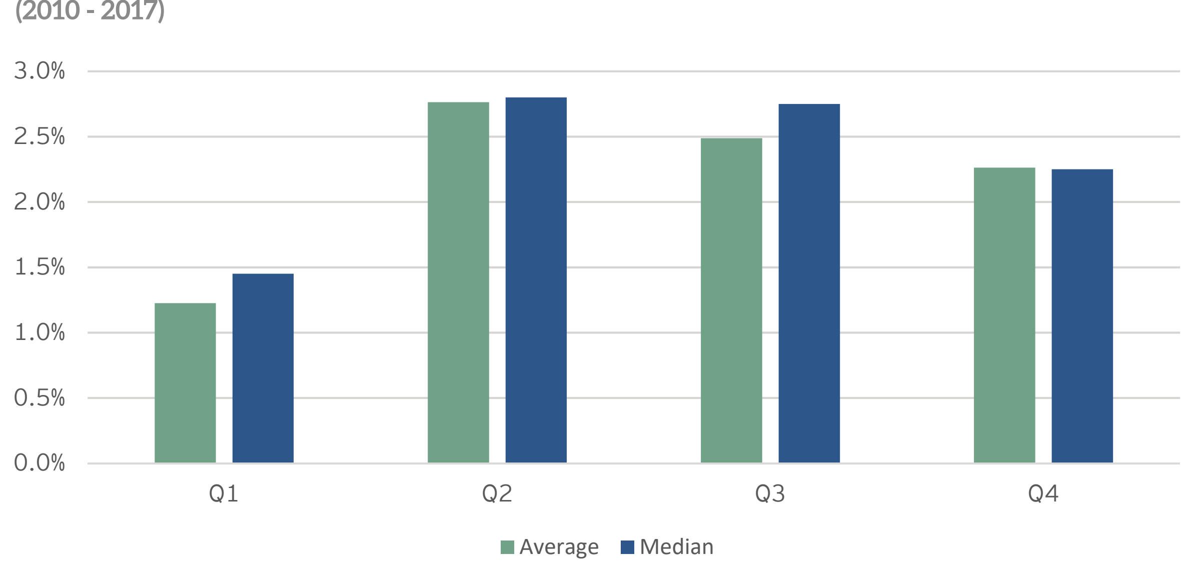
The initial fourth-quarter estimate of real, annualized GDP growth was 2.6%. The overall growth rate fell short of consensus estimates, but it was, nonetheless, a strong report as Personal Consumption jumped to its highest level in 18 months and Business Investment expanded. The Q4 GDP value will be revised two more times in the coming months as additional data is gathered, which may result in revisions to fourth-quarter growth. As it stands now, the economy expanded at 2.3% in 2017, consistent with the post-Financial Crisis pace and our "Good, But Not Great" economic thesis. However, that thesis may be challenged in 2018. Economic activity appears to be accelerating, and it stands to reason that with a stronger global economic backdrop, domestic economic growth may reach or even exceed 3% in 2018.

2017 Review

In many ways, 2017 was a prototypical post-Financial Crisis year with regards to economic growth. Once again, it was a good year, but not a great year for the economy. It began with a relatively slow first quarter (GDP 1.2%) followed by stronger growth in successive quarters (Q2 3.1%, Q3 3.2% and Q4 2.6%). This pattern has been prevalent since the Financial Crisis, as illustrated in the chart below. Moreover, annual GDP growth was in-line with the post-Financial Crisis average of 2.2%. However, in 2017 a handful of important changes created economic momentum that is carrying into 2018, including improved global growth, deregulation and tax reform.



Sources: Covenant Investment Research and Bloomberg L.P.

