# Economic & Market Commentary

In the 1992 U.S. presidential campaign, James Carville, a strategist for Bill Clinton coined a phrase that at the time was prescient: "It's the economy, stupid." Fast forward to today and this seems to be the primary thing most investors are currently paying attention to. The U.S. economy is cruising along at a good pace and earnings are strong – what else matters? Yet most of the risks to this scenario that we have written about before, have heightened and, in fact, been augmented by others. In spite of these concerns, most U.S. equity indices put together three positive months to end the quarter with low single digit returns. This was enough to offset the negative returns of the first quarter, so the six months ended with a modest positive showing. Small capitalization stocks continued to outpace large cap and produced a high single digit return for the first half. Value stocks significantly lagged growth, largely due to the influence of the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix & Google) for both the quarter and the first half. Global risks were given more heed outside the U.S., as most global equity markets underperformed the U.S. The Wall Street Journal monitors more than 70 global stock markets. With this year's strong dollar, it reports that less than 10% of global stock markets turned in results exceeding the S&P 500 (in dollar terms), and more than 80% produced negative returns. Likewise, bond returns, across the yield curve, were negative for the first half.

Once again the FAANGs (plus Microsoft) played a dominant role in U.S. equity performance. For the quarter, those six stocks (which account for 15% of the S&P 500 weighting) produced more than 70% of that index's return. Without them, the S&P would have shown a return of less than 1%. For the first half, the S&P 500 would have turned in a negative return (-1.4%) were it not for the FAANGs. These stocks are clearly dominating the equity market, and have tilted performance toward a small handful of highly priced issues, to the detriment of a broader range of businesses, whose economics are sound and whose valuations don't properly reflect those economics. Narrow performance led to few groups outperforming the S&P 500 for either the quarter or six months. Four of the ten S&P 500 sectors outperformed for the quarter, and only three did so for the first half. Energy led for the quarter, followed by Consumer Discretionary and Information Technology. For the full six months, Consumer Discretionary and Information Technology were at the top, followed by Energy (reversing its 2017 position when it was the worst performer). Financials and Industrials were laggards in both periods. The flattish yield curve and fears about global growth from potential trade issues weighed on each of the latter two sectors.

Narrow performance has been a factor for the better part of the past decade. Ten years ago, if you had simply bought the Russell 3000 Growth Index and gone away, you would have outperformed the S&P 500 by 25%. We recognize that these periods of unusual performance occur periodically. However, this has been a remarkably long one. It has put at a disadvantage anyone whose investment philosophy holds that the price paid for an asset in relation to its business economics is a major determinant of the return received. The price paid for the economics of a business is fundamental to the expected return on that investment. Too high a price increases the equity risk premium (ERP) and demands that the investor be correct on the business economics for a longer time - which in most cases is a low probability bet. We pride ourselves in understanding the economics of a company's business, and trying to put that in the perspective of the price paid.

For those believing "It's the economy, stupid," the current static outlook is good. U.S. economic growth (real GDP) for the first quarter was revised down from +2.2% to +2.0%, but the current outlook for the second quarter is +4.1% (Atlanta Fed), on the way to a year expected to be in the 3.0-3.5% area.

Employment gains remain strong and steady, and the employment market is tightening. Wage gains are still modest but good. The case for decent capital expenditure growth can be made, given the corporate tax cuts, accelerated depreciation, and the attractiveness of substituting capital for labor to enhance productivity. Consumer wealth has recovered, and wage gains, along with tax cuts, should be beneficial to the consumer's pocketbook. Housing is behind the curve and has room to be a contributor to growth. Globally, 2017 was the first year in ten that all forty six countries tracked by the Organization for Economic Cooperation and Development (OECD) had positive growth, and it was assumed we would continue to be in a "globally synchronized recovery." On the corporate side, earnings are very strong. First quarter S&P 500 earnings were +25%, with organic growth contributing +13-15% and the corporate tax cuts the rest. For the second quarter, estimates are +20%, and full year earnings gains in the mid 20% area. The consensus for 2019 is for a further 10% gain. With stocks (S&P 500) selling at 16-17x estimated earnings and interest rates low, the equity market looks fairly valued – if things progress according to plan (which they often do not).

