ECONOMIC OUTLOOK

bounty management
unique investment insight

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The Fed Begins to Unwind With One Eye on Financial Stability

In October, after years of extraordinary asset purchases, the Federal Reserve will begin to let some of the $4.5 trillion in treasuries and mortgage-backed securities roll-off its balance sheet. The decision to sell assets while core inflation remains below the central bank's 2% target, marks a shift in focus from unemployment and inflation toward financial stability risks (e.g., asset bubbles and excessive leverage). Globally, financial stability is improving, thanks to a more stable banking system and increased market confidence. Financial conditions across economies have given borrowers opportunities to fund investments and repair balance sheets. But there are threats on the horizon: from high levels of debt in many countries, to rapid credit expansion in China, to excessive risk-taking in financial markets. So far, policymakers have tended to view the benefits of unconventional easy money policy as larger than the potential costs of distorting financial markets. Now, with core inflation at 1.4% and a jobless rate of 4.2%, officials are thinking that pushing for the last few tenths of a percentage point on inflation misses the forest for the trees.

Over the last three decades, central banks have preferred to focus on the mandates of stable prices and/or full employment while mopping up bubbles or responding to crises after the fact. They took the view that asset bubbles are (1) hard to see in advance, and (2) poorly addressed with the blunt tool of interest rate adjustments. Still, in a recent speech Fed Chair Yellen noted "Persistently easy monetary policy might also eventually lead to increased leverage and other developments, with adverse implications for financial stability." Globally, central banks are pulling back or contemplating tapering their own asset purchases. However, even with these cuts, asset purchases will more than offset the Fed's reductions – the Fed's cuts are projected to total about $300 billion a year while global central banks are collectively purchasing $300 billion per month.

That the Fed is now looking to lean against markets with interest rate hikes as opposed to its regulatory tools (capital requirements or warnings to lenders about risky practices) marks a shift from the full-speed-ahead easing of recent years, and what many view as too-easy policy during the mid-2000s housing bubble. The political pressure in the wake of that crisis hasn't fully subsided, and officials are surely mindful that the response in the wake of a future bubble might further jeopardize the institution's credibility or independence. The shift in the monetary policy backdrop comes at a time when geopolitical risks regarding North Korea remain on the front pages, and political risks in the eurozone, including in Germany and Spain continue to simmer. Debt levels are elevated around the globe and debt is a common theme of many past financial crises. Total debt to GDP is higher now than in 2007 and the U.S. Congress may soon be adding significantly to future deficits. Tapping the policy brakes while navigating this slippery bend in the road will take some skill.

U.S. Economy

Near-term data will be impacted by hurricanes Harvey and Irma, and in ways that will obscure clear reads on activity and prices. August auto sales were impacted to the downside, but September turned around with flood replacements in Texas, while retail sales, consumer spending, and construction should be generally positive once rebuilding picks up. The rebuilding effort may also boost business surveys like the ISM (already strong though September), while price inflation measures will see a jolt on gasoline, up over 10% in September. Post-storm political unity meant a government shutdown was pushed off until at least December, and Senate Republicans finally tabled health care reform. That will allow Congress to re-focus on tax reform and tax cuts, but there are hurdles here too. Republicans will blanch at the cost, while Democrats will argue benefits are still too skewed to the rich.

Employment and Wages

The August report was soft, but in-line with what might reasonably be expected at this point in the expansion. A 165,000 private sector gain is only modestly below the trailing twelve month average. Wages were soft, but steady at 2.5% y/y, and the goods sector provided a clear tailwind of 70,000 jobs. Low-wage leisure and hospitality jobs continue to provide the bulk of gains on average. The Bureau of Labor Statistics' report on job openings and labor turnover suggests that most openings are also concentrated in those sectors as well, along with health care jobs. After lagging for most of the expansion, the Atlanta Fed's wage tracker, which tracks constantly-employed individuals shows a 3.8% y/y pace of wage growth for women (up from 2.5% to 3% on average in recent years), compared to 3% for men (down from 3.5%-4% in recent years). Adjusted for inflation, the average American worker now makes 2% less than in 1972.

Real Estate

Activity is slowing on the residential sales side, in part a reflection of tight supply. Housing starts and sales are lower while new home inventories have been rising. Slumping household formation is lowering demand at a time when affordability is under pressure, reflecting soft wage growth. Although a sharp downturn is not likely, the best days of this housing cycle appear to be behind us. The pending home sales index touched multi-year lows in August, off 2.6% y/y, while new and existing home sales are down from levels in the first half. The Case-Shiller Home Price index rose 5.8% y/y in July, continuing a pattern of steady advances, albeit at a pace a bit softer than in recent years. The fastest-growing locale is Seattle at 13.5% y/y, no surprise given tech sector tailwinds. Commercial vacancy rates ticked higher to 10% with a shallow bottoming occurring at 9.8% in mid-2016.

Consumer and Manufacturing

Inflation-adjusted consumer spending growth has been in the 2.5% to 3% range since early 2016, while the savings' rate moved to 3.8% in Q2, down from over 6% in 2015. Confidence surveys have been solid, with perceptions of the job market strong in the Conference Board's survey, and income expectations improved. Regional impacts from the hurricane did show up, as confidence in Texas slid 25.5 points to 119.9 in September, though the drop in Florida was less severe. Auto sales haven't posted a figure above 17 million in 2017 since February, after averaging 17.5 million in 2016. The September ISM Non-Manufacturing Survey rose to 60.8, the highest in the post-recession span, led by new orders and a rise in supplier delivery delays. The latter reflects hurricane-impacted supply chains, not surging demand stretching capacity. Employment in the sector has picked up after a long period of malaise on oil and strong-dollar drags.

