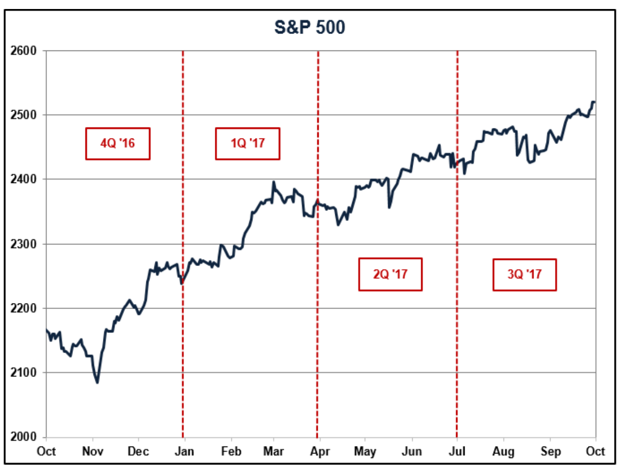
ECONOMIC & MARKET REVIEW

Third Quarter 2017

The beat goes on. Both the economy and markets are doing well. U.S. equities and bonds posted positive returns for the third quarter.

Third Quarter and Trailing 12 Months Performance

	3rd Quarter	Last 12 Months
S&P 500	*4.48%*	*18.61%*
Russell 2000	*5.67%*	*20.74%*
Barclays Agg.	*0.85%*	*0.07%*
MSCI EAFE	*5.40%*	*19.10%*
MSCI EM	*7.89%*	*22.46%*



Source: FactSet, Cavanal Hill Investment Management. As of 9/30/2017.

Economic news around the world continues to support the synchronized global growth theme. In the United States, GDP grew only 1.2% in the first quarter but jumped to 3.1% growth in the second quarter. Over time, the U.S. economy has grown around 2%, and we should be able to maintain, or even slightly improve on, that growth rate through 2018. The Eurozone has lagged the U.S. in overall growth, though estimates are that fourth quarter 2017 growth should be solidly above 2.0%.

Most Eurozone economic indicators point to stronger growth through 2017 and into 2018. The primary sources of increased expectations for growth in Europe are the lagged effects of European Central Bank easing, narrow corporate bond spreads (due largely to quantitative easing), and the decline in the Euro, which becomes a headwind in 2018 as the Euro has strengthened. It is interesting to note that growth is not uniform across all Eurozone countries. Germany, France and Ireland have strong-looking growth rates. Spain really fell hard from 2008 through 2014, instituted reforms, and since then has improved noticeably. Portugal, Greece and Italy all have had consistently weaker growth results. The consumer price index in Europe has moved higher, but is still below the European Central Bank's target of 2.0%. Core inflation, which excludes food and energy, is an anemic 1.2%. Additionally, unemployment is still high and loan growth is sluggish. Eurozone company earnings have improved but overall remain weak. Because of that, forward price earnings ratios are high, above their 10-year average. There are numerous fundamental problems in Europe: labor markets are rigidly operated, legal systems are clogged with cases, overall tax rates are high and government regulations interfere with private businesses' ability to function. France, Spain and Italy all have plans to address some of these impediments. Otherwise, it's a great place…to visit.

China has stabilized its growth rate. Concerns over the last several years centered on their intentional slowing of economic growth, which could have led to a major recession. That has not happened. In fact, China overall and many individual companies in China are doing well. Company profits in China jumped 24% year over year in August, up from 16% in July. As a gauge, estimates for S&P 500 earnings for the fourth quarter are a solid 12%.

Back in the U.S., the Federal Reserve is set to start the unwinding of the $4.2 trillion securities portfolio accumulated during its quantitative easing program. The reduction will occur at a slow and measured pace. It will allow $10 billion of interest payments and securities to roll off a month for three months. It will then raise the amount by $10 billion every three months. It is not known at what point the Fed would stop. Additionally, the Fed is set to raise rates again in December, despite the fact that inflation has not reached the target rate and most recently has retreated again. Inflation has declined despite the fact that the unemployment rate has dropped to just 4.4%. We should be seeing increases in the cost of labor…we are not. The Fed is convinced that recent weakness in inflation is temporary and that it will resume its upward march soon. However, Janet Yellen, Federal Reserve Chairwoman, said: “I think my main message about what we’ve been seeing is that 2017, the shortfall in inflation is a mystery”. U.S. businesses and consumers report high levels of confidence. Despite the turmoil in Washington D.C. and hurricanes, the U.S. is in an upbeat mood. That does beg the question as to just how much higher confidence can go, but for the time being, it is aiding growth, earnings and market performance.

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Disclosures

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All data presented is as of 3/31/2017, unless otherwise noted.