For much of 2015 and 2016, as the overall economy inched slowly ahead, two of our primary concerns were falling corporate earnings and a disconcerting lack of business investment, the latter suggesting a lack of confidence in the opportunity for growth moving forward. Earnings began to rebound during the second half of 2016, gaining steam as we moved through 2017, and now business investment seems to be following suit. Core capital goods orders climbed strongly during third quarter, rising 1.3% for three consecutive months, a surge that may finally confirm the expectations coming out of business surveys over the past 15 months. If the intentions expressed in those surveys are now turning into actions, we could witness a meaningful acceleration of investment in business equipment, strongly enhancing the potential for more sustained economic growth. That's the good news.

But if businesses are seeking to accelerate, where are we going to find the workers? The official unemployment rate is at 4.1% - a 17 year low - and trending lower. Jobless claims are at 44-year lows. The formerly vast pool of available workers – which includes "discouraged" workers who are not officially looking for work - continues to relentlessly decline, dropping a sharp 724,000 in October alone. Unfilled job openings remain at extraordinary highs, reflecting a mismatch in skills and/or geographic location with the remaining unemployed. Employers in a variety of industries report difficulty filling positions with qualified workers. Construction, as one example, has struggled with labor shortages for at least two years, and massive hurricane damage has only made the issue more acute, with no near-term solution in sight.

The intent by businesses is that greater capital expenditures will begin to produce material gains in productivity, helping to offset the need for labor. And indeed, all-important productivity growth, long dormant, has shown some recent signs of life, accelerating over the past two quarters to a solid 3.8% annualized rate. This could be crucial - without significant gains in productivity, companies otherwise capable of growing may face the reality that the workers they need simply aren't there. Wage inflation can be expected to follow, as companies compete for scarce labor.

In fact, the signs of wage inflation may finally be emerging. For both July and September, the rate of growth in average hourly earnings was at expansion highs. The rate fell sharply back to earth in October, with recent hurricane effects making the data difficult to interpret in the short run, but in analysis by Pantheon Economics, "leading indicators point to a clear and sustained acceleration in wages over the next two to three quarters".

A move higher for wages is long overdue. It is a clear positive for workers and, in proper context, can be a positive for the economy as well - but an excessive rate of wage inflation triggered by a progressively inadequate supply of qualified labor rather than as a product of strong economic growth has the potential to spark sharply higher interest rates, undermining one of the key justifications for current equity valuations.

It may seem perverse to be expressing caution because of improving conditions. The short-term economic outlook for not only the United States but the world in general is probably the best since the financial crisis. New signs of expanding business investment, improving productivity, and growth in compensation to workers – in an environment of low inflation, low interest rates, strong corporate earnings and the kind of synchronized global economic growth the world has not experienced since 2007 – are all quite positive. But it is important we are not blind to the possibility, as in all economic cycles, that some of the positives could contain the seeds of their undoing.

In that context, central banks bear watching, particularly given the unique circumstances of the current economic cycle. After nearly a decade of unprecedented measures designed to stimulate economic activity in the aftermath of the financial crisis, and with the economy on better footing, the Fed is now seeking to carefully withdraw stimulus by gradually raising interest rates and allowing its severely bloated balance sheet to begin to shrink. Other major central banks are ***talking*** about doing the same. It remains to be seen whether this will begin to happen on any broad scale, and what the pace may be, but if central banks domestically and/or globally should indeed move into a meaningful transition from a period of quantitative easing and extremely low rates to a period of shrinking balance sheets and rising interest rates, those conditions could prove very challenging for both stocks and bonds.

For these reasons and others, as we continue to monitor the strength of corporate earnings and seek to appropriately capitalize on current market opportunities, we are paying very close attention to factors affecting rates and currencies.

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