ECONOMIC OUTLOOK

bounty management
unique investment insight

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The Return of Volatility
Trade, Inflation, and Rate Hikes

After two years of relative calm in the markets, investors were jolted awake by increased volatility in the first quarter of the year. By early February, one-sided gains and minimal volatility transitioned into a period of large two-way swings. A grab-bag of disappointment including rising interest rates, inflation, opening salvos in what could be a longer trade war, unfavorable technology sector news, euro-zone data misses, the Trump-Mueller saga, and more, all suddenly mattered with valuations historically elevated in both the stock and bond markets. Signs of inflation and an expanding economy spurred the Federal Reserve to signal more rate hikes than anticipated at the beginning of the year. Suddenly, the second longest post-WWII bull market seemed worn out. Adding to the pain, neither bonds nor stocks were a refuge. In this environment, separating fundamental shifts from noise is both challenging and at the top of the list in investors' minds. Similar to driving on snowy winter roads, proceeding with caution is warranted.

U.S. growth and labor market performance remains solid in the first quarter and it is informative that one of the negative catalysts last quarter was a "too strong" result for average hourly earnings. Job growth was above trend, and Institute of Supply Management (ISM) surveys through March indicate further growth acceleration ahead, not a slowdown. Corporate profit expectations for 2018 are in the 15-20% y/y range, very strong historically, as the tax cuts take hold. Prior headwinds including fiscal policy, a strengthening dollar, slow global growth, and depressed energy prices are now tailwinds. Data surprises in Europe have been to the downside over the last month-plus, but conditions are far better than they were twelve to eighteen months ago. The new budget agreement signed in March increases spending by $300 billion over the next two years – not good for the nation's debt, but economic stimulus none-the-less.

Trade concerns are a key fly in the ointment, if only so far indirectly via sentiment and investment plans. Corporate planners may wait to see how the U.S. midterm elections play out to gauge the policy direction, but the executive branch has greater latitude on trade actions. Even incremental $50B or $100B tariff proposals eventually add up to real money, if enacted. The benign "this is noise" view treats comments as opening salvos with the aim of getting to a better final agreement, but even a harmless playground spat can end with a bloody nose. At the moment, China's early-April announcement of tariffs in response, including on soybeans and whiskey, suggests Republicans are being targeted by retaliatory measures in rather specific ways to send a message, not cripple industry. Proposed tariffs on U.S. aircraft exports hit only a thin slice of models actually bound for China. Motorcycles, bourbon, dairy, and jeans may also be featured in any European response.

U.S. Economy

After posting GDP growth of 1.5% in 2016 and 2.3% in 2017, estimates for 2018 are moving to the high-2% range for the full-year 2018. The expected lift from tax cuts and a new federal spending bill may contribute 0.4%-0.5% to growth, according to Federal Reserve estimates. Households will receive a steady drip of extra cash via reduced tax withholdings. For a middle-class household the benefits may amount to a less than $100 per month, though experiences will vary. Of course, we are taking on more debt to pay for the cuts – the latest estimate is an $800 billion deficit in 2018 increasing to $1 trillion by 2020. In response to the shift in fiscal policy, the Federal Reserve in March lifted its economic forecasts and turned more hawkish on inflation. New Fed Chair Jerome Powell is not an academic like his predecessors, and has historically been cautious about central bank largesse. The median policymaker expects three more hikes in 2018, then two-to-three in 2019, to meet the “neutral” rate of 3%. In addition to the rate hikes, the balance sheet is on track to run down by roughly $400 billion this year. The Fed raised their 2018 projection for growth from 2.5% in December to 2.7% in March in part due to the tax cuts, but left the long-term growth projection unchanged at 1.8%.

