The US Macro Environment

November 2018

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Political Rhetoric:

Once elected, politicians often find that campaign promises are difficult to implement. This is not new but has been a tried and true political strategy for decades. Our takeaway is that rhetoric should be viewed as more political positioning than any clear articulation of a formal policy plan. Politicians have been using nationalist rhetoric to win elections for centuries. Once in office, foreign policy, free trade and immigration enforcement tend to follow old plans. Cheap campaign promises are rarely, if ever, delivered. President Trump is not the first to argue for tariffs, border security, and an embassy move to Jerusalem. He just might be the first to attempt to deliver on some of his campaign promises.

The party in office is always dealing with the other side of the aisle's political ambition. In 2006, both Senator Obama and Clinton voted for the Secure Fence Act, which President Bush then signed into law. In 2013, every single Democrat in the Senate voted for a comprehensive immigration package that included 700 miles of border fencing. Now, when President Trump calls for "a wall," Democrats cry foul. During the 2008 campaign for President, both Hillary Clinton and Barack Obama advocated and threatened to leave NAFTA as a negotiation tool to get better terms. Now, when President Trump rips up trade deals, Democrats scream.

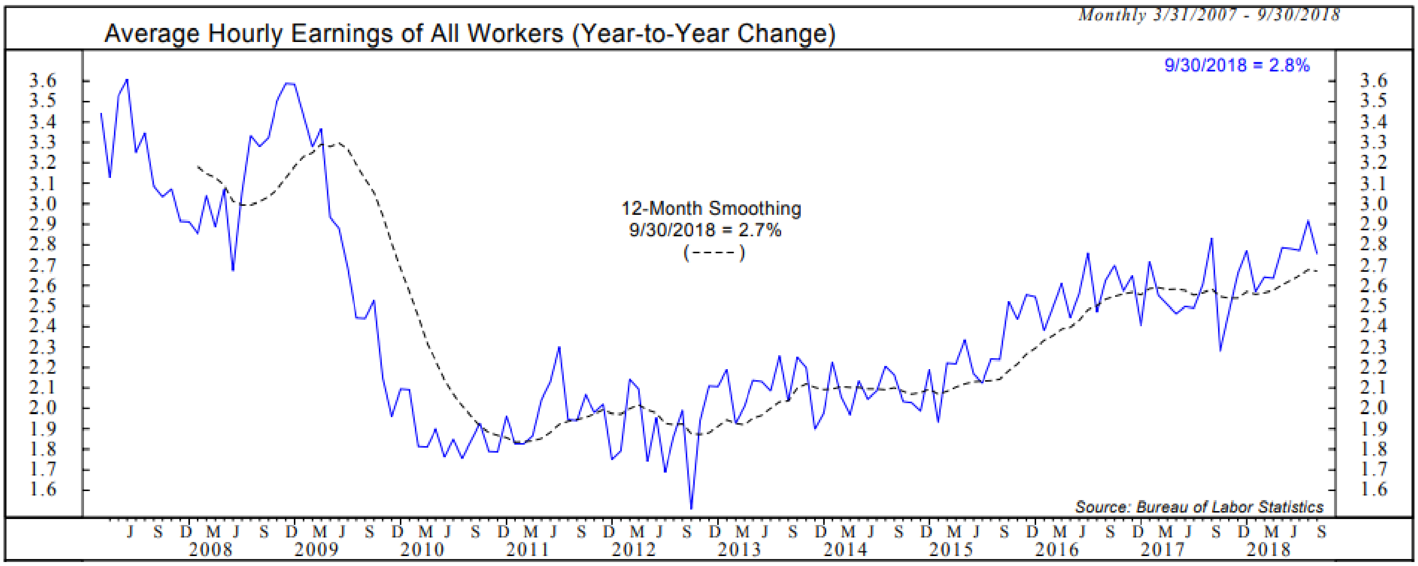
"The air is so crisp and filled with political polarization."

Before you think we are getting political, this rhetoric goes both ways. In 2008, following Barack Obama's presidential victory, he criticized President Bush for being more focused on rebuilding Iraq than investing in America. President Obama promised to do the opposite: focus on infrastructure spending and "nation-build at home." While he was on the campaign trail, Obama railed against our perennial trade deficit, the loss of good-paying American jobs and China's currency manipulation and intellectual property appropriation. Thus, campaign rhetoric versus political reality remain polar opposites.