Herein lies the problem: it is more than "just the economy stupid." We all know that the best laid plans often go awry, and the odds of that happening today are higher than normal. Most of the concerns voiced at the beginning of the year have been heightened and, in fact, augmented by more that were not on the radar screen earlier. There seems to be a complacency that has overlooked or ignored these concerns. After all, a generation of investors has not experienced troublesome inflation or rising interest rates. The late 80's had both, and the late 70's – early 80's had double-digit inflation and rates. Since 1995, the core Consumer Price Index (CPI) has not exceeded 2.5% and interest rates have been in a state of constant decline since Paul Volker was chair of the Federal Reserve (Fed). Nor have many of these investors experienced a bear market, since the last was 2007- March 2009, nearly a decade ago. Since then, stocks have been on a tear, with only modest corrections in the decade. It's understandable that some would simply look at our domestic situation and extrapolate the current status, and ignore the other noise.

So what are these concerns that have been lurking in the distant weeds that have moved closer to the playing field? Let's start with the current status of the global economy. As mentioned, the U.S. is in good shape for the time being. Sure, labor is tight and labor costs are showing signs of increase. Inflation is broaching the Fed's targeted 2%, with the latest readings at 2.3%. The Fed has signaled a willingness to let the target creep up, and also to continue increasing rates and diminishing its balance sheet. All the while, the U.S. Treasury will be flooding the markets with an estimated $1.1 trillion of new debt over the next two years to pay for the ten year $1.5 trillion tax plan, and accommodate an additional $300 billion in general spending over the next two years. So there are questions about two ingredients in the investment equation (inflation and interest rates) that could be a problem. At the beginning of the year, it was still assumed we were in a "globally synchronized" expansion. Since then, the economies outside the U.S. have shown signs of fraying. The U.S. is more self-contained than most economies, but the picture abroad is troublesome. In addition to which we have the global spread of populism, which can be unsettling. The elections in Mexico, Italy, Spain, and Germany and the recent situation in the U.K. in relation to Brexit, could result in policies that might be unfavorable to the U.S. What was synchronized is now desynchronized, so the economy is hardly a slam-dunk for us.

Next we have the Federal Reserve Board and its stance on monetary policy. In the prior paragraph, we mentioned the Fed's stated policy towards rates and its balance sheet. The Fed's balance sheet has been reduced from a peak of close to $4.5 trillion to about $4.3 trillion, with further to go, through maturities and run off. As long as outright sales do not occur, the liquidity in the economy should not be greatly impacted. This is important since it has been the easy money policy of the Fed, combined with stimulative fiscal policy, that has provided the liquidity to allow a recovery from the recession of 2007-2009, and powered the recovery in asset prices. The Federal Funds rate has been increased twice this year (last in June) and the expectation is for at least one or possibly two more in 2018, with more to follow in 2019. This assumes the U.S. economy proceeds “according to plan.” These actions could push short rates above 3% for the first time in a decade, and have a major effect on the shape of the yield curve. The yield curve represents how much investors are paid for purchasing fixed income securities of different maturities. The difference between the short-term portion of the yield curve and the longer-term portion is closely monitored by most economists and investors, as it serves as an indicator of sentiment about economic growth. Short-term rates are impacted by action of the Fed – tightening or loosening money through the Fed Funds rate. Long-term rates are more influenced by the pace of inflation and expectations for economic growth. When short rates exceed long rates we have an inverted yield curve, which in the past has served as a precursor for recession with some accuracy over the past 50 years (it is also an important indicator of profitability for most financial institutions, as they tend to borrow short and lend long). With the Fed pushing up the short end of the yield curve, and growth looking good in the U.S., the long end was expected to move up as well. It had begun to do just that, when continued subdued inflation, questions about global growth feeding back to the U.S. and fears of trade wars dampening U.S. growth, reversed the process. We now have a flattening yield curve, which throws a clinker into the normal equation. What we do know is that under “normal” policy the Fed would be increasing short rates and normalizing its balance sheet in a measured and transparent fashion that would not damage financial markets, unless the pace of rate increase and level of rates got to extremes. This “Quantitative Tightening” (the reverse of Quantitative Easing of the last decade), and the large issuance of new debt would take place in the face of the stimulative fiscal policy of tax cuts and lessened regulation. How these will mesh is a big question for which there is no precedent.

