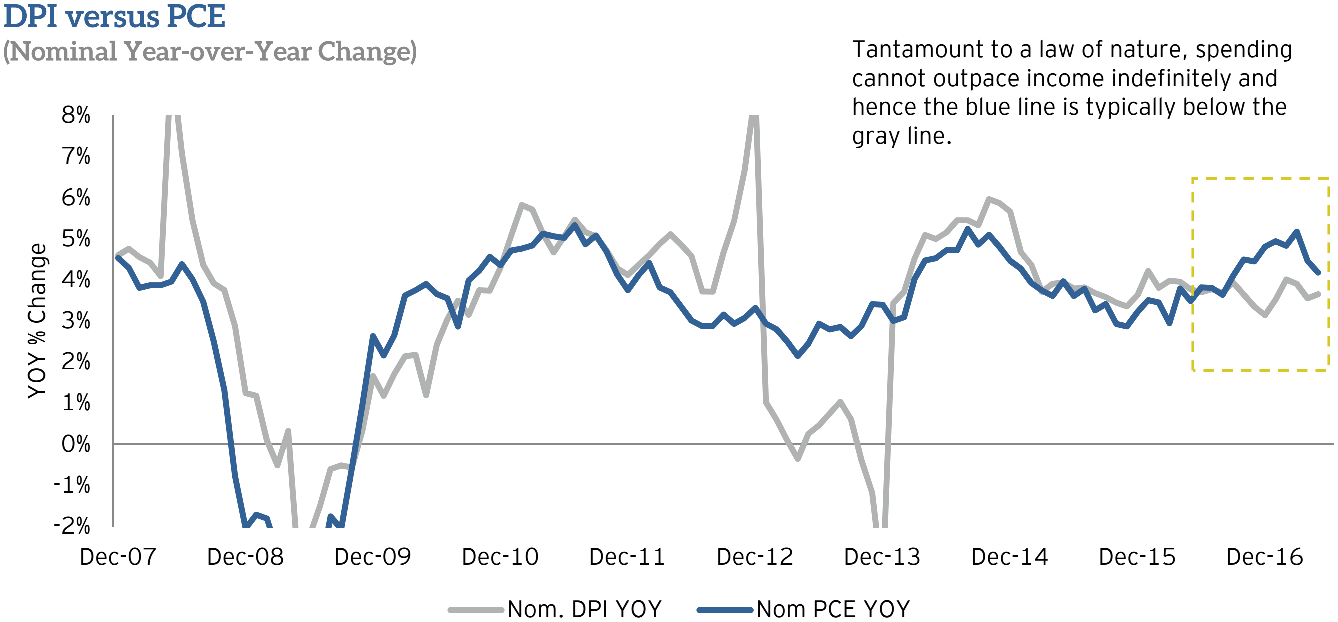
It's not as if the Fed is unaware of the conflicting signals between a tighter labor market and a lack of wage inflation. In describing his dissent regarding the decision to raise rates in June, Minneapolis Fed President Neel Kashkari observed the disparity between tightening labor data and weakening inflation.

> *On one hand, intuitively, I am inclined to believe in the logic … a tight labor market should lead to competition for workers, which should lead to higher wages. Eventually, firms will have to pass some of those costs on to their customers, which should lead to higher inflation. On the other hand, unfortunately, the data are not supporting this story, with the FOMC coming up short on its inflation target for many years in a row and now with core inflation actually falling even as the labor market is tightening.*
>
> *--Neel Kashkari, President of the Minneapolis Fed, June 16, 2017*

To Mr. Kashkari's point, a lack of meaningful wage growth leaves increased borrowing and spending down savings accounts as the only means to boost consumption levels. While consumption increased to a 2.8% annualized rate in the second quarter (vs. 1.9% in the first quarter), we believe a sustainable acceleration in the rate of consumption will be challenging. The boost in second quarter consumption was, similar to recent quarters, reliant on increased borrowing and reduced savings. In other words, consumers have been living beyond their means. As the chart below highlights, Disposable Personal Income (DPI) and Personal Consumption Expenditures (PCE) track each other closely and PCE (i.e. spending) cannot remain above DPI (income) for too long.

