

**WEAK “HARD” ECONOMIC DATA WILL PUNCTURE  
THE REFLATION TRADE AND RESTRAIN BOND YIELDS**

**In this Issue:**

- **100 Days of Strife**
- **Yawning Gap Between Hard And Soft Data**
- **The Economy Is Bereft of Growth Drivers**
- **More Subpar Growth And Volatile Geopolitical Backdrop Will Restrain Bond Yields**

The post-election euphoria that has underpinned stock prices and driven up consumer and business confidence received a major blow with Republicans’ failure to secure enough votes to “repeal and replace” Obamacare. With the defeat of the proposed American Health Care Act, the prospect of Trump’s ambitious fiscal stimulus package is thrown into doubt. The master of the “Art of the Deal” will now shift his attention to tax reform, believing this will be a simpler task given the party’s traditional preference for lower taxes. But if the healthcare fiasco tells us anything, it is that the Republican Party is a hydra-headed group, highlighted by polar opposite biases. The House Freedom Caucus insists that any reform is revenue neutral, but a central pillar aimed at offsetting the revenue losses from lower corporate taxes is the controversial border adjustment tax that is meeting stiff opposition both inside and outside the Beltway, including Walmart and the formidable Koch brothers.

We suspect that some watered-down version of tax reform will wend its way through Capitol Hill sometime late in the summer or fall, but the growth boost so hopefully embraced by Trump supporters and Wall Street will be extremely limited. The biggest bang for the buck lies with the promised \$1 trillion in increased spending on infrastructure that candidate Trump vigorously championed during the campaign. But good luck with that. Even as Republicans are deeply divided over tax policies, they are uniformly behind the principle of fiscal orthodoxy. The odds of a budget-busting spending program getting through Congress are slim to say the least.

As the prospect of fiscal stimulus fades into oblivion, so too will the “animal spirits” that have energized businesses and households since November 8. There is no question that expectations have been running ahead of reality as the hard

data has provided little confirmation of the elevated level of optimism revealed in recent studies. With Trump’s fiscal agenda now facing an uncertain future, those expectations are poised to fade. The financial markets are already pricing in a less optimistic outlook; since the AHCA fiasco, bond yields have slipped, stock prices have sagged, and the dollar has weakened. From our lens, the markets are making an accurate, if belated, reassessment of growth and inflation prospects.

**100 Days of Strife**

Trump is painfully finding out what many presidents before him have experienced: winning elections was the easy part, governing is the hard part. Indeed, the first 100 days of the new regime is turning out to be one of the most conflicting in modern history. Things won’t get any easier or calmer. Just as Republicans vowed to do everything in their power to thwart former President Obama’s agenda, the Democrats are hunkering down to return the favor. Worse, the Republican Party, as noted, is deeply divided over tax and spending policies, and the AHCA defeat suggests that many members are willing to oppose Trump, whose favorability ratings are sinking and whose threat of retribution has lost its sting.

Aside from the besieged fiscal agenda, Trump will have other battles to deal with in coming weeks and months. A showdown over funding discretionary spending may well bring the nation to the brink of another government shutdown, as the deadline for a resolution is April 28 and Congress goes on recess between April 10 and April 24. Even if a last-minute shutdown is avoided, the stage will be set for acrimonious negotiations over a litany of issues on Capitol Hill, where cooperation has long been a scarce commodity. Not only is Trump at odds with members of his own party, not to mention the Democrats, there are deep disagreements within his inner circle over the direction, substance, and messaging of Trump’s policy vision.

When the ongoing congressional investigations over Russian meddling are added to the mix, it is clear that the administration faces formidable obstacles in sustaining confidence or trust that a coherent package of policy ideas will see the light of day. So far, the public and, to some extent,

the financial markets have gingerly tolerated the tumultuous political landscape since the election. But unless the hard data begins to justify the heightened expectations for the economy, patience will soon wear thin and the Trump trade will unwind. The recent swoon in stock prices suggests that this may already be starting.

### Yawning Gap Between Hard And Soft Data

It is hard to remember another time when the gap between expectations and reality is as wide as is currently the case. Indeed, the numerator and denominator started moving in opposite directions immediately after the elections. Flushed with hope that the newly elected president would meet his campaign promise of boosting the U.S. growth rate to 4% from the lackluster 2% since the end of the Great Recession, all measures of business and household confidence skyrocketed. The heightened optimism on Main Street was echoed on Wall Street, as investors drove stock prices to record highs, expecting that the assuredly pro-business, pro-fiscal agenda would propel profits upwards. The latest survey by the Conference Board and the University of Michigan reveal that household expectations are somehow still elevated.

But even as expectations were ramped up, most of the hard data moved in the opposite direction. The exception was the jobs data, which actually exceeded expectations, partly because the mildest winter since 1954 spurred an outsized increase in construction hiring and partly because some businesses believed the growth hype and added staff in anticipation of stronger sales in coming months. One thing is sure: companies are not expanding payrolls in response to stronger growth.