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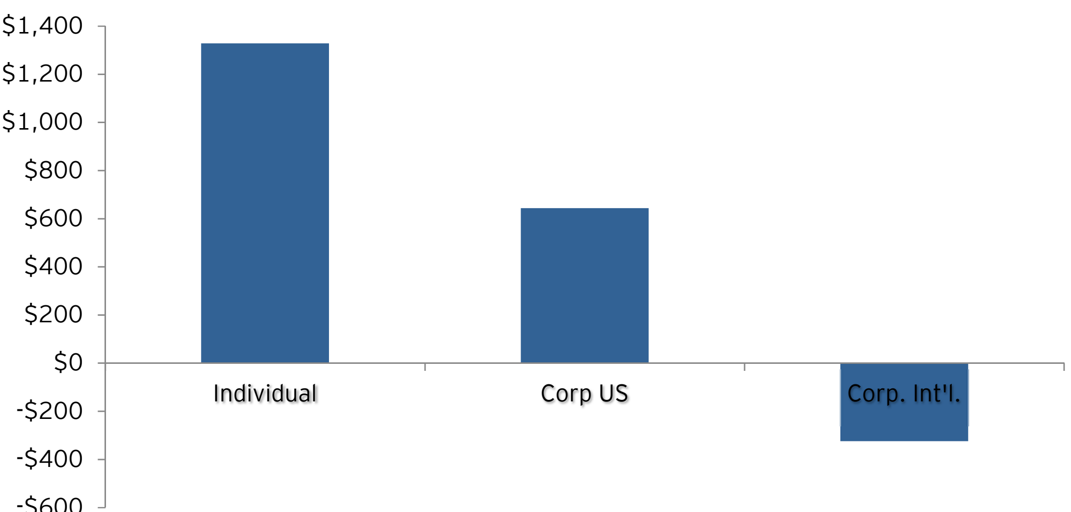
GLOBAL GROWTH

In contrast to the past seven years, growth outside of the United States has improved in a synchronous fashion. As we have discussed on many occasions over the last several years, actions by the Federal Reserve in the aftermath of the Financial Crisis enabled the U.S. economy to recover faster than its international counterparts. Although growth in the U.S. has been "good, but not great" for eight years, the U.S. economy remained well ahead of other key developed market economies. That dynamic changed in 2017 as accelerating growth in the Eurozone was one of the bigger economic surprises of 2017. Furthermore, Emerging Market economies remain on a positive growth trajectory. Broad-based economic expansion has given rise to the strongest global growth in a decade, spawning the oft-cited "Global Synchronized Growth" phrase in 2017. Stronger global growth stimulates demand for products and services and, as a result of deregulation and tax reform, U.S. corporations are now in a better position to compete within the growing opportunity set.

DEREGULATION & TAX REFORM

This brings us to the second important, growth-positive, difference in 2017: the Trump administration's policies with regards to deregulation and tax reform. Regulations serve an essential role in the framework of modern society. However, laws have associated costs (tangible and intangible) that reduce efficiency and, in some cases, productivity. Some of these costs are worth bearing for the protection of the citizens. Yet, too many regulations reduce the dynamism of society and negatively impact economic growth. While not everyone will agree with the Trump administration's decisions about which controls are removed or modified, less regulation should allow business owners to redirect a portion of their resources previously dedicated to regulatory compliance to more productive uses.

Tax reform, when announced, was beset with negative press coverage about "tax cuts for the wealthy" and "tax cuts for corporations," but very little in the way of benefits for "Joe and Jane 6-pack". That is not a political statement, but rather an observation that the stage is set for an unexpected pay raise for the majority of American citizens. Indeed, data from the Congressional Budget Office (CBO) indicates that individuals will receive the lion's share of the tax savings equating to $1.3 trillion through 2027. Domestic corporations will also benefit, saving $644 billion in taxes. In other words, households will receive about 2/3 of the tax savings, while corporations will receive 1/3.



Sources: Foleynomics and Congressional Budgetary Office.