DPI versus PCE

(Nominal Year-over-Year Change)



Sources: Bureau of Economic Analysis and Covenant Investment Research.
Note: The DPI spikes in 2012 (higher) and 2013 (lower) were anomalies resulting from pending 2013 tax hikes.

LABOR MARKET

In the aggregate, the Labor Market remains on a steady footing. But, it continues to exhibit the qualities of a maturing business cycle - characterized by full employment and slowing job growth:

- The headline Unemployment Rate (U-3) is near cycle lows at 4.3%;
- Private non-farm payroll growth, after peaking at 2.4% in mid-2015, has recently stabilized at 1.7%;
- Monthly Non-Farm Payrolls have averaged 170,000 new jobs over the first half of 2017 as compared to a 264,000 six-month average in 2014 (the peak job growth of the current cycle).
- Recently, there's been a pick-up in relatively low paying jobs, as more than half of new hires in 2017 were in the lesser paying sectors of healthcare/social assistance, leisure and temporary jobs.

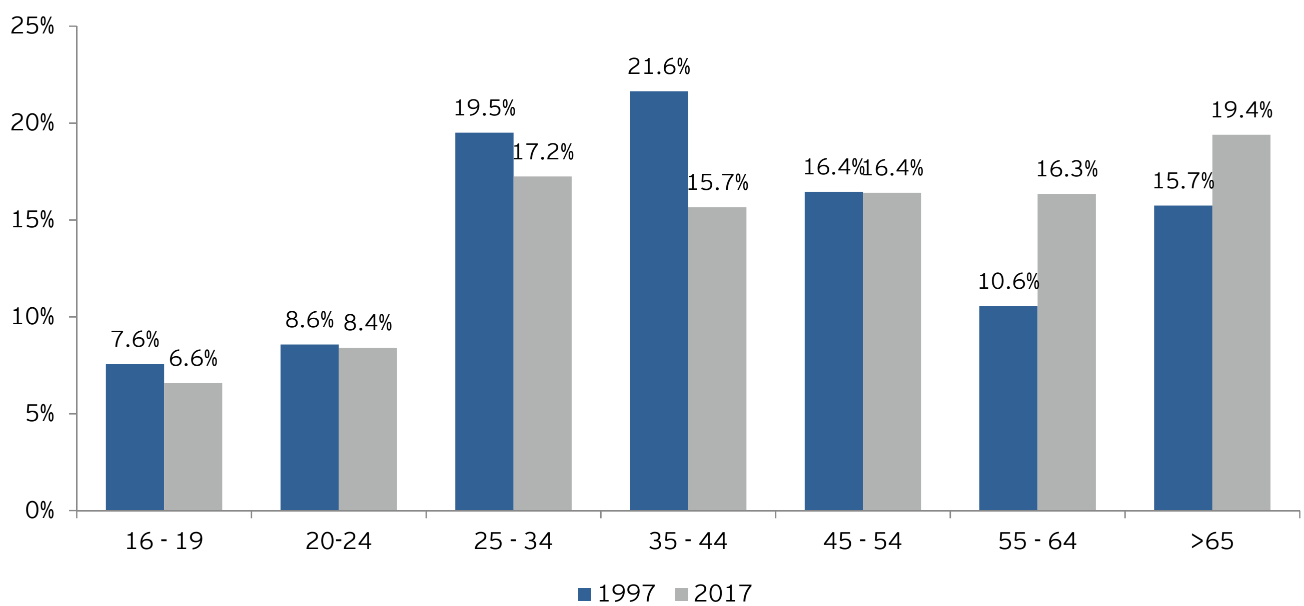
As the labor market has matured and is likely nearing structural limits, we have our doubts that the economy can reach another gear in its growth trajectory. Economic output is governed by three factors:

1. The number of people working,
2. Their productivity level, and
3. Expanding private credit.

With the latter two inputs trending downward, attracting more people to enter the labor force becomes of paramount importance to increase output. This is not an impossible outcome, but it will be challenging due to demographics (i.e. retiring Baby Boomers) and societal trends.

It is clear from the chart below the U.S. population is becoming proportionately older. The increase in the 55+ and 65+ year-old age cohort over the last ten years is a reminder that Baby Boomers are reaching retirement age in massive numbers and will be increasingly exiting the labor pool.

