2% year-over-year on an inflation-adjusted basis. In other words, job growth has been sufficient to overcome the slow pace of wage growth, resulting in higher aggregate income that has supported consumption growth.

Real YOY Aggregate Wage & Salary Growth

Sources: Bureau of Labor Statistics and Covenant Investment Research.

Outlook: Unless demand for labor weakens, the declining labor supply should result in accelerating wage growth as companies are forced to pay more to retain and attract workers. At that point, compensation growth will have a more pronounced impact on Aggregate Wages & Salaries than it has had in the last five years.

Despite labor market strength, Consumer Confidence appears to have plateaued. While confidence remains high, the widening divergence between current conditions and expectations is worth watching as these types of deviations have presaged periods of economic downturns in the past.

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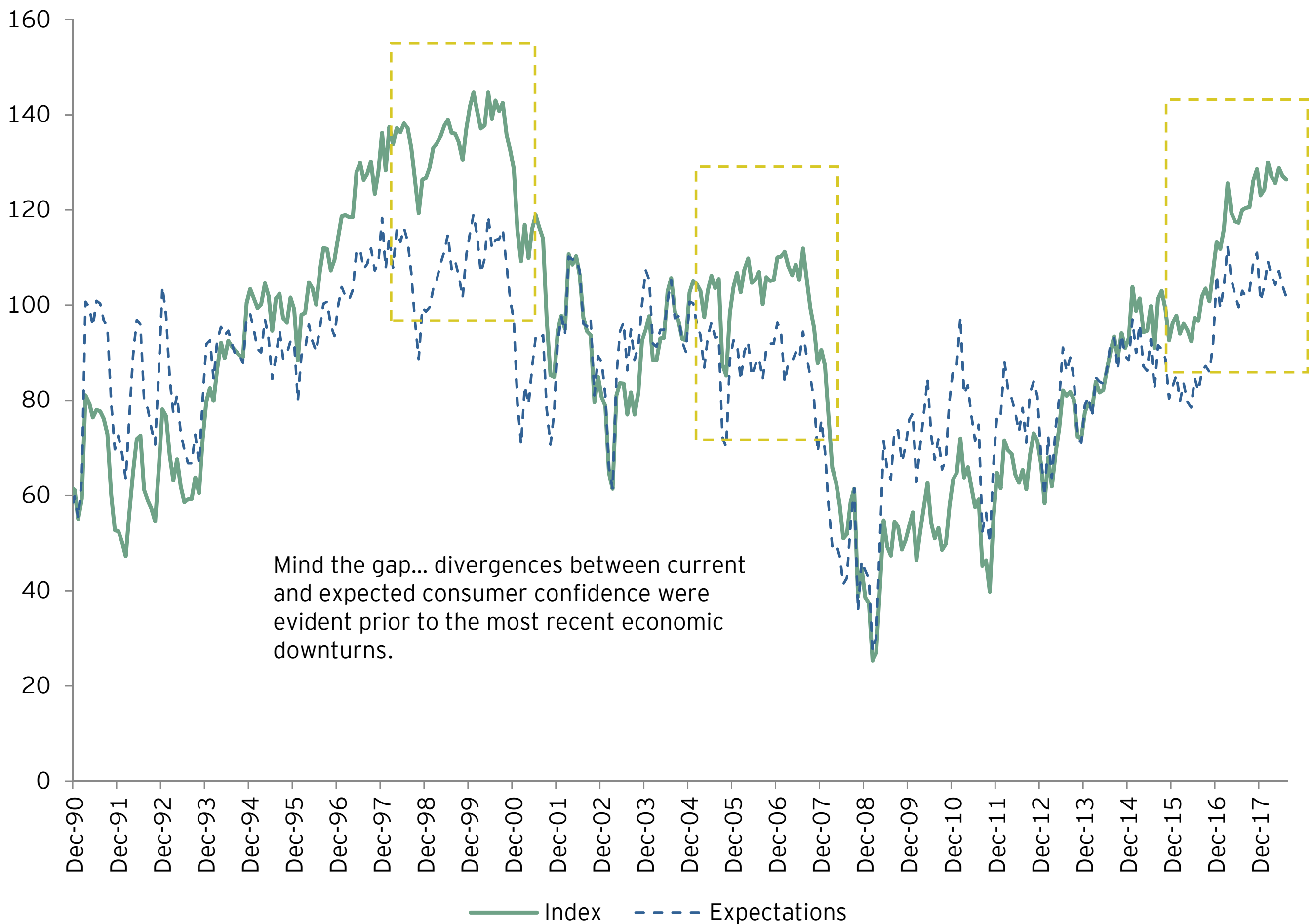
Consumer Confidence



Sources: Conference Board, Foleynomics, and Covenant Investment Research.