With data for January and February in the books, growth in the first quarter is on track to slow from the fourth quarter's 2.1% pace, with the Atlanta Fed's GDPNow model pegging it at less than 1.0%. One reason: consumer spending, the main growth driver, is showing much less vigor so far this year than over the second half of 2016. That was dramatically illustrated on March 31, when the Commerce Department reported that real personal consumption declined for the second consecutive month in February, the first back-to-back declines since April 2009, near the trough of the Great Recession. Underscoring the weakness, most pent-up demand for big-ticket items has been satisfied, as manifested by the leveling off of auto sales in January and February. Most importantly, household budgets are being strained by high debt burdens and lagging worker paychecks. Even as the record-setting pace of auto sales last year

boosted consumption, it also resulted in a mountain of auto debt that is reminiscent of the sub-prime mortgage debt that helped precipitate the financial crisis. Defaults and delinquencies on these loans are increasing rapidly, spurring banks to close the credit spigot. Other lenders are filling the void, but they are doing so at their own peril as repayments are not likely to improve.

At the same time, while job growth has been decent, the increase in worker pay has not. Even with the boost from minimum wage hikes across a plethora of states, wage increases are being held in check. True, the nominal increase in average hourly earnings did accelerate to a 2.8% annual rate in February from the 2.0 - 2.5% range in effect for the past several years. But the increase was eaten up by the rebound in fuel prices from last year's low, as real hourly earnings showed no gain in the 12 months through February, the first time since October 2012 that real pay did not register a year-over-year increase. Simply put, household spending is being constrained by high debt burdens and stagnant purchasing power.

### The Economy Is Bereft of Growth Drivers

With consumer spending not providing the spark to drive growth higher, it is hard to see the recovery breaking out of its 2% growth rut. Clearly the heavy lifting will have to come from other sectors of the economy. But prospects elsewhere are not very positive. Even if lawmakers are able to cobble together some fiscal stimulus, the finished bill would not be ready until the fall at the earliest, and, as already noted, the tax cuts, which are likely to come first, would not deliver as big a bang for the buck as increased spending, which has little chance of getting through Congress before 2018. Meanwhile, the bigger risk is that the administration's protectionist and trade policies will gain traction, putting a crimp on growth.

In the private sector, neither housing nor business investment is poised to pick up the slack from slowed consumer spending. Housing activity is the more promising of the two, but the upside is limited by supply constraints, as builders face shortages of land to develop and workers that have left the industry during the 2006-2009 housing bust for other pursuits. Some of them left the country and cannot return due to tougher immigration enforcement. What's more, the housing bust has left the industry with a much smaller footprint, as residential outlays now account for only 3.5% of total economic output compared to 6.5% before the collapse. Hence, its growth-boosting impact has been correspondingly diluted.

With industrial output running well below capacity, businesses are not about to step up capital spending to any meaningful extent. The capacity utilization rate, at 75.4%, is actually lower than the 75.6% of a year ago, and considerably below 79.9% long-term average (1972-2016). The major improvement over the past year has been in the mining sector, where the utilization rate rebounded from 74.0% last May to 80.4% in February, thanks to the rebound in oil prices. But the increase in oil production is feeding a supply of overhang that sows the seeds of another glut-induced price decline, which will exacerbate deflation. Trump's latest regulatory rollback on coal production will only aggravate the problem. What's more, big oil producers are ramping up fracking operations, elbowing out the wildcatters, since shale oil can be profitably sandblasted out of rock at a \$40 price point.

### **More Subpar Growth And Volatile Geopolitical Backdrop Will Retrain Bond Yields**

While a temporary rebound for a few months or a quarter may well take place – in line with the erratic performance of the recovery – Trump's pledge to lift growth to 4% on a sustainable basis is wishful thinking. Keep in mind that the economy's long-term growth potential is a product of growth in the labor force and productivity. Both have been under downward pressure for some time. The aging population is putting the labor force participation rate on a declining trend that will be impossible to reverse unless fertility rates increase or the doors open wider for immigrants.

With growth in the labor force downshifting, the only way to boost the economy's potential growth rate is through increase productivity. But productivity, which has been weakening for over a decade, is not likely to rebound, as the ongoing weakness in capital spending is depriving workers with more efficient tools to generate output. Despite the elevated confidence expressed by many business leaders in recent surveys, new orders for nondefense capital goods flattened out in January and February. Like consumers, businesses are feeling one way but behaving another way. The longer this divergence persists, the more hollow will surveys of optimism appear.

As it is, the financial markets are starting to reconcile expectations with reality. The stock market posted its first monthly decline in March since the election. We suspect that the "Trump trade" will continue to unwind as profits, like the real economy, fail to meet expectations. The bond market got swept up in the reflation trade over the second half of last year, as the Fed began its normalization policy and the post-election hype of faster growth and higher inflation gained traction. But after hitting a peak of 2.60%, in mid-December, the 10 Year Treasury yield has since receded, trading at 2.39% on March 31.

