STRATEGAS insight

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A Clear But Winding Path

The US stock market notched its 18th new high of the year—*and an all-time high at that*—on August 29, less than two weeks ago, and is up 7.4% through last Friday, September 7, 2018. The US economy grew at a robust 4.2% year-over-year SAAR (seasonally adjusted at annual rates) pace in 2Q18, and the Atlanta Fed's GDPNow forecast of current quarter growth stands taller at 4.4%—*which would be the highest rate in 16 quarters.* The unemployment rate is 3.9%—*a near 20-year low*—and the year-over-year wage increase is 2.9%. American companies are estimated to generate $156 of S&P earnings in the 12 months ending September 30—*an all-time high*—and 21.5% higher than the same period a year ago. And profit margins are running north of 11%—*you guessed it, at an all-time high.*

And yet…

In the three months ended last Friday, the market's classically defensive sectors—*Health Care, Utilities, and Staples*—have outpaced more growth-oriented cyclicals—*Information Technology, Energy, and Industrials*—by 810 basis points.[1] The yield curve (as measured by the spread between the 10-year and 2-year yields on US Treasury bills) has flattened to an unleavened 22 basis points. Commodity prices have fallen precipitously—*copper is down 21% since June; silver has fallen 19% since January; and oil is off 8.5% from late-June levels.* The tightening of overnight rates, the strengthening US Dollar, and a battery of idiosyncratic explanations have pulled emerging markets equities down 20% from this year's high recorded on January 26, 2018.

Why the long faces? Why the concern?

Market masons have certainly been busy: A number of issues have become bricks in the 'wall of worry.' Four of them seem to have moved front and center in recent months: geopolitics *(North Korea, Russia, Turkey, and then Venezuela and Argentina)*; tariffs and trade *(China, NAFTA, even European autos)*; interest rates, the yield curve, and the possibility of a Federal Reserve (the Fed) policy mistake; and the near-daily drama from the White House (whether it is from @realdonaldtrump or the pen of Anonymous) and the upcoming midterm elections. In isolation, much of this likely would be characterized as noise, but in concert, it commands attention.

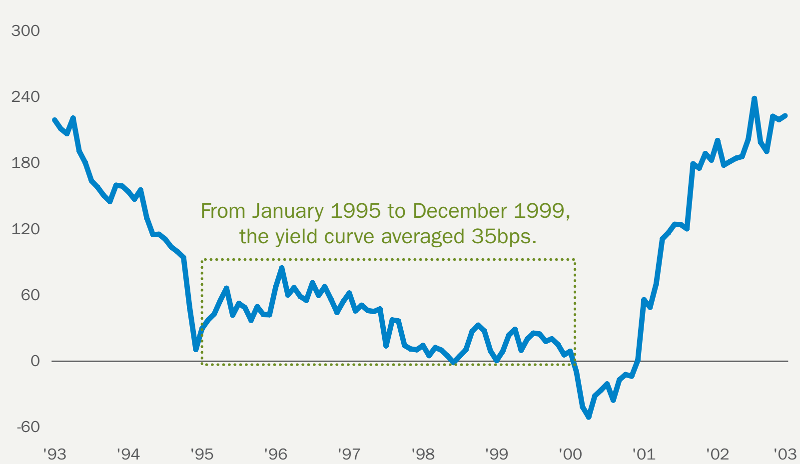
Of all of these threads, we are particularly focused on two. First, the Fed is unabashed in its desire to "normalize" interest rates. Boston Fed President, Eric Rosengren, who will rotate into a voting seat on the Federal Open Market Committee (FOMC) next year, reiterated this view in comments published over the weekend. To be fair, St. Louis Fed President, James Bullard, who also will have a vote next year, took the other side in his own comments last week, arguing for prudence (but he is in the minority among FOMC members). For its part, the market has discounted a Fed rate hike at the September meeting, and places better than 70% odds that another will come in December according to Bloomberg and based on the Fed funds futures market. We think they will hike at

[1] Weighted-average of defensive minus cyclicals

both. Coupled with prevailing guidance (four rate hikes in calendar year 2019 and two more 2020) it is not difficult to see why investors exhibit growing concern that the Fed may be at risk of making a policy error. The continued tightening of financial conditions (i.e., rising interest rates) is producing the expected results: *housing looks toppy, and money growth has slowed, the impact of which is particularly acute for emerging economies.* It is the unexpected result, however, that causes problems. In our view, an effort by the Fed to push forward with its plan to normalize policy, irrespective of global economic developments, would likely cause, as our chief economist, Don Rissmiller, has said, "something to break." Any indication that the Fed will pull back from the outlined pace of tightening should be viewed as a positive near-term catalyst for the equity market. Don and his team are watching developments on three fronts to gauge the likelihood of a policy shift: 1) Are global inflation and inflation expectations topping? 2) Are financial conditions tightening too quickly? and 3) Are international developments beginning to weigh on domestic growth? For now, any trouble appears to be contained abroad. Investors should keep an eye on the yield curve, which, as we note above, has flattened to 24 basis points. We are comfortable with a flat yield curve, but an inverted curve spells trouble. Importantly, there are notable precedents when the curve remained relatively flat for an extended period. In particular, in the late 1990s, *the curve averaged 35 basis points from January 1995 to December 1999. We believe the current period offers a number of parallels—faster output growth, low unemployment, and little inflation*… Stay tuned.