On top of all this, we have the latest and perhaps most serious concern – the Trump Administration’s trade policy. Where we stand at this writing is the U.S. has imposed tariffs on $34 billion of goods from China, and China reciprocated in like fashion. This was on top of the tariffs imposed earlier on steel and aluminum. Then, the administration threatened tariffs on autos and auto parts from the European Union. The most recent action has been the stated imposition of tariffs on $200 billion of additional Chinese goods. So we seem to be in a tit-for-tat game, with no clear idea where this leads. The administration seems to view global trade through a production lens. Which is to say we should make U.S. goods more attractive, so that our workers retain jobs. Economists, on the other hand, view trade through the consumption lens. Through the process of “comparative advantage” (a concept some of us were taught in introductory Economics) consumers would get more and cheaper goods, which would raise living standards. The imposition of steel tariffs earlier in the process seems to contradict the administration’s objective. According to the Bank Credit Analyst, the U.S. produces about as much steel as it did in 2000, yet employs 145,000 workers compared to 203,000 in 2000. On the other hand, there are more than two million workers employed in steel consuming industries. An increase in the price of steel (tariff) will probably increase the price of finished goods and inflation, thereby reducing demand and possibly employment. The administration’s trade policy claims to want to “level the playing field” on trade tariffs. Yet, according to the World Bank, the U.S. has a more onerous tariff policy than others in the developed world. It calculates that the overall level of tariff barriers within developed countries is quite low, with the U.S. at the top of the list, about double that of Canada, and higher than Japan and the European Union. China, on the other hand, is a different story. China has significantly higher tariffs on global imports than we do. According to the World Trade Organization (WTO), China averages about 10% on global imports, while the U.S. averages 3.5%. We import about $540 billion from China with higher tariffs, and

China imports about $192 billion from the U.S. at lower tariffs. When you throw in the issue of protecting intellectual property rights, the Chinese trade issue becomes larger. Where this will end is impossible to say, but the outcome could be extreme.

The U.S. is a fairly self-contained economy, so the direct impact of a trade war is estimated to be less significant on us than across the globe. Tariffs are a tax on the consumer, to the extent passed along, which has inflationary implications. If not passed on, they would be absorbed by producers, putting pressure on profit margins. Neither of these outcomes are beneficial to our economy, nor our financial markets. Most economists talk in terms of about a 0.25 – 0.50% reduction in our real GDP, but that is pure conjecture, and it measures only the first derivative impact. The second derivative impact could be even more important. Already some U.S. business are having second thoughts about capital spending, hiring, and plant location, as uncertainty builds. These derivative effects will take time to roll through the economy, so it will not be clearly visible for a while. All of this can and would feedback on both the way the Fed executes its policy, and ultimately on economic growth and company profitability.

So these are the concerns noted earlier - that the complacent “it’s the economy stupid” investor must contend with. They are serious, and heightened, and if any materialize could create a shock to financial markets, which would increase volatility and take a toll. While we recognize these risks, we think they represent a yellow flag warning sign rather than a red flag danger sign (currently). With the S&P 500 trading at 16-17x expected earnings, we think that is fair, given where interest rates and inflation are and what we currently know. The stocks we have purchased on behalf of clients, in aggregate, have better profitability, better secular growth, good balance sheets, and are selling at a lower valuation than the S&P 500. So as we have said in recent letters, we are inclined to “stay the course,” as we watch the scenario play out. We will, of course, retain the option to change our mind – stay tuned!