Budgeting and leading are about making difficult choices. The desire for lower taxes does not fit with the desire to strengthen and spend on the military. Our aging demographic profile is in desperate need of an influx of hard working, young immigrants, but that does not seem like an issue that is gaining traction. Our maturing population is reaching an age that will cause healthcare and other entitlement programs to become stressed. The fiscal conservatives, known for being deficit hawks, have also disappeared. With Paul Ryan stepping down as House leader next year, the deficit hawk will become an endangered species in Washington. Deficits are building and there does not seem to be a solution in sight. As the owner of the world's principal reserve currency, the US should be able to borrow for years. That will be the case, until it isn't. When S&P took our rating down to AA+ in April 2011, the stock market fell. At some point in our future, creditors will balk at supplying our country with endless amounts of capital.

Pro-Growth Agenda:

The Trump administration has made no secret of its intention to stimulate our economy and push a pro-growth business agenda. This is evidenced through its reduction in regulations, as well as its individual and corporate tax cuts. By lowering corporate taxes from 35% to 21%, US companies are paying the lowest rate since 1949, or 69 years. Not only is this a positive, that immediately gets reflected in stock prices, but also the tax cut included an incentive to repatriate accumulated profits from overseas. By bringing more than $2.5 trillion dollars back to the US, companies can begin to re-invest at home, invest in research and development, increase employee wages, purchase new equipment and build new manufacturing plants.



Simply stated, by our strengthening US companies, more jobs will be created. With more jobs and a strong consumer, consumer spending will rise. This obviously is good for businesses and the economy, which gets positively reflected in stock prices and reinforces a virtuous cycle. Prior stimulus efforts were more temporary and had modest economic benefits (i.e. the "Cash for Clunkers" program). This tax cut, while criticized by many as a one-time stimulus, is actually a long-term positive.

Our country is now the best place on earth to conduct business, which is now reflected in our stock market's outperformance versus other countries. The long-term structural changes, in how American companies do business, will likely boost growth for years. We believe that the ramifications of this transformational tax cut should be felt for decades to come.

Taxes:

Republican policy makers are rejoicing in their good fortune. The US economy is booming with output growing over 50% faster than the Fed earlier forecast. Economists are questioning whether or not this strong labor market will translate into higher wages for employees, but there can be no doubt in our stronger-than-expected economic growth.

When DC enacted corporate tax reform late last year, there were many unknowns. The equity market had a positive response, with January up nearly 8%. Keynesian economists argued that the US economy would only temporarily rise from this "sugar high" and would eventually return to more normal, slow growth rates. Others argued the tax cut was designed only to benefit the 1%'ers and corporate America. Even members of the Fed had uncertainty over how the economy would respond to the tax cuts and increased government spending. Federal Reserve Bank of Atlanta President Raphael Bostic stated that it was likely to "complicate future monetary policy." However, former Fed Board member Kevin Warsh recently stated, "Reforms in tax and regulatory policy were well-timed [and] the strong trends in the US economy are likely to continue." While it is still too early to tell which side of this argument is correct, we would be remiss not to look at how the economy is handling this change.

The Magic of Compounding:

The bipartisan Congressional Budget Office (CBO), just updated its US economic forecast. Before the tax cuts were passed, the CBO was expecting modest growth, similar to the sub-2.0% experienced from 2010 to 2017. Now, partly due to the Trump tax cuts, the CBO is expecting much higher economic growth. Let's do some quick math and see how these small changes in growth rate measure up.

This is when the magic of compounding can truly be witnessed. The markedly better and higher level of growth the US economy is experiencing will impact the next decade. The CBO is expecting $179 billion of better output this year, $465 billion next year, and $654 billion in 2020. Fast forward a decade, post the tax changes, and economic growth will result in $6 trillion of additional growth. If our government only captures 18% of this higher GDP growth, in the form of tax revenue, it still would bring in $1.1 trillion over the next 10 years. The corporate tax overhaul was estimated to cost the government $500 billion in *lost* tax revenue. Some Republican policy makers are arguing that the better-than-expected growth has already paid for the tax cut. While we are not willing to go that far, better economic growth can and does solve multiple future problems.