Employment and Wages

The share of small businesses that are having troubling filling open jobs is as high as it has been since the late 1990s, but nominal wage growth remains low. Temp-help jobs were up 4.2% y/y in February according to the Bureau of Labor Statistics, historically a leading indicator for turning points in the economy, and currently signaling little recession risk. Businesses are reporting tight labor markets and a lack of skilled workers. There are areas of stronger wage growth, particularly at the low- and high-end of the skill spectrum, but it’s worth noting wage growth for prime-aged individuals in the Atlanta Fed’s more granular tracker fell to its weakest pace of growth since 2014, at 3% y/y. Sluggish productivity growth, 1.1% y/y in the fourth quarter, is part of the problem, and the lion’s share of job gains are in the service sector. February’s jobs report was healthy as companies added 212,000 jobs, the strongest pace since 2015. The report for March wasn’t as strong, but still extended a remarkable run in the job market.

Real Estate

Multifamily residential and commercial real estate prices have risen, and as Fed officials have warned for years, capitalization rates (income/property value) are around historical lows. Unsurprisingly, shopping center and mall equities have borne the brunt of the softness as internet sales disrupt brick and mortar retail. On the residential side, land and labor remain key constraints for homebuilders, while an improved economic backdrop has been a tailwind. Case-Shiller home price appreciation maintained a steady y/y pace in the 6% range as inventory remains tight. High flyers including Seattle, Las Vegas, and San Francisco are posting y/y gains above or around double-digits, but the majority of price gains have been relatively contained.

Consumer and Manufacturing

A first quarter slowdown in consumer spending won’t be a concern given other tailwinds. Vehicle sales have moderated, but bonuses and tax refunds are coming. Interest costs will be higher, and vehicle insurance rates are among the fastest growing segments of U.S. consumer prices (9.7% y/y in February, accelerating from 5.8% annualized from 2013 through 2016). The March ISM Manufacturing survey remained strong at 59.3, and industrial production advanced 4.3% y/y in February, the strongest since 2012. The Non-Manufacturing version has also been exceptionally strong in recent months, four of the last six months the highest since 2005, exceeding all but two readings in the mid-2000s expansion.

World Economy

Europe

Another surprise in 2018 has been strength in the British pound against the dollar, where it's within a few percent of its pre-Brexit referendum level. Weakness against the euro has subsided, but the pound remains about 13% softer than in June 2016 against the common currency bloc. Buyer's remorse on Brexit continues to simmer, leaving open speculation that Britain will never actually end up leaving the EU. Costs are political and near term while the benefits remain in the realm of the hazy long-run. U.K. GDP growth continues to grind lower in contrast to better performance elsewhere, most recently to 1.4% y/y in the fourth quarter. Elevated consumer price inflation near 3% y/y hasn't been matched by wage gains, pressuring the consumer. Bank of England Governor Carney has emphasized that though more frequent, the rate hikes will be gradual. In the Eurozone, the ECB has also opted to keep interest rates unchanged for now. Eurozone survey data are showing moderation in the first quarter, including a miss in the regional manufacturing Purchasing Managers Index (PMI) in March, down 2 points to 56.6, while the services PMI fell 1.2 points to 55. Nevertheless, these are strong levels, and German GDP grew to 2.9% y/y in the fourth quarter, France 2.5%, Spain 3.1%, and Italy 1.6%. Save for Spain and Italy, those are the best readings since 2011.

Japan

Improved recent economic performance continues with real GDP lifting to 2% y/y in Q4, the strongest since 2015 on better business investment and steady consumer spending. Exports of goods and services logged stellar 6% y/y growth. That coupled with a jobless rate down to 2.4% in February (March 2.7%) explain why the Bank of Japan is unofficially tiptoeing to less-easy policy. Governor Kuroda quipped the appropriate timeframe to talk about stimulus exit would be in the fiscal year beginning April 2019, on its own a break from a "full speed ahead" approach, though internal discussions have already begun. Tariff risks linger, while regional tensions on the Korean peninsula have improved. A coming April meeting between the North and South Korean leaders will be watched closely, along with a tentatively-set May meeting with President Trump.