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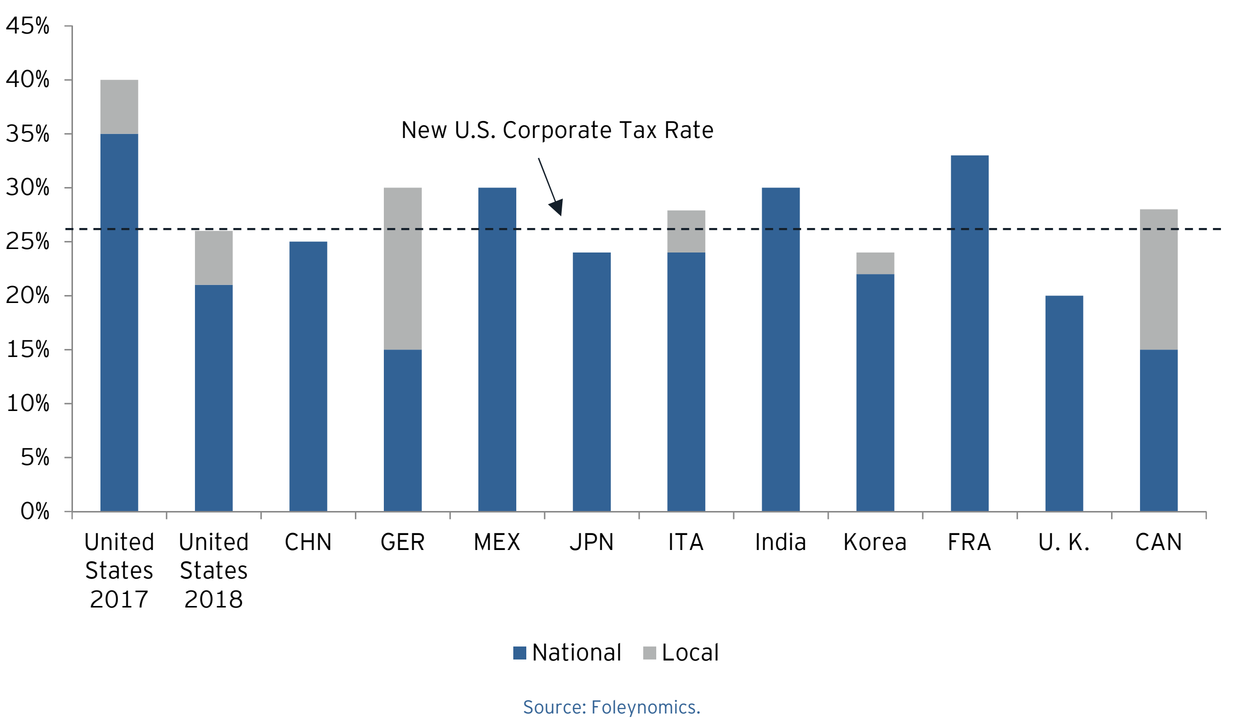
Economists can step around the thorny debate of who benefits more from this tax cut (the rich or the poor) because from an academic perspective it is clear that most of the U.S. labor pool will pay fewer taxes beginning in 2018. Many people don't believe this is the case, but in February payroll tax withholdings will be adjusted, and the majority of average Joe's and Jane's will be happily surprised by the lower withholdings and higher take-home pay they will receive. Since "average" laborers have a higher marginal propensity to consume additional discretionary income (compared to their affluent counterparts), tax reform should provide a boost to domestic consumption levels.

As mentioned earlier, corporations will also benefit from the tax reform policy, even if they are "only" receiving 1/3 of the total tax savings. The last significant tax reform took place under President Ronald Reagan in the 1980's. Since then, the world became increasingly globalized and mobile, but U.S. tax law remained relatively static making the U.S. an expensive option for conducting business. Under the new tax law, the U.S. will be more competitive on the global stage (see chart below).



Source: Foleynomics.

Outlook

All in all, the confluence of stronger global growth, deregulation and domestic tax reform should boost economic growth in 2018. But the question remains, for how long will it last? At present, most early recession indicators are not even flashing yellow, let alone red so it appears that absent a significant exogenous event, the economy should continue to expand for at least another 12-18 months.

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The one early indicator that is flashing yellow is the difference between the yield on 10-year US Treasury bonds and that of 2-year US Treasury bonds. Historically, when the spread has turned negative (i.e., 2-year bonds are yielding more than 10-year bonds), a recession has ensued within 6 – 18 months. The 10-year / 2-year spread has declined from 1.3% at the beginning of 2017 to approximately 0.7% currently. The overall trend is worth watching, but the absolute level of the spread is not signaling a recession is imminent.