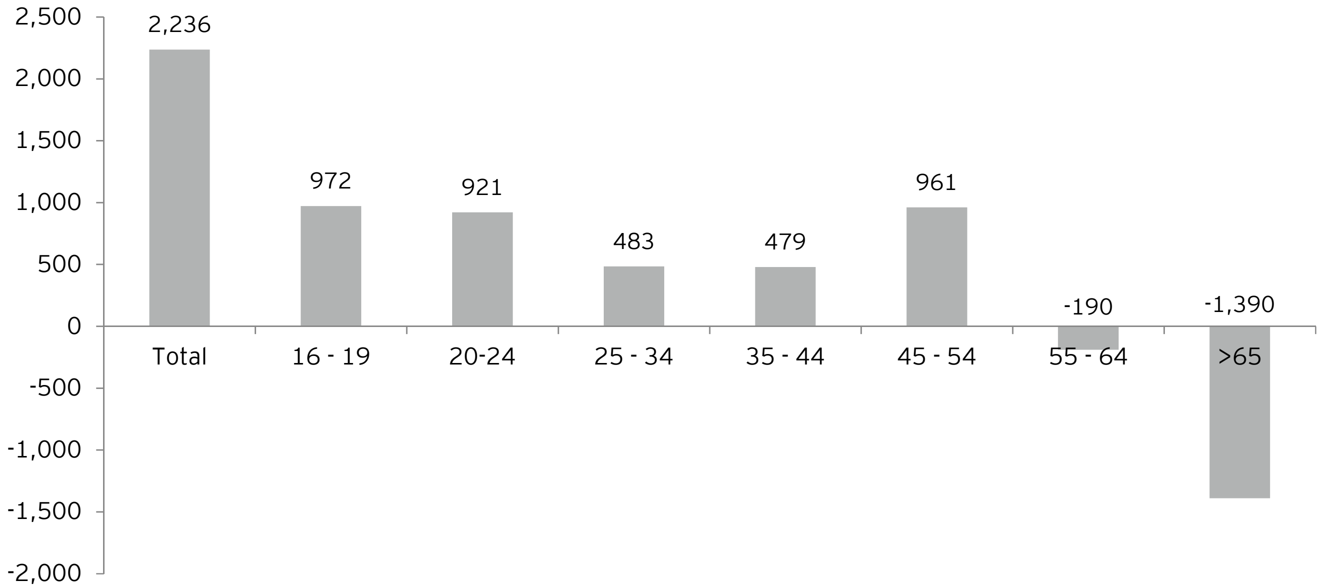
U.S. Age Cohorts-to-Total Population



Sources: U.S. Census Bureau and Foleynomics.

Two notable shifts in societal trends, however, adds a fair amount of nuance to this demographic shift. First, older people are working longer – likely an aftershock of the *Financial Crisis* which has made retirement unobtainable for a large swath of Baby Boomers. The second shift, highlighted in the chart below, is that, relative to pre-*Financial Crisis* levels, a large portion of the younger cohorts are simply not working.

Missing Workers
(In thousands; all data versus 2006 participation rates)



Sources: Bureau of Labor Statistics and Foleynomics.

While there is an argument to be made that Baby Boomers, in working beyond the traditional retirement age, are "stealing" jobs from the younger generations, it's not that simple. While that may provide a partial explanation, subtracting the nearly 1.4 million additional workers over the age of 65 leaves 2.4 million workers between the ages of 16 and 54 that remain "missing". Indeed, we have yet to find research that provides an adequate explanation for why younger people's working habits changed following the *Financial Crisis*. We suspect that increased unemployment benefits and government social programs are key explanatory factors, having provided a powerful disincentive to working, but this is only a hypothesis. Whatever the cause, the economy would benefit greatly if these missing workers decided to rejoin the labor market.

INFLATION

Broad measures of inflation reversed in the second quarter following a modest shift higher earlier in the year. As we mentioned at the time, while mathematically inflation was higher on a year-over-year basis, we believed it to be transitory owing to easy comparisons from the prior year when the price of oil was bottoming in early 2016. This "phantom" inflation is easily discernible in the chart on the following page which tracks the Fed's favored measure of inflation, Core Personal Consumption Expenditures (Core PCE). Core PCE moved further away from the Fed's 2.0% target and fell to 1.4% by the end of May (the latest available reading).