China and Emerging Markets

As a sign of how far emerging markets have come from being the basket cases in the 1990s to investor darlings now, central banks in major emerging markets have broken step with policies of developed market central banks. Central banks in Brazil, Russia and India, among others, despite accelerating economic growth, have been driving official rates lower. This divergence seldom happens. Underlying causes include improved emerging market fiscal positions, falling inflation, better foreign exchange management and more stable currencies vs. the U.S. dollar, stronger current account balances, and strong portfolio inflows to both equities and bonds in the search for higher returns.

Chinese GDP came in above estimates at 6.8% y/y in the fourth quarter and the tariffs on U.S. metals are likely to be of little direct consequence, while targeting intellectual property could have a greater impact. India's GDP outlook for 2018-2019 was raised to 7.4% from 6.6% last year. Brazil continues to recover with GDP +2.1% y/y in the last quarter and +1.0% for full year 2017 vs. -3.5% in 2016. The Organization for Economic Co-operation and Development (OECD) sees world growth strengthening from 3.7% in 2017 to 4% in 2018 and 2019. The International Monetary Fund forecast world growth in the same range at 3.9% for 2018.

Investment Perspective

March marked the ten year anniversary of the collapse of Bear Stearns in 2008, a once-storied investment firm with over $400 billion in assets and 85 years of history. Excessive leverage helped put the firm on the brink of bankruptcy, forcing it to sell to JP Morgan in a hastily arranged sale. Bear's fall was one of the first dominos in a downturn that lead to a meltdown of the financial system and the sale of Merrill Lynch, a $182 billion bailout of American International Group, and the bankruptcy of Lehman Brothers (to name a few). Fortunately for the global economy, the Federal Reserve stepped in with liquidity and later with monetary support in the form of zero percent interest rates and purchases of $3.5 trillion in bonds and mortgages. Fed Chairman Bernanke's low rate policy had the intended effect of pushing investors into buying riskier assets such as equities thus raising asset prices and valuations. The debate continues to this day on whether or not this was the correct response and the cause of the crisis, but few would argue that asset prices are higher as a result of the stimulus.

The real economy continues doing well. Unemployment is at a seventeen year low, hiring and growth are solid, and consumers and businesses are spending. Earnings growth is estimated at about 17% for the first quarter and sales are predicted to be up 7%, the highest since 2011. Tax cuts and the recent passage of the federal budget with an increase of $300 billion in spending are boosting the economy with fiscal stimulus. Increased spending and lower tax revenue may weaken U.S. credit and may explain part of the reason for the dollar's persistent weakness over the past year. Although a weaker currency helps with exports and boosts profits for multinational corporations, a rapid fall in the dollar's value risks investors faith in the dollar and complicates the Fed's plans to tighten monetary policy. Investors have also been spooked by the threat of a trade spat with China. Restricting trade with tariffs or other barriers is a form of de-globalization. If the era of globalization during the past few decades brought stronger growth and lower inflation, then the reverse could bring the opposite. Add a possible four rate hikes to the mix and it is no wonder investors are pausing.

Given the positive outlook for earnings and growth, we still favor equities over fixed income. The main driver of future returns is valuation and even with the selloff valuations are at the high end of historical averages. For equities, we favor industrials, healthcare, materials, energy, financials, and technology. Bond values are still high with flat real (after inflation) returns, a flattening yield curve, and the Fed expected to continue to aggressively raise rates. In this environment, we favor inflation protected securities and shorter-term treasuries. Fixed income is still an important anchor for times of increasing volatility. Brent crude, the global benchmark, closed over $70 this month, marking the highest price since December 2014. Gold's value remains a testament to the intrinsic value of the safe haven asset. Dollar weakness provides support for gold as does ballooning trade and government budget deficits along with geopolitical instability and the threat of more tariffs. We are steadfast in our long-term focus on finding well run, high quality companies at good valuations in areas that offer growth opportunities. In our quest, we remain vigilant and hopeful.

March 31, 2018
DJIA: 24,103.11
S&P 500: 2,640.87

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.