FINANCIAL SERVICES DEPARTMENT

Staff Report

To:	**Honorable Mayor Cheney and the Frisco City Council**
Thru:	**George Purefoy, City Manager** **Nell Lange, Assistant City Manager**
From:	**Anita Cothran, Director of Financial Services**
Date:	**July 18, 2018**
Re:	**Monthly Financial Report for June 2018**

Our Department Report for June is attached.

During the month, we continued our work on the Proposed FY 19 Budget, which will be presented to Council in August. We have a scheduled Budget & Audit Committee meeting on Tuesday August 7 and will be giving the entire Council a draft document that night for their review. The Annual Worksession is scheduled for Monday, August 13.

We implemented the voice response module of our utility billing system to allow for phone payments and inquiries, in addition to the online customer service portal we have been offering. The 800 number was rolled out the first of July. Customers have been asking for years for this customer service option, it will be interesting to see what usage we have in the next few months. The fees to use are the same as online – 2%.

Municipal Court hired the new Associate Judge, Jeff Richter, to replace Judge Drewry who is retiring in July. Mr. Abernathy's Office interviewed and selected a new contract prosecutor. With these hires, we only have one vacancy in our Department at the end of June, Senior Financial Analyst. We have interviewed several very good CPA's and the finalist will be made an offer the last week of July.

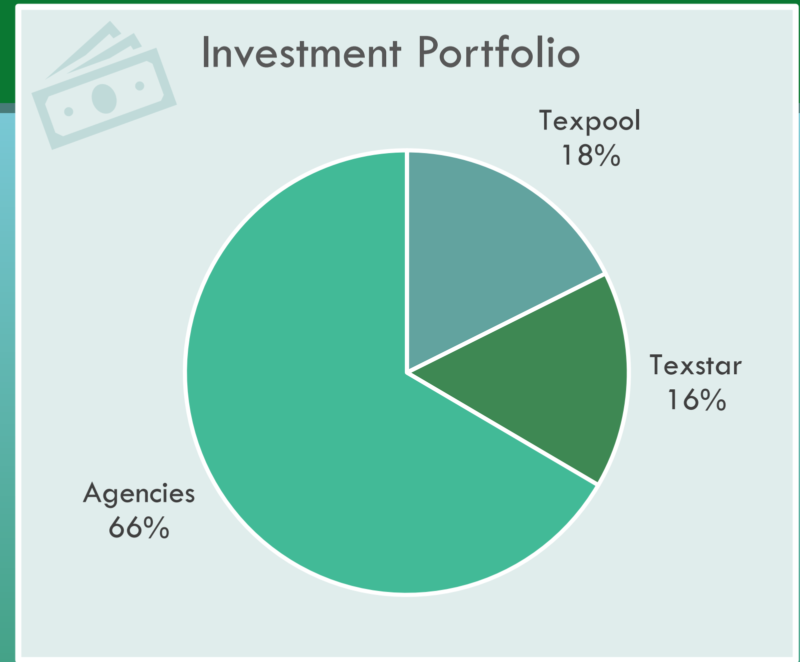
We processed three payrolls in June, which is reflected in the monthly actual column of the report. All operating funds continue to track as we projected in revised budget and are at or below the 75% budget thresholds for June.

Finally, I've attached the 2nd Quarter Economic Summary prepared by First Southwest Asset Management, our investment advisory firm for your review.

As always, if you have any questions, let me know. 972-292-5510, acothran@friscotexas.gov.

CITY OF FRISCO TEXAS
FINANCIAL SERVICES DEPARTMENT
JUNE 30, 2018
MONTHLY REPORT

Major Funds June 30 (,000)	General	% of Budget FY 18	FY 17	Utility	% of Budget FY 18	FY 17
Revenue Budget	$157,713			$94, 824		
YTD Actual	$137,097	87%	84%	$69,945	74%	72%
Expense Budget	$168,907			$94,630		
YTD Spent	$113,360	67%	69%	$69,565	74%	78%
Revenues Over (Under) Expenses	$ 23,737			$ 380		