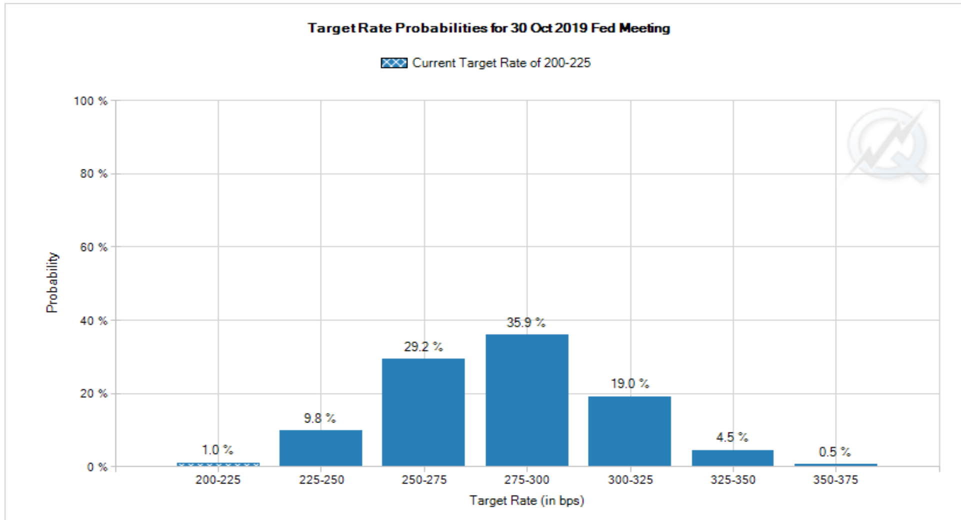
Lower taxes, coupled with a pro-business, lower regulatory environment, have clearly spurred our economy higher. The game plan was to revitalize our economy and create a pro-business atmosphere. Many said that our economy could never grow at 3% again, let alone 4%.

One can argue that the current economic growth was going to happen without the need to cut taxes, but the evidence simply is not there to support this. When businesses do well, this can have a positive effect on the whole country. When people have good-paying jobs, this spurs growth. Businesses can be a great platform for change. If one has a well-paying job, it leads to food on the table, good housing, healthcare coverage and money for discretionary spending. Unemployment is at historically low rates, wages are increasing, and the economy is growing at 4%. It is still too early to declare this a victory, but the corporate tax cut has been paying dividends. The market is higher and corporate America is doing well, which bodes well for the average American worker and consumer.

Interest Rates:

For the 3rd time this year, the Fed lifted short-term interest rates to a range of 2.0% to 2.25%. Fed officials have been eager to remove some of its emergency measures following the Financial Crisis. This is the 8th 25 basis point increase the Fed has made over the last 2 ½ years, in an effort to "normalize" interest rates.

If one examines the CME interest rate expectations tool (seen here), investors can see that the market is expecting one additional rate increase this year, two more in 2019 and one in 2020. While that is what the market is expecting, there absolutely can be changes to that probability. For example, the market was forecasting numerous interest rate hikes in 2016, but the Fed scratched those plans once market turmoil surfaced.



While the Fed no longer needs to be accommodative, questions arise about whether or not additional interest rate increases are needed to offset our economic growth. We believe that the Fed has steadily raised rates to come off the extremely low levels which were necessary following the Financial Crisis. Now that the economy is stimulated and growing, it made perfect sense to raise interest rates from essential zero-bound. The bigger question is what the future holds, right?

Goldilocks - Not Too Hot & Not Too Cold:

We believe the Fed is looking to lift rates to a "neutral level" that neither spurs nor slows the economy. The Fed is looking for that magic level that presses on neither the gas pedal nor the brake. The Fed's search for the neutral rate is a futile effort. Why? First, productivity growth should be a large component in determining this rate, but productivity has been nearly impossible to measure and forecast. Policy makers must factor in taxes, spending, trade, and their impacts on growth. In addition, interest rates are not the only factor in determining monetary policy. QE and the massive bond buying program undertaken following the Financial Crisis are impacting today's market. As the Fed unwinds QE, it is artificially impacting rates. Lastly, other central banks around the world are still in various forms of stimuli. There simply is no way to ever reach that perfect equilibrium or rate.