Outlook: The spike in Q2 retail sales appears to be driven by credit card usage, which is typically unsustainable. Still, continued labor market strength and rising wages should support healthy consumption levels going forward. The gap in consumer confidence levels is noted, but the timing for when it might lead to lower consumptions is indeterminable. A shift higher in future expectations would give us greater confidence in consumption levels going forward.

INFLATION

Inflationary pressures have firmed in the economy, but more so higher in the value chain than at the consumer level. The Core Consumer Price Index (CPI) is registering 2.4% on a year-over-year basis, while the Fed's preferred measure of inflation (Core Personal Consumption Expenditures) remains slightly below target at 1.9%. Further up the value chain, Producer Price Indexes (PPI) are rising faster than their CPI counterparts, suggesting that additional price increases could be passed onto consumers soon. Services, which account for nearly 2/3 of the PPI Index, have risen approximately 3% year-over-year and intermediate goods prices rose 6.8% year-over. ISM Manufacturing and non-Manufacturing surveys corroborate the PPI data, as both are trending higher.

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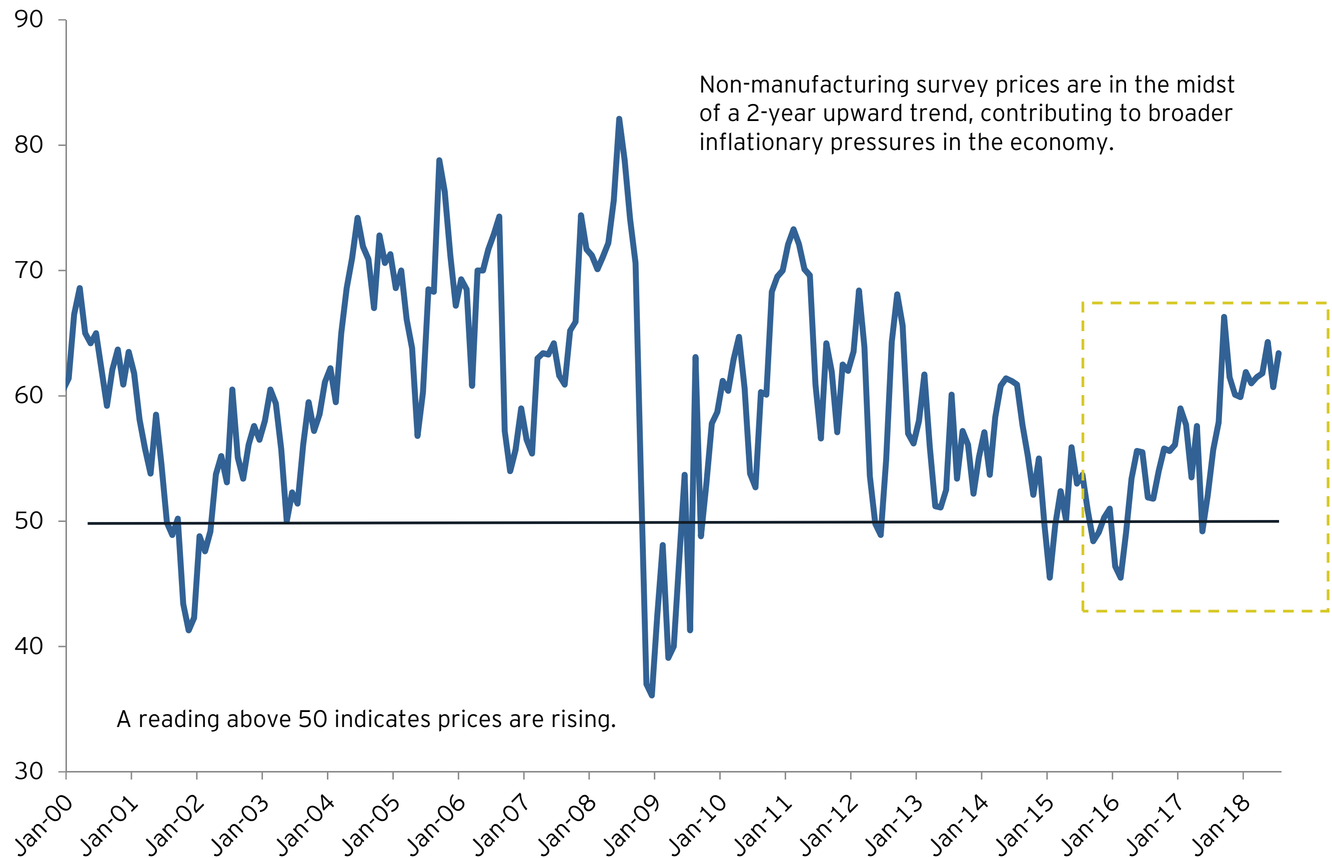
ISM Non-Manufacturing Prices Paid



Sources: Institute for Supply Management and Covenant Investment Research.