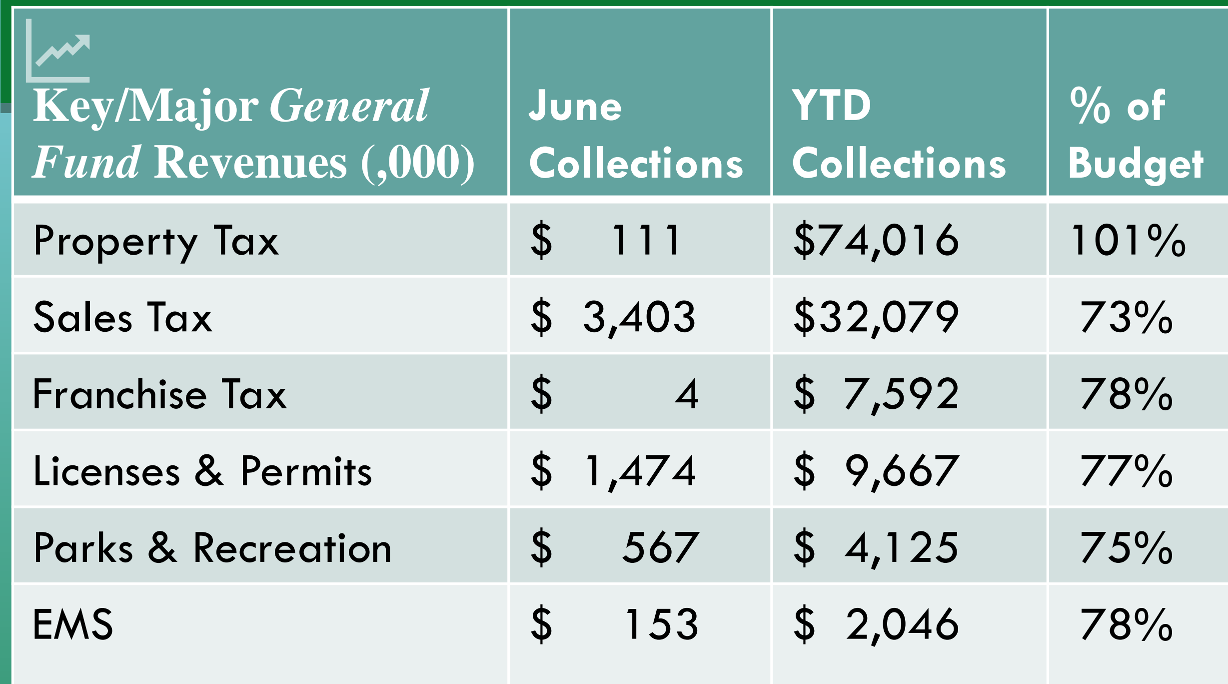


General Fund: General Fund revenues are 8% higher than prior year, with tax collections strong. Sales Tax collections are tracking at a 9% increase for FY 18 over FY 17. Expenditures are tracking as projected in budget with 67% of the budget expended. All Departments are within budget with nine months of the fiscal year expended.

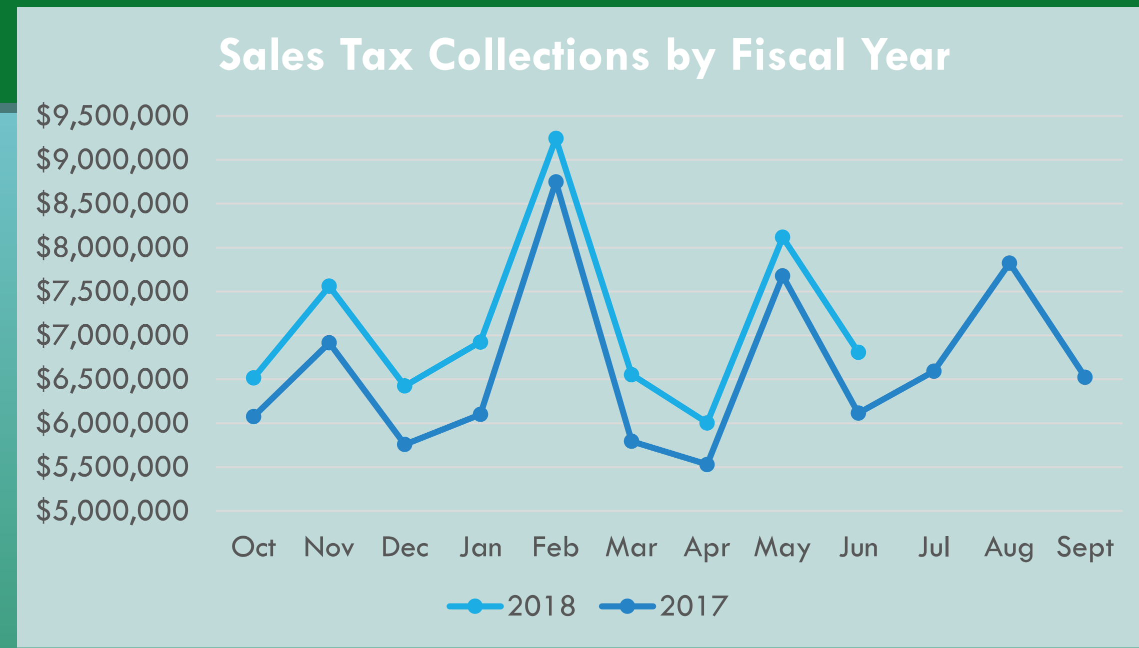
Utility Fund: Utility Fund sales and expenses are tracking as projected and consistent with prior year.

Portfolio Yields	June
Texpool	1.81%
Texstar	1.83%
Agencies	1.63%

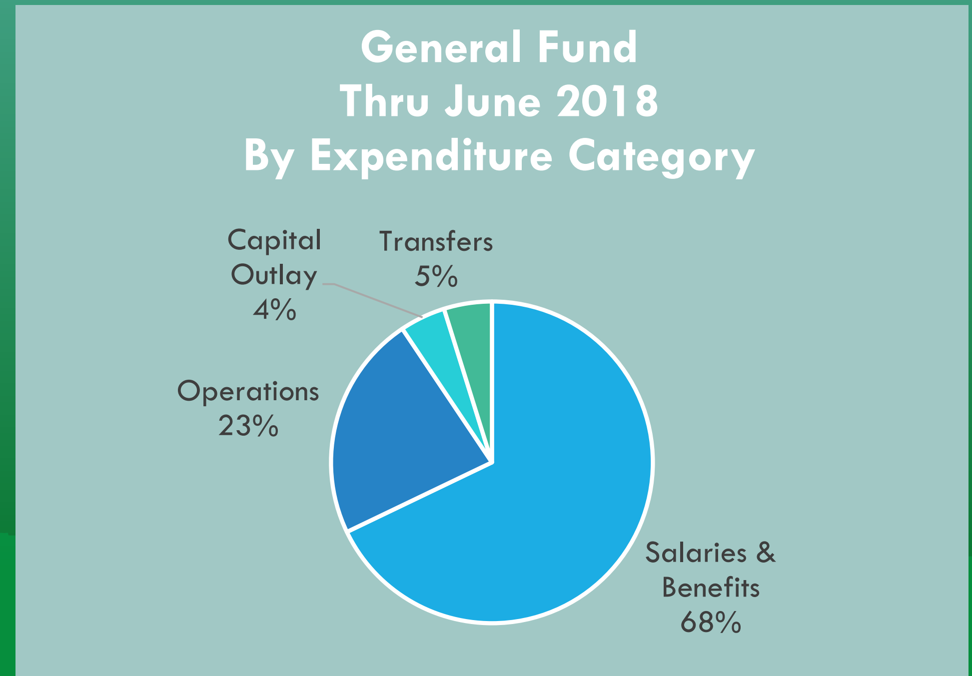
Portfolio Balances (,000)	June
Texpool	$ 82,788
TexStar	$ 74,186
Agencies	$312,295
Total	$469,269