## Fixed Income Review 2Q18

Bond returns were basically flat during the 2nd quarter, as the Bloomberg Barclays Aggregate Bond Index returned -0.16% and remained in negative territory at the end of the second quarter (-1.62%). Treasury yields had been steadily rising during the 2nd quarter, until the trade war rhetoric and tariffs enacted began to cause concern that these would lead to a slowdown in global economic growth. As the tensions escalated, yields fell particularly in the longer part of the yield curve (10 years and longer). The 10-year Treasury rate peaked in May at 3.11%, but then fell back to 2.86% by the end of the quarter. Over the 2nd quarter, short-term yields rose faster than long-term yields, as the Federal Reserve raised its Federal Funds target rate by 25 basis points for the 2nd time this year, at the June Fed meeting.

Inflation as measured by the Personal Consumption Expenditures (PCE) Index finally surpassed the Fed’s 2% target in May by reaching 2.3%. Despite late news that the 1st quarter GDP growth was revised down to 2.0% from 2.2%, we continue to see a clear case for the Fed to implement four rate hikes in 2018. Jobs gains in June of 213,000 topped projections in the latest Labor Department report. At the same time, more people entered the workforce which caused the unemployment rate to rise for the first time in nearly a year, to 4.0%. This indicates that there is more slack in the job market, from people who are unemployed or underemployed, which helps explain why wage growth has been so anemic, despite the large number of new of new jobs added in the past few years. The market is somewhat more skeptical about the potential 4th Fed Funds rate hike coming this year, as illustrated by Fed Funds futures, which indicate a 45% probability for that to occur by the end of 2018.

We are growing increasingly concerned about the flatness of the yield curve, particularly as the Federal Reserve raises short term rates, while longer term Treasury yields have stubbornly resisted moving up. The spread or difference between the yield on a 30-year Treasury and a 10-year Treasury was just 13 basis points at the end of the quarter, which is the lowest it has been in the past few decades. For comparison, the 10-year average of the 30-year/10-year spread is 85 basis points and the mean of this spread for the past 18 years is 66 basis points. If the trade war continues unabated, the Federal Reserve may need to deviate from its rate normalization policy or risk causing the yield curve to invert, which means that shorter term rates are higher than longer-term rates. An inverted yield curve has preceded all of the last seven major recessions going back to the 1960s. The last two times the yield curve inverted was in 2000 and 2006, before each of the two most recent recessions. The yield curve inversion does not cause a recession, but is a flashing signal that there likely is trouble ahead.

Complicating the decisions for the Federal Reserve has been the trade war initiated by President Trump, who leveled $34 billion in tariffs on Chinese goods, which predictably prompted retaliatory tariffs. Several major companies have voiced concerns about these weighing on economic growth and the pace of hiring and investment. For example, Harley Davidson already announced plans to shift some of its U.S. production to Europe in order to mitigate the impact of tariffs imposed on its vehicles. Although the negative economic impact from the trade war will be more gradual and spread over time than the positive boost from the tax cuts and government spending increase, we believe tariffs will start to impede worldwide economic growth unless a new trade compromise is reached. The Federal Reserve noted in their June meeting notes that they are watching closely for signs that economic growth and capital investments are being dampened or delayed by the newly enacted tariffs.

Overall, the prognostication for the US economy looks strong with the Atlanta Fed projecting 4.1% GDP growth in the second quarter of 2018. Although growth is expected to slow in the 2nd half of the year, economists still expect nearly 3% GDP growth for the year. We have a similarly positive outlook for the economy during the rest of year, with our optimistic view tempered by the unfolding trade wars.