“What goes up, must come down.” Sir Isaac Newton.

It has been more than a year since the S&P 500 Index has experienced a 5% correction, the fourth longest streak in the history of the Index. The Dow Jones Industrial Average has hit 33 all-time highs in 2017 and has done so with no more than a 3% correction. So the question on the minds of many market observers now is this: Are we setting up for a market correction? It feels that way when you consider the P/E ratios of stocks such as Amazon at 250 or Netflix at 220. Even stocks such as Facebook and Google, with P/E ratios in the 30’s seem a bit rich. However we need to eschew the astronomical market price headlines and take a good look at the underlying economy.

Leading Economic Indicators Point Upward

The Conference Board’s Index of Leading Economic Indicators increased in June for the eleventh straight month, reflecting a strengthening economy. The Index, which measures the outlook for the next three to six months, gained 0.6% in June after rising 0.2% the prior two months, according to data released July 20th. Expectations for June had only been for a rise of 0.4%.

Eight of the ten indicators in the Index contributed to the rise in June, led by Building Permits, New Orders and the Interest rate spread. Following is a table of the ten components and how each fared over the last five months:

<table>
<thead>
<tr>
<th></th>
<th>June</th>
<th>May</th>
<th>April</th>
<th>March</th>
<th>Feb</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Leading Index</strong></td>
<td>127.8</td>
<td>127.0</td>
<td>126.7</td>
<td>126.4</td>
<td>125.9</td>
</tr>
<tr>
<td>Building permits</td>
<td>0.21%</td>
<td>-0.15%</td>
<td>-0.08%</td>
<td>0.10%</td>
<td>-0.19%</td>
</tr>
<tr>
<td>ISM New orders</td>
<td>0.17%</td>
<td>0.08%</td>
<td>0.04%</td>
<td>0.19%</td>
<td>0.20%</td>
</tr>
<tr>
<td>Interest rate spread</td>
<td>0.13%</td>
<td>0.16%</td>
<td>0.16%</td>
<td>0.19%</td>
<td>0.20%</td>
</tr>
</tbody>
</table>
Leading credit        0.09%  0.04%  0.02%  0.00%  0.00%
Ave. Consumer expectations  0.06%  0.08%  0.08%  0.12%  0.07%
Stock prices          0.06%  0.06%  -0.01%  0.06%  0.09%
Non def. Cap goods orders  0.01%  0.01%  0.01% -0.01%  0.00%
Consumer goods orders  0.01% -0.01% -0.05%  0.01%  0.02%
Average workweek       0.00%  0.00%  0.07% -0.07%  0.00%
Jobless claims        -0.05%  0.05%  0.10% -0.09%  0.05%

A Buoyant Stock Market

The second quarter of 2017 exhibited a very positive stock market environment, with the Indexes continuing to hit a series of all-time new highs in the month of July. For the second quarter, the S&P 500 was up 2.57%, or 3.09% if you include reinvested dividends. The best performing sector for the quarter was Healthcare with a return of 7.1%. That was followed by Industrials, which were up 4.7% and Financials, which were up 4.3%. The worst performing sectors were Energy and Telecommunications, which were down 6.3% and 7.0%, respectively. The party has continued to roll right on into the third quarter as the indexes have continued to make a series of new highs on through July and into early August.

A Strong Housing Market

According to Commerce Department data released July 19th, residential construction ended the second quarter on a strong note as groundbreaking on new homes rose in June at the fastest pace in four months. Residential starts increased 8.3% to an annualized rate of 1.22 million. Construction of single family homes rose 6.3% and groundbreaking on multifamily homes, such as townhouses and apartment buildings rose 13.3%. Building Permits, a proxy for future construction, also climbed 7.4% to a 1.25 million rate.