Key/Major *General Fund* Revenues (,000)	June Collections	YTD Collections	% of Budget
Property Tax	$ 111	$74,016	101%
Sales Tax	$ 3,403	$32,079	73%
Franchise Tax	$ 4	$ 7,592	78%
Licenses & Permits	$ 1,474	$ 9,667	77%
Parks & Recreation	$ 567	$ 4,125	75%
EMS	$ 153	$ 2,046	78%



General Fund Expenditures By Function (,000)	June	YTD Expend	% of Budget
General Government	$4,127	$33,944	64%
Public Safety	$8,023	$54,653	70%
Public Works	$1,308	$ 9,974	64%
Culture & Recreation	$2,602	$14,788	67%



Building/Development Fees	June Activity
Fees Collected	$1,351,054
Collin County Permits	913
Denton County Permits	570
Valuation	$300 Million

Municipal Court	June Activity
# of cases filed	1,672
# of cases closed	1,711
# warrants issued/cleared	448/236
% of on-line/phone payments	25%

Key Other Funds Revenues (,000)	June Collections
Hotel Taxes	$530

Utility Billing	June Activity
# of active customers	56,060
# new meter sets	256
# new customers	324
# on line pay/% of total pay	12,966/23%
Fees collected UB	$9.0 Million

Budget Summary for June
Fiscal Year 2018
(Compare to 75%)

	Approved Original FY18 Budget	Revised FY18 Budget	Monthly Actual	% of Bdgt	YTD Actual	% of Bdgt	FY 17 Actual	Monthly Actual	% of YTD Act	YTD Actual	% of YTD Act	% Inc /(Dec) 17/18
Gen Fund Rev												
Property Tax	73,669,831	73,629,831	110,683	0%	74,015,800	101%	69,719,828	135,668	0%	68,769,217	99%	8%
Sales Tax	42,332,481	44,064,396	3,403,273	8%	32,078,962	73%	40,265,592	3,057,252	8%	29,331,158	73%	9%
Beverage Tax	822,935	822,935	0	0%	503,627	61%	834,437	0	0%	383,967	46%	31%
Franchise Tax	9,705,458	9,705,458	4,032	0%	7,592,685	78%	9,104,999	129	0%	6,625,140	73%	15%
Licenses & Permits	12,353,419	12,516,734	1,473,965	12%	9,667,258	77%	12,904,536	1,184,234	9%	9,418,898	73%	3%
Intergovernmental	1,867,488	2,063,250	666,132	32%	1,675,300	81%	2,401,473	23,215	1%	1,256,133	52%	33%
Charges for Services	8,540,637	8,666,674	805,521	9%	6,764,194	78%	9,487,800	1,007,987	11%	6,696,974	71%	1%
Fines	1,990,898	1,990,898	179,121	9%	1,569,370	79%	2,044,424	181,689	9%	1,486,679	73%	6%
Interest Income	378,750	652,000	110,087	17%	860,898	132%	493,758	51,644	10%	344,732	70%	150%
Contributions	22,000	98,475	451	0%	33,837	34%	26,801	2,502	9%	23,613	88%	43%
Rental Income	1,167,435	1,148,435	101,031	9%	864,032	75%	1,204,041	132,251	11%	898,518	75%	-4%
Other Fees	788,033	242,194	31,041	13%	393,961	163%	708,596	29,024	4%	488,245	69%	-19%
Transfers In	2,068,524	2,111,524	43,000	2%	1,076,644	51%	984,000	0	0%	984,000	100%	9%
Total	155,707,889	157,712,804	6,928,337	4%	137,096,568	87%	150,180,285	5,805,595	4%	126,707,274	84%	8%
Gen Fund Exp												
Administration	6,581,382	6,683,677	755,221	11%	4,642,058	69%	6,461,925	668,221	10%	4,227,437	65%	10%
Financial Services	11,080,152	13,509,236	780,426	6%	6,771,369	50%	9,802,404	601,957	6%	6,338,116	65%	7%
Police	40,009,612	39,854,244	3,969,344	10%	27,873,251	70%	34,745,518	3,487,890	10%	25,261,886	73%	10%
Fire	37,386,597	38,352,307	4,053,541	11%	26,779,946	70%	34,390,338	3,606,351	10%	23,618,446	69%	13%
Public Works	11,274,510	13,335,585	1,088,965	8%	8,563,786	64%	7,033,338	548,508	8%	4,591,633	65%	87%
Human Resources	2,236,034	2,253,872	255,489	11%	1,536,747	68%	1,985,328	237,895	12%	1,374,563	69%	12%
Administrative Serv	9,223,956	11,233,661	683,214	6%	6,047,232	54%	7,701,708	664,000	9%	5,442,459	71%	11%
IT Serv	6,427,515	6,415,043	893,062	14%	4,170,111	65%	3,519,091	287,709	8%	2,537,711	72%	64%
Library	4,953,716	5,296,540	760,406	14%	3,905,313	74%	4,451,875	443,003	10%	3,270,462	73%	19%
Parks & Recreation	16,259,759	16,721,108	1,841,960	11%	10,882,973	65%	14,876,129	1,546,329	10%	10,169,195	68%	7%
Engineering Serv	2,279,897	2,341,723	219,259	9%	1,410,663	60%	5,014,906	407,023	8%	3,419,637	68%	-59%
Development Serv	7,184,826	7,672,442	728,283	9%	5,313,259	69%	6,562,897	788,689	12%	4,837,579	74%	10%
Non-departmental	447,496	5,237,795	31,283	1%	5,462,838	104%	3,516,530	303,007	9%	2,191,530	62%	149%
Total	155,345,452	168,907,233	16,060,453	10%	113,359,546	67%	140,061,987	13,590,582	10%	97,280,654	69%	17%
Rev-Exp	362,437	(11,194,429)	(9,132,116)		23,737,022		10,118,298	(7,784,987)		29,426,620		