What do we mean? Well, the stock market has had a very difficult month of October. It essentially ignored another solid jobs report and a steadily increasing wage picture. The rise in yields, with the 10-year at 3.15% and subsequent fall of Treasury prices, seemed like the only thing the market was focused on. In our opinion, this is exactly what we wanted to have the market do: not go down, but react to inputs and alter long-term interest rates. Long-term interest rates needed to head higher, to properly reflect the strength in the economy. It does not need to indicate that something ominous is coming or that inflation is about to head materially higher. We believe rising yields are appropriate for the strength of the economy and that interest rates are simply rising from historically low levels.

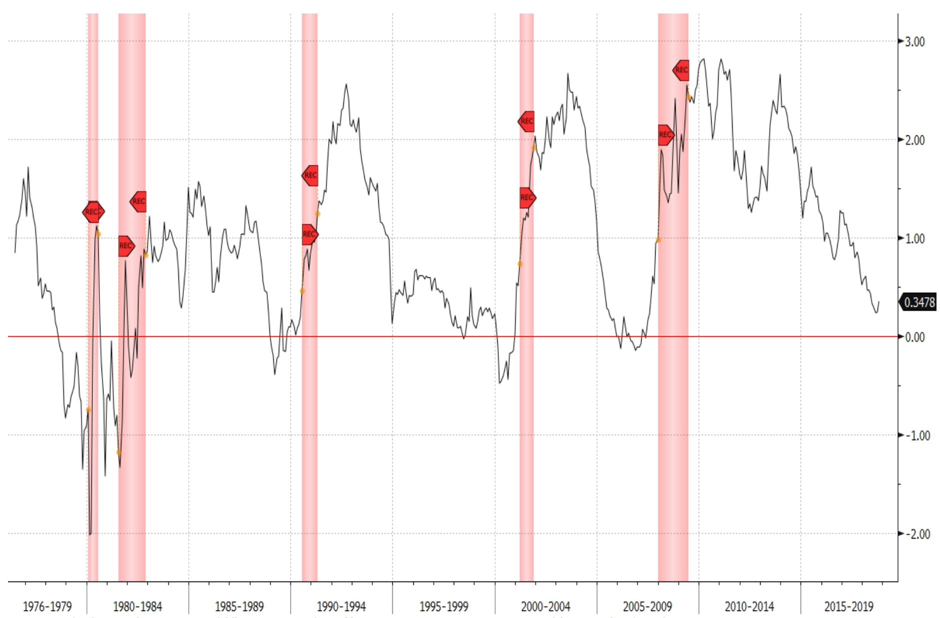
This is normal trading activity and nothing disastrous should be inferred from a steepening yield curve. Quite the opposite. It is exactly what we were looking for and wanted to see. With our portfolio heavily weighted towards financials and companies that benefit from higher interest rates, this is yet another positive development.

We anticipate the Fed will hold steady, once it reaches this point (i.e. the neutral rate) at some period in 2019. Fed officials have emphasized that their target rate is "symmetric" and used this word 10 times in their May meeting notes. Clearly, they believe it is not necessary to raise rates faster than necessary, even if inflation does overshoot a bit.

