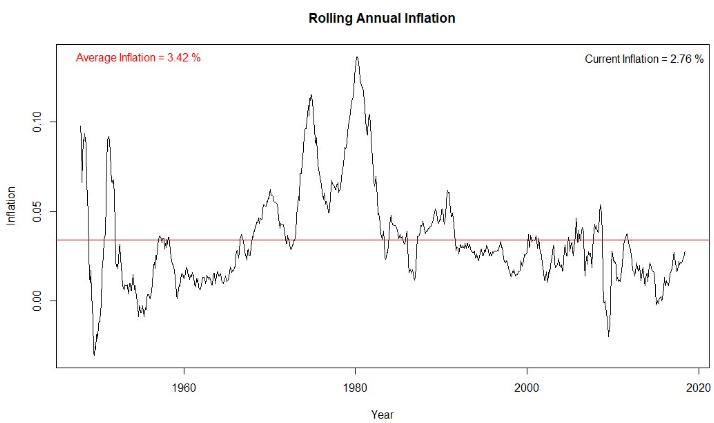
Review and Outlook

August 2018

Global Economic Thoughts and Reflections

Global Backdrop

We have been cautious for some time now regarding the economy. Given the advanced stage of the economic cycle, a lot of good news in earnings is discounted. The U.S. remains the one bright spot in an otherwise peaking global economy. There are several risks that are beginning to come to the forefront. The clash between monetary policy and financial markets is drawing closer. The Federal Open Market Committee (FOMC) may soon be forced to aggressively tighten the monetary screws. Full employment and rising inflation ultimately will push the Feds hands.



The European Central Bank (ECB) has signaled they will begin tapering their bond buying program. This is a form of monetary tightening.

China has eased monetary policy in response to a slowing economy, but the already heavily indebted economy and past tightening will continue to weigh heavily. Part of this shift may be due to potential impact of rising tariffs.

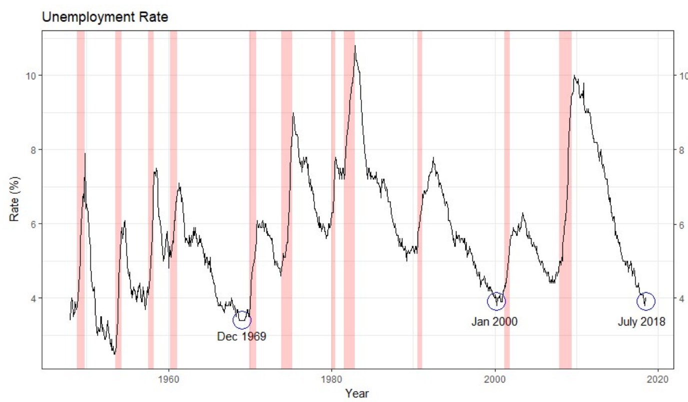
The Trump administration announced an additional $200 billion in trade tariffs on the Chinese. We would expect the Chinese to retaliate but the reality is that if they do, it would cover more than the entire imports from the U.S. To put it in numbers, we import close to $525 billion from the Chinese and we export about $190 billion. In other words, this is a losing strategy for the Chinese. They would have to lash out in a different context. South China Sea? Predicting this would be akin to predicting a black swan event or low probability scenario. We tend to shy away from predicting outliers as this is a losing game in the long run.

Remember the goal of the Trump administration is to reduce the chronic U.S. trade deficit and it is certainly fair to ask the Chinese to pay for intellectual property it takes from other countries. There are more than a few dynamics to getting the trade deficit to shrink but suffice it to say, it is likely to swell because of excess domestic investment.

Fiscal policy here is pumping up the economy while trade woes are souring confidence abroad. While the approach is somewhat disconcerting, the fact remains that many of the U.S. trade agreements favor those abroad. Again, highlighted by our ongoing trade deficit.

U.S.

We have highlighted in the past on China and Europe but will focus this paper on the U.S. The unemployment rate, which has dropped below 4% (see chart below recessions are shaded), and the economy, which continues to be robust as recent real growth has topped 3%.



Fiscal stimulus and full employment fuel continued growth, but it does come at a price as inflation has moved steadily upward (see chart on page 1) topping 2.75%. Inflation is a forgotten story along with the potential for rising rates. The Federal Open Market Committee (FOMC) expects the Fed Funds rate to rise to about 3% in the near-term. In recent minutes, they point to labor shortages and inflation pressures. Guess what? Inflation is already here! This time is not different though I have already heard from pundits that it is. My point is don't try too hard at predicting the next recession. This is a losing strategy. The track record of economists is pretty poor at predicting downturns. Let's examine where we are in the business cycle and look hard at valuations. I'd suggest being a bit nimble and less greedy. Ride the wave and at the first sign of trouble get off your board.

