STRATEGY INSIGHT

July 2018

People's United Advisors

Economic Overview

Economic Indicators	3Q'17	4Q'17	1Q'18	2Q'18	3Q'18	4Q'18
Real GDP *	3.2%	2.9%	2.0%	3.4%	3.0%	2.6%
CPI (year over year)†	2.2%	2.1%	2.4%	2.7%	2.8%	2.5%
Unemployment Rate†	4.2%	4.1%	4.1%	3.8%	3.8%	3.7%

------------------------- estimated -------------------------

Source: Bloomberg

* Quarter over quarter annualized † end of period

Increase from last reported

Decrease from last reported

A New Regime for Corporate Profits?

One of the pillars of stock market performance since 2009 has been corporate profitability. The chart below shows one way of measuring corporate profits – as a percent of national income, the income equivalent of gross domestic product. As is evident from the chart, corporate profits peaked in the first quarter of 2012 at nearly 11% of national income. As of the first quarter 2018, profits were at 9.3% as personal incomes have risen to take a larger share.

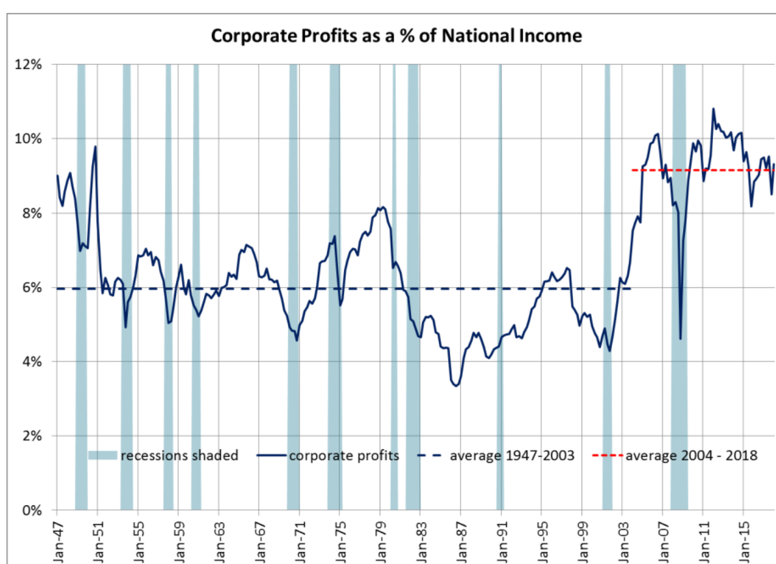
As a share of national income, corporate profits have averaged over 9% since 2004 – more than 50% higher than the average of 6% that prevailed from 1947 through 2003. The key question here is "can this last?" Has corporate profitability entered a new regime, or is it bound to revert to the long-term average? A new regime will support a higher stock market valuation relative to GDP. A reversion to average will put pressure on stock prices.

We believe corporate profitability is in a new regime and is not likely to revert to the levels of the post-war 20th century. Several factors account for the new regime. First is technology, which has enabled more efficient use of labor and more effective cost controls. It has also enabled more effective communications allowing companies to build global supply chains to take advantage of lowest cost providers.

Second is a reduction in the bargaining power of labor, both as a result of the decline in the percentage of unionized workers and as a result of technological changes that have reduced the demand for local labor.

Third is a change in the nature of American industry. As the technology sector has grown in size relative to the rest of the economy, the high profit margins typical of the tech sector have increased the average profitability of American companies. In 2000, the five largest U.S. companies by revenue were General Motors, Walmart, Exxon Mobil, Ford, and General Electric. Apple ranked 285th. Today, Apple is second in size of revenue.

The new regime for corporate profitability is good news for investors, but it bears careful watching. Increased capital spending holds the promise of increased productivity and higher margins while a tighter labor market may threaten profit margins with higher labor costs.



Source: Bureau of Economic Analysis

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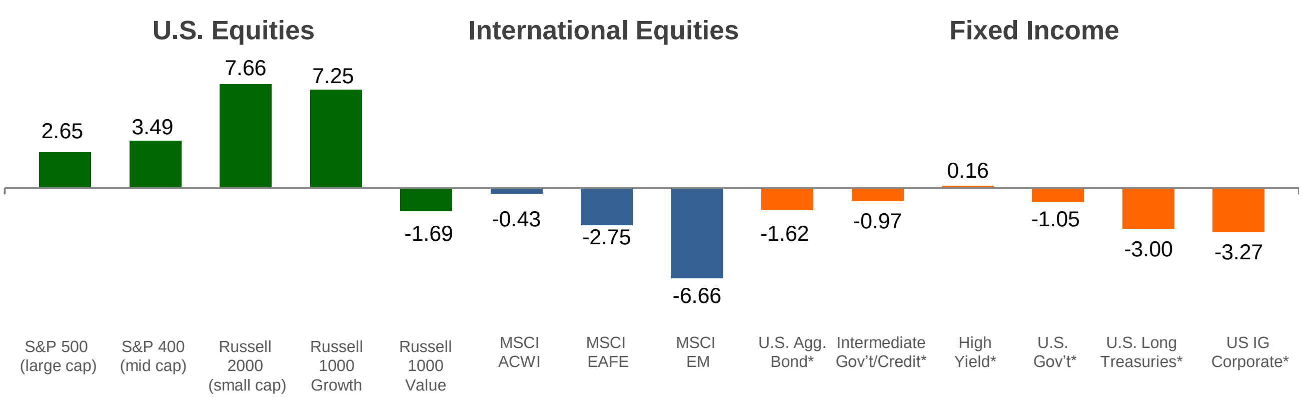
Equity: "...trade wars are good, and easy to win." - President Trump

- Despite closing out the second quarter with worries over tariffs and concerns over future Fed rate increases, the market (S&P 500 Index) gained well over 3% for the second period and is up over 2.5% year-to-date. Growth continues to trump value, with a 7% plus increase in the Russell 1000 Growth index versus a decline of about 1.7% for the Russell 1000 Value index.
- Although small cap stocks faltered in the last week of the quarter, they were the place to be for the second quarter and year to date. The Russell 2000 index was up almost 8% for the quarter and year to date. Small caps are benefitting from fears of possible trade wars and tariffs due to their lack of exposure to foreign markets. In addition, with a greater portion of earnings from domestic sources, small caps reap a greater benefit from the recent tax legislation. Here, as with large caps, growth significantly outperformed value.
- Historically, stock market corrections typically take four to six months to work through. We are now in the fourth month of this correction and, based on history, should see better trends by the end of the summer. Second-quarter earnings season may provide the needed positive push.

Market Returns (%) Year-to-Date As of June 29, 2018



Source: Bloomberg *Bloomberg Barclay's indices

Fixed Income: Bond Market Strategy: Mind the [Yield Curve] Gap

- The Treasury yield curve flattened to the lowest levels since 2007 after the Fed's decision to hike in June and stay with the previously messaged 4 hikes for all of 2018, suggesting that the bond market is becoming increasingly concerned about the Fed mistakenly hiking rates too aggressively given relatively tame inflation expectations.
- Flattening yield curves have historically been a sign of potential pending inversion – when short term interest rates are higher than longer term rates, implying that bond investors expect a slowdown in growth and potentially a recession in the near term.
- There have been several instances where monetary policy – specifically, too-aggressive implementation of policy rate hikes [too fast or too high] has directly resulted in a recession.
- Enough Fed officials have expressed concern about an inverted yield curve and what it signals for the economic outlook over the past few months that it's surprising how willing they appear to be to bring about that scenario.

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