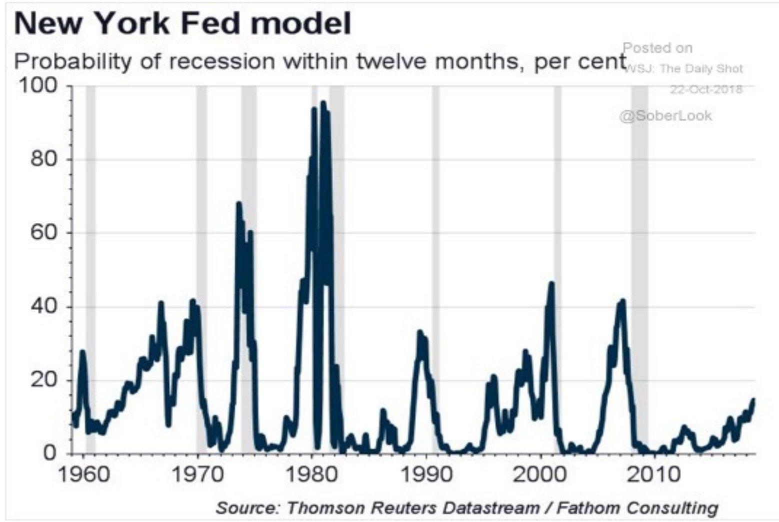
Should we pause interest rate increases until inflation pressures become more noticeable? While the domestic economic outlook is bright, the picture abroad is much cloudier. Should we hesitate to lift our interest rates while financial turbulence is causing turmoil and impacting some emerging markets? We believe that the Fed, will not aggressively raise interest rates to the detriment of the US economy.

The Yield Curve:

As we just mentioned, the flattening of Treasury yields is receiving ample market attention. Economists and policymakers agree on few things, but many believe the shape of the yield curve is the single best indicator of where an economy is headed. For example, once short-term interest rates exceed long-term rates (i.e. become inverted), a recession is imminent. Over the last 50 years, an inverted yield curve has predated a recessionary environment. While this is not a perfect indicator, it has predicted 5 out of the last 5 recessions (see the chart to the right).



Research indicates that recessions start a median of 18.5 months after a 2 versus 10-year Treasury inversion. While the yield curve has not yet inverted, it remains fairly flat. The chart to the right is from the New York Fed. It suggests a 15% chance of a recession over the next twelve months.



Instead of focusing on economist predictions, we will wait to see what the shape of the yield curve tells us. Since the Fed began its short-term interest rate increases, the spread between 2-year and 10-year Treasuries has shrunk from 134 basis points to a mere 10 to 20 basis points.

When it comes to interest rates and the yield curve, we like to examine and analyze what the bond market appears to be telling us. It is clearly stating that inflation expectations appear anchored and that the economy is not showing signs of overheating. As Chairman Powell recently said, "There is no sense in the data that we're on the cusp of an acceleration of inflation."

Over the last year or so, Congress has enacted a large tax cut, as well as dramatically boosted its spending. Throw in the fact that the Federal Reserve has begun to wind down its balance sheet, which increases the amount of bonds the private market must absorb. The amount of 10-year Treasury securities that the private sector is holding has doubled during 2018 versus 2014. In theory, this additional supply should be putting downward pressure on prices and driving yields higher. Maybe massive quantitative easing and historically low monetary rates have depressed 10-year rates. Could it be that the Fed's expanded balance sheet is holding down the long-end of the curve? Maybe investors are concerned with trade tensions and are buying Treasuries to hedge those issues? If the market was expecting higher inflation or stronger economic growth, it would be showing up in higher long-term bond yields. Could this suggest that monetary policy has already brought rates back towards a "new normal" or neutral rate? The best answer is that we simply do not know.

A Yield Curve Inversion Could Be Bullish:

One bullish statistic is that the median average S&P 500 return - from the inversion date to a stock market peak - is an impressive +21.13%. Looking at the last three yield curve inversions provides some bullish results. The last inversion occurred in late 2005, but the market generated a positive +24.6% return until peaking in October 2007. Before that, the prior yield curve inversion occurred on May 1998. The S&P 500 generated +39.6% returns over the next 22 months. Back in December of 1988, the yield curve inverted, but the stock market rose +34.0% over the next 19 months. Even if the yield curve does invert, we will not panic. Using history as a guide, following an inversion, the stock market could perform handsomely for another 1 to 2 years.

As we examine the US market right now, we do not believe equity markets are excessively valued for the positive environment they currently are experiencing. Certain valuations are elevated, but one could justify these higher than average prices because of better-than-normal revenue growth and profit margins. We believe the Fed understands that raising rates too quickly has the potential impact of inverting the yield curve and putting the brakes on our economy. Deciphering all these signals can be difficult, no economists have a perfect record of predicting when the cycle will end. Despite a vast amount of data and quantitative analysis, this unfortunately is more art than science.