Budget Summary for June
Fiscal Year 2018
(Compare to 75%)

	Approved Original FY18 Budget	Revised FY18 Budget	Monthly Actual	% of Bdgt	YTD Actual	% of Bdgt	FY 17 Actual	Monthly Actual	% of YTD Act	YTD Actual	% of YTD Act	% Inc /(Dec) 17/18
Utility Rev												
Water	50,101,067	50,101,067	5,490,082	11%	36,472,375	73%	47,917,674	4,543,942	9%	32,956,877	69%	11%
Sewer	39,052,741	39,052,741	3,111,140	8%	27,391,949	70%	32,268,008	2,797,579	9%	23,966,605	74%	14%
Licenses & Permits	1,650,000	1,650,000	176,366	11%	1,697,660	103%	3,725,542	199,474	5%	2,748,024	74%	-38%
Interest	150,000	150,000	28,705	19%	321,750	215%	220,719	18,040	8%	149,061	68%	116%
Misc	550,000	550,000	106,849	19%	741,503	135%	1,003,015	75,885	8%	760,723	76%	-3%
Transfers In	3,319,743	3,319,743	0	0%	3,319,743	100%	3,300,281	0	0%	3,300,281	100%	1%
Total	94,823,551	94,823,551	8,913,142	9%	69,944,980	74%	88,435,239	7,634,920	9%	63,881,571	72%	9%
Utility Exp												
Administration	82,977	117,977	18,156	15%	120,582	102%	56,952	52	0%	48,089	84%	151%
Financial Services	1,700,613	1,795,213	161,499	9%	1,157,839	64%	1,502,578	162,979	11%	1,083,276	72%	7%
Public Works	69,613,154	69,399,928	5,639,977	8%	51,206,510	74%	63,626,487	5,497,618	9%	47,752,099	75%	7%
Administrative Serv	190,134	192,534	19,803	10%	128,082	67%	141,728	16,946	12%	87,918	62%	46%
IT Serv	2,762,767	2,724,690	358,239	13%	1,838,613	67%	2,319,119	299,805	13%	1,652,856	71%	11%
Engineering Serv	3,796,419	3,936,716	402,223	10%	2,727,544	69%	3,443,054	386,079	11%	2,486,019	72%	10%
Non-departmental	16,164,066	16,462,610	368	0%	12,385,730	75%	14,508,481	-23	0%	13,237,750	91%	-6%
Total	94,310,130	94,629,668	6,600,265	7%	69,564,900	74%	85,598,399	6,363,456	7%	66,348,007	78%	5%
Rev-Exp	513,421	193,883	2,312,877		380,080		2,836,840	1,271,464		(2,466,436)		
Utility Stormwater												
Revenue	3,760,598	3,760,598	323,109	9%	2,857,710	76%	3,638,105	307,145	8%	2,705,707	74%	6%
Expenses	3,600,322	5,531,005	192,202	3%	3,152,845	57%	3,073,889	196,172	6%	1,826,976	59%	73%
Rev-Exp	160,276	(1,770,407)	130,907		(295,135)		564,216	110,973		878,731		
Environmental												
Revenue	15,322,579	15,322,579	1,462,377	10%	11,838,611	77%	13,649,525	1,180,351	9%	10,288,102	75%	15%
Expenses	14,565,356	14,936,837	1,406,473	9%	11,957,944	80%	13,712,687	1,101,198	8%	10,158,607	74%	18%
Rev-Exp	757,223	385,742	55,904		(119,333)		(63,162)	79,153		129,495		

Asset Management Economic Summary — 2nd Quarter 2018

"The domestic economy is on solid ground…for now. But, the underlying foundation is showing some potential cracks."

		Fed Funds	3 mo T-bill	6 mo T-bill	2 yr T-note	5 yr T-note	10 yr T-note
Last	3/31/18	1.50% - 1.75%	1.70%	1.91%	2.27%	2.56%	2.74%
High			1.94%	2.13%	2.59%	2.94%	3.11%
Low			1.70%	1.90%	2.25%	2.55%	2.73%
End	6/30/18	1.75% - 2.00%	1.92%	2.11%	2.53%	2.74%	2.86%

The US economic recovery is now nine years old, second only to the 1990s expansion which lasted exactly 10 years. No single growth cycle has exceeded 10 years, so, it's only natural to scan the horizon for the inevitable recession. It's not a question of *if* so much as *when* …but "when" could be years away. The first quarter of the year was somewhat disappointing with GDP at +2.0% (seasonally adjusted, quarterly/annualized), but the second quarter appears to have accelerated sharply. Recent tax reform is apparently having the desired effect. The initial Q2 GDP report won't be released until late July, but the Atlanta's Fed's GDPNow model was tracking at +4.1% as of July 2nd. If this level were to hold, it would be the fastest pace since Q3 2014. The momentum is there …and so is the confidence.

Consumer spending resumed at a brisk pace in the spring after a post-holiday nap, and employment conditions were solid … regardless of the measuring stick. Small business optimism climbed to a 34-year high in May, with more than a third of respondents claiming "it's a good time to expand," while the percentage of U.S. business owners planning price increases was the largest in a decade. Consumer confidence has slipped a bit, but remains within spitting distance of the 17-year peak reached in February. Homebuilder sentiment has also receded in recent months after posting an 18-year high in December. Purchasing managers in the manufacturing and service sectors still indicate elevated optimism, although down slightly in recent months from 14-year highs. Managers in both surveys reported rising costs.

Higher GDP, combined with increasing price pressures and a positive outlook has kept the Fed squarely in tightening mode. To the surprise of no one, Fed officials followed the March rate hike with another quarter point move in June. The June increase was the seventh since "lift-off" from zero began in December 2015.