A Pick Up in Manufacturing

Economic activity in the manufacturing sector expanded in June, and the overall economy grew for the 97th consecutive month, according to the latest Institute for Supply Management’s (ISM) Report on Business, released July 3rd. The manufacturing expansion was broad based, with fifteen of the eighteen industries that the ISM tracks reporting growth in new orders. Factories powered up in June at the fastest pace in nearly three years, with robust advances in production, orders and employment. This is all good news showing that the economy is strengthening.
Growth was seen in the following industries: Electrical Equipment; Appliances & Components; Printing & Related Support Activities; Furniture & Related Products; Machinery; Wood Products; Nonmetallic Mineral Products; Plastics & Rubber Products; Paper Products; Transportation Equipment; Chemical Products; Computer & Electronic Products; Food, Beverage & Tobacco Products; Fabricated Metal Products; and Petroleum & Coal Products. The three industries reporting contractions were: Textile Mills; Primary Metals; and Apparel.

Also within the ISM Report on Business, the Employment Index registered 57.2, an increase of 3.7 from the May reading of 53.5.

Close to home, the Federal Reserve Bank of Richmond reported on July 25th that the overall business activity in the district rose twice as much as was anticipated. Of note in the report was a very strong reading for new orders. The Richmond district covers manufacturing in Virginia, the Carolinas, Maryland, D.C. and West Virginia. The Richmond Fed District accounts for just a touch over 9% of the nation’s GDP.

A Strong Labor Market is Humming Right Along

The strength of the Labor market remains one of the most encouraging features of the current economic cycle. Initial jobless claims numbers continue to trend downward. The most recent reading from the Department of Labor, released August 3rd, showed weekly jobless claims falling 5,000 to 240,000.

The most recent data from the Bureau of Labor Statistics, issued August 4th, showed a very strong employment market hitting full stride. Payrolls increased a very strong 209,000 in July versus an expected jobs gain of 180,000. Private employment increased by 205,000 and government payrolls rose by 4,000. Within the private employment number, the largest gain was seen in leisure and hospitality, with an increase of 62,000 jobs. Factory jobs rose by 16,000, while retailers added 900.

The BLS report also showed the overall Unemployment rate at 4.3%. That matched a 16 year low. The U-6, or underemployment rate, was unchanged at 8.6%. This figure includes part-time workers who would prefer a full-time position and people who want a job but are not actively looking for one.

The GDP Continues to Improve

Real GDP Growth in the second quarter of 2017 was 2.6%, according to Commerce Department figures released July 28th. The underlying growth rate for the economy is now 2.1% in year-on-year terms, which is markedly better than the 1.2% pace at this
point last year. The second quarter growth rebound is largely attributable to a recovery in consumer spending. More folks are working, consequently more folks are spending. It’s a virtuous cycle.

The rebound was driven primarily by consumption of goods: Durables consumption was up 6.3% and non-durables consumption was up 3.8%. Spending on services was softer, rising only 1.9%. Other highlights from the Commerce Department’s report include strong numbers in non-residential fixed investment, which rose 5.2% in the second quarter, following an impressive 7.2% growth in the first quarter of the year. These GDP results send an important message that the economy is on sound footing at the midpoint of the year.

Amazon.com

Online retailer Amazon.com held a nationwide job fair on August 2nd at nearly a dozen U.S. warehouses. Advertising that there were more than 50,000 jobs available across the country, Amazon planned to offer thousands of jobs on the spot. Nearly 40,000 of the 50,000 jobs will be full time. Starting wages ranged from $11.50 an hour in Chattanooga, TN to $13.75 an hour in Kent, WA, near the company’s headquarters in Seattle. Job fairs were also held in Ohio, Kentucky, Wisconsin, New Jersey, Illinois and Indiana. Part-time positions were also being offered in Oklahoma and New York. This news should help to boost the next payrolls number.

Double Digit Corporate Earnings Growth

On the Corporate earnings front, we are more than eighty percent through Second Quarter earnings reports and with 420 of the S&P 500 having reported through August 4th, the results have been very positive. 327 companies have reported higher earnings per share while only 84 have reported lower earnings per share. Nine companies have reported earnings that were unchanged. Average weighted earnings are up 11.8%, with most reports (302 out of 420) exhibiting positive earnings surprises.