Core PCE
(Year-over-Year % Change)

Sources: Bureau of Labor Statistics and Covenant Investment Research.

At a more granular level, the table below details the three-month average year-over-year inflation reading for a variety of sectors. This table highlights the broad disinflation experienced in the second quarter and the challenge the Fed is facing in fine-tuning monetary policy to generate inflation of 2% (its target rate).

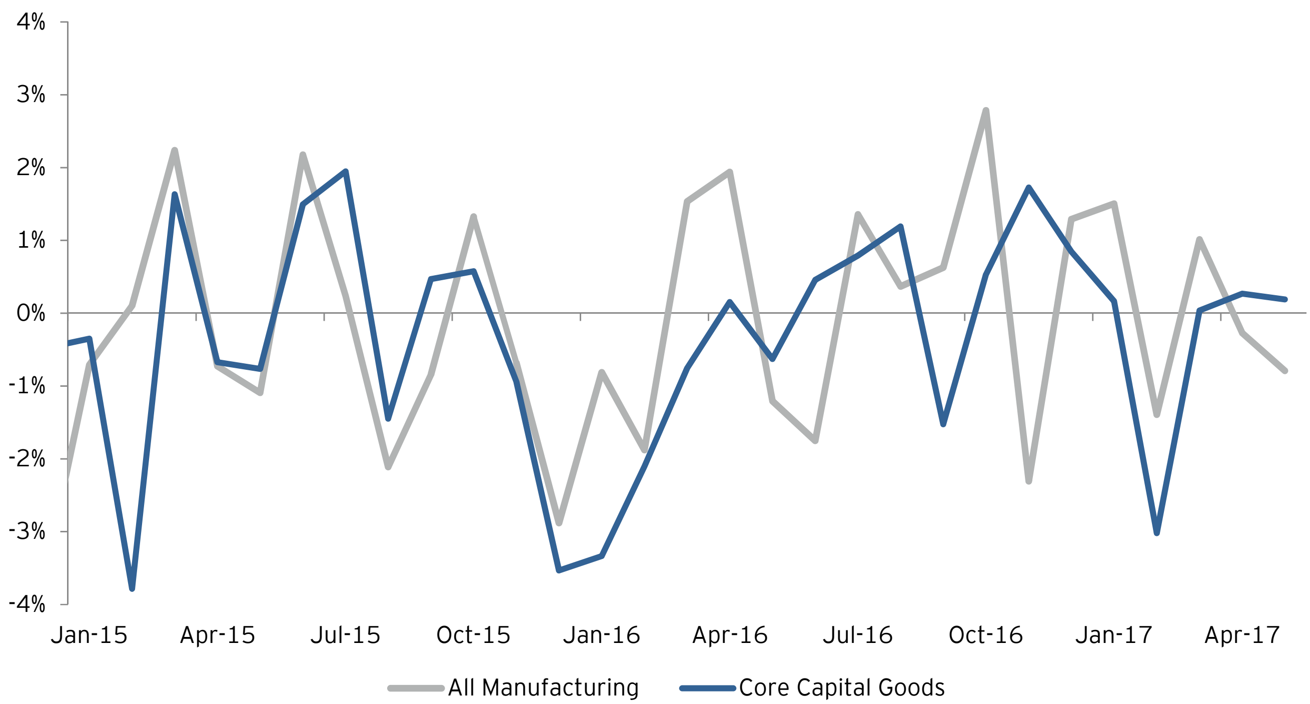
CPI Input	3-Month Average
Services	2.17%
Services, less Rent of Shelter	0.90%
Commodities, less Food & Energy	-0.32%
Food	1.25%
Rent of Shelter	3.09%
Medical Care	0.81%
Recreation	-0.66%
Education	-1.21%
Other Goods	4.72%
Apparel	-4.90%
Transportation	-7.54%

Sources: Bureau of Labor Statistics and Covenant Investment Research.