While the Fed continues to "normalize" its interest rate policy and unwind its multi-trillion dollar quantitative easing portfolio, the rest of the world remains on an extremely stimulative monetary policy path. The European Central Bank has amassed a total QE portfolio of approximately €5.6 trillion as of May 2018, equating to roughly 40% of the total GDP of the 28 member European Union. By comparison, the Fed's $4.4 trillion QE portfolio is roughly 22% of U.S. GDP. Japan's central bank assets as a percentage of GDP is a nauseating 98%. How they eventually unwind this is anybody's guess.

Global trade was again the biggest story of the quarter. In fact, President Trump's political gambit may now be at the brink of a full blown trade war. It began earlier this year with tariffs on Chinese washing machines and solar panels, and later a 25% tariff on imported steel and 10% on aluminum for everyone. When Trump decided to slap a 25% tariff on up to $50 billion of assorted Chinese goods, China retaliated by targeting products from farm-belt states where Trump has significant political support. There are 2½ million Americans employed in agriculture, who benefit significantly from international trade. Soybean farmers could feel the pressure quickly as half of all U.S. soybean exports go to China.

By quarter end, the U.S. tacked-on the threat of a 10% tariff on an additional $200 billion with the possibility of a second $200 billion if China didn't wave the white flag. If fully implemented, $450 billion would represent 90% of all Chinese imports into the United States. When the $200 billion number was unveiled, the Chinese Commerce Minister responded by saying the U.S. had "initiated a trade war" and China would "retaliate forcefully." Chinese President Xi Jinping warned that while many may turn the other cheek, "in our culture, we punch back."

China is clearly an economic power, but it's also a developing country with average per capita income of just $8,000, compared to $56,000 in the United States. In hopes of moving into more technology oriented industries, Chinese leaders unveiled the "Made in China 2025" initiative three years ago. The initiative involves government subsidies, increased investment in research and innovation, and local manufacturing targets. It also continues government policies requiring foreign businesses entering Chinese markets to form joint ventures and share technology with local businesses. This policy flies in the face of Trump's "Make America Great Again" initiative and puts the two economic giants squarely in each other's crosshairs.

Since China imports just $130 billion from the U.S., the stakes in the trade game seemingly had risen above the obvious leverage point, but there's quite a bit more to the story. Since 2008, U.S. multinational companies ramped up business in their Chinese subsidiaries making sizable investments in factories and brick and mortar stores. Currently, the fastest growing market for Starbucks coffee is China with new stores to be opened every 15 hours through 2022, while Walmart, the largest private employer in America, has 424 stores in China. The list of U.S. companies with stores or factories in China include AT&T, Best Buy, Black & Decker, Campbell's Soup, Coca Cola, Craftsman Tools, Cracker Barrel, Family Dollar Stores, Frito Lay, J.C. Penny's, Nike, Old Navy… this list goes on and on.

According to Michael Cembalest, chairman of market and investment strategy at JPMorgan, "U.S. companies are doing almost the same amount of business in China as Chinese companies are doing in the U.S., but through their subsidiaries rather than via exports." Cembalest believes the bilateral U.S. trade deficit with China almost disappears when sales of in-country subsidiaries are included.

The possibility that China would retaliate against these subsidiaries presents a problem not only for Pizza Hut, McDonald's and Kentucky Fried Chicken, but for Intel and Boeing and Caterpillar and Deere, companies that do tens of billions of dollars in business with the fast growing Chinese market of 1.3 billion people. All of these are public companies, which means falling sales and profits will be shared with stockholders.

Another precarious angle is that China holds $1.2 trillion in U.S. Treasury debt. Although it's extremely unlikely they'd sell any significant percentage, a reduction in trade would result in a reduction in U.S. bond purchases, which would mean higher debt costs to the U.S.

The trade battle got uglier when neighboring Mexico and Canada (previously excluded) were targeted. The U.S. actually has a trade surplus with Canada. The situation worsened just before the June G7 meeting when President Trump insisted the U.S. would impose steel and aluminum tariffs on Japan, Germany, France, Italy, Canada and the United Kingdom until they abandon "unfair trading practices." The U.S. does import considerably more from Europe than it exports, but similar to China, U.S. companies have a significant on-the-ground presence. Predictably, just about everyone threatened to retaliate, and a war of words broke out between Canadian Prime Minister Justin Trudeau and President Trump. Leaders representing all 28 EU countries said in statement that U.S. steel and aluminum tariffs "cannot be justified on the grounds of national security," and declared that they would "respond to all actions of a clear protectionist nature."

The updates are coming fast and furious; some bluffs, some real. Canada announced it would impose tariffs on $20 billion worth of U.S. imports, including metals, toilet paper, motorboats and maple syrup, and would consider tariffs and quotas on Chinese steel to mitigate a flood of imports from global producers seeking to avoid U.S. tariffs. The EU, China, Mexico and Canada will all target American whiskey. It sounds trivial, but Forbes reported that 1.5 million jobs rely on the whiskey industry. Mexico is reportedly studying tariffs on corn and soy imported from the United States, and the U.S. has indicated it will consider slapping 25% tariffs on all imported vehicles. Although European automakers without U.S. plants would suffer the most, General Motors, which imports roughly a third of the cars it sells in the U.S., would be slammed as well. The whole thing is dizzying.

It's hard to imagine that prices won't rise. The WSJ reported that washing machine prices have shot up 17% in the last three months, while a new 25% tariff could increase imported car prices by $4,000 to $5,000 and cars assembled in the U.S. by roughly $1,300. Steel and aluminum are utilized in thousands of household and industrial products, all of which could see marginal increases in the coming months.