The second hot button is the prevailing uncertainty on the trade front. The Administration's tactics (presumably at the President's direction or with his implicit blessing) are economically suspect and the range of outcomes too difficult to handicap. This may be an effective negotiating technique, but it is far from market friendly. Investors have welcomed the unilateral trade deal announced with Mexico (and the likelihood of a deal with Canada). But the real story is China. Enter the US midterm elections: More than just providing domestic theater, the outcome will have important implications for ongoing US-Sino trade discussions. Despite polling that suggests a Democratic wave, the White House has maintained a confident posture and has pressed forward with additional tariffs on a growing list of Chinese goods, presumably in the hope of bringing sufficient pressure to bend the negotiations in Washington's favor. Beijing is less sure the President's hand will be strengthened when the polls close on November 6. We will continue to watch global commodity prices as a signpost indicating whether weakness in China and other emerging economies remains contained or metathesizes into trouble felt closer to home.

Monthly Treasury Bond Yield Curve
(10-Year Treasury Yield Minus 2-Year Yield)



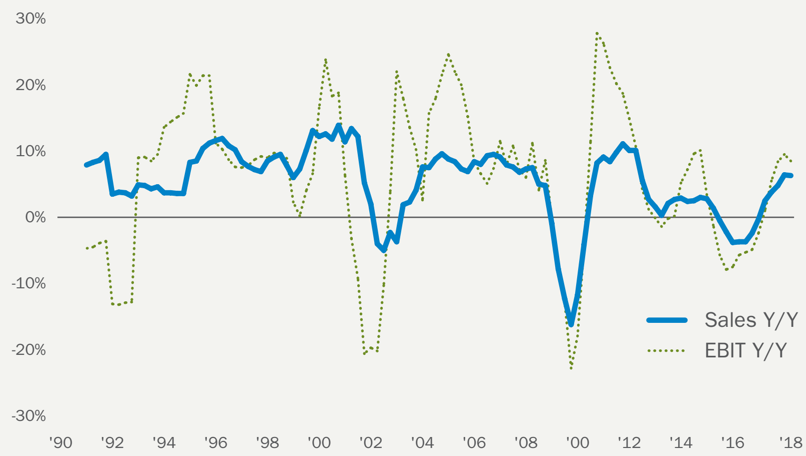
Source: Bloomberg

The less frequently asked question, but in our mind more interesting, is what could go right?

By our lights, a fair amount. As a starting point, do not discount the underlying health of the US economy. Although the cut in corporate tax rates boosted profits with a pen stroke—*subsequently evidenced by three sequential quarters of 20%+ growth*—this accounting adjustment tells only part of the story. How a company deploys the tax savings is the key. A company can pursue seven principal outlays with uncommitted cash: 1) buy back shares; 2) pay a dividend; 3) retire debt; 4) make an acquisition; 5) make a capital expenditure; 6) raise wages or hire more employees; or 7) save it for another day. Although there naturally has been debate on the impact any one of these outlays would have on the broader economy (or what evidence would indicate a lag in their impact), to put it simply, companies have increased funding into all of them. We prefer to watch sales and EBIT (earnings before interest and taxes) for a better read on the supply-side impact of last year's fiscal stimulus, rather than look at only EPS (earnings per share). Despite money's proclaimed proclivity to be conservative, it tends to burn a hole in Americans' pockets, particularly corporate pockets, where there is pressure to generate a return on equity. So a tax cut for one becomes revenue for another. If this continues as it has this year, both sales and EBIT growth will pick up as the tax cut moves beyond the EPS growth rates in 1Q19. Both series are moving in the right direction—*sales are up 6.3% year over year, and EBIT is up 8.5% for the same period.*

Consumer confidence is high, wage growth is strong, unemployment is low, and jobless claims are trending at historic lows. As a result, consumer confidence is pressing to highs last seen in the late-1990s and, prior to that, in the late 1960s. Retail sales have stayed strong.

S&P 500 Sales Growth vs EBIT Growth



Source: Factset Market Aggregates, Last Twelve Months (LTM) Year Over Year (Y/Y) percentage change

Despite faint signs of stress in the periphery, questionable tactics from policymakers (monetary and trade), and seasonal wobbles in the market, we remain broadly bullish on the economy. A clear path remains for the economy to expand well into next year (and beyond—but first things first). The efficient deployment of corporate tax savings should result in productivity gains and a further increase in wages. We are increasingly in an alpha-driven market—*what stocks do you own, what bonds do you own?*—as opposed to a beta-driven market—*how much equity do you own, how much debt do you own?* Positioning clients to take advantage of this market likely will require a greater active component in portfolios than has been typical over the past decade. The path is clear, and although it is not a straight one, it will be worth it.

Advisor Takeaway:

Investors have a tendency to climb a 'wall of worry,' and a couple of bricks seem to support that stance: Fed policy and global trade. As the Fed proceeds on its fast track to normalizing interest rates, the risks are threefold: global inflation could rise; money could become too tight; global economic developments could stymie growth. Conversely, a Fed pause could be a strong catalyst for equities to rise. In addition, investors have welcomed the recently renegotiated trade arrangement with Mexico, but China could be a stumbling block. We do not expect to see a deal until after the November 6 midterm elections, but interim clarity and resolution could be a positive force for the market.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **Gross Domestic Product (GDP)** rate is a measurement of the output of goods and services produced by labor and property located in the United States. **Real Gross Domestic Product (GDP)** is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. **Nominal Gross Domestic Product** is gross domestic product (GDP) evaluated at current market prices. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **PCE (Personal Consumption Expenditure) Index** of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. **FAANG** is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The **North American Free Trade Agreement (NAFTA)** is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The **Seasonally Adjusted Annual Rate (SAAR)** is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The **Atlanta Fed GDPNow** forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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