Recession Early Indicators	Status
Conference Board Leading Economic Indicators	Green
Unemployment Rate Declining	Green
Purchasing Managers' Index	Green
Small Business Optimism Index	Green
Consumer Confidence	Green
High Yield Spread over US Treasuries	Green
10-year / 2-year Spread	Yellow

Although a recession is unlikely in 2018, we do not expect "breakout" growth such as the 5% - 6% levels achieved in the late 1990's. Rather, above-trend real (inflation-adjusted) growth in the 3.0% range should be achievable in 2018 and would be a welcome change from the 2.1% average growth level experienced since the Great Recession officially ended in June 2009. If that forecast comes to fruition, this recovery will become the longest on record even as it is one of the weakest with regards to growth.

A robust near-term outlook notwithstanding, some risks must be considered. Below are some of our more tangible concerns.

- **Monetary Policy Mistake** – If growth accelerates faster than expected or meaningful inflationary pressures finally push through to consumer prices, the Fed's natural reaction function is to raise rates to slow credit growth and cool the economy. Historically, Federal Reserve rate hikes have killed the majority of economic expansions and initiated the ensuing recessions. However, we do not expect excessive rate hikes in 2018. Moreover, there is growing support within the Fed to consider a shift from the Fed's current strategy of inflation-targeting to a price-level targeting approach. Under price-level targeting, the Fed would still target a 2% inflation level, but that target would consider the average inflation rate over an intermediate timeframe. In other words, the Fed would be more tolerant of inflation rising above 2% for a period if it had remained below that level in the preceding period (a la' the last nine years since the Financial Crisis). This approach has not been officially adopted, but the new Fed Chairman Jay Powell appears open to further deliberation on the concept.
- **Global Quantitative Tightening** – The era of Quantitative Easing (QE) is over, and Quantitative Tightening (QT) is set to begin in earnest this year. The Federal Reserve started to reduce their balance sheet in late 2017, and the European Central Bank cut its bond purchasing program by 50% in January 2018. Although the Bank of Japan continues to buy bonds in size, two of the three central banks that were instrumental in the QE movement are increasingly shifting towards withdrawing liquidity from the global economy. By July of this year, the combination of balance sheet reductions by the Fed and reduced bond purchases from the ECB will result in a net withdrawal of global liquidity for the first time since QE began nearly ten years ago. Since QE had never been conducted at the scale that was engaged in response to the Financial Crisis, the reversal of QE will also be an experiment leaving open the possibility of unintended consequences on the economy and financial markets.

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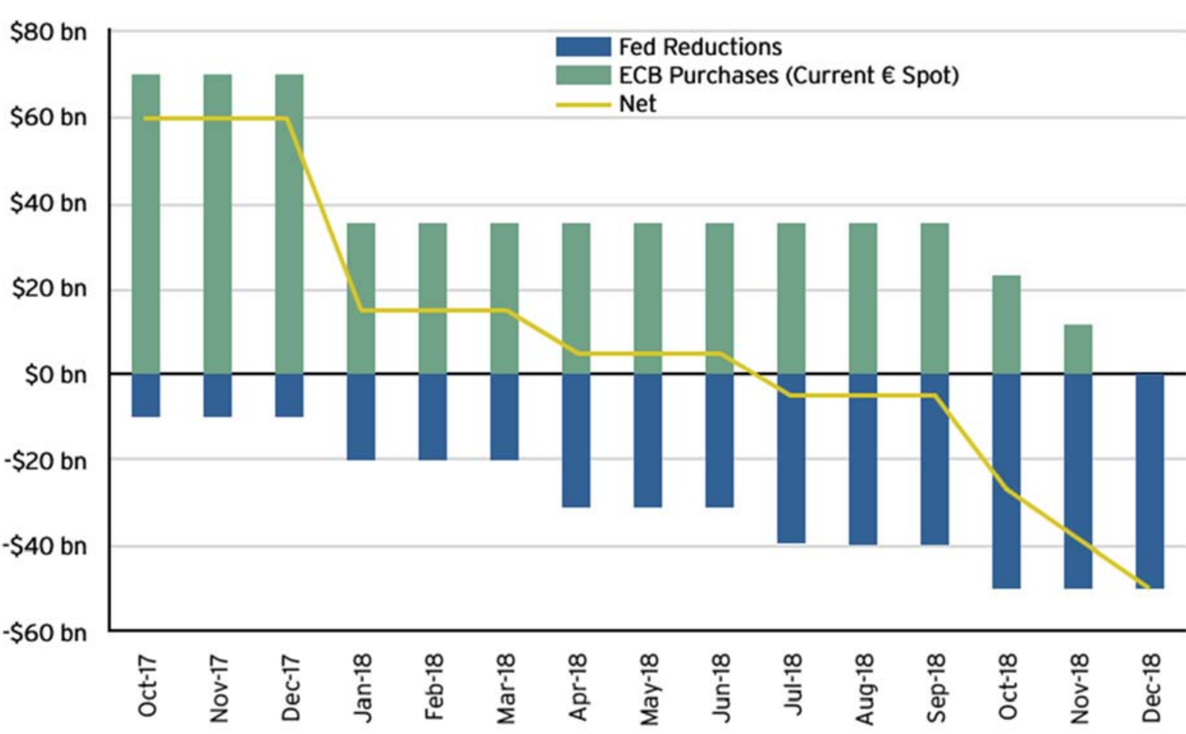