MANUFACTURING

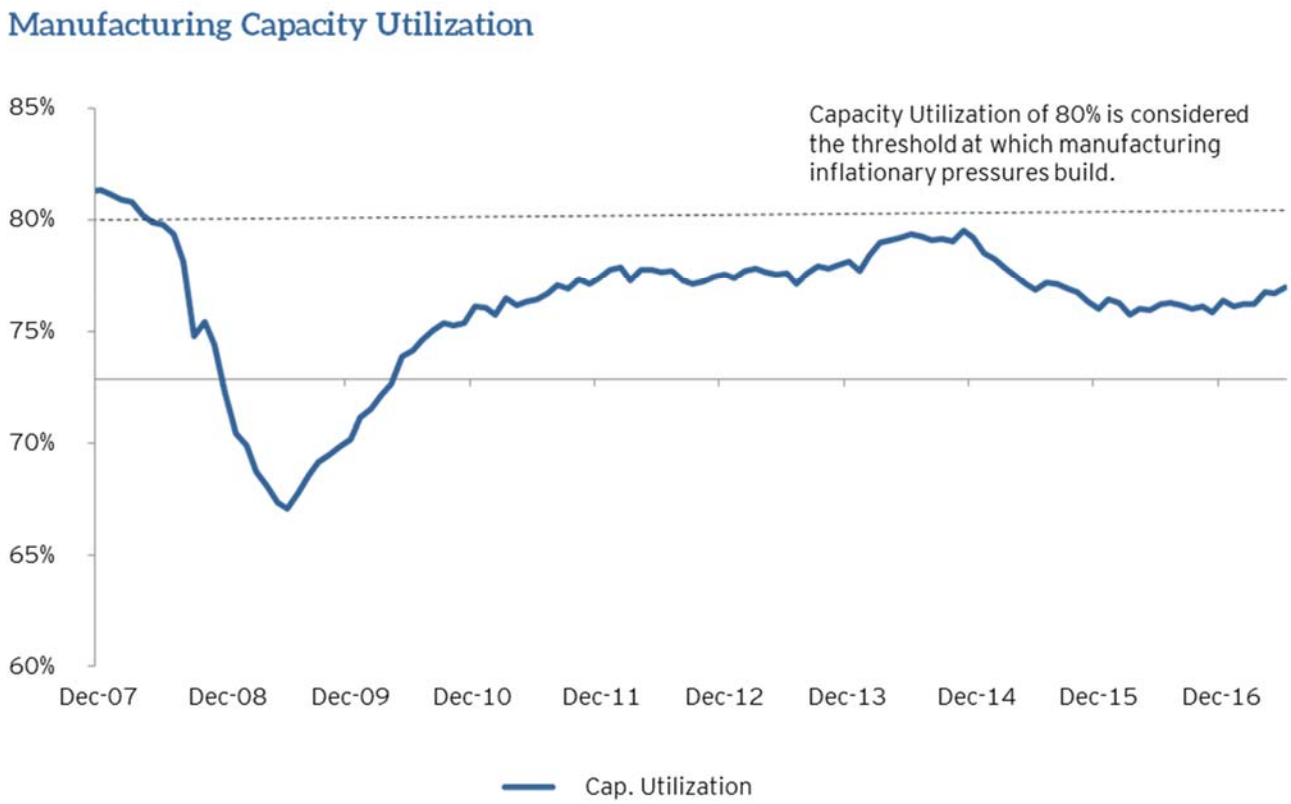
The Manufacturing sector remains in limbo as improved sentiment following President Trump's election has yet to translate into hard data. Headline Factory Orders closed out the second quarter with an impressive 7% year-over-year increase. However, this growth is largely illusory, as the increase was boosted by downward historical revisions. Moreover, sequential Factory Order data is hovering around 0% growth as seen in the chart below.

Factory Orders



Sources: U.S. Census Bureau and Covenant Investment Research.

Still, there is a reason to be optimistic as the US Dollar declined by more than 6% in the first half of the year and international economic growth has improved. The combination of these factors and the potential for a domestic fiscal stimulus package, may boost demand for U.S. manufactured products in the back-half of the year. Increased activity in Manufacturing would be a welcome change as the sector provides relatively high paying jobs and current capacity utilization remains well below 80%.



Sources: Federal Reserve and Covenant Investment Research.