Conclusion

Global growth is slowing, and the consensus may be too complacent about the timing of the next recession. The dark side of the current strong growth is capacity pressures that warn of inflation surprises and upward pressure on interest rates. Profit growth has remained much stronger in the U.S. than I expected but the forces driving this performance are temporary. Rising wage pressure suggest labor's share of income will rise leading to lower margins. Additionally, the problem is not demand but is supply! This is the first occurrence of this in almost 20 years as the economy produces above its potential output. Global debt levels remain elevated even post 2008. The shift has been transferred from the consumer to governments.

Overall, there are no indications that a U.S. recession is imminent. At the same time, there are late cycle pressures and thus risks are building. I'll remind you that economists and the Fed (including myself) are not very good at predicting recession.

Fed Economic Forecasts Versus Outcome

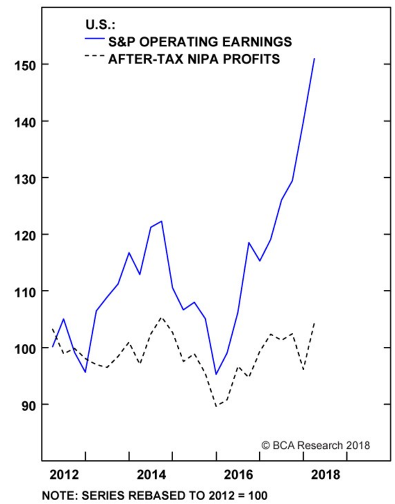
FORECAST MADE	FORECAST CHANGE IN REAL GDP OVER NEXT 4 QUARTERS	ACTUAL CHANGE IN REAL GDP OVER NEXT 4 QUARTERS*	PEAK-TO-TROUGH % DROP IN GDP*
DECEMBER 1969	1.4%	-1.2%	-1.5%
NOVEMBER 1973	2.4%	-4.9%	-7.8%
JULY 1981	0.9%	-1.9%	-2.5%
JULY 1990	1.9%	-0.8%	-0.8%
MARCH 2001	2.6%	1.4%	-0.3%
DECEMBER 2007	1.3%	-0.5%	-4.2%

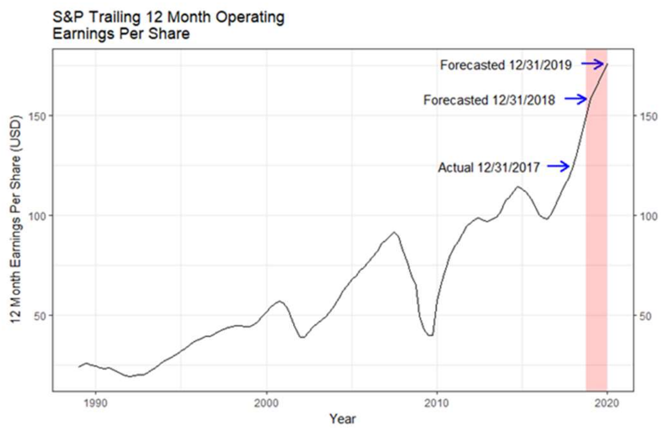
* THESE CALCULATIONS ARE BASED ON THE GDP DATA AVAILABLE AT THE TIME, NOT CURRENTLY PUBLISHED GDP DATA WITH REVISIONS AND CHANGES TO DEFINITIONS ETC.

Markets and Portfolios

Will U.S. Stocks Ever Go Down Again?

Yes. However, the words of Keynes still ring true "*The market can stay irrational a lot longer that you can stay liquid*". That's my way of telling you I have no idea when! The evidence continues to build that being overly exposed to equities will be problematic. We are never out of equities even when the long-term expected returns go negative. All that being said, earnings appear to be peaking. The S & P 500 operating margins are still rising due to recent legislation and strong demand but overall margins in the U.S. (after-tax margins - NIPA) are leveling out. Forecasted margins may be a bit too optimistic as well.





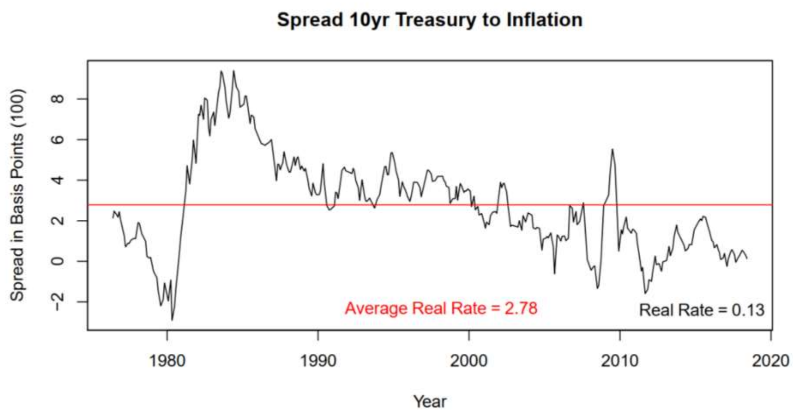
Valuations have reached the second highest all-time as measured by CAPE. Other measures of valuations are similar. Pundits' arguments are that ultra-low rates are justification for higher valuations and there is some legitimacy to this statement. However, rates are rising.