World Economy

Europe

Populism isn't quite dead in Europe despite the pro-Europe French election earlier this summer. A September German election resulted in Chancellor Merkel's CDU/CSU escaping with a plurality, but in a weaker than expected position that will still make forming a coalition difficult. The far-right AfD party won 94 seats to the CDU/CSU's 246, a small but still not insignificant proportion of the Bundestag. Results raise the chance of another election down the road and any ruling coalition will still be at odds on a number of key issues. Nevertheless, faster GDP growth has started to spread beyond the EU core to the periphery in 2017. Spanish growth (3.1% y/y) has slowed marginally from the strong rebound in 2015 and 2016, as a result of some moderation in housing. The country will be navigating a vote for independence in the Catalan region, responsible for a fifth of the nation's output. The IHS Markit Composite Eurozone PMI showed a robust jump in September to 56.7, a four-month high, suggesting that the ongoing expansion has some legs.

In the U.K., 0.3% growth in the first half of 2017 was the slowest six-month growth rate since 2012, making the U.K. the worst performing economy in the G-7 Group. The primary factor behind tepid GDP performance is anemic household spending due to weak real income gains, as wages fail to respond to a robust labor market. The decline in the unemployment rate to 4.6% in August - a 42-year low - comes amid an even faster rise in prices, after the Brexit-induced pound weakness added upward pressure to imported goods prices.

Japan

A snap general election has been announced for October, a bid by Prime Minister Abe to consolidate power in the wake of the North Korean crisis to change the country's pacifist constitution with a 2/3 majority vote. A new "Party for Hope" is springing up to challenge the vote and a period of uncertainty is likely if the opposition proves stronger than expected. Strong profit growth hasn't filtered down to households, despite profits driving large manufacturing sentiment to decade-highs. GDP growth held above 1% for a fourth consecutive quarter (Q2 1.4%, after Q1 1.5%), still above the Bank of Japan's estimate of sustainable GDP growth around 0.5% y/y. A tight labor market and weak price pressures persisted in Japan in August and September, with the national CPI ex-food and energy up 0.2% y/y in August, up from 0.1%, while the corresponding Tokyo measure for September held at a weaker 0% y/y.

China and Developing World

October brings the long-awaited odd-year Party Congress, where leadership transition is expected to result in a tighter grip on power for President Xi Xinping, possibly at the expense of Premier Li Keqiang. The latter has been responsible for many of the country's economic reforms in recent years, an economist by training and the official who years back cast doubt on the nation's GDP figures as "for reference only." The property sector continues to cool though top-line GDP figures still look solid, and authorities added to curbs on credit in the third quarter. New home prices in Beijing rose 5.6% y/y in August, compared to double-digit gains as of June, and 3.2% y/y in Shanghai, compared to 10% in June. India's growth slowed to 5.7% down from 6.1% in the previous quarter. The weaker GDP numbers are still due to the decision to get rid of 86% of India's paper currency or "demonetization" which has temporarily stopped India's economic boom. The International Monetary Fund (IMF) nudged up its forecast for world growth this year to 3.5%, the fastest rate in five years.

Investment Perspective

Despite the threat of nuclear war after multiple missile tests in North Korea, a London subway bombing, a terrorist attack in Spain, Washington chaos, the massive Equifax data breach, and multiple hurricanes, fear was absent from the stock market over the summer and into the fall. Complacency is always worrisome especially when caution might be appropriate. As the market continues to push above historically normal valuations fueled on the back of years of easy money and low interest rates, investors registered varying degrees of alarm, but this has not stopped investors from buying equities. When an already rich market rallies on no real news then the balance of fear and greed is tipping toward greed.

Since the end of World War II, there have been twelve bull markets including the current one. On average, these runs have lasted about 58 months. The current bull market is now 105 months old making it the second longest since WWII. The 1990's bull market and the current market are both beneficiaries of lower interest rates which can support higher valuations. Longevity, high stock prices, and political turmoil are certainly reasons for caution, but the economy keeps plugging along at a low growth rate and global central banks are still supporting the markets by buying assets while keeping rates low. The stock market is expensive on most measures with the highest price-earnings ratios since the technology boom/bubble/bust. Stocks are not the only asset in a bull market - stocks, bonds, and property are all strikingly expensive compared to long-term averages. Investing from relatively high points in the market usually leads to low/muted future returns.

At the same time, U.S. and European economic data and growth continues to come in better than expected which, along with low interest rates, is supporting stock prices. Globally, short-term momentum has become broader based with improved growth and continued monetary support. In the bond market, credit spreads (the gap between safer treasury bonds and riskier bonds) have narrowed dramatically – a sign investors are willing to take on more risk. Shorter-term yields have risen with the Fed rate hikes, but medium and longer-term rates are flat this year. Estimates for third quarter earnings growth are 4.2% down from 7.2% a few weeks ago due to the effect of the hurricanes. As has been common the past few years, many companies will beat analyst's expectations. Future earnings growth is predicted to be about 8% in the next year. Technology, materials, industrials, energy, and healthcare sectors remain appealing with consumer stocks still under pressure.

After a decade with slow growth well below long-term potential, there are now signs the world economy is picking up. With better economic data, central banks are anxious to raise interest rates back to more normal levels both to rebalance economies and to create room to cope with unexpected future downturns. As the Fed raises rates and reduces its balance sheet, there is a risk of over-tightening and slowing the recovery. Given the size of the stimulus since 2008, it seems reasonable to expect some bumps in the road as central banks try to unwind monetary support. During these times of uncertainty, we feel it is important to maintain our disciple of finding and holding individual quality companies with strong financials, a favorable competitive position and growth at reasonable valuations. We will continue to invest with diligence, patience, and remain vigilant.

September 30, 2017
DJIA: 22,405.09
S&P 500: 2,519.36

About Bounty Management

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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