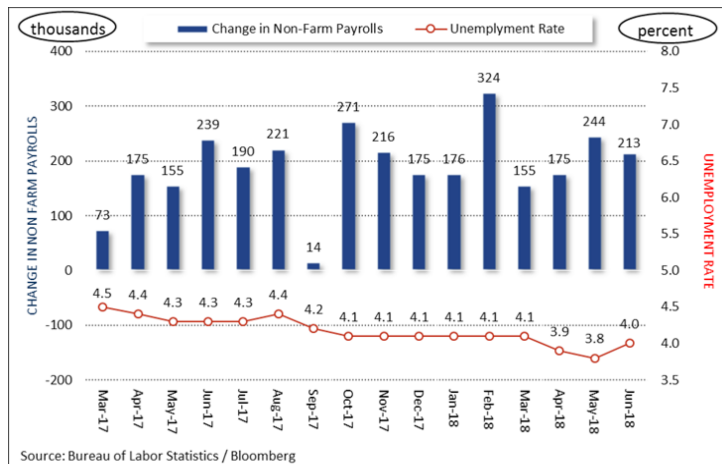
But, an escalating trade war could actually lower cheese prices. The Department of Agriculture announced in late June that cheese stockpiles had reached a staggering 1.4 billion pounds, an all-time high. Apparently, processors have too much milk on their hands and milk is more easily stored as cheese. Profit margins at farms and dairies are already thin and vulnerable if exports fall.

Although trade was clearly the story of the quarter, there were others, the most important from an economic standpoint was

the rapid rise in energy costs. AAA reported that Memorial Day pump prices were 31% higher than last year. This increase is primarily due to higher crude oil prices. Brent crude, the global benchmark that has the biggest influence on gas prices, topped $80/barrel in June, a 50% year-over-year increase, while WTI crude topped $74 per barrel in late June for the first time in four years. The reasons for the rise were multifold: higher global demand, production cuts from OPEC and Russia, a complete collapse in Venezuelan production, and the announcement by President Trump that the U.S. would withdraw from the Iran nuclear deal and halt all Iranian oil imports.

It's easy to miss important generational events when politics dominate the news …so in case you missed it, NASA just launched an American rocket carrying the first robot designed to explore the surface of Mars. The two-year project is the prerequisite to future human missions. This particular story doesn't have any effect on the financial markets, but it's hopeful.

EMPLOYMENT

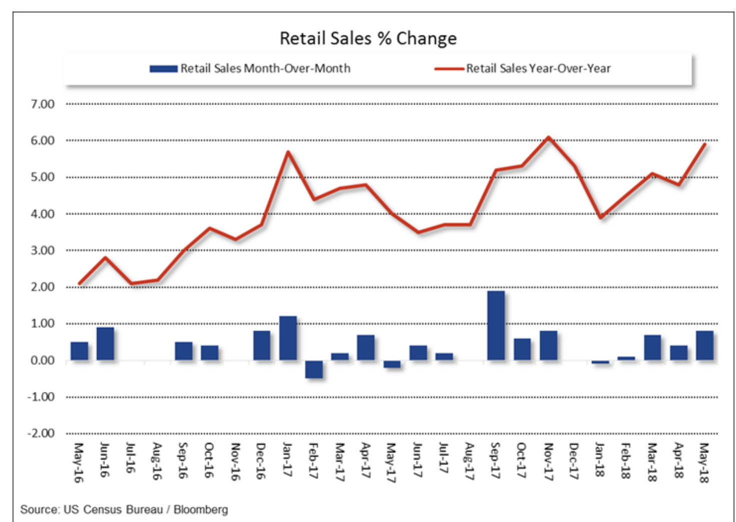


American companies hired another +622k workers in the second quarter of 2017, continuing a string of three straight quarters in which nonfarm payrolls rose by a heathy monthly average of +200k or more. The unemployment rate fell in both April and May, reaching a 48-year low of 3.8%, before climbing back up to the 4.0% mark in June as over +600k reinvigorated workers entered (or reentered) what they perceived as a hopeful labor market. The U6 or "underemployment rate," which includes part-time workers who would prefer to work fulltime, as well as marginally attached workers who are neither working nor looking, but available for work, rose from 7.6% to 7.8% in June. Many believe the U6 rate is a truer labor indicator, but regardless of the measuring stick, it's hard to deny that overall employment conditions are as favorable as they've been in at least a decade. And, the lessor known surveys and data reports indicate an even more positive outlook.

The Job Openings and Labor Turnover (JOLT) survey indicated for the first time in 18 years there were more job openings than people actively seeking employment in April …and again in May. The National Federation of Independent Business reported 34% of small companies find job openings hard to fill, the highest percentage since 2000. In most cases, these businesses expect to raise wages to attract and retain workers. According to ManpowerGroup, the labor shortage goes beyond U.S. shores. In Manpower's Talent Shortage Survey, 89% of Japanese, 81% of Romanian and 78% of Taiwanese companies reported difficulty finding qualified workers, compared to 46% in the United States. Bloomberg News suggested employers are now recruiting beyond the traditional labor pools, increasingly open to hiring workers with criminal records.

By most accounts, it's a tight market, but so far, the expected wage pressure hasn't materialized. The most common measure is average hourly earnings, and in June, it held steady at +2.7%, essentially flat over the last two years. This lack of wage pressure has puzzled economists, but average hourly earnings includes only salaries and wages. Wells Fargo economist Sarah House suggests that the missing piece can be found in the benefits category. In addition to traditional medical, dental and retirement plans, nonproduction bonuses, (not directly related to worker output) have risen +13% over the past year. According to House, these include any one-off bonuses offered in response to the Tax Cuts and Jobs Act as well as signing bonuses, which are at a five-year high for new college graduates. Another piece that doesn't clearly fit is the fact that 95.5 million working-age Americans are not included in the labor force. According to BLS data, this number was 79.3 million 10 years ago and has climbed every year of the recovery cycle.