Outlook: Over the last several years, housing has been the primary contributor to inflation, but that is no longer the case. Inflationary pressures from accelerating economic growth are spreading in the economy and should continue to rise as the economy is operating near full capacity. Nonetheless, with the Fed tightening in multiple dimensions and growth waning in other parts of the world, the prospects for runaway inflation are remote.

HOUSING & CONSTRUCTION

Long the stabilizing pillar of the Great Recovery, the housing market is showing signs of fatigue as residential investment has exhibited negative growth for two consecutive quarters. Other symptoms of slowing growth include a rising inventory of existing homes since the beginning of the year and a decline in the value of both new and existing home sales. The most likely explanation for these trends is affordability as price appreciation (the median existing-home price is up 15% since the start of the year), higher mortgage rates, and slow wage growth are headwinds to home ownership. Supporting the "affordability" thesis, first-time buyers now account for only 31% of existing home sales vs. a long-term historical rate of close to 40%.

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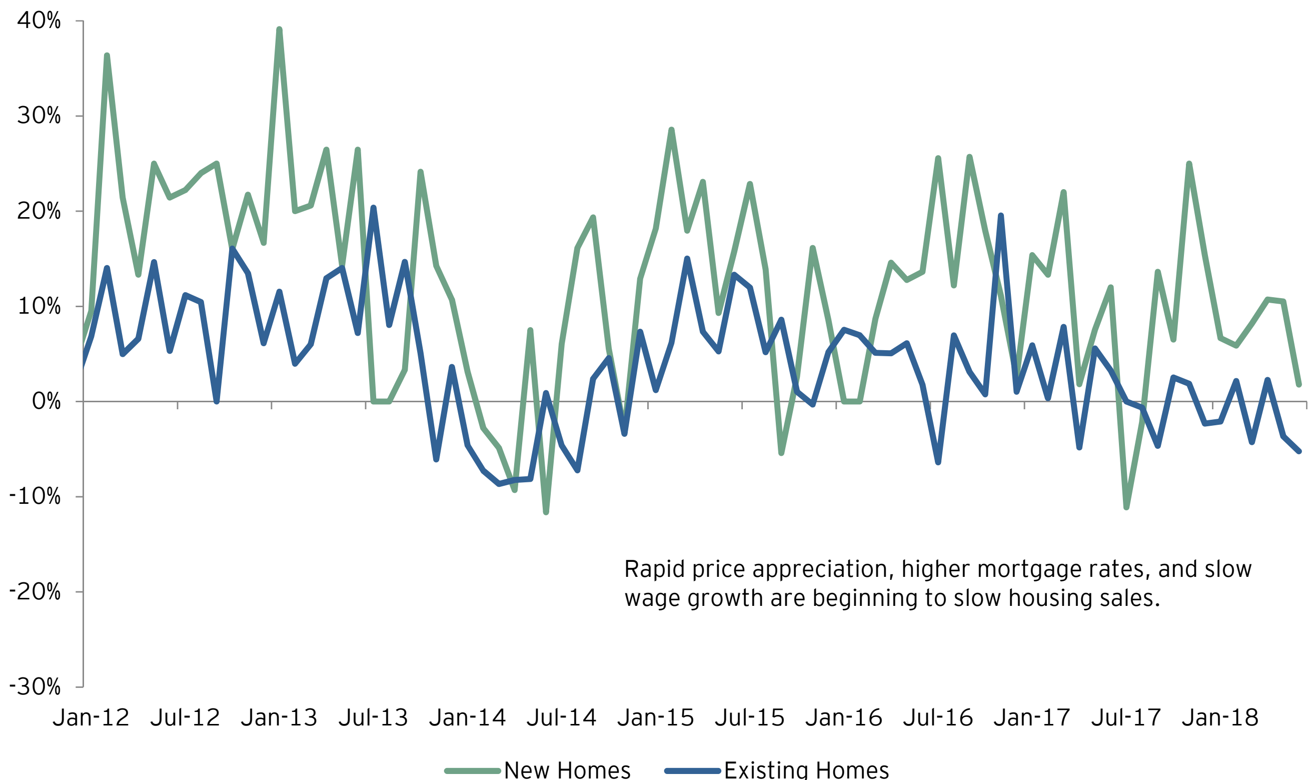

Sources: Census Bureau and Covenant Investment Research.

Outlook: Rising housing prices (and rents) are not a new phenomenon and, in fact, have been one of the primary reasons Core CPI has remained close to 2% for the last several years (shelter comprises approximately 40% of the Core CPI calculation). If the Fed continues to raise interest rates as we expect, the pace of housing price appreciation is bound to slow. Already, the Fed-effect is evident in the back-to-back quarterly declines of residential spending.