Independence:

The Fed was created in 1913, to help offset and alleviate market conditions, following a series of financial panics. Structured under the Federal Reserve Act, it is designed to be entirely bipartisan. The Fed is a critical component of a properly functioning economy, and it is vital in the operational effectiveness of the entire global economy.

In 1956, Dwight Eisenhower said, "The Fed is set-up as a separate agency of government…it would be a mistake to make it definitely and directly responsible to the political head of state." This is not to say the Fed has no accountability or that the government has no oversight on this body. Congress names key Fed personnel, and there is ample opportunity for experts and journalists to critique every aspect of the Fed's policies. However, if the market wants to continue its wonderful economic growth, the Fed must be politically unbiased and economically dependent. In the 1990s, President Clinton's economic adviser Bob Rubin initiated an unwritten decree called *The Rubin Rule*. It stated that the White House would make no comments, even anonymously, on any Fed policies.

On July 19th, President Trump broke decades of presidential precedent by openly criticizing Jay Powell and The Fed for continuing to raise interest rates. By stating he was "not thrilled" with higher interest rates, President Trump clearly was favoring an easier monetary environment, to continue to boost the US economy.

Trump blamed the Federal Reserve for raising interest rates too fast and for damaging economic growth. He said, "I think the Fed is making a mistake. They're so tight. I think the Fed has gone crazy." President Trump later stated that "every time we do something great, he (implying Chairman Powell) raises the interest rates." When asked to name the biggest risk to the economy, President Trump said "the Fed".

Alan Greenspan, served as the Fed's Chairman from 1987 through 2006, under Presidents Ronald Reagan, George H.W. Bush, Bill Clinton and George W. Bush. During that period, he was called the "maestro" in his adept handling and orchestrating of the shifting markets. Former Chairman Greenspan recently commented about any "input" he received from the White House, during his time leading the Fed. Not only did he say it "happened all the time", but he said, "I was at the Fed for 18 ½ years. I got innumerable notes, pledges, requests, et cetera to lower rates. I do not recall a single instance where somebody in the political realm said we need to raise rates, they're too low."

Greenspan also highlighted his confidence in new Chairman Powell and suggested he ignore outside political pressures. In fact, he said the best thing to do was to "put earmuffs on". With summer finally coming to an end, and the weather starting to get a little chillier, we couldn't agree more. As President Trump approaches mid-term elections, he undoubtedly wants a strong economy to boost Republican candidates. The best way to insure Trump can push through his agenda is to keep his House and Senate majorities. A strong economy, aided by low interest rates, is a critical aspect to ponder and certainly is something our Tweeter-in-Chief considers every day.

Conclusion:

We are strong believers that Fed accountability, independence and legitimacy are valuable ideals that must continue to be reinforced. In our opinion, a gradual course of rising rates is exactly what the economy needed, as it recovered from the Financial Crisis. However, the biggest question facing the stock market is will Chairman Powell make the mistake of raising interest rates too fast and snuff out the long run expansion. Indicating a trend towards continued tightening, Chairman Powell recently stated that the Fed's short-term target, now at 2% to 2.25%, remains "a long way from neutral." With President Trump declaring a clear preference for low interest rates, can the central bank appear independent, if it stops raising rates?

Widespread fears of inflation are very different from today's environment. The Labor Department just reported that consumer prices, excluding food and energy, are only up 1.8%. Rising bond yields are normally a negative for stocks (i.e. 1994, 2006 and February of 2018), but this only is temporary. Recent market volatility, during this earnings season, seems "more normal" to us and might be more attributable to the upcoming mid-term elections than anything else. The current situation seems to be mostly a temporary correction and a mild case of indigestion. The global economy does not steadily move higher in a synchronized upswing. There will always be ups and downs.

Tame inflation, combined with a positive earnings backdrop, should allow this bull market to run for longer. This low inflationary environment has been below the Fed's target for so long, that we believe the Fed will let it rise for a little longer, before interceding. We believe the Fed will be patient and examine all of the global inputs. We believe it will decide to pause its steady interest rate increases during 2019. If the Fed steps back from tightening, some will claim that he was coerced or forced by President Trump. Others will highlight that the Fed is simply reacting to global inputs and interpreting the data. Either way, we see the Fed acting cautiously.

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