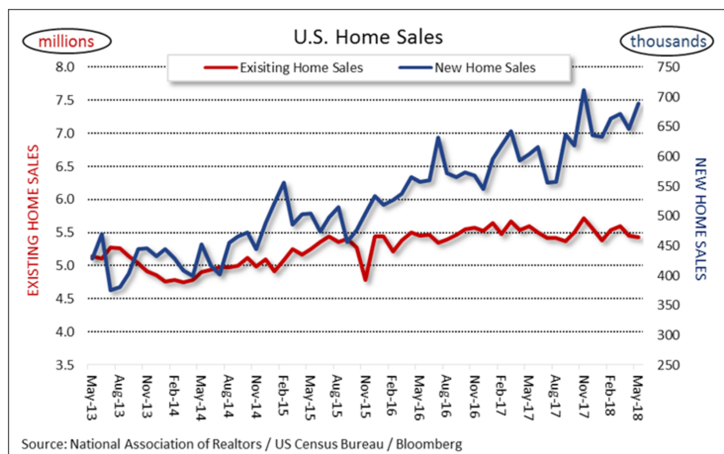
CONSUMER SPENDING



Much of the second quarter economic rebound can be attributed to a significant rise in consumer spending, and whether the growth rate continues will depend on consumers' ability to sustain the brisk pace. Retail sales rose an impressive +0.8% in May following solid advances of +0.4 in April and +0.7% in March. By comparison, retail sales were unchanged in December, down -0.1% in January and up +0.1% in February. Confidence remains elevated by historical standards, although slightly off the high point from earlier this year. The obvious reason for the spending spree is tax reform. Most paychecks got bigger in February, but higher gasoline prices have started to whittle away the extra dollars. The U.S. personal savings rate was 3.2% in May. Although it's off the record low of 1.9% from July 2005, it's a still long way from the 8.2% average over the last six decades. On the other hand, borrowing has soared. Total outstanding credit as a percentage of disposable income rose above 26% earlier this year for the first time ever.

It also appears that Americans are again tapping into their home equity value. According to Federal Housing Finance Agency data, equity extracted from U.S. homes rose in the first quarter to the highest level in nearly a decade. This practice is fine …as long as home values continue to rise, but it could amplify the pain of a housing market correction.

HOUSING

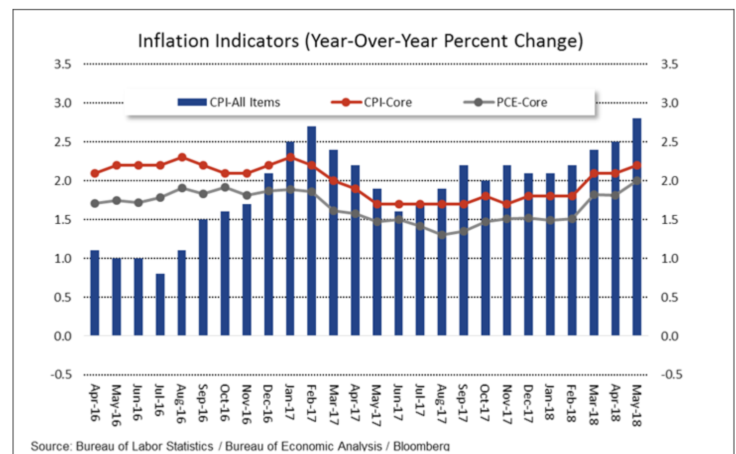


For the better part of a year, underperformance in the housing sector was thought to be a supply issue, but the blame is shifting. Bloomberg News reported earlier this year that home prices had hit record highs in two-thirds of U.S. cities, while mortgage lending rates are up nearly three-quarters of a point in the past six months. ATTOM Data Solutions, a national property data warehouse, reported in June that U.S. home prices are less affordable than historic averages in 59% of markets, while 75% of markets are no longer within reach of average wage earners. According to ATTOM, home affordability now sits at 10-year lows. The chief economist at the National Association of Realtors finally admitted that "the combination of higher prices and rising mortgage rates are pinching budgets of prospective buyers and keeping some from reaching the market."

There's no indication that housing prices won't continue to climb. Builders finally responded to the lean supply as housing starts rose to a 10½ year high in May …but these brand new homes are likely to cost buyers more. Material costs are surging. According to UBS research, lumber prices have risen more than 50% over the past year due to import tariffs on Canadian lumber and transportation bottlenecks. The average price of a single-family home has reportedly increased $9,000 since January 2017, and homebuilders have generally passed the cost increases to buyers. While new home sales have been relatively brisk this year, they represent less than 12% of the total market. By contrast, existing home sales declined in both April and May and have essentially been flat over the past three years. Pending home sales, a leading indicator which tracks signed contracts, was down -2.8% year-over-year in May, while building permits, also a leading indicator, declined in both April and May to the lowest level since last September.

Home prices have risen at twice the pace of income over the past decade. The income/price relationship doesn't bode well for most Americans. It may mean that a larger percentage of future homes are bought by wealthier individuals as investment property. This suggests less stability in the housing market going forward.

INFLATION



Trade has thrown a wrench into the inflation outlook, so few economists are making any bold predictions at this point. A number of imagined scenarios involving much higher prices are possible, but for now most economists are dealing with the situation at hand, which involves more gradual increases. The Fed has long mentioned +2.0% as their inflation target, and for years,

CPI and PCE core rates had fallen short. Now, most inflation indicators have moved above the target. The +2.0% year-over-year increase in the May PCE core represented the first time in six years that the Fed's preferred measure reached their key inflation target. The core consumer price index (CPI) rose at a +2.2% annual pace through May, while the core producer price index (PPI) was at +2.6%.

In this uncertain economic period, where inflation goes from here is just as debatable as anything else. Consumer capacity to spend already seems stretched. Several quarters of robust growth could result in higher wages and increased consumer demand, but most industries have enough current capacity to increase supply. If prices spike, it won't likely result from a supply/demand imbalance, but rather the negative effects of widespread tariffs. In this environment, Fed rate hikes would only slow growth and potentially usher in an era of stagflation.