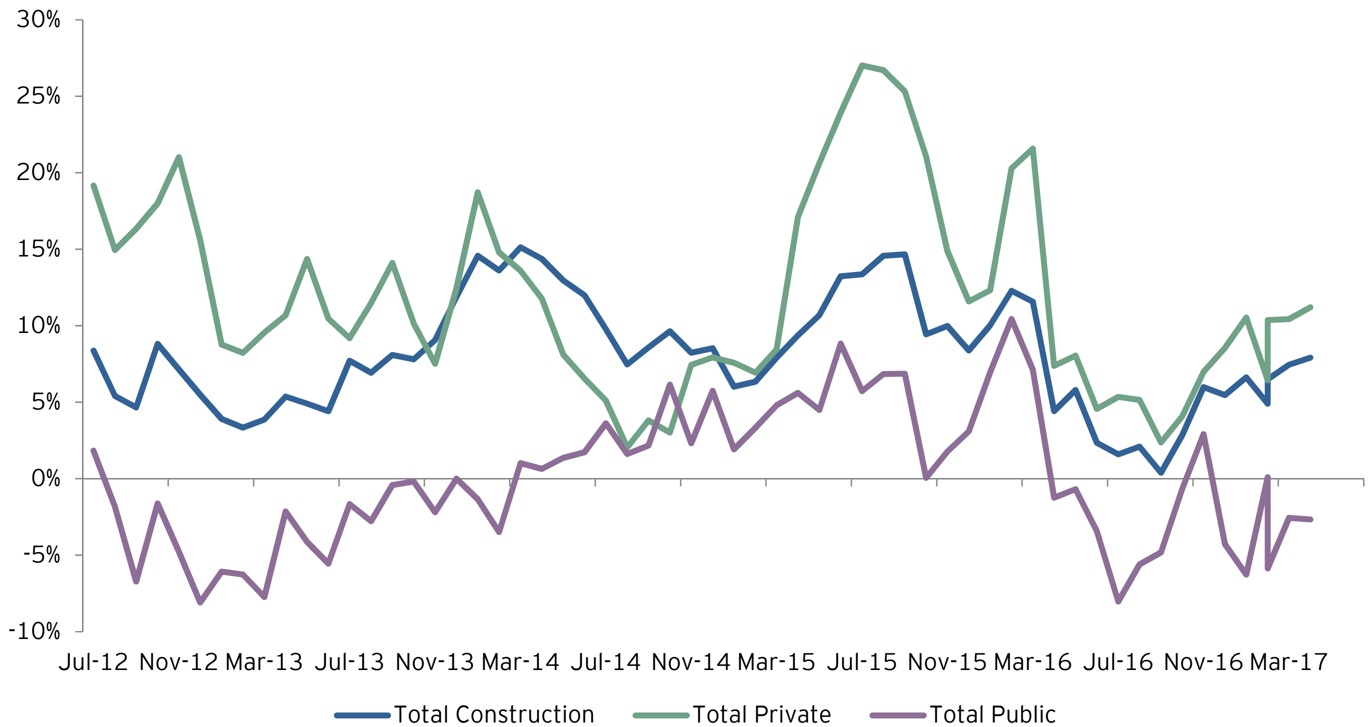
HOUSING & CONSTRUCTION

Both Housing and the broader Construction sector data were steady in the second quarter. While we suspect that Housing's overall impact on economic growth has peaked, we do not foresee a likely scenario in which it becomes a drag on growth in the near to intermediate-term. During the second quarter:

- New single family home sales were stable, at approximately 600,000 per month (annualized).
- Single Family Permits were 779,000 per month (annualized), down from 826,000 at the end of the first quarter.
- Multifamily Permits were 389,000 per month (annualized). This compares to 434,000 at the end of the first quarter. The slowdown in Multifamily permits is healthy for the sector as Multi-family construction has been at a high level for an extended period – potentially leading to an oversupplied market.

Activity in the broader Construction sector continued to trend higher. Importantly, this growth is being driven exclusively by the private sector, as public sector spending has been negative on a year-over-year basis. Obviously, a fiscal stimulus package that includes infrastructure spending would alter this trend, further boosting overall construction activity.