Clearly, the energy sector shows the largest earnings increase for the period so far, with a weighted percentage change of 321%. All eleven sectors of the S&P 500 are showing earnings increases for the second quarter. The only negative report came from the Retailing sub-sector of the Consumer Discretionary Sector, where earnings declined 24.6%. Overall earnings growth in the Consumer Discretionary Sector was 2.5%, as seen in the table below:
### Sector Summary:

<table>
<thead>
<tr>
<th>Sector</th>
<th>Reported /Total</th>
<th>Weighted % Chg.</th>
<th>Surprises (+)</th>
<th>Same</th>
<th>(-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Discretionary</td>
<td>49/81</td>
<td>2.5 %</td>
<td>29</td>
<td>3</td>
<td>17</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>24/36</td>
<td>6.1 %</td>
<td>15</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Energy</td>
<td>32/34</td>
<td>321.2 %</td>
<td>19</td>
<td>2</td>
<td>11</td>
</tr>
<tr>
<td>Financials</td>
<td>66/66</td>
<td>8.4 %</td>
<td>49</td>
<td>5</td>
<td>12</td>
</tr>
<tr>
<td>Health Care:</td>
<td>50/61</td>
<td>7.3 %</td>
<td>44</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Industrials</td>
<td>63/67</td>
<td>6.7 %</td>
<td>19</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Information Tech:</td>
<td>52/67</td>
<td>19.0 %</td>
<td>44</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Materials:</td>
<td>22/25</td>
<td>10.4 %</td>
<td>14</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>Real Estate:</td>
<td>31/31</td>
<td>7.7 %</td>
<td>20</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Telecommunications:</td>
<td>4/4</td>
<td>5.0 %</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Utilities</td>
<td>27/28</td>
<td>6.8 %</td>
<td>20</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

**Total** 420/500 11.8% 297 39 79

### Fed Funds Rate

The Federal Open Market Committee (FOMC) of the Federal Reserve raised the Fed Funds rate for a third time in seven months when they met on June 14th. The Fed Funds Rate now stands at a range of 1.00% to 1.25%. The Committee noted in its formal statement that the labor market continues to strengthen and that economic activity continues to expand. The Committee meets again three more times in 2017: September, November and December. The implied probability of another 0.25% increase at one of those meetings currently stands at 52%, according to Bloomberg.

At the June meeting the Committee also confirmed that they would begin to shrink the enormous $4.5 trillion balance sheet beginning later this year, primarily by allowing some of the assets acquired in the wake of the financial crisis simply to mature, without reinvesting the proceeds.

### The Oil Field is Rigged!

According to data released by Baker Hughes on July 28th, working Rig counts have more than doubled from a low of 316 in May of 2016 to 766 at the end of July 2017, as shale explorers saw oil prices strengthening to near $50 a barrel. This report followed a slight pause in the expanding Rig counts earlier in the month, prior to which the Rig count had expanded for 23 straight weeks. This growth is likely to continue, on and off, through the rest of the year. Chevron said on the 28th that it
planned to add a rig every several weeks in its Permian Basin operations, with a goal of having 20 rigs in the region by the end of 2018.

A Good Buzz

More good news, this time from the world of nature. According to a report issued by the U.S. Department of Agriculture on August 1st, the number of honeybees increased in 2017. As of April 1st, the total number of commercial honeybee colonies rose 3% to 2.89 million. The report also noted that the number of incidences of Colony Collapse Disorder had declined 27% over the past year. Now that’s good news that we can all buzz about!

Back to Newton

So while the stock market seems to have gotten ahead of itself at the present moment and a 3% to 5% correction would not be out of the ordinary, the long-term prospects of our economy are looking up, not down. The Leading Economic Indicators, the strong labor market, the growing housing market, the robust Manufacturing sector and resilient double digit corporate earnings growth are all good reasons for looking up. It would be wise to remember then, after all, that Sir Isaac Newton was referring to an apple falling from a tree, and not Apple Inc.’s stock price falling from an all-time high. Newton’s apple never got back up in the tree.

McKim Williams, Jr.
Chief Investment Officer
August 5th, 2017

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