As was widely expected, the Federal Reserve left interest rates unchanged at its August 1 meeting, but upgraded its assessment of economic growth to "strong" in its policy statement. Previous statements had described economic growth as "solid", so this change is being interpreted as an indication that rate hikes will continue on schedule, at the rate of once a quarter. As in prior statements, there was no reference to uncertainty over the effects of trade policy, noting only that "risks to the economic outlook appear roughly balanced."

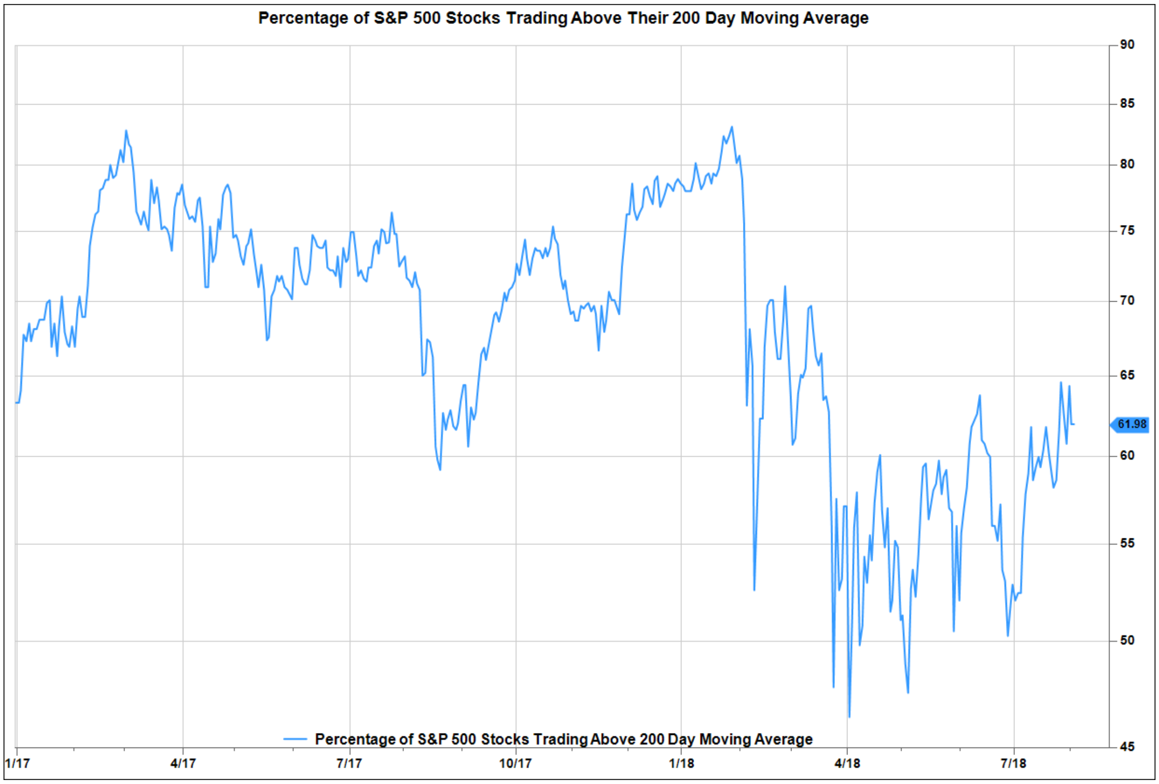
At 4.1% annualized growth, second quarter GDP expanded at more than twice the Fed's estimate of sustainable growth potential. It is worth noting, also, that as good as the reported numbers are, we have seen even better numbers during the current economic expansion. Real GDP growth expanded at a 5.1% annualized pace in the second quarter of 2014, followed by 4.9% annualized growth in Q3 2014. On a year-over-year basis, real GDP growth is up 2.8%, which is at the high end of the range during this recovery period, but below the 3% levels realized during the first two quarters of 2015. The bottom line is that the robust 2nd quarter data is unsustainable, as was the 2014-15 growth spurt, so long as the economy's growth potential is constrained by weak productivity and labor force growth. So while two more rate hikes this year is a reasonable assumption, projecting additional rate hikes into 2019, as many are doing, is a tricky proposition. A strong case can be made for much slower growth next year as the stimulus effect of tax cuts begins to erode and the lagged impact of Fed tightening begins to take effect.

On inflation, the Fed's statement simply noted that headline and core inflation remain near 2%, and that inflation expectations have been little changed. However, it would be reasonable to expect that wage pressures will continue to build with unemployment at or below 4%, unfilled jobs at all-time highs, and initial jobless claims at a 49-year low.

If Fed policy is one risk to this long economic and market expansion, the other is a slowdown induced by rising tariffs, as we have written in past *Outlooks*. Both GM and Caterpillar have issued cautionary warnings of trade related risks to their profit forecasts, and no one really knows how demand will react to rising prices of products affected by tariffs. Nor can anyone really compute the effect of disruptions to the supply chain, as we wrote about last month. Our leading industrial companies, as well as China's and our other trading partners, are heavily reliant on imports of crucial components and materials used in their manufacturing processes, so this risk must be acknowledged and cannot be over-stated. However, the lack of a meaningfully negative market response to negative trade headlines is encouraging, as it suggests that much of the bad news is already discounted in the market, and that a favorable resolution supportive of widening global trade would be positive for global equity markets.

The U.S. market, itself, has continued to perform well following a volatile start to the year. The S&P 500 Index rose 3.6% in July, following a positive 2nd quarter, and is now 9% above the low seen in February. Equally encouraging is the fact that more than 60%

of the stocks in the index are now trading above their respective 200-day moving averages, indicating that market breadth and momentum are improving. That measure had fallen to below 50% in the wake of the correction earlier this year.



Apart from the risk of a widening trade war, the major question appears to be how long the current expansion can last, given that this expansion, now in its 109th month, is a year away from becoming the longest in U.S. history. A Goldman Sachs report of other countries that have experienced growth periods of 10 years or more (Japan 1975-1992, U.K. and Canada 1992-2008, Australia 1992-to-now) cited significant similarities between our current economic situation and theirs: full employment and low inflation, strong financial regulation, and an absence of financial bubbles or imbalances. It also noted that in the last three U.S. expansions, the late cycle phase lasted 2-4 years, suggesting that the next recession could be as far out as 2021.

It is conventional wisdom that expansions do not die a natural death, but are killed by the Fed or by policy mistakes. So long as policymakers and the Fed remain undistracted by periodic reports of growth above that which is sustainable, and we remain free of financial imbalances, we believe there is every reason to remain optimistic for the foreseeable future.

Joseph J. Tascone
Senior Vice President &
Senior Investment Officer

Michael D. Blatt, CFA
Vice President &
Portfolio Manager

Michael S. Lares, CFP
Vice President &
Portfolio Manager

John E. Shea
Vice President &
Portfolio Manager