Sources: Wells Fargo Securities and Bloomberg L.P.

- **Reduced Consumption** – The U.S. economy is reliant upon consumption as it comprises approximately 70% of Gross Domestic Product. Although we expect the tax reform policy to boost consumption, there is the potential for households to redirect the additional income to paying down debt or increasing savings. For the last two years consumers, in aggregate, have spent more than they earned. Over this period consumption has been financed through increased borrowing and reduced savings. Consumer debt as a percentage of personal disposable income is at an all-time high and savings reached a new cycle low of 2.4% in December 2017. The long-term average savings rate is approximately 7%, so consumers would be well-advised to keep their wallets in their pockets for a while and work on rebuilding their personal balance sheets.

There are, of course, many other risks that should not be ignored. The world is as unpredictable as ever, from the dangers relating to China's transition to a consumption-led economy to the cold war with North Korea turning hot. But as of today, the economy is poised for a solid 2018.

In spite of our optimistic short-term outlook, serious issues remain that if left unaddressed will negatively impact the long-term growth potential of the U.S. economy. Chief amongst these issues is the Government's spending problem. According to forecasts from the Congressional Budget Office (CBO), the budget deficit will more than double from -$690 billion in 2017 to -$1.5 trillion in 2027. Addressing the spending problem will require the government tackling entitlements, as "Mandatory" spending is roughly 63% of the annual federal

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budget.[1] While Social Security has many well-known problems, it pales in comparison to the amount spent each year on Medicare and Medicaid. As the population ages, the problem will only get worse. Current forecasts indicate the net outlays related to these two programs will rise from $827 billion in 2017 to more than $1.5 trillion in 2026 (Source: Congressional Budget Office).

Even using the CBO's rosy GDP growth forecast of 3.9% per year with no recessions through 2027, the budget deficit will only get worse. Absent a reduction in spending, the government's only option will be to take on more debt. The problem with debt-as-a-solution is that the nation's debt level already exceeds 100% of annual GDP and academic research of other highly indebted countries indicates a causal relationship between excessive debt and slower economic growth. Specifically, debt levels of more than 90% of annual GDP have been shown to diminish trend economic growth by 1/3 or more (Source: Hoisington Investment Management). This is one reason why we believe the effects of tax reform will be relatively short-lived and the U.S. economy is destined to return to a growth rate of around 2% before the next recession.

But, debt-induced slower growth is a problem for the future – at least that is how politicians have been treating it by repeatedly kicking the can down the road – so let's enjoy what promises to be an above-trend growth year in 2018.

- The Covenant Investment Team

Disclosures

The principal sources used in the preparation of this Report include: Bloomberg L.P., Foleynomics, Congressional Budgetary Office, Wells Fargo Securities, and Covenant Multifamily Offices, LLC ("Covenant"). Some data included in this report including government reports and other data has been taken from secondary sources and were not derived from the primary sources. Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Covenant), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Covenant. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Covenant is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the Covenant's current written disclosure statement discussing our advisory services and fees is available upon request. If you are an Covenant client, please remember to contact Covenant, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services.

[1] Appropriated spending (aka discretionary spending) is only 30% of the budget. The remainder of the budget is dedicated to debt service, the cost of which will become more burdensome if interest rates move higher. Unfortunately, the solution to the budget deficit riddle includes reducing Mandatory expenses.

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