STOCKS

	DOW	S&P 500	NASDAQ
3/31/18	24,103	2,641	7,063
6/30/18	24,271	2,718	7,510
% Change for Q2-2018	0.7%	2.9%	+6.3%
% Change for all of 2018	+6.4%	+3.5%	+9.8%

It was a choppy quarter for stocks as geopolitics repeatedly whipped the markets. All three of the major indexes finished up for the three-month period, but both the S&P 500 and the DOW were down for the year at quarter end. The underlying fundamentals seemed to have improved with 89% of companies in the S&P reporting higher sales, up from 36% at the recession low point and 76% at the peak of the last business cycle. The effect of the tax reform on U.S. businesses was evident in the first quarter earnings reports. Although pretax profits slipped a bit, after tax profits jumped by 25%. Businesses tax liability fell from $446 billion annualized in Q4 2017 to $328 billion annualized in Q1 2018, bringing the average tax burden for U.S. businesses down from 26% to 12.6%.

Since stock market performance is loosely tied to the economy, the near-term outlook is generally positive. But, there are risks. The higher volatility introduced earlier this year is likely to continue, and any negative news stemming from the ongoing trade war could easily push equities lower. And, as the Fed continues to raise rates, the perceived value of riskier stock investments relative to safer bond investments should fall. With the 90-day Treasury-bill yield now trading above the S&P dividend yield, any future flight to quality could be more pronounced.

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ECONOMIC AND INTEREST RATE OUTLOOK

The domestic economy is on solid ground…for now. But, the underlying foundation is showing some potential cracks. It's impossible to measure the effect a trade war would have on the economy. There would be winners and losers. Oxford Economics estimated 10,000 new jobs would be created in U.S. metal-producing industries, but 80,000 jobs would be lost in metal-consuming industries. The first victims of the trade war on the U.S. side will be the large multinational corporations that sell products in China; notably Boeing, Caterpillar, Deere, Telsa, Qualcom (which shockingly gets 65% of its revenue from China), Intel and Micron. And, the effects are likely to manifest themselves in higher consumer prices, lower corporate sales and reduced profit margins. If it gets worse, it's likely to have a detrimental effect on company hiring and the stock market, which suggests confidence would take a hit.

If reduced trade resulted in China investing in fewer Treasuries, there would be more supply for the remaining bond investors to absorb, which means higher market yields. Higher yields mean higher borrowing costs which normally slow economic growth. But remember, this won't be the only brake being applied. The Fed is tightening policy on two fronts; not only boosting the overnight target rate, but also unwinding their massive asset portfolio. By the fourth quarter, the Fed will be shedding $50 billion per month; a total of $600 billion in both 2019 and 2020. And, the U.S. Treasury its ramping up borrowing to cover the larger budget deficit in the wake of tax reforms. The Wall Street Journal reported that Treasury note and bond sales increased 9.2% in the first half of the year to $1.1 trillion. History offers no clue on how all this will play out, but it's certain to be an anchor on growth.

Another recent concern that continues to make headlines is yield curve inversion, or the possibility that long-term bond rates will drop below short-term rates as the Fed tightens monetary policy. Every recession over the past sixty years has been preceded by an inverted curve. These downturns have happened between six months and two years after the inversion occurs. The spread between the two-year and 10-year closed the quarter at just 30 basis points; the last time it was this low was 2007….*just before the Great Recession*. The Fed has a direct influence on short rates, but long rates are a function of inflation expectations and the economic outlook. The market is suggesting that the recent strength in economic growth could be short lived. A flattening yield curve, in and of itself, causes no harm …except to financial institutions which borrow short and lend long.

Congress has extra incentive to try and whittle down the bloated budget in the coming years as the financial condition of Social Security and Medicare was shown to have deteriorated significantly in the most recent Trustees Report. The projected insolvency date for Social Security is still 2034, but Medicare moved three years closer from 2029 to 2026. More importantly, both will have to tap into reserves for the first time since 1982, as payroll taxes and interest earned will no longer cover current costs. Government belt tightening (if it actually happens) will negatively affect growth.

The biggest obstacle on the consumer side (besides stubbornly low wages and record high debt levels) are rising energy costs. Moody's Analytics estimates that every 10 cent increase at the pump extracts $11 billion a year from consumer pockets. If oil prices were to hold at $70 per barrel through the remainder of the year, Moody's believes energy costs would absorb half of the tax benefit to households. At quarter end, WTI crude closed at $74.

Economies in all the developed countries are still expanding, but hardly at a breakneck pace. The most recent Bloomberg economic forecasts for 2018 show the U.S. at +2.8%, the EU at +2.3%, Japan at +1.1% and China at +6.5%. Although the European Central Bank will end QE this year, it expects to maintain its deposit rate at -0.40%, while the Bank of Japan recently voted to maintain its short-term rate target at -0.10% and the Bank of England held steady at +0.50%. The Fed, currently at 1.75-2.00%, continues to tighten policy. The "dot plot" from the June FOMC meeting indicated a majority of committee members now believe two more rate increases are appropriate for 2018 and three in 2019. As the Fed hikes, the dollar is likely to strengthen further, making our exports even more expensive.

While the FOMC continues its campaign to aggressively hike rates, individual members have expressed a range of concerns. Several believe the compressed yield curve should be watched closely, while most see the brewing trade war as a potential problem. On the whole, the committee expects the U.S. economy to slow next year, believing the tax cut benefit to be unsustainable. This doesn't entirely mesh with the Fed's aggressive June dot plot.

So far, tax reform has provided the expected spark. The president and congress chose to extend the expansion cycle, and economic growth responded by shifting into a higher gear in the second quarter. The cost of the extension was a higher budget deficit, which will probably be addressed sometime after the midterm elections. It will inevitably end in recession, but the timing and magnitude of the downturn is anybody's guess. With protectionist rhetoric growing around the world, borders are tightening and free trade is evaporating. The world is evolving. There's probably much more volatility to come.

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