The Fed is committed to a gradual rate-hiking campaign as long as the economy does not fall off a cliff, if only to build a cushion to fight the next recession with rate cuts. But even if the next increase occurs in June, as expected, the constraints on bond yields remain formidable. As tumultuous as the domestic political landscape is, the geopolitical backdrop is even more volatile, which is a time-honored catalyst for foreign capital to seek the safety of U.S. assets. Indeed, the uprising of populist sentiment overseas is threatening mainstream governing parties throughout Europe, with the next salvo coming from the looming elections in France. If the party of "Frexit" wins, the glue holding the EU together would be torn asunder, reinforcing the flight to safety.

In the U.S., the battle over tax reform is about to heat up. Ironically, the Republican plan contains several elements that would actually put downward pressure on bond yields. One feature would remove the ability of corporations to deduct net interest costs as an expense. If passed, this would greatly reduce the incentive of corporations to issue debt, thus lowering the supply of bonds available to investors. Another proposal is aimed at encouraging corporations to repatriate the trillions of dollars sitting overseas by lowering the tax rate to 8.75%. This too would have a similar effect on bond issuance, as the repatriated funds would most likely be used to fund mergers and acquisitions or other activities normally financed with borrowed money. Simply put, the reflation trade faces some formidable domestic and geopolitical headwinds and is likely to deflate in coming months.

## RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market (Bloomberg Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	03/31/2016	12/31/2016	3/31/2017	Last Quarter <sup>(1)</sup>	Last Year <sup>(2)</sup>
6 Mo. Bill	0.39	0.62	0.90	0.15	0.60
2 Yr. Note	0.74	1.20	1.26	0.26	0.08
5 Yr. Note	1.22	1.92	1.93	0.46	-1.96
10 Yr. Note	1.78	2.43	2.39	0.79	-3.96
30 Yr. Note	2.62	3.05	3.02	1.30	-6.18

Municipal Bonds	Yields (%)			Total Return (%)	
	03/31/2016	12/31/2016	3/31/2017	Last Quarter <sup>(1)</sup>	Last Year <sup>(2)</sup>
ML Rev 22+ Index	2.67	3.36	3.24	1.46	0.53
ML G.O. 22+ Index	2.52	3.32	3.18	1.56	-0.71

Equities	Levels			US \$ Terms (%)	
	03/31/2016	12/31/2016	3/31/2017	Last Quarter <sup>(1)</sup>	Last Year <sup>(2)</sup>
S&P 500	2,059.74	2,238.83	2,362.72	6.06	17.15
DJIA	17,658.09	19,762.60	20,663.22	5.18	19.88
NIKKEI (Tokyo)	16,758.67	19,114.37	18,909.26	-0.37	14.88

Commodities	US \$			Percent Change (%)	
	03/31/2016	12/31/2016	3/31/2017	Last Quarter <sup>(1)</sup>	Last Year <sup>(2)</sup>
COMEX Gold Active Monthly	1,232.71	1,152.27	1,249.35	8.43	1.35
CRB Future Com. Pr. Index*	170.52	192.51	185.88	-3.44	9.01
West Texas Intermediate Crude (\$ per bbl)	38.34	53.72	50.60	-5.81	31.98

Currencies	Levels			Percent Change (%)	
	03/31/2016	12/31/2016	3/31/2017	Last Quarter <sup>(1)</sup>	Last Year <sup>(2)</sup>
Yen	112.57	116.96	111.39	4.76	1.05
Sterling	1.44	1.23	1.26	1.70	-12.60
Euro	1.14	1.05	1.07	1.28	-6.40

Foreign Bond Markets	Levels			US \$ Total Return (%)	
	03/31/2016	12/31/2016	3/31/2017	Last Quarter <sup>(1)</sup>	Last Year <sup>(2)</sup>
3-Mo. LIBOR DEM Fixing <sup>(3)</sup>	-0.28	-0.35	-0.37	N/A	N/A
ML German 10-Yr.+ Bond Index	0.58	0.63	0.76	-1.86	-2.16
3-Mo. LIBOR Yen Fixing <sup>(3)</sup>	0.00	-0.05	0.03	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.29	0.40	0.47	-1.16	-2.72

Source: Bloomberg Financial Data

Notes: <sup>(1)</sup> 12/31/2016 thru 3/31/2017 <sup>(2)</sup> 3/31/2016 thru 3/31/2017

\*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

**Disclaimer:** This publication contains the current opinions of the manager and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This publication is distributed for education purposes only. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Forecasts are based on proprietary research and should not be interpreted as an offer or solicitation, nor the purchase or sale of any financial instrument. No part of this publication may be reproduced in any form, or referred to in any publication, without the express written permission of Smith Affiliated Capital Corp.