Rising Rates - What are the implications?

The U.S. economy grew at 4.1% in the second quarter, the fastest pace since 2014. There has been a structural change in the dynamics as the issue of supply comes to the forefront. The U.S. will slow because of supply constraints and this will cause the Fed to raise rates. Why? Inflation will become more of an issue as wages rise and supply constraints take a foothold. New investment will add to the economy's capacity over time but not soon enough to handle aggregate demand from full employment.

My expectations are for short raise to head towards 4% over the next 18 months or so. Either the yield curve will invert, or long rates would rise. The 10-year treasury note, before quantitative easing, trades on average around 2.78% above inflation.

This would put the 10-year treasury at about 5.60% from here. At some point, rates will normalize. Again, forecasting is difficult, but this time is different only in how it looks not the outcome.



Rising rates and inflation have potentially significant consequences to portfolio returns. Coupled with high equity valuations and portfolio returns look challenging. We hold shorter maturities than normal in our portfolios currently.

A look at Portfolio Returns – It isn't just the S & P 500!

A lot of discussion has surrounded the stock market the last year or two. U.S. stocks are up almost 4 times since the low of 2009. Year-to-date U.S. stocks are about the only asset that is up. Most other assets are either flat or down for the year. Portfolio construction gets lost on most during times like these. In fact, many abandon the notion of diversified portfolios. In my lengthy career, I have heard conversations like *"If I would have put all money in Google, I would have done better".* These are the conversations I hear during market tops. I've seen many since 1980! Volatility has been mostly absent the last two years as well. A brief bout in January but that has been about it. We also know that volatility is non-constant. We suggest moderating your enthusiasm for stocks and think about taking your foot off the gas a bit.

Below are a couple of examples of what portfolios look like year-to-date. Of course, yours will be different but if you are running globally diversified portfolios with varying degrees of risk they would be similar to the returns below. We took the liberty of showing how much better the S & P has done in isolation relative to portfolios and other assets.

I'd be happy to discuss in detail how these portfolios are built and why they are constructed in various ways.

All the Best,

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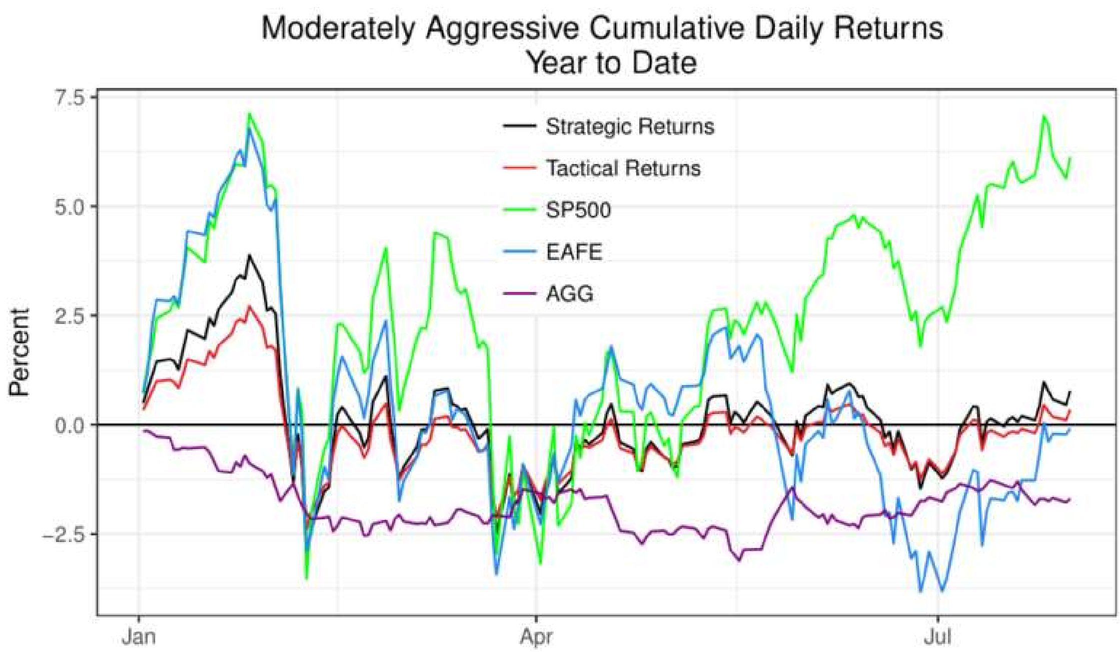

Table 1: **Year to Date:** January 1, 2018 to July 31st, 2018

	Mod Con	Moderate	Mod Agg	Aggressive
Returns Strategic	0.26	0.62	0.89	1.27
Returns Tactical	0.10	0.26	0.47	0.85
Volatility Strategic	5.17	6.95	8.63	10.71
Volatiltiy Tactical	4.06	5.03	6.22	8.42

Disclosure