Construction Spending
(Year-over-Year)

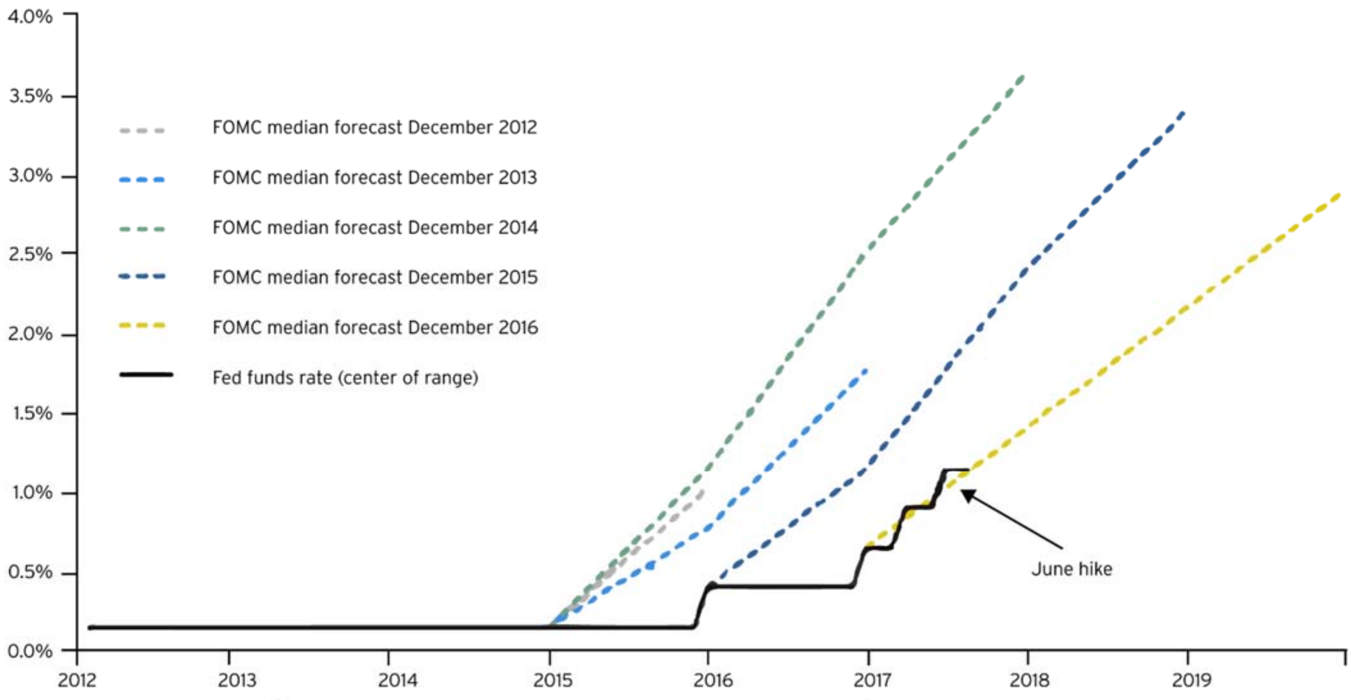


Sources: U.S. Census Bureau and Covenant Investment Research.

Looking Forward

Although there have been no significant changes to the economy since the election, there has been a noteworthy shift in how the Fed is approaching monetary policy. The new approach heightens the risk of a policy mistake at a time when subpar economic growth affords little margin for error.

The Fed has become notably agitated about the low unemployment rate, under the belief that it will lead to wage-push inflation. After moving rates higher only once since the *Financial Crisis*, the Fed has raised rates three times in the last nine months. Indeed, 2017 marks the first year since the *Financial Crisis* that the Fed has not immediately abandoned their planned rate hikes (as the chart below illustrates).