FEDERAL RESERVE & INTEREST RATES

Against a national backdrop that includes an economy running at, or near, full capacity, increased government spending, and significant tax cuts, the Federal Reserve is on the move. Having raised interest rates twice this year, new Fed Chair Jerome Powell has indicated that raising rates once per quarter is appropriate. Hence by the end of the year, the Fed Funds rate will likely reach 2.5%. Concurrent with moving rates higher, the Fed is also reducing the size of its balance sheet, which has declined from $4.5 trillion at its peak to $4.2 trillion today. Rate hikes have a known impact on the economy, whereas the effects from reducing the Federal Reserve's balance sheet are unknown.

What we can say with certainty is that financial conditions are tightening, and with the US Dollar (USD) acting as the dominant global reserve currency, the Fed is the de facto central bank to the world. Consequently, the Fed’s local monetary policies are having a global impact by reducing USD supply worldwide. The effects of declining USD liquidity are already showing up in weaker emerging market countries such as Argentina, Brazil, and Turkey whose currencies are buckling under the weight of their sizeable USD-denominated debt balances.

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In addition to the global impact, the Fed's monetary policy forecast is currently engaged in a game of "chicken" with the domestic market. The Fed's monetary policy actions impact rates at the short end of the yield curve (US Treasuries maturing within two years), but the Fed has little impact on long-term rates which are determined by market forces. While the Fed has been raising rates and pushing up the front end of the yield curve, thus far the market does not believe we are in a new phase of the economic cycle in which 3%+ annualized growth is sustainable. As such, US Treasury futures are only pricing in three more rate hikes by the end of 2019 vs. the Fed's forecast of five increases.

Absent the market coming around to the Fed's view and allowing longer-dated yields to rise, the next two Fed rate hikes (forecast for 0.25% in each of September and December) will invert the yield curve between 2-year and 10-year bond maturities. Currently, the yield spread is a scant 0.26%.

UST 10yr/2yr Yield Spread

Sources: Census Bureau and Covenant Investment Research.

Economists and investors pay close attention to the shape of the yield curve because it has a direct impact on credit creation by banks, the lifeblood of economic expansions. A bank's cost of funds is determined by the overnight rates set by the Fed, whereas the market sets the interest rate that a bank can earn on making long-term loans. An inverted yield curve places banks in a precarious position where there is a strong possibility that they will not earn enough from interest on the loans they make to cover their cost of funds. While there are arguments that the long-end of the yield curve is artificially low because of quantitative easing domestically and abroad, in practice the reason for low long-term interest rates is irrelevant. A US-domiciled bank doesn't care if the 0.3% yield on 10-year German Bunds is keeping local rates low, it only cares about the profit it can earn between its cost of funds and the interest it can charge on the loans it extends. Recognizing the impact to the real economy of an inverted yield curve, several Fed members have cautioned against implementing rate

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hikes at a pace that risks an inversion. Those arguments may be put to the test in the next few months if the Fed continues to follow its forecast and raises rates 0.5% by the end of the year.

On the other hand, the Fed could decide to pause its rate hiking cycle in the hope that continued economic strength will convince the market that interest rates should be higher. Such a scenario would be reminiscent of Fed Chairman Alan Greenspan's decision in the mid-1990's to stop hiking rates when the economy was beginning to slow. The pause gave the economy new life as financial conditions eased and growth resumed. On the heels of a 4.1% GDP print, the concept of a slowing economy may sound absurd, but it is unlikely the economy will continue to expand at this rate for long. If the Fed chooses to push ahead and longer-term rates do not rise, look for growth to slow quickly as rate hikes begin to bite into credit supply.

Conclusion

The economy is firing on nearly all cylinders at a propitious time as protectionist trade measures and slower international growth threaten the synchronous global growth story. Moreover, even as the economy is expanding at an above-potential pace, wage growth and inflationary pressures have remained mostly inert. Nevertheless, both are lagging indicators of which the Fed is well aware and, as such, the Fed will likely continue to hike rates to stay ahead of inflation. For the time being, however, the domestic economic picture is one of strength. Specific financial markets (i.e., longer-dated US Treasuries) are less sanguine about the future, perhaps signaling that the Fed's role in stabilizing prices will curtail future growth. Other leading indicators such as equity market volatility, tighter financial conditions, and wider credit spreads sympathize with the view of US Treasuries. None of these are signaling a recession, but they do indicate that 4% annualized growth in the economy is unsustainable. And that's OK because, at this advanced stage of the business cycle, economic growth of 2%-3% would be welcome.

- 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.

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