Market Pulse Report

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PATHSTONE
FEDERAL STREET

SUMMARY

Despite a poor Q1 reading and slow rollout of growth-oriented fiscal policies, the U.S. economy should continue to trudge along at a rate that is supportive enough for equity markets.

A Very Mediocre Recovery

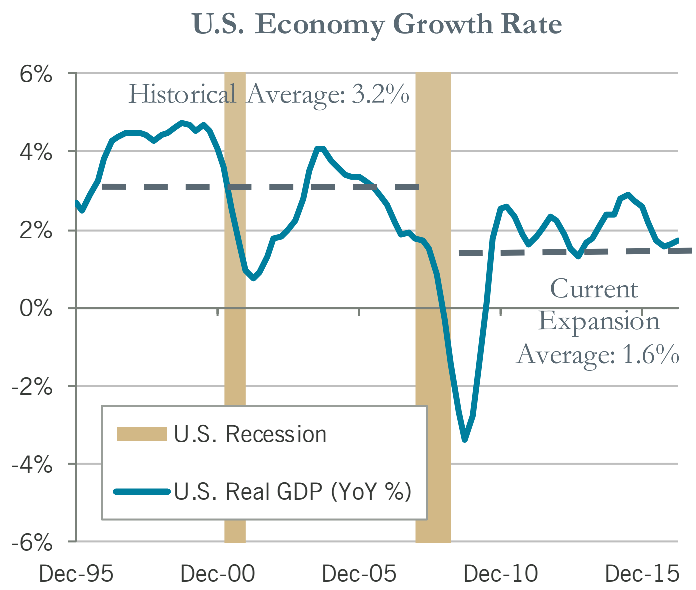
Being mediocre, by definition, signifies being simply adequate—neither great nor terrible. Nevertheless, the word tends to have a negative connotation. Whether it is sports, one's job, or everyday activities such as driving, nobody dreams about being undistinguished and unexceptional.

But perhaps when it comes to the economy, being mediocre does not deserve such a bad rap. The word originates via French from a Latin word (*mediocris*) meaning "halfway up the mountain". That seems like a pretty apt description of where the unremarkable U.S. recovery is currently positioned—well off the bottom, but with plenty of room to climb higher. Therefore in the context of investing, maybe a mediocre ascent up that proverbial economic mountain can be viewed positively.

A Slow Ascent. Following the 2008 credit crisis, massive central bank stimulus helped propel the economy out of the depths of recession. Since then, and with the backstop of accommodative monetary policy, the U.S. economy has been able to scratch out consistently positive rates of growth. Yet for various reasons (including a massive debt overhang and shifting demographics), the current expansion has been unable to achieve escape velocity to reach the peaks of prosperity.

Real gross domestic product (the broadest measure of economic output) does a good job of telling the story. The economy has expanded at an uninspiring 1.6% annualized rate since the last recession, about half as fast as is historically typical. And the recent change in administration has not quickly remedied things—the most recent reading for first quarter 2017 real GDP came in at a 0.7% annualized rate, the slowest pace in three years. But at least growth is still positive.

Stuck in the Mud. Slow but stable growth presents an interesting dichotomy. While the economy trudges uphill, middling wage gains and stuck-in-the-mud standards of living have led to frustration for many consumers. U.S. capital markets, on the other hand, have greatly enjoyed economic mediocrity. Historically, the combination of positive economic growth, limited inflation, and low interest rates has added up to a very conducive environment for stocks. And the past eight years have been no exception—while Main Street may be left wanting, Wall Street is skipping along. The S&P 500 has generated an 18% annualized return since spring 2009, not mediocre at all!



Sources: Bloomberg, National Bureau of Economic Research

But economic mediocrity does not come without risks to stocks, and the disparity between stellar stock returns and subpar economic growth cannot continue forever. Of immediate concern is that subpar economic growth could, quite simply, be easily derailed and stopped in its tracks. U.S. corporate earnings are on the rebound but could be challenged by rising wages and restrictive trade rhetoric. Upcoming overseas elections (France, Germany) and the exit of the U.K. from the European Union (now formally underway) may prove disruptive to the global economy. Geopolitical hotspots (Syria, North Korea) may spur investors to flee equities in lieu of "safer" bonds. And the Federal Reserve could be surprised by a spike in inflation, sparking a rapid shift toward a more restrictive liquidity environment. In other words, there are plenty of elements that can raise concerns and cause the economy to stumble.

Keep on Climbing. While it is easy to get apprehensive, now is not the time for panic. From many points of view the U.S. economic outlook is rather encouraging. The labor and housing markets are booming, and household balance sheets are in much better shape than they were eight years ago. With wages showing some improvement, the consumer may be poised to start carrying the load (the Fed will no longer need to act as a Sherpa) and put the economy on a better path. According to most estimates, the second quarter's growth rate is expected to exceed Q1's result.

The good news about mediocre economic growth—excess and overheating that typically spell the end of expansion are still a ways off. Furthermore, investors are hopeful that policy changes, tax reform in particular, may supercharge growth (the current administration has expressed a goal of getting back to a 3% or better real GDP growth rate). Regardless, the air is not getting thin yet and it is very possible that the current rate of expansion can continue for some time. That would be good news for stocks. While the trajectory of equity returns may not be as steep over the next few years (thanks to now elevated valuations) and there may be bumps along the way, stocks may be able to generate adequate returns. That alone could be good enough to help portfolios meet investment objectives.