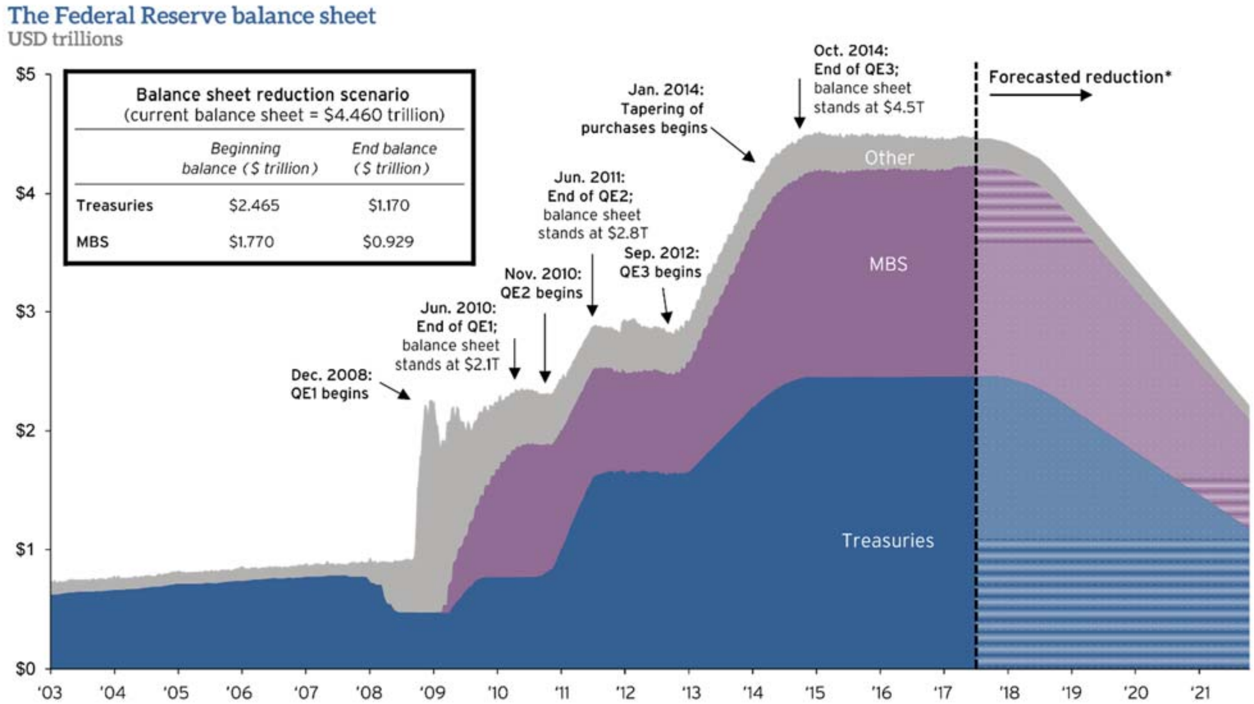


Source: St. Louis Fed and FTN Financial.

Regarding this change in policy discipline, Chris Low of FTN Financial remarked that the Fed is no longer "data dependent", that is, basing monetary policy decisions on current economic conditions.

> *"They are now making policy decisions based on the output of their forecasts of where inflation, unemployment, and growth will be in 2-3 years. These forecasts are now informing their rate decisions."*

In addition to moving to a more mechanical decision making process for setting interest rate levels, the Fed recently released a plan for reducing the emergency expansion of their balance sheet, signaling it will begin later this year (possibly as early as October). The Fed has tried to talk down the impact this will have on markets, but if they follow the maximum reduction rate outlined in their plan, the balance sheet drawdown rate will look very similar to its emergency increase. While we hope the Fed is correct that the reduction will occur "quietly in the background", it is difficult to conclude financial markets will remain at historically low volatility levels as the Fed tightens monetary policy in two dimensions (raising interest rates + removing quantitative easing).



Source: JP Morgan.

Fortunately, time appears to be on the Fed's side. It is unlikely that the Fed will raise interest rates again until at least December, using the September Federal Open Market Committee meeting to announce the balance sheet reduction. Using December as the next potential date for another rate move, the Fed will have an additional five months of data to assess economic conditions. Thus far, the Fed has characterized weak consumption and inflation metrics in 2017 as transitory, hiking interest rates on two occasions. By December their assessment may change. One would expect that the Fed's monetary policy would change in sync with the data. Yet, as noted above, the Fed has recently gravitated to economic forecasting models that have proven unreliable and out of step with the dynamics of the current labor market. Should this practice continue, it significantly increases the likelihood of a policy mistake.

- The Covenant Investment Team

Disclosures