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Insight

Entering the Bell Lap for 2018

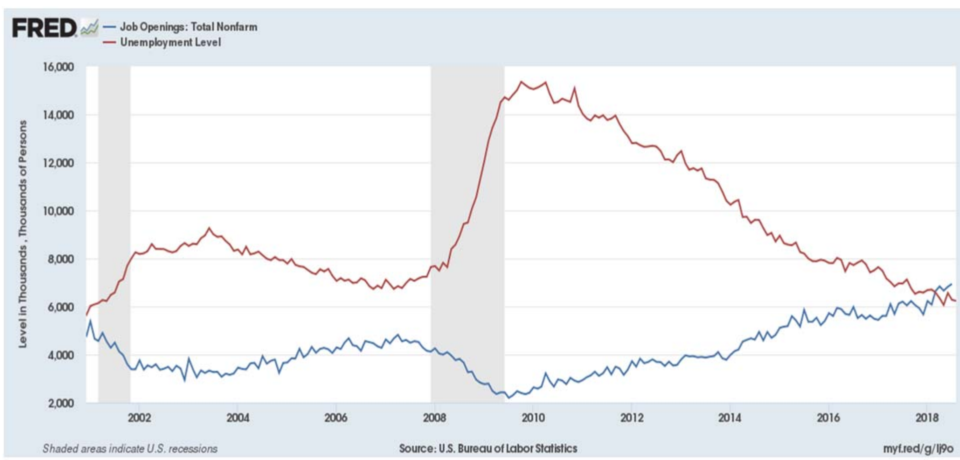
-Craig Lewis, Chief Investment Strategist

As we enter the final lap (quarter) of the year, a lot has been settled: the Fed has left no question about their intent to raise rates and shrink the size of their balance sheet, and corporations and individuals are busy allocating their tax savings. Many issues remain unresolved, including trade "peace treaties" with Canada and the European Union, Brexit negotiations, mid-term elections, and of course the trade war (or skirmish, depending on your point of view) with China. It should be an interesting finish.

As the Fed shrinks the size of its balance sheet from $4.5 trillion back toward its pre-financial crisis level of $870 billion,[1] which incidentally would take six years at the current reduction rate, they are creating a scarcity of money. This will impact nominal growth and feed into concerns about future profit growth. Fortunately, fiscal policy in the form of tax cuts and deregulation have offset monetary tightening. As a result, we may not be as late in the business cycle as many believe.

Corporate tax savings and cash repatriated from abroad are being used for capital expenditures, in addition to "financial engineering" in the form of dividend increases and share repurchases. An increase in capital expenditures historically leads to improved productivity, which provides companies cover to increase wages without a rise in unit labor costs.

Wages are already rising, having increased 2.9% in August.[2] As evidence of a healthy consumer, the Johnson Redbook retail sales index shows an average sales increase of 5.8% over the past four weeks.[3] The unemployment rate remains at a very healthy 3.9%, and as of July, there were actually 11 open jobs for every 10 people unemployed.[4]



This worker shortage should logically result in wage increases, thus we are beginning to see inflationary pressures develop. In addition, oil prices have risen from $51 to $71 per barrel over the past year and could move higher given current supply/demand imbalances. Oil production in the U.S., as evidenced by the Baker Hughes rig count,[5] is slowing as inadequate pipeline and transportation infrastructure has become a bottleneck to increasing supply. OPEC remains disciplined in limiting their production, hence the potential for prices to remain stubbornly high. Our outlook for oil and other commodities is constructive, given their historically positive correlation to rising inflation. We will look to "upgrade" our allocation solutions to capitalize on this opportunity in the coming weeks.

The Federal Reserve continues to raise interest rates as the economy picks up pace. The textbook calculation of GDP is the sum of consumption, investments, government spending, and net exports. It is difficult to find weakness in these measures. Given the current strength, it is hard to argue that the Fed is being too hawkish in raising interest rates. We expect continued hikes, and the Fed to express a preference for addressing the inflationary potential associated with a tight labor market, as opposed to the effects on the market of a potentially inverted yield curve. For that reason, we remain cautious in our bond positioning, preferring low duration and not reaching for yield via lower credit issues.

We are encouraged by domestic earnings growth. While the earnings growth rate may be peaking at around 25% growth, the current backdrop is supportive of earnings continuing to grow on an absolute basis for several more years. We believe it is quite healthy that this year's market rise has come despite contraction in price/earnings multiples. Useful historical analogues for the S&P 500 may be 1984 and 1994, which were similar periods of strong GDP growth, 20% earnings growth, and multiple contraction. Incidentally, 1985 and 1995 were strong return years (this is an observation, not a forecast!).[6]

Tariffs have dominated the news cycle of late. While tariffs are important, U.S. complaints about Chinese industrial policy run much deeper than mere dissatisfaction with uneven tariff rates and a trade imbalance. The European Commission recently published ideas on refining the World Trade Organization, offering support for our contention that China's practices of forced technology transfers and industrial subsides are unfair and unsustainable.

Emerging market equities, particularly in China, remain beholden to developments in trade policies as well as moves in the dollar. The U.S. dollar has weakened of late, as those countries most affected by its strength have worked to address their fiscal issues which contributed to their own weak currencies. Despite the recent reprieve, contagion caused by emerging market currency-related weakness remains a possibility. China, meanwhile, has not suffered from currency weakness but rather concerns about the effects of a trade war on its future growth. In response, China has stepped up its spending on infrastructure projects in an effort to insulate themselves from the trade fight. They are also redoubling their efforts to boost domestic demand. We are encouraged about this development as the crux of our thesis for investing in emerging market equities revolves around the strong demographic benefits of a more affluent consumer class.

...investing is a marathon, not a sprint

This year's challenges have reminded us that investing is a marathon, not a sprint, though we are optimistic that markets have enough left in them for a strong kick to finish the 2018 race.

Stuart Birdt running the 2016 New York City Marathon

ENDNOTES

[1] www.federalreserve.gov
[2] www.bls.gov
[3] www.redbookresearch.com
[4] fred.stlouisfed.org
[5] phx.corporate-ir.net/phoenix.zhtml?c=79687&p=irol-rigcountsoverview
[6] strategasrp.com